CALIFORNIA BUDGET PROJECT

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PROPOSITIONS 1A AND 3: SHOULD CALIFORNIA AUTHORIZE HIGH-SPEED RAIL AND CHILDREN'S HOSPITAL BONDS?

Propositions 1A and 3, which will appear on the November 4, 2008 ballot, would authorize a total of $10.9 billion in general obligation (GO) bonds to fund construction of a high-speed passenger rail system and capital improvement projects at children's hospitals. This *Budget Brief* provides an overview of these bond measures and the policy issues they raise. The California Budget Project (CBP) neither supports nor opposes these measures.

What Would Proposition 1A Do?

Proposition 1A, the Safe, Reliable High-Speed Passenger Train Bond Act, was initially placed on the ballot by the Legislature in 2004. The Legislature postponed action on the measure first to 2006 and then again until the November 2008 general election. Proposition 1A would authorize the state to issue $9.95 billion in GO bonds for construction of a high-speed passenger rail system and related pre-construction activities and improvements to existing passenger rail systems.

Proposition 1A would provide $9.0 billion to begin construction of a high-speed train system that would connect the San Francisco Bay Transbay Terminal to Los Angeles' Union Station and Anaheim. Bond funds also could be used for high-speed train corridors that link the state's major population centers, including Sacramento, the San Francisco Bay Area, the Central Valley, Los Angeles, San Diego, and Riverside, San Bernardino, and Orange counties. The measure specifies that funds could be used for the high-speed rail system's capital costs, but not for rail operations or maintenance. Proposition 1A requires that:

- Bond funds not be used for more than 50 percent of the costs of each train corridor and that remaining expenses must be obtained from private and/or other public sources;
- No more than 10 percent of bond proceeds be used for environmental studies, planning, and preliminary activities;
- No more than 2.5 percent of bond proceeds be used for administrative purposes;
- Selection of high-speed rail corridors be based upon those that would require the least amount of bond funds as a share of total construction costs; and
- The high-speed train system be designed to achieve specified performance goals.

Prior to the expenditure of bond funds, Proposition 1A also requires completion of a detailed funding plan for each rail corridor and an assessment of that plan prepared by financial experts. Both documents must be submitted to the Department of Finance, the Legislature, and a newly established independent peer review group. The Director of Finance must approve the funding plan prior to the expenditure of bond funds and the State Auditor must periodically audit the use of bond funds to ensure "consistency with the requirements" of Proposition 1A.

Proposition 1A also would provide $950 million for capital improvements to intercity and commuter rail lines and urban rail systems "that provide direct connectivity to the high-speed train system... or that provide capacity enhancements and safety improvements." Twenty percent ($190 million) of these funds would support the state's intercity rail services and 80 percent ($760 million) would support urban and commuter rail services, including light rail and cable cars.

How Has the State Traditionally Funded Public Works?

Both sources and levels of funding for state public works projects have changed over time. The building boom of the 1950s was primarily financed through annual cash expenditures – "pay-as-you-go" financing. Throughout the 1950s, capital outlay represented more than one out of every six dollars in the state budget.[1] The building boom continued, albeit at a slower rate, through the 1960s. During this period, capital outlay accounted for about one out of every eight dollars of total state spending, with bond financing increasing over the decade. In the 1970s, capital outlay dropped to less than 5 percent of state spending, with debt financing representing a small share of funds.

Beginning in the 1980s, however, the state shifted almost entirely to debt financing. This was partially attributable to competing demands for resources, as well as changes in federal tax policies that encouraged investors to buy tax-exempt state and municipal bonds. In addition, local government spending on public works slowed for several reasons. Proposition 13 of 1978, which imposed a 1 percent cap on the basic property tax rate and required approval of two-thirds of the voters to impose additional tax rates, limited the primary source of funding for local capital investment. While Proposition 13 allows local governments to increase the property tax rate above 1 percent for debt service, they must obtain the support of two-thirds of the voters to do so.[2] In addition, Proposition 218, approved by voters in 1996, made it more difficult for local governments to fund projects using local sales tax rates by imposing a two-thirds vote requirement for approval of local sales tax rates dedicated to specific purposes.

The state's role in infrastructure finance includes providing access to tax-exempt bond financing. Tax-exempt debt is less costly than other forms of debt, and is thus highly desirable, since investors are not required to pay income taxes on the interest payments they receive on their investment. The Legislature established the California Health Facilities Financing Authority (CHFFA) in 1979 to provide a mechanism for public and nonprofit hospitals to issue tax-exempt debt to finance hospitals' construction costs and acquisition of equipment. Bonds issued through CHFFA are the debt of the individual hospital or health care system and are repaid by the health care provider. The state's Infrastructure and Economic Development Bank, established in 1994, provides access to low-cost capital for a variety of state and local infrastructure and economic development projects.

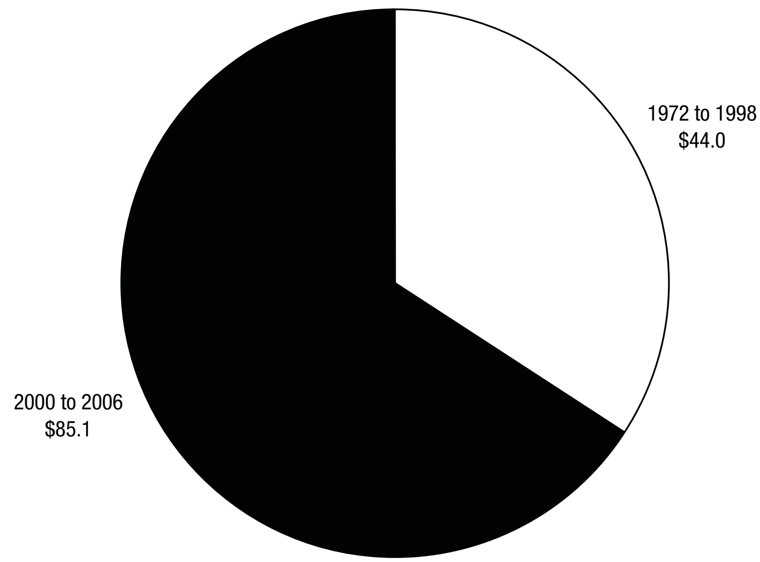
What Policy Issues Does Proposition 1A Raise?

What Issues Are Associated With a High-Speed Rail System?

Unlike traditional highway and urban transit projects, the proposed high speed rail system is unusual in both its scale and complexity. In addition to the policy issues related to the impact of debt service costs on the state budget, Proposition 1A raises several issues voters should consider:

- **Will high-speed rail gain access to rail corridors used by commercial and commuter trains?** High-speed trains likely will require access to rail corridors – so-called right-of-way – currently used or owned by commercial or commuter train operators. The growth in freight transport at California's ports and increased ridership on California's commuter rail lines may mean that high-speed trains may have difficulty gaining required rights-of-way in certain highly trafficked corridors. Furthermore, some commercial operators have expressed opposition to use of their rights-of-way for the high-speed rail project.
- **Will public and private sources contribute the funds required?** Proposition 1A requires at least half of the costs of each train corridor be obtained from private or non-Proposition 1A funds. There is no guarantee that these sources will provide sufficient matching funds nor does Proposition 1A address what would happen if these funds are not raised.
- **Will high-speed rail attract the passengers necessary to fulfill revenue forecasts?** Proponents of the high-speed rail system forecast it will generate $3.1 billion in revenue in 2030 based on estimates of 93.9 million annual passenger trips.[3] However, critics argue these passenger estimations are overly optimistic and cite studies that project as few as 22.1 million riders in the same year.[4] Although Proposition 1A funds could not be used for operating costs, it is unclear whether the state would need to provide operating subsidies if ridership targets are not achieved.

Figure 1: Voters Approved Nearly Two-Thirds of General Obligation Bonds Between 2000 and 2006



Total Approved General Obligation Bonds, 1972 to 2006 (Dollars in Billions)

Source: California Five-Year Infrastructure Plan 2008

How Much Should the State Spend on Infrastructure?

The state Treasurer recently reported:

> "California's infrastructure has fallen on hard times. Once preeminent, it's now a decaying victim of neglect. We send about one-third of our children to learn in schools that are dilapidated, outdated or overcrowded. California has the most congested urban interstate highways in the nation. Ports, levees, parks, water treatment and solid waste treatment plants – they all need work."[5]

While there is broad agreement that the state should spend more on public facilities, there is little agreement over what the most urgent problems are or how to pay for them.

California voters have approved $129.1 billion in GO bonds since 1972. Voters approved nearly two-thirds (65.9 percent, $85.1 billion) of this amount since 2000 (Figure 1).[6] In November 2006, voters approved $42.7 billion in GO bonds for a range of public works projects; transportation bonds accounted for nearly half (46.6 percent, $19.9 billion) of the bond debt authorized.[7] In contrast, between 1972 and 2004, transportation bonds made up only a small fraction (3.5 percent, $3.0 billion) of total approved GO bond debt.

Supporters' Arguments

Supporters argue that Proposition 1A would provide:

- A safe, convenient, and affordable alternative for travel throughout California;
- Nearly $1 billion to improve commuter rail systems that connect to high-speed trains; and
- Public oversight and review of financing plans.[8]

Opponents' Arguments

Opponents argue that Proposition 1A would:

- Spend $20 billion from the state's General Fund over the life of the bonds;
- Not provide adequate measures to avoid cost overruns; and
- Not provide congestion relief for commuters.[9]

How Does the State Currently Fund Public Works?

The state funds public works projects using General Fund, special fund, and federal fund monies.

General Funds. Long-term debt financing – primarily in the form of GO bonds and lease-revenue bonds – is the largest source of funding for state public works projects. Unlike years past, General Fund revenues are now used primarily to pay debt service on bonds, rather than to directly support capital investments. GO bonds are a form of debt backed by the state's General Fund. GO bonds are repaid from the General Fund and have constitutional priority over other spending in the event of a budget shortfall. GO bonds can be placed on the ballot by a two-thirds vote of the Legislature or through the initiative process and require the approval of a majority of voters. Lease-revenue bonds, also known as lease-payment bonds, are repaid through annual lease payments to bond holders by state agencies and departments that use the facilities financed through the bonds. Lease-revenue bonds are slightly more expensive than GO bonds – since repayment has lower priority than repayment of GO bonds in the event of a budget shortfall – and generally are not subject to voter approval.[10]

Special Funds. The state also funds public works projects using pay-as-you-go financing, often through special funds – funds that are designated for a particular purpose. For example, transportation projects are largely funded by fuel tax revenues and the proceeds of the sales tax on motor vehicle fuels, and many water projects have been paid for through water user fees. Pay-as-you-go financing is the least expensive method to pay for capital outlay since there is no debt upon which interest must be paid.

Federal Funds. Federal funds traditionally have provided a large share of the state's pay-as-you-go dollars for capital investments and are cited in Proposition 1A as a potential source of financing for high-speed rail construction. Like special funds, federal funds are restricted to specific programs such as highway construction, veterans' homes, and military projects.[11]

How Much Does the State Currently Spend on Public Works?

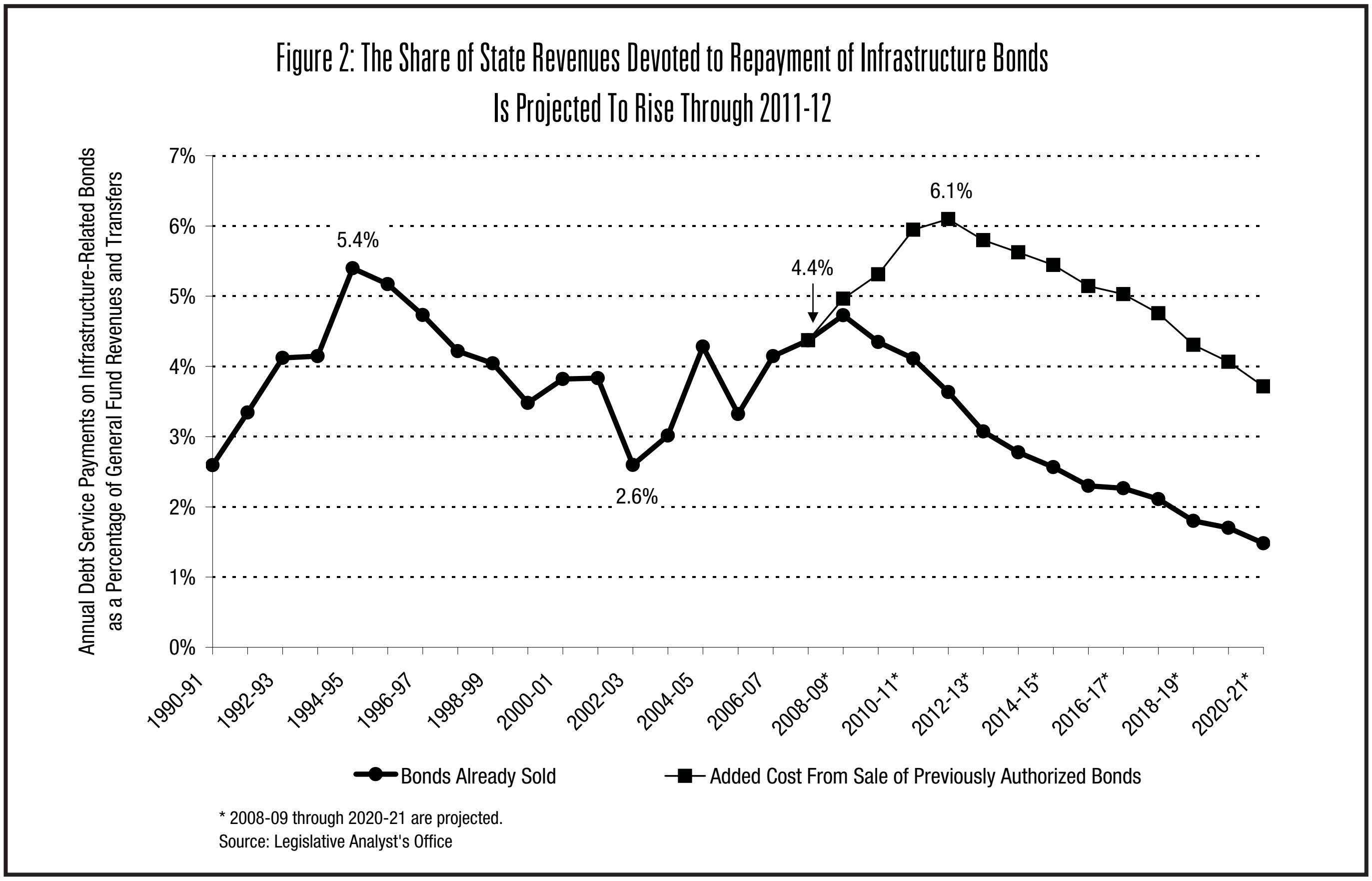
The state spent $5.7 billion on capital outlay in 2006-07, the most recent year for which final spending information is available. GO bond spending accounted for more than half (56.0 percent) and lease-revenue bonds made up nearly one out of every seven dollars (13.8 percent) of capital outlay spending. The General Fund provided 5.3 percent of state public works spending in 2006-07. The remainder of capital outlay funding came from federal funds, special funds, and other sources.

What Would Proposition 3 Do?

Proposition 3, the Children's Hospital Bond Act, would authorize the state to issue $980 million in GO bonds for constructing, financing, or providing capital improvements to children's hospitals. The measure authorizes the California Health Facilities Financing Authority (CHFFA) to make grants out of the bond proceeds to eligible children's hospitals in California. The measure requires that 20 percent of the total funds available for grants be awarded to University of California (UC) children's hospitals.[12] The measure requires four out of five dollars available for grants (80 percent) to be awarded to private nonprofit children's hospitals based on specific criteria. The Legislative Analyst's Office (LAO) states that the following private nonprofit hospitals likely would be eligible for Proposition 3 funds:

- Rady Children's Hospital, San Diego;
- Children's Hospital Los Angeles;
- Children's Hospital and Research Center at Oakland;
- Children's Hospital of Orange County;
- Loma Linda University Children's Hospital;
- Lucile Salter Packard Children's Hospital at Stanford;
- Miller's Children's Hospital, Long Beach; and
- Children's Hospital Central California.

The measure requires children's hospitals to apply to the CHFFA for grants. Decisions to award the grants would be based on several criteria, including whether the funding would improve health care access for low-income, underserved, and uninsured children and contribute to improving children's health or health care. Granting decisions also would be based on whether the hospitals applying for the grants promote pediatric teaching or research programs.



How Much Does the State Currently Spend on Debt Service?

According to the LAO, as of June 1, 2008, the state's outstanding infrastructure-related bond debt totaled about $53 billion, including about $45 billion in GO bonds and $8 billion in lease-revenue bonds. In addition, about $68 billion in bonds have been authorized, but not yet issued. The LAO estimates that General Fund debt service payments for GO and lease-revenue bonds for public works purposes totaled about $4.4 billion in 2007-08, roughly 4.4 percent of General Fund spending, and will rise to $9.2 billion in 2017-18.[13] The state also owes $11.0 billion for the bonds issued to finance the state's budget shortfall, which are repaid at a cost of approximately $1.5 billion per year.[14]

One measure of the state's debt is the share of the state budget devoted to debt service – its debt service ratio (DSR).[15] California's DSR peaked at 5.4 percent in 1994-95, fell below 3 percent in 2002-03, and is currently 4.4 percent (Figure 2).[16] The LAO estimates that the sale of currently authorized bonds could increase the state's DSR to 6.1 percent in 2011-12. [17]

The LAO estimates annual debt service costs of $647 million per year for Proposition 1A and $64 million per year for Proposition 3.[18] Total debt service payments over the life of both bonds would total about $21.9 billion, twice their authorized amounts.[19]

According to recent forecasts, the state will face significant operating shortfalls – that is, expenditures will exceed revenues – in 2008-09 and beyond.[20] The California Constitution requires the state to make debt service payments for GO bonds prior to all other expenditures, other than most education expenditures. As a result, dollars the state spends on debt service are not available for other state-supported programs such as health care, education, and human services.

What Policy Issues Does Proposition 3 Raise?

Do Children's Hospitals Bonds Address State Needs and Priorities?

Proposition 3 would provide $980 million in funds for California's children's hospitals. In November 2004, voters approved Proposition 61, a similar measure which provided $750 million in GO bonds to children's hospitals. As of June 1, 2008, roughly $347 million (46 percent) of Proposition 61's authorized funds had yet to be disbursed.[21] In his 2008 infrastructure plan, released earlier this year, Governor Schwarzenegger identified $111.3 billion in public works needs over the next five years. The infrastructure plan, which the Governor is statutorily required to submit to the Legislature each year, "reflects the infrastructure needs of state programs and recommends funding priorities based on considerations of criticality, equity, and funding availability."[22] The Governor's infrastructure plan does not include funding for children's hospitals although it does include funding for other health facilities.

Should the State Finance Private Nonprofit Hospitals?

Proposition 3 would require the state to issue bonds that would be repaid out of the state's General Fund and disburse bond funds to UC and private nonprofit children's hospitals. In contrast to bonds issued through the CHFFA, which are repaid out of hospitals' own funds, the bonds authorized by Proposition 3 would be entirely repaid out of the state budget. Voters may wish to consider whether it is appropriate for the state to pay for debt that benefits private, nonprofit hospitals that are neither controlled by nor accountable to the public.

Supporters' Arguments

Supporters argue that Proposition 3 would:

- Allow children's hospitals to purchase the latest medical technologies;
- Help children's hospitals build more bed capacity and buy essential equipment; and
- Invest in the health of California's children over the next 30 years.[23]

Opponents' Arguments

Opponents argue that Proposition 3 would:

- Increase the state's level of debt when Californians' ability to repay that debt is questionable;
- Circumvent the legislative process by which state spending priorities are better determined; and
- Authorize spending on children's hospitals, even though funds from Proposition 61, a children's hospital bond approved in 2004, are still available.[24]

Conclusion

Propositions 1A and 3 would provide funds for infrastructure projects that California voters may desire. However, approval of these bonds would increase spending at a time when the state already faces continued budget shortfalls. Voters should consider the issues associated with the high-speed rail system and whether increasing the state's investment in children's hospitals would be the most appropriate use of limited state funds.

Jonathan Kaplan prepared this Budget Brief with assistance from Jean Ross. The California Budget Project (CBP) neither supports nor opposes Propositions 1A or 3. This Budget Brief is designed to help voters reach an informed decision based on the merits of the issues. The CBP was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

[1] Capital outlay is "a character of expenditure of funds to acquire land, plan and construct new buildings, expand or modify existing buildings, and/or purchase equipment related to such construction." Department of Finance, *Finance Glossary of Accounting and Budget Terms,* downloaded from http://www.dof.ca.gov/fisa/bag/DofGlossFrm.HTM on September 29, 2008.

[2] Proposition 39 of 2000 lowered the requirement to 55 percent voter approval for school facilities.

[3] *Bay Area/California High-Speed Rail Ridership and Revenue Forecasting Study: Ridership and Revenue Forecasts* (Cambridge Systematics, Inc. for the Metropoltian Transportation Commission and the California High-Speed Rail Authority: August 2007), pp. 2-7 to 2-8.

[4] Wendell Cox and Joseph Vranich, *The California High Speed Rail Proposal: A Due Diligence Report* (Reason Foundation: September 2008), p. 27.

[5] Bill Lockyer, California State Treasurer, *Making the Municipal Bond Market Work for Taxpayers in Turbulent Times, State of California's 2008 Debt Affordability Report,* p. 15.

[6] Governor Arnold Schwarzenegger, State of California, *California Five-Year Infrastructure Plan 2008,* pp. 235-238. In addition, the state owes $11.0 billion toward deficit recovery bonds approved by voters in 2004 to finance the state's budget shortfall as of July 1, 2008.

[7] As of August 1, 2008, $1.4 billion of Proposition 1B bonds have been sold. Annual debt service payments on Proposition 1B bonds sold to date is approximately $87 million per year.

[8] Secretary of State's Office, "Proposition 1A. Safe, Reliable High-Speed Passenger Train Bond Act," *Supplemental Official Voter Information Guide, November 4, 2008,* pp. 6-7, downloaded from http://voterguide.sos.ca.gov/pdf-guide/suppl-complete-guide.pdf on October 3, 2008.

[9] Secretary of State's Office, "Proposition 1A. Safe, Reliable High-Speed Passenger Train Bond Act," *Supplemental Official Voter Information Guide, November 4, 2008,* pp. 6-7, downloaded from http://voterguide.sos.ca.gov/pdf-guide/suppl-complete-guide.pdf on October 3, 2008.

[10] California Budget Project, *A Mini-Primer on Bonds* (February 2006).

[11] Governor Arnold Schwarzenegger, State of California, *California Five-Year Infrastructure Plan 2008,* p. 174.

[12] The measure specifies that 20 percent of total available grants would be awarded to the following hospitals: the University of California, Davis Children's Hospital; the Mattel Children's Hospital at University of California, Los Angeles; the University Children's Hospital at University of California, Irvine; the University of California, San Francisco Children's Hospital; and the University of California, San Diego Children's Hospital.

[13] Legislative Analyst's Office, "An Overview of State Bond Debt," in Secretary of State's Office, *Official Voter Information Guide, November 4, 2008,* pp. 78-79.

[14] Proposition 57, approved by voters in 2004, authorized $15 billion in bonds to help pay off the state's budget deficit and other debts.

[15] The state's DSR equals the annual debt service payments on infrastructure-related bonds as a share of General Fund revenues and transfers.

[16] Legislative Analyst's Office, "An Overview of State Bond Debt," in Secretary of State's Office, *Official Voter Information Guide, November 4, 2008,* p. 79. In 2002-03, a one-time reduction in the state's DSR resulted from a restructuring of outstanding state debt to generate one-time savings in response to the state's budget crisis. This measure of the state's DSR excludes deficit related debt.

[17] Legislative Analyst's Office, "An Overview of State Bond Debt," in Secretary of State's Office, *Official Voter Information Guide, November 4, 2008,* p. 79.

[18] Legislative Analyst's Office, "Proposition 1A. Safe, Reliable High-Speed Passenger Train Bond Act," in Secretary of State's Office, *Supplemental Official Voter Information Guide, November 4, 2008,* p. 5, and Legislative Analyst's Office, "Proposition 3. Children's Hospital Bond Act. Grant Program. Initiative Statute," in Secretary of State's Office, *Official Voter Information Guide, November 4, 2008,* p. 21. LAO estimates assume 5 percent interest rates over a period of 30 years.

[19] Legislative Analyst's Office, "An Overview of State Bond Debt," in Secretary of State's Office, *Official Voter Information Guide, November 4, 2008,* p. 79.

[20] Legislative Analyst's Office, *Fiscal Outlook: LAO Projections 2007-08 Through 2012-13* (November 2007), p. 5.

[21] Legislative Analyst's Office, "Proposition 3. Children's Hospital Bond Act. Grant Program. Initiative Statute," in Secretary of State's Office, *Official Voter Information Guide, November 4, 2008,* p. 21.

[22] Governor Arnold Schwarzenegger, State of California, *California Five-Year Infrastructure Plan 2008,* p. 1.

[23] Secretary of State's Office, "Proposition 3. Children's Hospital Bond Act. Grant Program." *Official Voter Information Guide, November 4, 2008,* pp. 22-23, downloaded from http://voterguide.sos.ca.gov/pdf-guide/Props/arguments-rebuttals/prop3-arguments-pg22-23.pdf on October 3, 2008.

[24] Secretary of State's Office, "Proposition 3. Children's Hospital Bond Act. Grant Program." *Official Voter Information Guide, November 4, 2008,* p. 23, downloaded from http://voterguide.sos.ca.gov/pdf-guide/Props/arguments-rebuttals/prop3-arguments-pg22-23.pdf on October 3, 2008.