October 2008

Drowning in Debt: Bond Measures Threaten California's Already Precarious Debt Situation

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POLICY BRIEF 73

Reason Foundation

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Executive Summary

California has many infrastructure needs, but the four bond measures on the November ballot are unaffordable and unnecessary. If approved, the measures—Propositions 1A, 3, 10, and 12—would authorize a total of over $16.8 billion in general obligation bonds. After factoring in the cost of paying interest on the bonds, the total cost would be approximately $33.1 billion, resulting in debt service of over $1.1 billion a year.

The state's borrowing is simply not sustainable without significant increases in taxes or reductions in service levels. California's debt has nearly tripled in just the past six years, from $42.1 billion in fiscal year 2001-02 to $120.1 billion in FY 2007-08. The debt-service ratio—the portion of the state's annual revenues that must be set aside for debt-service payments on infrastructure bonds—currently stands at 4.4 percent and is projected to rise to 6.1 percent in FY 2011-12 as more bonds that have already been authorized are sold. This will surpass even the high rate of 5.4 percent the state maintained during the early 1990s. As the Legislative Analyst's Office notes, the investment community considers a debt-service ratio of more than 5 or 6 percent to be a red flag. No wonder the state holds the second-worst credit rating in the nation, ahead of only Louisiana. Should more bonds be passed in November, the state's debt-service ratio will only get worse.

Roughly 50 years ago, nearly 60 percent of the budget for capital projects came from the General Fund and special funds. Today, nearly all state improvements are financed through borrowing. As the state, and the economy at large, struggles to manage its mountains of debt, it is time to re-

evaluate California’s borrowing binge and ensure that high-priority projects and programs are paid for in the annual budget.

The legislature and the governor have proven time and time again that they have enough difficulty balancing the budget without the imposition of other significant costs such as those contained in the bond measures on the November 2008 ballot. If California is to return to a state of fiscal responsibility, it must put an end to its borrowing and spending binge. Californians must carefully consider the details of the bond measures discussed herein, and consider whether they, or their children, will be able to afford the ultimate bill.

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Part 1

Introduction

If you think the consumer credit crisis is bad, just take a look at the debt problem the State of California is facing. The state's budget situation is dire, but you'd never know it by looking at all the bond measures on the November ballot. It took the legislature and Governor Schwarzenegger a record-breaking 85 days into the current fiscal year to approve a budget that papers over a deficit estimated at around $15 billion, and, given the magnitude of the accounting gimmicks involved, the structural budget deficit is sure to rear its ugly head again next year (and probably for years to come).

To put the $15 billion budget deficit in perspective, consider that the entire General Fund budget is just over $100 billion. For most of us, the thought of borrowing more when we already owe 15 percent of our total earnings for an entire year would be unconscionable, yet that is precisely what the legislature is doing. Then again, we don't have the power to tax others to make up for our fiscal capriciousness.

On the November ballot, there are four bond measures which, if passed, would add a total of over $16.8 billion in debt. After including the cost of interest for the bonds, the total cost, if all four measures were to pass, would be approximately $33.1 billion, with debt service of over $1.1 billion a year (see Table 1). The bond measures are:

1. **Proposition 1A.** Would authorize $9.95 billion in general obligation bond debt to start building an 800-mile high-speed rail system. Annual debt service is estimated at $647 million, and the total cost to taxpayers (principal plus interest on the bonds) would be approximately $19.4 billion.

2. **Proposition 3.** Would authorize $980 million in general obligation bond debt for capital improvement projects at children's hospitals. Annual debt service is estimated at $64 million, and the total cost to taxpayers would be over $1.9 billion.

3. **Proposition 10.** Would authorize $5 billion in general obligation bond debt for various renewable energy, alternative fuel, energy efficiency, and air emissions reduction programs. Annual debt service is estimated at $335 million, and the total cost to taxpayers would be about $10 billion.

4. **Proposition 12.** Would authorize $900 million in general obligation bond debt for the veterans' farm and home loan program. Annual debt service is estimated at $59 million, and the total cost to taxpayers would be about $1.8 billion.

The recently signed FY 2008-09 budget made up a $15 billion deficit only through numerous tortured accounting gimmicks and smoke and mirrors. Legislators have become increasingly creative in devising such gimmicks to "solve" recurring budget deficits, but such patches can only hold for so long. Sooner or later, reality will catch up with them, and significant tax hikes are the likely result. Indeed, during the most recent budget debate, taxpayers were threatened with tax hikes totaling as much as $8 billion. The legislature has proven that it cannot cover current government expenditures. How much more will be needed in the form of tax hikes to pay for billions upon billions of dollars more in new bonds?

Table 1: Summary of Bond Measures on November 2008 Ballot

Proposition	Amount	Total Cost (Principal and Interest)	Average Debt-Service Cost Per Year	Cost Per Household
1A	$9.95 billion	$19.4 billion	$647 million	$1,458
3	$980 million	$1.9 billion	$64 million	$143
10	$5 billion	$10 billion	$335 million	$751
12	$900 million	$1.8 billion	$59 million	$135
Total	$16.83 billion	$33.1 billion	$1.105 billion	$2,487

Long-term bonds should never be used to pay for day-to-day government operations because it is unfair to saddle future generations with debt for our expenses today. These expenditures should be included in annual budget appropriations bills. We have already made this mistake once by approving a $15 billion bond (Proposition 57) in March 2004 to pay off the budget deficit. This is like taking out a mortgage to pay off your credit card bill! Moreover, it obviously did not work. Less than five years after passing a $15 billion bond to pay down the budget deficit, the state recently found itself with, yet again, a $15 billion budget deficit and more tax and bond proposals! Yet California taxpayers are still paying off the bill for the original deficit.

If history serves as any guide, putting bond measures on the ballot only relieves the legislature from having to make budget trade-off decisions that would normally occur during the annual appropriations process, leading to ever more spending. Furthermore, approval of bond measures is often secured by exploiting sympathetic groups such as veterans and sick children to tug on the heartstrings of voters. Instead of relying upon taxpayers to bail them out, legislators should be forced to do the job they were elected to do and prioritize spending based on the revenue available.

Just two years ago, Californians approved $42.7 billion in bonds. Given the state's current financial straits, the state simply cannot afford to take on up to $16.8 billion in additional debt.

According to a poll conducted for the California Teachers Association, a majority of likely voters (59 percent) believe that the state already has too much bond debt, compared to just 12 percent who say it has too little and 8 percent that feel it is just about right. This sentiment held true across all political parties, including 59 percent of Democrats, 56 percent of Independents, and 59 percent of Republicans. In addition, two-thirds (66 percent) of voters agreed with a statement that California has borrowed too much and that this debt has contributed to the state budget crisis.[1]

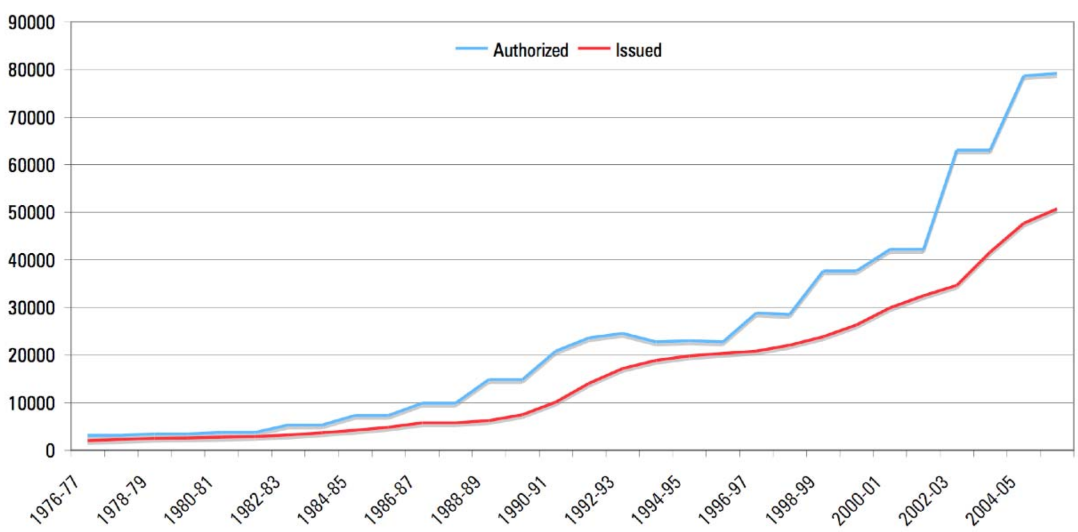
Part 2

California's Current Debt Situation

In just the past six years, the amount of general obligation bonds authorized has nearly tripled, from $42.1 billion in FY 2001-02 to $120.1 billion (well more than the state's total General Fund budget) in FY 2007-08 (see Figure 1).[2] According to the Legislative Analyst's Office (LAO), as of June 1, 2008, California had about $53 billion of infrastructure-related General Fund bond debt outstanding (approximately $45 billion in general obligation bonds plus $8 billion in lease-revenue bonds), and an additional $68 billion in bonds had been authorized but not yet sold.[3]

Bonds are an expensive way of financing. In addition to the principal cost of the bonds, the state must pay interest on the bonds, which typically doubles the cost. Even after adjusting for inflation, bond financing costs about 30 percent more than pay-as-you-go financing. In other words, total bond costs are about $1.30 for every $1 borrowed.

Figure 1: General Obligation Bonds Authorized and Issued

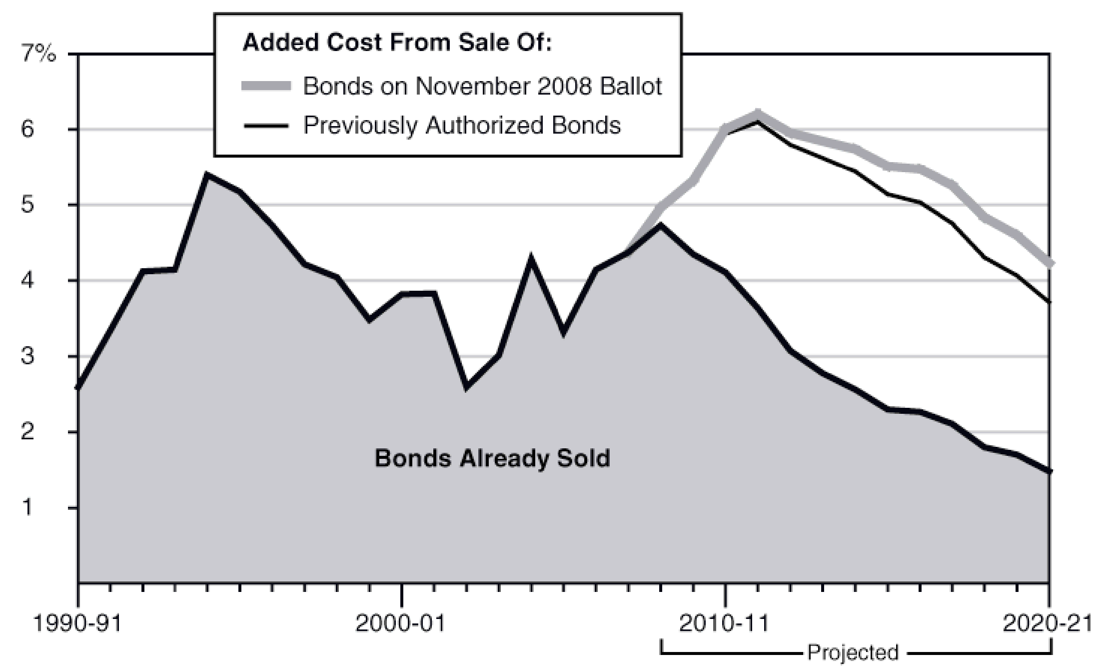


Source: Department of Finance, see Chart K-4: General Obligation Bonds, http://www.dof.ca.gov/Budget/documents/CHART-K4.pdf (accessed September 16, 2008).

California suffers from a high debt burden. It has the highest total amount of net tax-supported debt in the nation, and its debt per capita of $1,685 ranks ninth-largest in the nation. The average debt per capita for all states in 2007 was $1,158. In terms of personal income, California's net tax-supported debt is 4.3 percent of personal income, compared to the national average of 3.2 percent.[4]

California already holds the dubious distinction of having the second-worst credit rating in the nation, besting only hurricane-ravaged Louisiana.[5] General Fund debt payments for infrastructure-related bonds totaled $4.4 billion in FY 2007-08, and are expected to rise to $9.2 billion in FY 2017-18, as currently authorized, but not yet sold, bonds are put on the market. The state's debt-service ratio is already rather high. It has risen from less than 3 percent in FY 2002-03 to 4.4 percent today, and is expected to peak at 6.1 percent in FY 2011-12, eclipsing the most recent high of 5.4 percent during the early 1990s (see Figure 2). (Note that these figures relate only to infrastructure bonds and do not even count the 2004 $15 billion budget deficit bond. The total debt-service ratio is thus even higher.) These numbers will only worsen if the bond measures on the November ballot pass. The LAO has noted that members of the investment community start to worry if a state's debt-service ratio rises above 5 or 6 percent.[6] Yet while California is already preparing to eclipse these marks, more plans for more borrowing are being proposed.

Figure 2: General Fund Debt-Service Ratio
(Not including $15 billion budget deficit bond) [a]



[a]Ratio of annual debt-service payments on infrastructure-related bonds to revenues and transfers.

Source: Legislative Analyst's Office, "An Overview of State Bond Debt," August 29, 2008, p. 4, http://www.lao.ca.gov/ballot/2008/bond_11_2008.pdf.

Part 3

Historical View of Borrowing vs. Pay-As-You-Go Financing of State Infrastructure

Forty-seven years ago infrastructure was financed using current tax dollars, especially from special fund sources. Table 2 depicts the changes since 1960, especially the shift from using current tax dollars (general and special funds) to debt (bond funds). In 1960–61, for example, nearly 60 percent of the Governor's Budget for capital projects came from general and special funds.[7] This reflects spending on higher education and flood control projects. By 2002-03, less than 8.5 percent of infrastructure projects were financed from the general and special funds. Currently, almost all state capital improvements are financed over time using proceeds from the sale of bonds.[8]

Table 2: State Revenue Sources for Infrastructure Financing

	1960-61	1965-66	2002-03
General Fund	13.5%	1.8%	0.9%
Special Funds	44.2%	27.9%	7.5%
Bond Funds	15.8%	42.2%	77.5%
Federal Funds	26.6%	28.0%	14.1%
Total Amount*	$4,104	$5,789	$10,607
Amount per Capita*	$259	$307	$299

*Dollar figures are given in millions of dollars in 2003 dollars

Source: Shelly de Alth and Kim Rueben, *Understanding Infrastructure Financing for California*, Public Policy Institute of California, June 2, 2005, p. 8, http://www.ppic.org/content/pubs/op/OP_605SAOP.pdf.

Part 4

Proposition 1A: The Safe, Reliable High-Speed Passenger Train Bond Act

Proposition 1A would authorize the state to sell $9.95 billion in general obligation bonds for the purpose of starting to build an 800-mile high-speed rail system connecting San Diego, Anaheim, and Los Angeles in the southern part of the state with Sacramento and the Bay Area in the north. The vast majority—$9 billion—of the money would be available to develop and construct the high-speed train system, with the remaining $950 million devoted to capital projects designed to improve other passenger rail systems or allow passengers to connect to the high-speed rail system.

Financing Flaws

A fatal flaw of the proposal is its lack of a financing plan. The approximately $10 billion is less than one-fourth of the projected $45 billion total cost of the project. The California High-Speed Rail Authority (CHSRA), hopes to obtain about one-third ($15 billion) of the cost from the federal government, which has budget problems of its own and is currently struggling with a $700 billion bank bailout and a possible $25 billion bailout of the auto industry. The remainder (about $20 billion) is supposed to come from the private sector, and there is similarly no guarantee that this money will ever materialize.[9] Furthermore, a business plan that the California High-Speed Rail Authority (CHSRA) was required by law to submit by September 1 still has not been completed, and, conveniently enough, apparently will not be available until after the election.

Overly Optimistic Cost and Ridership Assumptions

Even if the $45 billion is ultimately secured, significant additional funds will likely need to be acquired, as the CHSRA's cost assumptions are highly suspect. An analysis of the proposal commissioned by Reason Foundation, Howard Jarvis Taxpayers Association, and Citizens Against Government Waste (CAGW) found that actual project costs are probably in the range of $65.2 billion to $81.4 billion.[10]

Sadly, this cost escalation would be on par with most large public infrastructure projects. Boston's infamous Big Dig project was announced in 1989 with an estimated cost of less than $4.5 billion, 90 percent of which was to come from the federal government. Nineteen years later, the total cost is estimated at $22 billion, and three-quarters of the amount has had to come from the state, diverting money from numerous other state and local infrastructure projects.[11] The Blue Line light rail from Los Angeles to Long Beach ended up costing more than three times the original projections (even after accounting for inflation).[12]

The CHSRA's ridership projections are also unrealistic. The Authority estimates that as many as 117 million passengers will utilize the high-speed rail system by 2030.[13] To put that in perspective, consider that Amtrak's high-speed Acela service, which serves a larger, denser market consisting of Washington, D.C., New York, and Boston, has an annual ridership of a little over three million.[14] In fact, the entire Amtrak system, which covers over 500 destinations and 21,000 miles of routes in 46 states, serves only about 26 million passengers a year.[15] Even more unsettling is the fact that in 1999 the CHSRA projected ridership of only 23 million.[16] What in the world would reasonably cause it to inflate the numbers more than four times those earlier projections?

Unfortunately, such wide-eyed cost and ridership projections are the rule, not the exception. Danish professor Bent Flyvbjerg conducted a worldwide study of 258 rail, bridge, and road projects. He found that 90 percent of projects came in over budget, and the vast majority of these suffered drastic cost overruns. Another analysis of his showed that ridership of the average transit system is less than half that of original projections. Flyvbjerg's conclusion: the difference is due to political pressures to exaggerate the numbers to gain project approval.[17] Taxpayers should keep this in mind when considering Proposition 1A.

Comparisons with Other Travel Modes and Nations

The cost and ridership projections of Proposition 1A are dependent on the ability to get significant numbers of people out of their cars and off of planes to take the new high-speed trains. This is unlikely to happen for a number of reasons. Even accepting the CHSRA's optimistic ticket price estimates, travel between Northern California and Southern California would be at least as cheap by air, and the trip would take much less time. Bus travel is even cheaper for those who have more time available to travel. For shorter trips, automobile travel is cheaper and offers much greater mobility since one can use it to go wherever he or she needs to go, rather than having to take a taxi, bus, or rental car to and from the few rail stations.

High-speed rail proponents often tout the benefits of high-speed trains by pointing to examples of systems in other parts of the world, such as in Japan or Europe. These comparisons fail due to significant differences between the foreign markets and California, however. These foreign high-speed rail systems generally serve much larger markets and operate in denser urban areas and business districts that are closer together where transit usage is much higher and automobile usage is much lower.[18]

Negligible Environmental and Congestion Effects

In addition to faulty cost and ridership projections, assumptions regarding the high-speed rail system's effect on emissions and traffic congestion are similarly flawed. According to the Reason-Howard Jarvis-CAGW report,

> *One of the most important selling points of HSR has been its claimed potential to reduce CO_2 emissions. The data indicates otherwise. The cost per ton of CO_2 removed by HSR is projected to be between 39 and 201 times the international IPCC ceiling of $50. HSR has been greatly oversold for its CO_2 emission reduction potential. The reality is that HSR's impact on CO_2 would be inconsequential while being exorbitantly costly.*[19]

Moreover, the environmental and congestion issues are related. One of the significant causes of wasted emissions is automobiles stuck idling on jammed roads. According to a May 2008 report by the Portland Cement Association, congestion wastes 3 billion gallons of fuel each year, emitting 27.2 million tons of CO_2.[20] Improving congestion would lead to improved emissions levels.

One of the best ways to improve congestion is simply to build and expand more roads. From 1980 to 2006, the state's population increased over 57 percent[21] and the number of vehicle-miles traveled on state highways increased over 112 percent,[22] yet the number of lane-miles built has increased less than 7 percent.[23] No wonder congestion has increased so dramatically! This is simple supply and demand. States like Texas that actually have expanded their road capacity have, not surprisingly, been successful at reducing congestion.

Public vs. Private Sector Incentives

Even if one feels that a high-speed rail system is worth having, that does not mean that the public sector should be responsible for building it. The public sector and the private sector have very different incentives built in to their decision-making processes, which often lead to dramatically different courses of action. The public sector is subjected to great influence from various political constituencies and is not subject to market competition. In this case, that might mean politicians lobbying to include routes and stations in their districts, or environmental interests trying to get the CHSRA to adopt a "zero-emissions" policy for operating the trains or pursue mitigation agreements to remedy the effects of building and operating the trains in certain areas deemed environmentally sensitive. Private-sector businesses, by contrast, seek to satisfy customers so that they can make profits. Public-sector decisions and promises—whether they relate to cost and ridership assumptions, prices, where routes and stations should go, or how long it will take to complete the project—are driven by politics. Private-sector decisions are based on economic realities.

Proposition 1A backers have devised some dubious projections of cost, ridership, ticket price, revenues, etc. If there truly is such a demand for this high-speed rail system, then the private sector should be permitted to build it. If there are certain regulations preventing private providers from satisfying this demand, then the state should remove these impediments. The fact that the system has not yet been built, and the apparent lack of any real interest in the private sector to build it, is a strong signal that it is not needed and would be an inefficient use of capital. Finally, it is worth asking whether all taxpayers should be forced to pay tens of billions of dollars for something that only a small percentage of them will ever use.

Part 5

Proposition 3: The Children's Hospital Bond Act. Grant Program

Proposition 3 seeks the authority to issue $980 million in general obligation bonds for capital improvement projects at children's hospitals. Of the total funds available, 80 percent would be reserved for nonprofit children's hospitals, and the remaining 20 percent would be available to the five University of California children's hospitals. Grants would be awarded by the California Health Facilities Financing Agency based on factors such as "whether the grant would contribute toward the expansion or improvement of health care access for children who are eligible for governmental health insurance programs, or who are indigent, underserved, or uninsured; whether the grant would contribute toward the improvement of child health care or pediatric patient outcomes; and whether the applicant hospital would promote pediatric teaching or research programs."[24]

Setting aside for a moment the question of whether public financing of children's hospitals is a good thing, and the fact that bond financing is an expensive way of paying for things, the fact is that this bond is entirely unnecessary because there are already hundreds of millions of dollars available for children's hospital projects that have not yet been spent. Four years ago, voters approved a similar measure, Proposition 61, a $750 million children's hospital projects bond. According to the LAO, as of June 1, 2008, only $403 million of these funds had been dispersed,[25] so why are taxpayers being asked to approve an additional $980 million in bonds when little more than half of the previous bonds have been put to use? If money is available and it is not being used, perhaps other reforms or changes in the law would have a more positive impact than another round of debt.

Furthermore, if funding for children's hospitals truly is a high priority, lawmakers should ensure that it can be paid for through the normal annual appropriations process, even if that means reducing or eliminating lower-priority programs or engaging in other budget reforms such as selling surplus property or rooting out waste and inefficiency in other areas of the government. The uncomfortable truth is that this is a feel-good measure designed to exploit a sympathetic group—sick children—in order to get around including the funding in the annual appropriations bill. During a time when the state is in a fiscal crisis, this only allows legislators and the governor to avoid making the difficult priority and program trade-off decisions they were elected to make.

Measures such as this additionally crowd out spending on health-care facilities by the private sector and nonprofit organizations. Why should these groups build new facilities if they know that taxpayers will just pass another bond every few years? It is possible that the removal of existing legal or regulatory barriers would spur greater hospital construction and facilities improvements.

Part 6

Proposition 10: Alternative Fuel Vehicles and Renewable Energy

With the average cost of gasoline hovering around $4 a gallon in California (according to AAA), and the state's CO_2 emissions among the worst levels in the country, the state is actively seeking solutions to the growing problems. In an effort to meet both issues in one measure, Proposition 10 seeks authority for a $5 billion general obligation bond for "various renewable energy, alternative fuel, energy efficiency, and air emissions reduction purposes."[26] The money would be divided up as follows:

> *"(1) $3.4 billion for financial incentives to reduce the cost to purchase or lease high fuel economy vehicles and dedicated clean alternative fuel vehicles (primarily rebates for trucks and other medium- and heavy-duty vehicles), and (2) $1.6 billion to fund research, design, development, and deployment of renewable electricity generating technology."*[27]

Among other things, Proposition 10 would fund a program to offer cash incentives for citizens to invest in hybrid cars and personal fuel stations, and sets aside grant money for alternative energy research. Though apparently well intentioned, this ballot initiative presents a myriad of problems. Beyond the fact that this $5 billion bond would impose another $5 billion in interest, putting California $10 billion deeper in debt, the measure sets forth an impractical, inefficient and improper plan for encouraging greater alternative energy use to foster the state's environment.

Impractical Incentives

First, those who buy or lease a new "high fuel economy vehicle," that is, a light-duty vehicle that "can achieve a combined fuel economy of not less than forty-five (45) miles per gallon for highway use as determined by the United States Environmental Protection Agency," would get a $2,000 rebate.[28] However, only one vehicle, the Toyota Prius, currently meets this standard, with a combined fuel economy rating of 46 miles per gallon. The Honda Civic comes in a close second at 42 miles per gallon, but Honda fans would not get the cash rebate.

Second, the bond would grant $4,000 rebates for the purchase of a "very high fuel economy vehicle," which needs to meet a 60-miles-per-gallon standard. To date, no vehicle on the U.S.

market would qualify for these rebates. Third, individuals or businesses would be able to secure a $10,000 rebate by purchasing or leasing a “dedicated clean alternative fuel vehicles,” one using specifically natural gas, biomethane, electricity, hydrogen, or propane to achieve at least a 10 percent reduction in CO_2 emissions, when compared to traditional petroleum-based fuels. There are only a few dozen public, 24-hour compressed natural gas fueling stations in California, so Proposition 10 also provides an additional $2,000 to build home refueling stations. Yet, the only new passenger car that meets this benchmark is the natural gas powered 2008 Honda Civic GX CNG.

There simply are not enough vehicles meeting the proposition’s standards to make this incentive practical.

The “clean alternative fuel” definition also overlooks recent advances in technology. Ford will release the Fiesta ECOnetic next year that runs on its innovative Clean Diesel Technology, getting 65-miles per gallon, but it will only be sold in Europe because of the high diesel taxes in the United States. Despite the fact that it has at least 30 percent less CO_2 emissions than conventional fuels, the ECOnetic would not qualify for the rebates anyway because it uses a diesel-based fuel source.

The painful irony is that of the two cars currently on the market meeting the proposition’s standards—the Prius and Civic CNG—the proposition gives more money to the car with worse greenhouse gas efficiency. According to federal fuel ratings, the natural-gas-powered Civic emits 35 percent more carbon dioxide than the Prius.[29] In fact, Proposition 10 sets aside five times more dollars—$550 million—for the Civic than the Prius.

Ineffective Incentives

There are three key inefficiencies with Proposition 10’s incentive plan. First, since the rebates will be given out over the next five years, they will not have the effect of spurring on market demand for technological innovation. Instead, the rebates simply subsidize the cost of a select number of vehicles that are already on the market or planned in the near future.

Second, the rebates will disproportionately end up lining the pockets of Californians who already have the means to buy higher-priced, high-efficiency vehicles. A 2007 survey of Toyota Prius owners found that 40 percent were upper-middle class consumers (with a median income between $100,000 and $150,000 per year) who would have purchased a more expensive luxury vehicle if the Prius was not available, 12 percent purchased a Prius to drive solo in carpool lanes, and 50 percent overall had a household income of more than $150,000.[30] In addition, drivers of hybrid vehicles have already received numerous taxpayer-funded perks, including state and federal tax deductions, free parking in cities like Los Angeles and San Jose, and HOV carpool lane privileges. Since the bond debt will affect all California taxpayers, including the poor, this measure is effectively taking from the poor to give to the rich.

Also disturbing is a finding by the LAO that car retailers may raise their sale prices proportionate to the rebates, as they have tended to do with similar vehicle programs in the past.[31] Thus, rather than make hybrids and alternative fuel vehicles more readily available, it would push them further out of reach to the average Californian than they already are.

Third, there is no provision in the proposition to ensure that cars purchased under this program remain in California. Commercial drivers could capture these grant funds and take the cars out of state. Billions of dollars would be spent by the state and its taxpayers without any guarantee that it offers any appreciable benefit in state-allocated greenhouse gas emissions.

Improper Incentives

Proposition 10 is being bankrolled by T. Boone Pickens. The Pickens Energy Plan is presented as a vision of America using wind, solar and natural gas power. However, it also uses taxpayer money to fund Mr. Pickens's business interests. His company, Clean Energy Fuels Corporation, has already secured $107 million in public grants for its private projects, which include building out natural gas filling stations across California and the nation.[32]

The proposition also creates significant redundancy with several previously approved state programs. The Alternative and Renewable Fuel and Vehicle Technology Program already authorizes the California Energy Commission to provide $120 million annually as incentives to public agencies, businesses, public-private partnerships, academic institutions, and others. The Public Interest Energy Research program mandates that the state energy commission research and develop alternative energy technology. If these programs, along with the Enhanced Fleet Modernization Program and New Solar Homes Partnership, are succeeding they could be further funded. If they are not, it is improper for yet another program to be set up to fail in their place.

Finally, the proposition specifies that not more than 1 percent of the funds in each allocation be spent on administrative efforts to distribute the rebates and grants. The LAO criticized this provision, arguing, "The measure's 1-percent limit on administrative costs may leave the various state departments with insufficient funds to implement the programs consistent with the provisions of the proposition. To the extent the measure fails to provide adequate funding for its administration, other state funds may face pressure, potentially averaging up to about $10 million annually, to fund implementation of the measure through about 2018-19."[33]

Proposition 10 is riddled with inefficiencies, mandates impractical measures, and is improper for the State of California.

Part 7

Proposition 12: The Veterans' Bond Act of 2008

The Cal-Vet Home Loan program was established in 1921 to help veterans finance the purchase of a home. Since June 1972, 13 veterans' home loan bonds have passed. The last veterans' bond totaled $500 million and was approved in November 2000. As of July 2008, the program still had $102 million remaining to support new loans for veterans.[34] Yet, Proposition 12 requests another bond authorization for $900 million in general obligation bonds for the Cal-Vet program, larger than any of the previous measures. According to the LAO, these bonds would provide "sufficient funds for at least 3,600 additional veterans to receive loans" for housing purchase use.[35]

This bond, like others, is not in the financial interest of California or the taxpayers. Interest on the bond would push the total future debt of the state $1.8 million deeper into the red. While the Cal-Vet program has always been fully supported by payments from the veterans participating in the program, there is still a risk to taxpayers. Because general obligation bonds are backed by the state, taxpayers would have to make up any shortfall if the veterans' payments were not enough to cover the amount owed on the bonds.

If the housing market continues to fall and real estate prices continue to decline, program participants who purchase a home in the near future with one of these loans would be at greater risk of defaulting on their mortgages. In this case, the Cal-Vet program would be stuck with losses in the same manner as the major financial institutions under fire in America today, such as Fannie Mae, Freddie Mac, Wachovia and Citigroup. Rather than seeking to expand the mortgage loans it hands out, Cal-Vet should be looking to shore up its current exposure, given the unpredictability of the housing market.

As with Proposition 3, Proposition 12 exploits a politically sacrosanct group—veterans—in order to get around including the funding in the normal budget appropriations bill. If additional funding is needed, either to shore up present risk or expand the program, it should come from the General Fund so state officials are held accountable for their decision to fund the program. During a time when the state is in a fiscal crisis, bond financing of the program only allows legislators and the governor to avoid making the difficult priority and program trade-off decisions they were elected to make. As it is, they have shuffled off that responsibility to the taxpayers, forcing them to vote "no" to helping out veterans in order to act in a fiscally responsible manner.

If the legislature deems the program worthwhile, it needs to stop putting bond measures on the ballot every few years or so and instead start including them in the annual budget. Moreover, given the recent slide in housing markets across the state, one must wonder if this program is as necessary, or fiscally responsible, as it was in the past.

Part 8

Recommendations and Conclusions

California must invest in its infrastructure, but it must do so in a responsible way by prioritizing its needs and ensuring that it can afford the projects it undertakes. This is especially true in such a difficult economic climate, which is expected to persist at least in the near term.[36] In order to maintain some semblance of prudent fiscal management, there are a few steps that voters and lawmakers should take.

1. Accept only the best and most necessary bond proposals, and only when the state's fiscal house is in order.

Californians must recognize that, at this time, the state cannot afford to take on additional debt for even the most worthy causes. This is particularly true for Propositions 3 and 12, where hundreds of millions of dollars set aside for just these purposes remains unspent. Even if the money wasn't already available, if such programs truly are such a high priority, then legislators and the governor must find a way to pay for them through the annual appropriations process, rather than asking taxpayers to bail them out by providing an additional funding source because they know it will be difficult for the average voter to vote against measures designed to help groups such as sick children and veterans.

If these measures are unaffordable, then certainly expensive boondoggles such as Propositions 1A and 10 should be off the table altogether. Proposition 1A is a poorly constructed plan that would finance only a small fraction of the proposed high-speed rail system's total cost, likely leading to another large infrastructure project money pit, and would not deliver anywhere near the promised benefits. The tortured assumptions made to present the plan as somewhat viable were driven by a political desire to sell a project desired by high-speed rail admirers, not by economic realities. If there really is a market for such a high-speed train, then, by all means, the private sector should be allowed to build it and the government should work to remove any red tape or environmental hurdles that may be preventing such a project. Proposition 10 would provide duplicative alternative fuel and renewable energy programs and offer ineffective and inefficient incentives.

2. Improve bond funds oversight

In addition to ensuring that California does not take on more debt that it cannot afford, more needs to be done to ensure that the bonds that have already been approved and sold are utilized properly. In January 2007, Governor Schwarzenegger issued an executive order to attempt to implement a stricter bond oversight process. According to a State Auditor Report,

> *The order states that "departments shall be accountable for ensuring that bond proceeds are spent efficiently, effectively and in the best interests of the people of the State of California." The order requires each department to establish a three part accountability structure for the bond proceeds they may receive. The first part of the accountability structure requires departments to follow existing criteria for bond expenditures including state or federal law, regulations, implementation plans, or a capital outlay program. The second part of the structure requires these departments to document ongoing actions to ensure projects funded with the bonds stay within their scopes and budgeted costs and for each administering department to report about its actions semi-annually to [the Department of Finance]. The third point of accountability makes department expenditures funded with bond proceeds subject to audit by Finance.*[37]

The executive order may not be enough, however. Past bond measures, even the recent 2006 infrastructure bonds, have been plagued by lack of oversight, misuse of funds, and the brazen politicization of project selection.[38] The state should develop an effective and comprehensive oversight process to make certain that the money taxpayers approve for bond measures is spent wisely. As the State Auditor notes, "Given the size, complexity, and cost of the State's infrastructure needs and the public funds made available to address them, oversight will be critical to ensuring the programs are run efficiently and effectively and provide maximum benefit."[39]

At a minimum an effective oversight program would include:

1. Legislation requiring that the use of bond proceed be audited and evaluated against the commitments of the authorizing legislation, with audits issued as public reports.
2. Regular and meaningful legislative oversight of the use of bond proceeds.
3. Adequate funding for necessary auditing and reporting performed by the Controller's office or Bureau of State Audits.
4. Commitment and leadership from legislators and the Governor's office to follow up on those audit results.
5. A single website providing full access to the public and the media full information on all issuance of debt, the use of debt proceeds, and relevant audits.

3. Implement a state debt limit

California will not get its fiscal house in order until it learns to control its spending. The Gann spending limit was implemented in an attempt to rein in state spending, but numerous loopholes have rendered it impotent. A more effective alternative would be the revenue limitation of the Taxpayer Bill of Rights (TABOR) model, which limits state revenues to the previous year's level plus population and inflation growth, and returns any amount exceeding this to taxpayers.[40] Since lawmakers sometimes get around the normal annual appropriations process by putting spending measures on the ballot and relying on voters to ratify additional funds, a different approach would be to impose a limit on the amount of debt the state can take on at any time. Not surprisingly, states that maintain a debt limit are more effective at controlling the amount of their borrowing.[41]

A debt limit would cap the percentage of the General Fund budget that could be devoted to debt service. If the debt limit were to be breached, the state treasurer would be prohibited from selling any additional bonds. Moreover, if the debt-service ratio exceeds the limit, no additional general obligation bond proposals could be submitted to voters. Given the LAO's previous guidance, and the preponderance of the sentiment in the investment community, a debt-service limit of 6 percent would be an appropriate measure.

With a state debt limit, voters could still approve bonds, but they could not authorize an unlimited amount of debt. More precisely, they could authorize more than the limit, but the state would be prevented from incurring debt over the limit until its financial position improved to the point to where it could afford to pay for the bonds while respecting the debt limit. The limit would thus serve as a final check against fiscal irresponsibility.

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