

SMART INVESTMENTS 2006



FIVE KEYS TO SMART INVESTMENTS IN CALIFORNIA'S FUTURE

California State Treasurer Phil Angelides
December 2005



PHILIP ANGELIDES
Treasurer
State of California

December 20, 2005

Honorable Arnold Schwarzenegger
Governor

Honorable Don Perata
President pro Tempore of the Senate

Honorable Fabian Núñez
Speaker of the Assembly

California's future success depends on making smart and prudent investments today in educating our people and providing the infrastructure to ensure the state's economic prosperity and quality of life in the decades ahead. We must invest in our state's infrastructure – the public foundation of California's future economic success – and we must do it the right way.

As the state embarks on a renewed discussion of its infrastructure needs, it is critical to put together a comprehensive, fiscally sound investment plan that is environmentally responsible and expands opportunity for all Californians. It is also critical that any such plan be adopted in the context of a truly balanced budget. The enclosed report by my office, *Smart Investments 2006*, outlines five key principles of smart investing to help California reach those goals.

I look forward to working with you toward a plan that lives by these smart investment principles.

Sincerely,

A handwritten signature in black ink, appearing to read "Philip Angelides".

Phil Angelides
State Treasurer

Smart Investments 2006: Five keys to smart investments in California's future

California's future success depends on making smart and prudent investments today in educating our people and providing the infrastructure to ensure the state's economic prosperity and quality of life in the decades ahead.

This is as true now as it was in June 1999, when this office issued *Smart Investments*, which made the case that, "The state's intelligent investment of its public resources in a manner that supports environmentally respectful, well-planned growth and promotes equality of opportunity is vital to our sustained economic progress."

We must invest in our state's infrastructure – the public foundation of California's future economic success – and we must do it the right way. ■

Filling California's huge unmet needs for, among other things, new and renovated schools, a modern transportation network, affordable housing, clean water, parks, open space, and stronger levees requires a plan that is comprehensive, fiscally prudent, environmentally sustainable and aimed at promoting equality of opportunity. To ensure that California has the infrastructure to support the growth of a vibrant economy and keep pace with the state's population growth – currently half a million a year – the state must follow five principles of smart investment:

We must invest in our state's infrastructure – the public foundation of California's future economic success – and we must do it the right way. ■

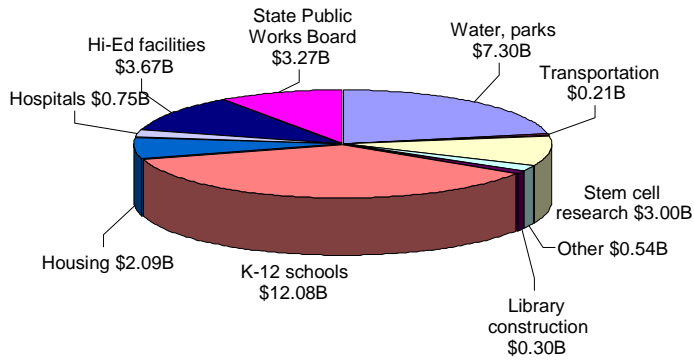
1. **Deliver on promises made.**

A critical component of any infrastructure plan must be for the state to accelerate the delivery of the \$17.1 billion worth of bond-funded projects and programs that have already been approved by the Legislature and the voters but not built or completed, and to restore the \$3.5 billion that has been diverted from transportation projects to cover General Fund deficits.

California has a total of \$33.2 billion of authorized bonds that have not been sold. Of those, \$17.1 billion in bond funding is available for state capital projects and programs that have been authorized but not delivered or completed. (See

Appendix A. The balance of the unissued bonds is for projects under local and private responsibility, such as schools, libraries, and hospitals, and for stem cell

\$33.2 Billion of GO and Lease Revenue Bonds Approved by the Voters and the Legislature Remain Unissued



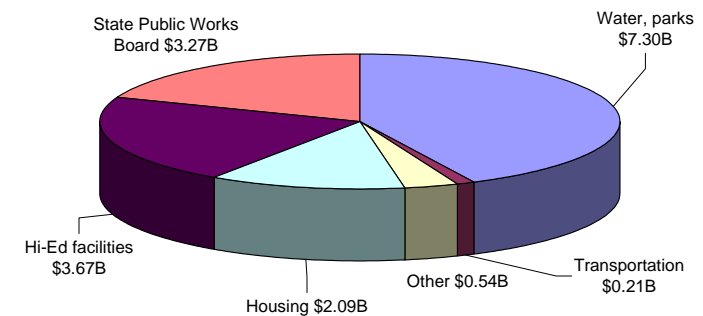
research, which has been delayed by litigation). The State Treasurer’s Office makes money available for projects as soon as project spending is ready to begin. Indeed, the Pooled Money Investment Board has already authorized loans of \$7.6 billion to allow these projects to move forward. Authorized bonds have not been issued because the projects are not ready to use them.

In each of its last two budget analyses, the Legislative Analyst’s

Office has noted that state resources departments have been slow to initiate bond-funded programs. In its analysis of the 2005-06 budget, the LAO noted, “We find that past-year staffing reductions and other constraints significantly slowed the implementation of some bond-funded programs, particularly new ones, and that delays persist in getting funds out the door.”

The California Performance Review, in its August 2004 report commissioned by Governor Schwarzenegger, concluded that, “California lacks an integrated infrastructure policy; infrastructure projects are not centrally managed or coordinated; infrastructure investment lacks stable funding; and multiple agencies involved in infrastructure make it difficult to complete projects.”

\$17.08 Billion⁽¹⁾ in Bond Funds Remain Available for State Projects and Programs Not Yet Delivered



⁽¹⁾ Excludes K-12 schools because local school districts are in charge of project delivery. Excludes stem cell research bonds because they are being held up in litigation. Excludes the library bonds because local governments are responsible for project delivery. Excludes the hospital bonds because the recipient hospitals are in charge of project delivery.

In addition, critical transportation projects have not been delivered because, from 2001-02 through the 2004-05 budgets, \$3.5 billion of transportation funding was diverted to the General Fund. In all, out of the \$2.4 billion expected from the voter-approved Proposition 42 for FY 2003-04 and FY 2004-05, only \$295 million has flowed to transportation projects. These delays in transportation funding

come at a significant cost to Californians and the state's economy and

The General Fund Has Borrowed \$3.5 Billion from Transportation Projects
(\$ in Billions)

	Transportation Investment Fund (Prop 42 related)	Traffic Congestion Relief Fund	Total
2002-03 and Prior	\$ -	\$ 1.4	\$ 1.4
2003-04	0.9	-	0.9
2004-05	1.2	-	1.2
Total	\$ 2.1	\$ 1.4	\$ 3.5

environment: for example, 18,000 jobs lost for each \$1 billion not spent; 73 hours a year lost to congestion by each Bay Area driver; and increased air pollution.

As the state's leaders consider approaching the voters again to approve new bond financing, they need to keep faith with voters by delivering approved bond-funded projects and restoring funds previously earmarked by voters for transportation.

2. Make a comprehensive, fiscally sound plan.

If voters are going to be asked to approve billions in new infrastructure investment, it is critical that money be well spent and that precious taxpayer dollars be used in ways that best meet California's needs. As *Smart Investments* noted in 1999, California must have a strategic plan to guide the nature and exact level of public investment, not "a 'magic' percentage of the state's budget or a laundry list of capital projects desired by various agencies.... The next wave of investment should be designed with the vision to meet the vastly changing needs of the next 50 years - and should not be a mere replication of the types of facilities that were built to serve Californians for the last 50 years."

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As it launches a new round of infrastructure investment, California needs a comprehensive plan that weighs our competing needs, respects taxpayer dollars, improves the environment, and expands economic opportunity.

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The plan must identify California's highest priorities and the types of investment that will yield the highest return to our people, and meet the state's needs in the most cost-effective and environmentally responsible ways. If the plan proposes public-private partnerships, such ventures must provide a fair return for the public.

In 1999, the Legislature passed AB 1473, which picked up many of the threads woven into *Smart Investments* by requiring the Governor to produce an annually updated five-year infrastructure plan as part of the budget. The prior administration delivered five-year

infrastructure plans in both 2002 and 2003. The Schwarzenegger Administration failed in both 2004 and 2005 to provide the legally required plans, and has not released any comprehensive overview of the state's infrastructure needs or assessment of infrastructure priorities.

As it launches a new round of infrastructure investment, California needs a comprehensive plan that weighs our competing needs, respects taxpayer dollars, improves the environment, and expands economic opportunity.

3. Protect our schools, our colleges, and our kids.

California must ensure that any significant infrastructure plan will not crowd out investment in our children's future.

Bonds are not a free source of infrastructure dollars. Every new bond increases state debt and the amount the state must budget for debt service. California cannot afford to add recklessly to its General Fund debt at a time when the state continues to have a structural budget deficit and is failing to adequately invest in the state's highest priority: educating our children to give them the skills and knowledge to compete in the global economy.

This year the state will pay some \$5 billion in tax revenue to service \$55 billion in tax-supported debt. Next year, the state will pay \$3.5 billion alone to cover the cost of its nearly \$25 billion of deficit borrowing, more than it spends on the entire University of California system. A \$10 billion infrastructure bond would add close to \$690 million in annual debt service; a \$20 billion bond would add \$1.4 billion, and a \$50 billion bond would add \$3.4 billion annually.

To protect education and other critical investments and services, a new infrastructure program must have a fiscally prudent plan to pay for it and must be adopted in the context of a truly balanced budget. California must find innovative and fair sources of bond repayment, including fairly assessing the users and beneficiaries of projects. For example, the state should examine financing improvements aimed at moving goods out of ports with container fees or other charges on shippers. As another example, landowners and businesses that benefit from maintaining and strengthening levees should be assessed to pay for the higher level of flood protection they receive.

4. Make a plan that works for taxpayers and on Wall Street.

Any large bond program California undertakes must be smart and fiscally prudent. It must come with a long-term infrastructure plan that calls for a

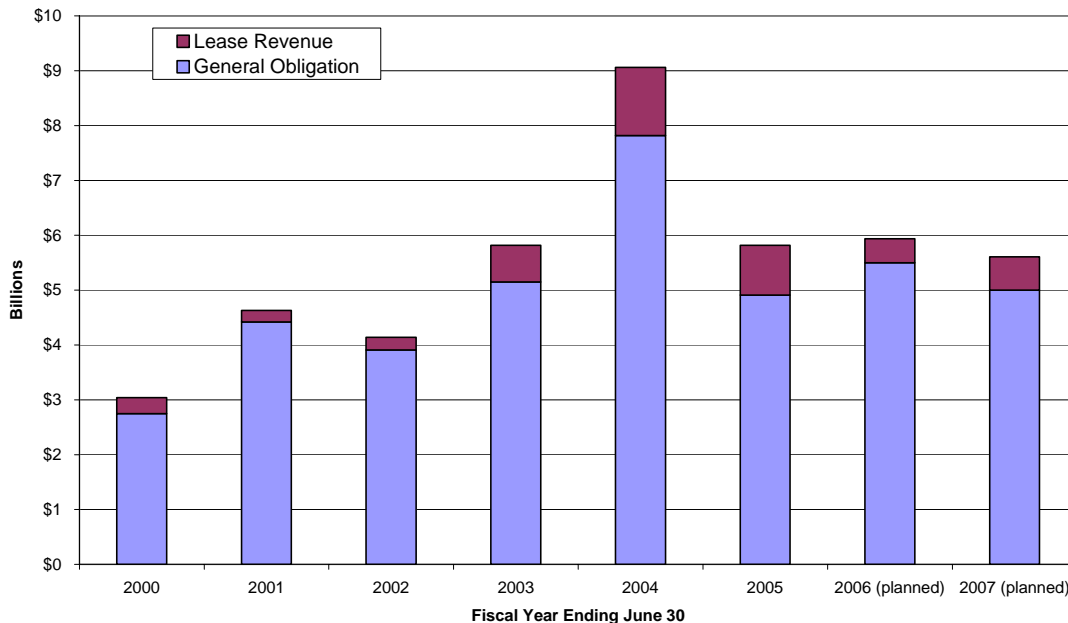
sensible strategy for issuing debt. It must fund vital infrastructure projects without unreasonably burdening the General Fund with crippling debt. It must not flood the market with bonds, driving up interest costs for taxpayers. And, as noted above, it must be accompanied by a plan for a truly structurally balanced budget.

Because the budget has not been balanced, California's credit ratings are the lowest in the nation. Lower ratings mean higher interest rates, imposing an interest penalty of about \$40 million for each \$1 billion the state borrows, both for bonds voters have already approved and any that would be sold for a new investment program. For the \$33.2 billion in bonds that have been authorized but not issued, that penalty amounts to more than \$1.3 billion over the life of the bonds.

A comprehensive infrastructure plan must also take into account that the state will also suffer an interest penalty if it attempts to sell too many General Fund-supported bonds into the market in any one year. Relatively speaking, the more bonds the state sells, the higher the rate of interest it is likely to pay.

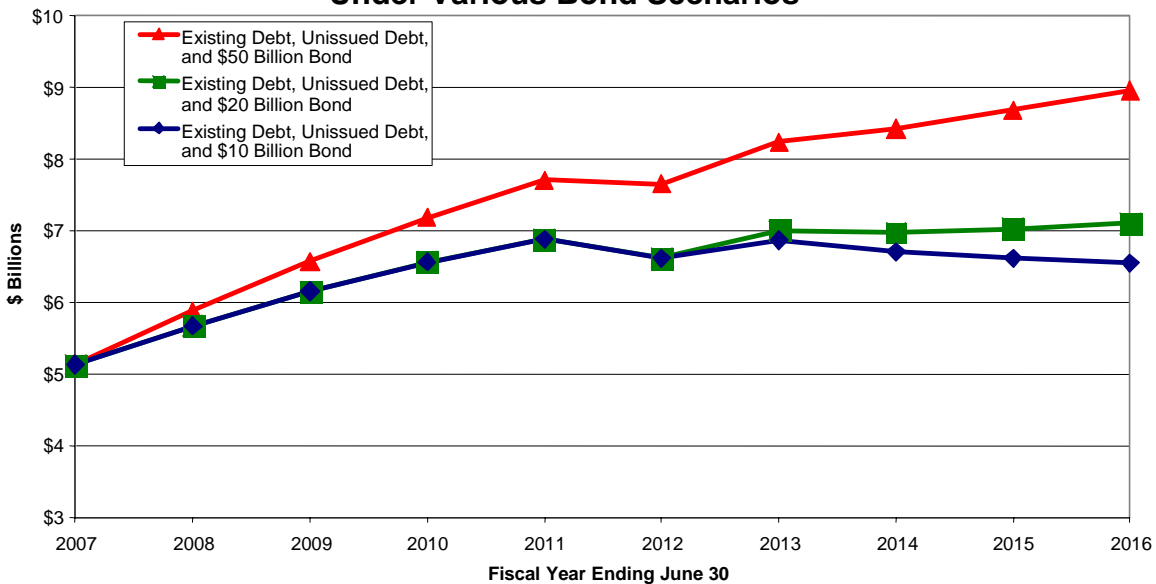
Since 2000, the state has sold about \$32 billion in General Fund-supported bonds; the largest amount it has ever sold in one fiscal year was \$9 billion in 2003-04. The state expects to issue \$5.9 billion in General Obligation and Lease Revenue bonds in 2005-06 and \$5.6 billion in 2006-07 for already authorized projects.

California Sold Between \$3 Billion and \$9 Billion Annually in General Obligation and Lease Revenue Bonds Since June 30, 1999



If the amount of General Fund-supported bonds sold were substantially increased, California would face higher borrowing costs. Market experts estimate the interest penalty to be between 0.15 and 0.25 percentage points. For example, adding a \$50 billion General Fund-supported infrastructure bond program, with bonds sold over ten years, onto the state’s existing bond program would result in an increased interest cost of \$2.8 billion to \$4.8 billion on the \$83.2 billion in bonds – \$33.2 billion already authorized but unissued and \$50 billion proposed. California can reduce the penalty by using funding sources other than the General Fund (e.g. user fees, dedicated revenues) to support infrastructure projects.

Future Annual Tax-Supported Debt Service Under Various Bond Scenarios



- (1) The \$50 and \$20 billion bonds are assumed to be issued over 10 years.
 - (2) The \$10 billion bond is assumed to be issued over 5 years.
 - (3) Unissued Debt is assumed to be issued over 7 years.
 - (4) Existing Debt includes scheduled debt service on General Obligation Bonds, Lease Revenue Bonds, and Economic Recovery Bonds.
- Assumption for all future issuances: 5.5% interest, 30-year level debt service amortization.

5. Make smart investments.

California must recognize that how we invest is just as important as how much. Our future economic strength is in no small part dependent on the quality of our environment and the continued attractiveness of California not only as a place to locate a business, but also as a good place to work and live. Sprawling growth patterns that accelerate environmental degradation, erode our economic competitiveness, and

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exacerbate the widening gap in economic opportunity among our residents threaten California's future success.

To that end, *Smart Investments* offered a set of principles to guide how the state should best invest to secure California's environmental quality and economic future. Since 1999, the Treasurer's Office and the state's pension funds have successfully used them to guide over \$24 billion in investment, to the benefit of taxpayers and communities around California. In accordance with these principles, any infrastructure investment plan must:

- Invest to support livable communities, sustainable development, and sound environmental practices that strengthen the economy. Any investment plan must move California toward sustainable development that supports, among other things, mass transit, a mix of housing and other uses within neighborhoods, and more efficient use of land.
- Re-invest in at-risk communities to reverse a dangerous trend toward "two Californias." California as a whole cannot succeed economically if there are two Californias - with some portions of the state prospering while others are falling behind. Investments should be directed to support communities that are most in need to create new economic opportunities.
- Make investments that are cost-effective and yield a fair return on investment to sustain California's economic growth. Every public dollar must be viewed as a precious resource, and every investment proposal should be analyzed, as a business would do, in terms of its long-term impact on the state's economic strength. For example, it may be more cost effective to encourage smart growth and pursue conservation instead of building in traditional ways.
- Rely on strong regional planning to meet objectives. Strong regional planning is elemental to achieving sustainable growth and community reinvestment goals, as many infrastructure issues transcend city and county boundaries. Accordingly, any state investment process must include a strong regional planning component, with state infrastructure investments made in accordance with regional plans that foster sustainable growth principles.

Enacted General Obligation and Lease Revenue Bonds For Projects and Programs to be Delivered by State Agencies⁽¹⁾
(\$ in Billions)

Description of Bond Program	Year Approved	Amount Authorized	Amount Unissued
Higher Education Facilities Bond Act	2004	\$ 2.30	\$ 2.29
Water Security, Clean Drinking Water, Coastal and Beach Protection	2002	\$ 3.44	\$ 2.81
Cal Clean Water, Clean Air, Safe Neighborhood Parks	2002	\$ 2.60	\$ 2.12
Housing and Emergency Shelter Trust Fund Act	2002	\$ 2.10	\$ 2.09
Higher Education Facilities Bond Act	2002	\$ 1.65	\$ 1.23
Voting Modernization Bond Act	2002	\$ 0.20	\$ 0.14
Safe Drinking Water, Clean Water, Watershed Protection	2000	\$ 1.97	\$ 1.20
Safe Neighborhood Parks, Clean Water, Clean Air	2000	\$ 2.10	\$ 0.83
Higher Education Facilities Bond Act	1998	\$ 2.50	\$ 0.15
Safe Clean Reliable Water Supply Act	1996	\$ 1.00	\$ 0.34
Seismic Retrofit Bond Act	1996	\$ 2.00	\$ 0.14
Clean Air and Transportation Improvement Bond Act	1990	\$ 1.99	\$ 0.21
State Public Works Board (lease revenue bonds) ⁽²⁾	Various	\$ 3.30	\$ 3.27
Other	Various ⁽³⁾	\$ 29.80	\$ 0.26
Total		\$ 56.95	\$ 17.08

(1) Includes only those bond programs for which the state is in charge of project delivery. Excludes K-12 schools because local school districts are in charge of project delivery. Excludes stem cell research bonds because they are being held up in litigation. Excludes the library bonds because local governments are responsible for project delivery. Excludes the hospital bonds because the recipient hospitals are in charge of project delivery.

(2) Approved by the Legislature from 2000-2005.

(3) Various General Obligation bond acts approved by voters from 1976 through 2000.