Senate Counsel & Research
ROOM 123, CAPITOL

Short Subjects

TITLE: Capital Budgeting DATE: November 5, 1986

AUTHOR: Mark Misukanis PHONE: 296-3817

Capital spending by state government is determined every two years by the Legislature as part of the overall budgetary process. The purpose of this short subject is to describe the process and policies that define the capital budget. The practices of other states will be examined. The impact of the new federal income tax law on the state and local government bond market, to the extent it has implications for capital budgeting, will be discussed.

History

Between 1957 and 1973, recommendations for capital spending were prepared by the Legislative Building Commission. The Commission was comprised of five members from each house, with executive branch participation limited to advisory reports and research. The Commission was abolished in 1973, and preparation of the capital budget was undertaken jointly by the Departments of Administration and Finance. Since 1975, capital budgets have been prepared by the Department of Finance.

Policy

Minnesota, like most states (see Table 3), sells long-term bonds to finance capital projects such as highways and university facilities. Since these projects are expected to have long useful lives, debt financing is appropriate to maintain intergenerational equity. When a project, for example a building or a bridge, will be used by more than one generation, it is only fair that the costs are shared among generations.

The authority to issue long-term bonds is given under Article VI of the state Constitution. Bonds can be issued for no more than 20 years. To finance this debt, the Constitution requires the state auditor to annually levy on all taxable property in the state a tax sufficient to pay all principal and interest on bonds issued by the state. This authority means these bonds are backed by the full faith and credit of the state. Prior to 1966, state long-term obligations were financed through a statewide property tax. Since 1966, in lieu of this tax, the Legislature has appropriated amounts from the general fund and the trunk highway fund to service debt on bonds previously issued and any additional debt incurred for new projects. This does not change the constitutional requirement for a statewide property tax should the appropriated amounts for some reason fall short of the amount needed.

Generally, bonds issued to finance new buildings or related capital improvements are paid for with appropriations from the general fund. Debt the state incurs for highway and road construction is serviced from the trunk highway fund. However, about 10 percent of the outstanding bonds serviced through the general fund are for road and bridge projects. Table 1 below indicates the principal amount of bonds outstanding as of June 1, 1986. Of the total, 39.3 percent will mature in five years and 71.4 percent will mature within 10 years.

Table 1

GENERAL OBLIGATION BONDS OUTSTANDING
June 1, 1986
(in thousands)

Type	Principal Amount	
General Fund:		
Building	$630,820	
Natural Resources	11,000	
Parks and Recreation	32,400	
Transportation	101,270	
Pollution Control	68,150	
Zoological Garden	14,825	
Vietnam Veterans Bonus	24,000	
Waste Management	9,300	
Refunding Bonds	158,690	
Exchange Bonds	6,300	
School Loan	14,465	
School Loan Refunding	9,935	
State Universities	13,595	
School Energy Building	21,500	
Total General Fund		$1,116,250
Trunk Highway Fund		99,755
Total Outstanding, June 1, 1986		$1,216,005

Source: Preliminary Official Statement, June 25, 1986.
General Obligation Family Farm Security Loan Bonds.

Once the Legislature authorizes the issuance of bonds, the timing and related financial operations are controlled by the Department of Finance. Unlike appropriations, bonding authorization does not cancel automatically. It remains available until cancelled by the Legislature. Table 2 below indicates general obligation bonds authorized but not fully issued.

Table 2

GENERAL OBLIGATION BONDS AUTHORIZED, ISSUED, AND NOT-ISSUED

Purpose of Issue	Law Authorizing	Total Authorization	Previously Issued	Remaining Authorization
Municipal Aid (1)	1971, Ch. 856	$ 4,330,000	$ --	$ 4,330,000
Water Pollution Control	M.S. 116.17	156,000,000	140,100,000	15,900,000
Transportation	1979, Ch. 280	52,000,000	50,000,000	2,000,000
Building	1979, Ch. 300	3,775,000	3,135,000	640,000
School Loan	1980, Ch. 545	20,000,000	15,025,000	4,975,000
Waste Management	1980, Ch. 564	15,000,000	7,600,000	7,400,000
Building (1)	1981, Ch. 334	46,315,000	4,435,000	41,880,000
School Energy Building	1983, Ch. 323	30,000,000	23,000,000	7,000,000
Building	1984, Ch. 597	127,540,000	74,473,000	53,067,000
Transportation	1984, Ch. 597	16,000,000	9,000,000	7,000,000
Building	X-1985, Ch. 15	154,865,000	61,500,000	93,365,000
Transportation	X-1985, Ch. 15	2,035,000	-0-	2,035,000
Waste Management	X-1985, Ch. 15	11,400,000	2,700,000	8,700,000
Reinvest in Minnesota	1986, Ch. 383	16,000,000	--	16,000,000
Family Farm Security	X-1986, Ch. 2	20,000,000	--	20,000,000
Rural Finance Administration	1986, Ch. 398	50,000,000	--	50,000,000
Total as of October 1, 1985 (2)				$334,292,000

X Indicates Special Session Laws.

(1) Laws 1984, Chapter 597, reduced Building Bond authorizations as follows:

Laws 1981, Chapter 334, by $3,685,000; and Laws 1983, Chapter 344, by $7,660,000. Laws 1984, Chapter 597, also reduced the Transportation Bond authorization in Laws 1981, Chapter 361, by $58,900,000 and the Municipal Aid Bonds authorization in Laws 1971, Chapter 856, by $15,670,000.

(2) Laws 1984, Chapter 597, authorizes the increase of all authorized and not-issued bonds, as authorized before 1984, by 5 percent for payments made under contracts for interest rate reduction measures.

Source: Preliminary Official Statement, June 25, 1986.
General Obligation Family Farm Security Loan Bonds

The executive branch has developed general policy objectives and guidelines in establishing the capital budget recommended to the Legislature. These apply only to bonds serviced through the general fund. The policy objectives are:

1. To restore the state's AAA credit rating.

2. To minimize the costs of borrowing.

3. To provide a reasonable financing capacity within a prudent debt burden.

Three guidelines have been adopted to achieve these objectives. They are:

1. <u>Appropriations from the general fund for debt service are to be limited to three percent of general fund non-dedicated revenue each biennium.</u>

This general policy was adopted in 1979, with the limit set at 2.5 percent. It was increased to three percent in 1984. Between 1980 and 1985, the guideline was exceeded four times, a problem caused mainly by budget shortfalls which necessitated short-term borrowing. This guideline relates debt service to the revenue capacity of state government.

2. <u>The ratio of total general obligation long-term debt is limited to 2.5 percent of state personal income.</u>

This relates the state debt to the tax base available to support debt service. This ratio is often used by financial analysts to evaluate state debt and allows for comparisons across states.

3. <u>The ratio of total revenue and general bond obligations of state agencies, state public corporations, and the University of Minnesota is limited to 3.5 percent of state personal income.</u>

Although revenue bonds are not backed by the full faith and credit of the state, to the extent bond rating agencies incorporate non-guaranteed debt in their evaluation of state general obligation bonds, this debt needs to be considered.

Following the Governor's presentation of the capital budget in March, the Legislature reviews it as it does the general operating budget. An important distinction is that the Constitution requires a three-fifths vote rather than a simple majority. This requires a more direct involvement by members of both houses in the individual provisions of the bill, such as the location and size of various projects. The final provisions adopted must, of course, satisfy the required number of members.

The Process

Planning for the capital budget begins in the spring prior to the session in which the budget is reported to the Legislature. The Department of Finance releases capital budget guidelines to be followed by each agency in making its project recommendations. The agencies are required to submit additional information to evaluate projects. The last budget cycle (FY 86-87) included the following:

-- A status report on all authorized but unfinished projects.

-- A summary of requests in priority order.

-- Information explaining the rationale for each project.

-- Development and operating cost estimates.

-- Monthly cash flow projections through the following two bienniums.

-- Population and utilization information.

Using this information, each project is evaluated by the Departments of Finance and Administration and the State Planning Agency. Recommendations are then made to the Governor.

Federal Tax Considerations

The federal tax bill recently passed by Congress has some important implications for state debt policy.

Congress has changed the arbitrage rules concerning tax-exempt bonds. These rules control the practice under which a tax-exempt bond is sold and the proceeds, prior to their use for a capital project, are reinvested in a higher yielding investment. The income earned due to the difference in yields is called arbitrage. This income can be used to service the debt on outstanding bonds, reducing the amount needed from the general fund for this purpose. A tightening of the arbitrage rules will reduce this income and require additional general fund appropriations for debt service, leaving less for other programs.

A second important consideration is the impact the bill will have on the interest rates for state-issued bonds. While there are a number of countervailing provisions in the bill, national economists generally predict that the overall impact will be to reduce interest rates. If this analysis is correct, the state will incur lower debt costs to finance future capital projects.

State Comparisons

While each state has a unique set of priorities in determining its capital budget, they share common approaches in financing arrangements and other procedural matters. The attached tables indicate these commonalities.

Table 3 indicates whether or not a state has a distinct capital budget, the most common ways capital spending is financed, and whether financing is tied directly to the life of the asset being built or purchased. This table is based upon a U.S. General Accounting Office survey. Thirty-seven of the 45 states that responded indicated they have a distinct capital budget. The three largest sources of revenue for capital expenditures are general taxes, long-term borrowing, and federal funds. Of the 37 states reporting a capital budget, 19 indicated they do not link the term of borrowing to the expected life of the asset.

Table 4 shows how state debt relates to personal income. This table is based on reports from the Bureau of the Census and is not strictly comparable to the guideline for debt management described above. However, it does show how Minnesota compares to other states in its debt burden. For FY 1984, the ratio for Minnesota was 2.17 percent, somewhat above the median value for the U.S. of 1.81 percent.

Table 3

STATE CAPITAL BUDGETS

RESOURCES AND BUDGETING PROCESS

Distinct Capital Budget		Three Largest Revenue Sources Identified by State			Long-Term Borrowing Linked to Asset Life
		(1)	(2)	(3)	
Alabama	No				
Alaska	Yes	General Taxes	Federal Funds	Special Funds	No
Arizona	Yes	Special Funds	Trust Funds	General Taxes	NA
Arkansas	Yes	NA	NA	NA	No
California	Yes	General Taxes	Federal Funds	Special Funds	No
Colorado	Yes	Long-Term Borrowing	Short-Term Borrowing	Trust Funds	No
Connecticut	Yes	Long-Term Borrowing	Special Funds	NA	Yes
Florida	Yes	Long-Term Borrowing	Trust Funds	General Taxes	Yes
Georgia	Yes	Long-Term Borrowing	General Taxes	NA	Yes
Hawaii	Yes	Long-Term Borrowing	Federal Funds	Special Funds	No
Idaho	Yes	General Taxes	Federal Funds	Donations	No
Illinois	Yes	Special Funds	Long-Term Borrowing	Federal Funds	Yes
Indiana	No				
Iowa	No				
Kentucky	Yes	Long-Term Borrowing	Federal Funds	Investment Income	Yes
Louisiana	Yes	Long-Term Borrowing	Federal Funds	Gas Tax	No
Maine	No				
Maryland	Yes	Long-Term Borrowing	NA	NA	No
Michigan	Yes	General Taxes	Special Funds	Federal Funds	No
MINNESOTA	Yes	Long-Term Borrowing	Federal Funds		No
Mississippi	No				
Missouri	Yes	Long-Term Borrowing	General Taxes	Trust Funds	No
Montana	Yes	General Taxes	Long-Term Borrowing	Federal Funds	No
Nebraska	Yes	NA	NA	NA	No
New Hampshire	Yes	NA	NA	NA	Yes
New Jersey	Yes	General Taxes	Long-Term Borrowing	Federal Funds	Yes
New Mexico	Yes	Long-Term Borrowing	General Taxes	NA	Yes
New York	Yes	Federal Funds	Miscellaneous Revenues	General Taxes	Yes

	Distinct Capital Budget	Three Largest Revenue Sources Identified by State			Long-Term Borrowing Linked to Asset Life
		(1)	(2)	(3)	
North Carolina	Yes	General Taxes	Long-Term Borrowing	Special Funds	No
North Dakota	No				
Ohio	Yes	Federal Funds	Long-Term Borrowing	Trust Funds	No
Oklahoma	No				
Oregon	Yes	Dedicated Funds	General Taxes	Federal Funds	Yes
Pennsylvania	Yes	Federal Funds	Long-Term Borrowing	Special Funds	Yes
Rhode Island	Yes	Long-Term Borrowing	Special Funds	General Taxes	Yes
South Carolina	Yes	Long-Term Borrowing	Special Funds	General Taxes	Yes
South Dakota	Yes	Federal Funds	State Highway Funds	General Taxes/Tuition	NA
Tennessee	Yes	Long-Term Borrowing	NA		Yes
Texas	No				
Utah	Yes	Fuel Tax	Federal Funds	General Taxes	No
Vermont	Yes	Long-Term Borrowing	General Taxes	NA	Yes
Virginia	Yes	General Taxes	Higher Education Fund	Highway Funds	Yes
Washington	Yes	General Taxes	Long-Term Borrowing	Federal Funds	Yes
Wisconsin	Yes	General Taxes	Trust Fund	Special Funds	Yes
Wyoming	Yes	General Taxes	NA	NA	Yes

Source: Capital Budgeting Practices in the States.
U.S. General Accounting Office (July 15, 1986).

Table 4

LONG-TERM GUARANTEED DEBT

AS A PERCENT OF PERSONAL INCOME

Fiscal Year 1984

State	Long-Term Debt As A Percent Of Personal Income
Colorado	0.00%
Iowa	0.00%
Wyoming	0.00%
Indiana	0.00%
Arkansas	0.00%
District of Columbia	0.00%
Nebraska	0.00%
South Dakota	0.00%
Arizona	0.00%
Idaho	0.00%
North Dakota	0.07%
Kansas	0.09%
New Mexico	0.09%
Oklahoma	0.38%
Missouri	0.41%
Virginia	0.58%
Kentucky	0.59%
Michigan	0.66%
Texas	0.70%
Florida	0.89%
California	1.30%
Montana	1.32%
Tennessee	1.35%
North Carolina	1.49%
Georgia	1.68%
New York	1.81%
Median	1.81%
Utah	1.87%
Alabama	1.95%
Ohio	2.02%
South Carolina	2.08%
Rhode Island	2.16%
Minnesota	2.17%
New Jersey	2.30%

State	Long-Term Debt As A Percent Of Personal Income
Illinois	2.34%
Nevada	2.48%
Maine	2.61%
Pennsylvania	2.94%
Mississippi	2.95%
New Hampshire	3.25%
Wisconsin	3.68%
Maryland	4.16%
West Virginia	4.29%
Washington	4.42%
Massachusetts	4.55%
Connecticut	4.73%
Vermont	5.66%
Louisiana	5.76%
Delaware	7.34%
Hawaii	13.24%
Oregon	19.65%
Alaska	20.01%

Source: 1984 Governmental Finances
U.S. Bureau of Census