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State Practices for Financing Capital Projects



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Preface

In February 1985, we issued Managing the Cost of Government: Building an Effective Financial Management Structure (GAO/AFMD-85-35 and 35A), which summarized the federal government's problems in financial management, including the federal budget structure. Since that time, we have been actively studying, evaluating, and discussing the concept of a capital budget for the federal government as a way of improving the budget decisionmaking and control processes. As part of our continuing effort to examine the many issues surrounding the development of capital budgeting concepts, we undertook this study of state practices for budgeting and financing capital projects. We believe the study will be useful to the Congress, the Office of Management and Budget (OMB), and federal departments and agencies as they evaluate the issues involved in adopting a capital budget for the federal government.

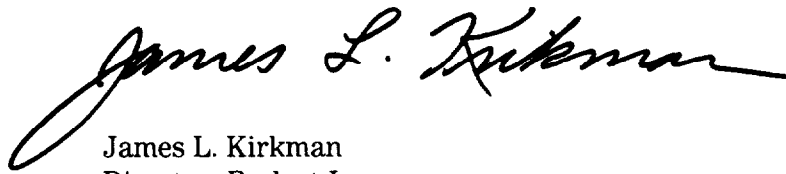
The study discusses the criteria nine states use to define capital assets, describes how these states budget for capital assets, and provides information about whether the states link borrowing maturities to asset life. In addition, the study discusses the methods the states use to finance capital assets. Chapter 1 describes our scope and methodology in more detail.

In summary, our study discusses the following:

- Most of the nine states we studied have developed strict criteria for determining what constitutes a capital asset, while others have only general and broad criteria. Generally, those states which strictly define capital assets include the criteria that the asset have, at a minimum, a specific dollar value and life expectancy. Also, most of the states have specific procedures for budgeting for capital assets, but practices vary from state to state. (See chapter 2.)
- Most states, including the nine we studied, primarily use two sources to finance capital assets: current revenues and long-term debt financing. (See chapter 3.)
- Generally, the nine states we studied do not link the financing method and borrowing maturity directly to a capital asset or its useful life. The financing method and its borrowing maturity are more directly linked to other factors, such as prevailing market conditions, the states' desire to achieve the best economic results, the need to maintain a high quality bond rating, legislative limitations on the type and amount of debt, and other considerations, such as the political environment. (See chapter 4.)

We are sending copies of this study to the Congressional Budget Office, OMB, various Congressional Committees, and others who have been studying these issues. We will also make copies available to other interested parties.

The major contributors to this study are identified in the appendix.



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Abbreviations

GAO	General Accounting Office
OMB	Office of Management and Budget

Introduction

We have been examining the concept of capital budgeting as a step in strengthening financial management within the federal government. We have reviewed various aspects of this issue.¹ Last year, we released an exposure draft (Budget Issues: Capital Budgeting for the Federal Government, GAO/AFMD-88-44, July 1988) which proposes restructuring the unified budget into operating and capital components.²

Most states have had experience with capital budgeting and related financing techniques. In our 1986 study of states' capital budgeting practices, 37 of 45 states responding indicated they had some form of a capital budget. Furthermore, 21 states replied they used long-term borrowing to finance capital assets. According to the U.S. Bureau of the Census, the 50 states spent over \$34.5 billion in 1986 on capital assets.

The federal government, on the other hand, has limited experience using a capital budget as a decision-making tool during the budget process. Its unified, cash-based budget treats outlays for capital and operating activities the same. This should not be the case. Capital outlays, whether they are for buildings or loans, produce future streams of benefits to the government or the economy. The benefits may be cash flows, facilities to carry out government operations, or other such economic returns. Although the current budget provides a comprehensive report of cash receipts and outlays, it does not distinguish between expenditures for capital investments and current operations.

While our previous work provides an overall framework for capital budgeting at the federal level, a number of issues must still be resolved prior to implementing a capital budget within the unified federal budget. One of those issues concerns developing specific procedures for defining and identifying capital assets. A second issue is how capital acquisitions should be financed. A third issue, which has generated congressional interest, is whether borrowing maturity can or should be linked to the life of the capital asset. We examined how the states budget for and finance capital investments. Their experiences could provide useful information to the Congress, OMB, and federal departments and agencies

¹Budget Issues: Capital Budgeting Practices in the States (GAO/AFMD-86-63FS, July 15, 1986); Capital Budgeting for the Federal Government (GAO/T-AFMD-88-3, December 8, 1987); and Budget Reform for the Federal Government (GAO/T-AFMD-88-13, June 7, 1988).

²The term "capital budget" is not universally defined. In our capital budget proposal, we define a capital budget as that part of the unified budget which segregates capital revenues and investments from the operating budget's revenues and expenses. Capital revenues and capital investments are excluded from the calculations of the operating budget's surplus or deficit, but the operating budget is charged for depreciation.

as they evaluate and discuss the concept of implementing a capital budget for the federal government.

Objectives, Scope, and Methodology

The principal objectives of this study were to (1) identify the criteria states use for defining a capital asset and the procedures they use in developing their capital budgets, (2) identify the methods states use to finance capital assets, and (3) determine the extent to which states link borrowing maturities to the useful life of a capital asset.

To achieve our study objectives, we reviewed related books, articles, and other published reports, including prior GAO reports, for information on state budgeting practices for financing capital assets. In addition, we selected nine states for detailed study.

In selecting these states, we used our 1986 report (Budget Issues: Capital Budgeting Practices in the States, GAO/AFMD-86-63FS, July 15, 1986) which identified 19 states that (1) used long-term borrowing for financing capital assets and (2) linked borrowing maturities to asset life. From these 19 states, we wanted to select states which were responsible for a majority of the capital expenditures. For the 19 states, we reviewed (1) the amount of the state's total capital outlays, (2) the state's capital outlays as a percentage of total state expenditures, (3) the amount of the state's long-term debt, and (4) the percentage of the state's capital outlays financed by long-term debt. For our current study, we wanted to determine whether and, if so, how the states directly link borrowing maturities to asset life.

As a result of considering the above criteria, we selected a judgmental sample of 8 states for study—Florida, Georgia, Illinois, Kentucky, New Jersey, New York, Pennsylvania, and Virginia. These 8 states accounted for 73 percent of the capital expenditures made by the 19 states in our 1986 survey. In addition, we selected Colorado because it not only uses a capital budget, but it also responded to our 1986 survey that it does not link long-term borrowing maturities to asset life. Colorado also identified long-term borrowing as its largest source of revenue for capital expenditures. In addition, Denver, Colorado, is the home of the National Conference of State Legislatures, where we obtained valuable information for this study.

In each of the nine states, we interviewed various state officials to obtain information regarding their capital budgeting approach and process and to gather data on their respective state's debt. We also used

U.S. Bureau of the Census data on capital expenditures if the information we obtained from the individual states was not presented in the format necessary to complete our review.

The results of our review are presented in the following three chapters. Chapter 2 describes the criteria states use for defining capital assets and the procedures they use in developing their capital budgets, and it also provides specific details on the nine states in our survey. Chapter 3 discusses the states' general methods of financing capital projects. Chapter 4 examines whether there is a linkage between the financing method or borrowing maturity and a capital asset's useful life.

State Budgeting for Capital Assets

A majority of the 50 states use a capital budget, segregating capital and non-capital expenditures. Furthermore, most states have established (1) criteria for defining capital assets and (2) specific capital budgeting procedures. The nine states we reviewed all use a capital budget and most have defined capital assets and developed capital budgeting procedures.

Defining Capital Assets

Capital assets are often defined as those intended for long-term use or possession. They are relatively permanent in nature, and they are not intended for resale. Usually, they are classified into general groups, such as land, buildings, and equipment. The general classifications represent many types of capital projects which cover various functions such as medical and educational facilities, prisons, parks and recreation, general public buildings, airports, and highways.

In fiscal year 1986, the 50 states reported that they spent about \$34.5 billion on capital projects. Table 2.1 provides the 50 states' capital expenditures by function, according to the U.S. Bureau of the Census. The table also includes the capital expenditures made by the nine states included in our study. Because most states in our study presented their expenditures by departmental or cabinet structure rather than listing them strictly along functional lines, we used the Census Bureau's data on capital expenditures.

According to the National Council of State Legislatures, there are seven states which have no specific written definition for a capital asset. In the nine states we visited, most have developed strict definitions for determining what constitutes a capital asset, while others have only general and broad criteria. The criteria each of the nine states uses to define capital assets are discussed below. For purposes of the following discussion, the terms capital asset, capital project, and capital items are used interchangeably, depending on the state's choice of terminology.

Colorado - A capital asset is any nonstructural improvement to land such as land-grading, drainage, roadways, or sewers, which costs more than \$100, but less than \$5,000; any alteration or repair which costs more than \$100, but less than \$15,000; and any equipment, furniture, etc. with a useful life over 1 year, which is continuously used, and which costs \$100 to \$50,000. Projects such as site purchase or development, major repairs or renovations, building construction or equipment purchases which cost more than \$50,000 are considered capital construction.

**Table 2.1: States' Capital Expenditures,
Fiscal Year 1986**

Dollars in billions		
	All states	Nine states in GAO review
Highways	\$20.4	\$6.8
Education	5.1	1.2
Natural resources	1.1	0.3
Hospitals	0.8	0.3
Correction	1.6	0.4
Parks and recreation	0.4	0.1
Public buildings	0.4	0.2
Health	0.3	0.2
Police	0.3	0.1
Airports	0.2	0.1
Other	3.9	2.1
Total	\$34.5	\$11.8

Source: U.S. Bureau of the Census State Government Finances in 1986.

Florida - A fixed capital outlay is real property (land, buildings, appurtenances, fixtures and fixed equipment, structures, etc.), including additions, replacements, major repairs, and renovations to real property which materially extend its useful life or improve or change its functional use. Also, it includes the capital outlay necessary to furnish and operate a new or improved facility.

Georgia - This state's budget office determines what constitutes a capital asset. It bases its decision primarily on an estimated useful life determination of proposed capital projects. The life of the capital asset or project should equal or exceed 5 years. Additionally, the project must be "bondable," that is, market conditions are favorable for selling bonds, and bond ratings will not be adversely affected.

Illinois - This state's budget office also determines, at its discretion, what constitutes a capital asset. It relies on the project's bondability in determining whether it can be classified as capital. For bonding, projects must meet certain criteria, including: the project is of a durable nature; the project is not subject to inherent risk of failure or intended to fulfill temporary needs; expenditure of funds must appreciably increase or enhance the interest of the state; the state must have a direct interest; and project expenses must exceed \$25,000.

Kentucky - Capital projects are any construction item, or any combination of capital construction items necessary to make a building or utility

installation complete which are estimated to cost \$200,000 or more and major items of movable equipment estimated to cost \$50,000 or more.

New Jersey - This state defines capital projects as any undertaking proposed to be funded by general obligation bonds, or by an appropriation in the annual capital budget. They include the acquisition of land and the purchase of construction and equipment which exceed \$50,000.

New York - Capital projects are any projects which would be financed through debt issuance by the state, funded by an appropriation from the Capital Projects Funds, or funded by an appropriation from the Capital Projects Budget Bill. Capital projects are those involving the acquisition, construction, demolition, or replacement or major repair of a fixed asset.

Pennsylvania - Capital projects include any building, structure, facility, or physical public betterment or improvement; any land; any furnishings, machinery, apparatus, or equipment for any public betterment or improvement; or any undertaking to construct, repair, renovate, improve, equip, furnish, or acquire any of the foregoing, provided that the project is designated in a capital budget as a capital project. The project or equipment must have an estimated useful life in excess of 5 years and an estimated cost in excess of \$100,000.

Virginia - Capital items include real property acquisitions; new construction greater than 5,000 square feet or greater than \$75,000; improvements to existing facilities greater than \$200,000 or resulting in operating costs greater than \$15,000; and equipment, if financed through revenue bonds. The detailed descriptions and criteria for property and improvements, plant and improvements, and equipment are provided in state budgeting procedure guidelines.

How States Budget for Capital Assets

A prior GAO report¹ on capital budgeting issues reported that 37 of 45 states responding said they have a distinct capital budget where capital amounts are reported separately. The report also provided the following information about the states that responded:

- 17 states maintain separate capital and operating budgets,
- 13 states combine capital and operating amounts into an overall budget total, and
- 7 states use various other procedures to report capital.

¹Budget Issues: Capital Budgeting Practices in the States (GAO/AFMD-86-63FS, July 15, 1986).

In November 1987, the National Conference of State Legislatures completed a study, Capital Budgeting and Finance: The Legislative Role, regarding the legislative role in the capital budgeting and finance process for the states. One of the recommendations the study made to the states was that the “executive branch should be required to submit to the legislature a single capital budget that includes all capital requests for the forthcoming budget period, by priority, across agencies, presented by funding source.” The study’s authors favor a single and separate capital budget request because they believe that

- presenting all capital requests, arranged by proposed funding source, in one separate document enhances the examination of alternative financing mechanisms for various projects and
- showing all requests in one place and ranking them allows legislators to better consider the trade-offs among different projects across state agencies.

Because capital budgeting practices in the nine states we visited vary from state to state, it would be very difficult to call any one state typical. Some states are more centralized than others, with greater decision-making on capital projects within the governor’s office. On the other hand, some states are strong legislatively and use legislative committees to establish priorities.

For example, in Florida, Kentucky, and New Jersey, all state agencies are required to prepare a capital facilities plan every year. In Florida and Kentucky, the governor’s office reviews and consolidates the plans before submitting them to the legislature. In New Jersey, the state’s Office of Management and Budget is charged with coordinating the agencies’ plans. The final plan is then presented to the State Capital Planning Commission which develops and maintains, on an ongoing basis, short- and long- range capital spending plans and makes final recommendations to the Governor for inclusion in the annual state budget. In contrast, Colorado has a permanent legislative committee, known as the Capital Development Committee, which is charged with ranking capital construction projects in order of importance for annual recommendation to the Joint Budget Committee.

All nine states we visited maintain distinct capital budgets, but only five combined the capital and operating budgets into one overall budget. For instance, as part of its annual financial report, Kentucky prepares combined general purpose financial statements showing sources of revenue, including proceeds from bond sales, and overall expenditures, including

those for capital projects. In addition, the financial report provides more detailed statements for individual funds such as the general fund, special revenue funds, and federal funds. One of these individual funds is the capital projects fund. According to Kentucky's annual financial report, the capital projects fund accounts for financial resources appropriated by the General Assembly for the acquisition, construction, or renovation of major capital facilities, and for the acquisition of major equipment, other than items financed by proprietary funds, certain trust funds, and university and college funds.

Similarly, Illinois' state budget provides summary statements indicating general uses for all appropriated funds. However, the budget also provides detailed financial data for all the state's departments, agencies, and programs. The capital program is included in the budget report as a separate program. It provides information regarding the sources of capital funds and a description of all current and proposed capital projects.

Methods of Financing Capital Assets

States finance capital assets primarily through the use of current revenues and long-term debt. In a 1986 GAO survey,¹ 29 of the 37 states who responded that they used a capital budget indicated that one of their primary funding sources for financing capital assets was current revenues (state revenues and intergovernmental funds from the federal government and local governments). Similarly, 21 of the reporting states indicated that long-term borrowings were also a primary source of funds for financing capital assets.

Current Revenues

Current revenues consist of state revenues and intergovernmental funds. State revenues are collected primarily from taxes, current charges, and miscellaneous general revenues. Taxes constitute the largest segment of state revenues, with sales and gross receipts taxes, income and license taxes being the major kinds of taxes.

Miscellaneous general revenues comprise the second largest type of state revenues. These revenues include interest earnings, rents, royalties, lottery net income, donations, and fines and forfeitures.

Current charges are the third largest type of state revenues. States receive these revenues from the public for performing specific services benefitting the person charged, such as rents and sales from furnishing commodities or services, and intergovernmental transfers.

In addition, states receive intergovernmental funds. These funds include federal funds and funds from local governments. The federal funds are frequently grants for physical capital investments, such as highways or community and regional development projects. The funds from local governments are for shares in the financial support of state-administered programs, reimbursements for services performed or expenditures made for them by the state, payments on debt service of state debt issued for their benefit, and repayment of advances and contingent loans extended to them.

In some of the nine states we visited, current revenues fund most capital expenditures, with a majority of those revenues provided by the federal government. In Georgia, a state official told us that the state's 1988 projected capital outlays would be about \$900 million. Current revenues,

¹See footnote 1 in chapter 2.

including state revenues of \$180 million and federal funds of \$315 million, would finance 55 percent of the total capital expenditures. The federal funds were earmarked for Georgia Department of Transportation projects.

In Virginia, the 1987 capital budget program was projected at \$343 million. Except for \$36 million of long-term debt, the program was financed entirely from current revenues. For the 1987-88 fiscal year, New York planned capital outlays of \$2.2 billion. Approximately 50 percent, or \$1.1 billion, would be derived from current revenues. Of that portion, federal funds would comprise 62 percent.

In six of the states that we visited, lottery revenue is used to support specific programs. Pennsylvania, for example, primarily uses its net lottery revenues for programs in its Departments of Aging or Public Welfare. However, some states are beginning to use lottery revenues for capital projects. For instance, Colorado's 1988-89 budget has dedicated lottery proceeds to finance \$16.5 million in capital projects.

We also found that state governments use current revenues for lease payments in order to finance capital projects. Leasing is a capital financing mechanism that allows a state to pay for the purchase or use of a facility or equipment in installments rather than all at once. State governments use leasing as an alternative to bond financing or full cash payments.

There are several types of leases. The two more common forms are operating leases and capital leases.

An operating lease is a short-term rental agreement where the state leases an asset for only a fraction of the asset's useful life. As the lessee, the state uses the asset in return for regularly scheduled rental payments, which are classified as current expenses. The lessor, normally a manufacturer or vendor, provides the asset in return for the agreed-upon payments. The lessor is usually responsible for maintenance, insurance, and taxes. These responsibilities enable the lessor to claim the tax benefits of ownership.

A capital lease, also known as a lease-purchase agreement, is one where the ownership of the asset normally transfers from the lessor to the lessee at the end of a lease term. This agreement establishes periodic payments divided into both principal and interest, and a date when title

to the asset may transfer, if the lessee meets all contractual requirements. A capital lease may involve a single item or multiple items.

States reported they use leasing instead of borrowing for several reasons:

- A state is unable to enter the bond market with a new issue because it has reached its legal debt limit.
- A state is unable or unwilling to enter the bond market because of high interest rates.
- The need for voter approval on bond issues makes leasing more attractive.
- The useful life of an asset or changing technology makes issuance of long-term bonds an inappropriate financing mechanism. Lease agreements are typically 4, 6, or 8 years, whereas long-term bonds are normally for 10 years or more.

Some of the nine states we visited use leases extensively. Florida leased nearly \$400 million worth of equipment in 1986. Kentucky leases \$35 million to \$40 million a year in small equipment. Similarly, Colorado's state agencies had issued about \$26 million in lease-purchase agreements through 1985. New York planned to issue about \$426 million of lease-purchase debt to finance about 20 percent of its 1987-88 capital program.

Debt Financing

States use a combination of short-term and long-term debt to finance capital expenditures. Short-term debt consists of interest-bearing debt payable within 1 year from the date of issue, such as bond anticipation notes, bank loans, and tax anticipation notes and warrants. States use short-term debt mostly in anticipation of tax receipts; it is seldom used to finance the start of capital projects.

Long-term debt, however, is the most frequently used debt financing tool for capital assets. In 1988,² we reported that the use of long-term debt by the 50 states increased, in aggregate current dollars, from about \$19 billion in 1961 to over \$212 billion in 1985. During the 1981-85 period, state debt grew at an annual rate of 12 percent.

There are two major forms of long-term debt—full faith debt and nonguaranteed debt.

²Budget Issues: Overview of State and Federal Debt (GAO/AFMD-88-11BR, January 27, 1988).

Full Faith Debt

When a state issues full faith debt, it promises to repay the debt using, if necessary, its taxing powers to obtain the needed funds. Full faith debt is generally issued in the form of general obligation bonds. A distinction does exist between general obligation bonds payable from unlimited taxing powers, and those where the power to tax for debt repayment is subject to some kind of limitation. In either case, the bondholders rely on the state government to take whatever action is necessary to ensure repayment. For this reason, general obligation bonds generally have lower interest rates than nonguaranteed debt.

The states we visited finance varying portions of their capital projects with general obligation bonds. In New York, new general obligation debt totaling \$365 million was planned to finance about 17 percent of the 1987-88 capital plan. Georgia was planning on issuing \$405 million of general obligation bonds to finance 45 percent of its \$900 million capital program.

Another category of full faith debt is zero coupon bonds. These bonds are offered at a discounted rate and are payable at maturity at their full par value. Of the nine states in our review, Illinois was the only state that was using this financing method. The state is calling the bonds "General Obligation College Savings Bonds," and they are issued in denominations which have maturity values in \$5,000 multiples. Illinois' first zero coupon bond issue in 1988 was for about \$93 million. Officials indicated that they sold out immediately and probably could have sold about three times the state's initial issue.

Debt Limitations

Most states have constitutional or statutory debt limitations to prevent state and local government fiscal mismanagement and to protect the interests of bondholders. One common form of debt limit restriction is placing a limit on the dollar amount of the debt the state may incur. This amount is either given as an absolute value or as a flexible limit, such as a percentage of the state's revenue receipts or a percentage of the assessed value of the state's property tax. For example, Pennsylvania's constitution establishes a debt limit at 1.75 times the average of the state's annual tax revenues for the previous 5 years. In Georgia, the constitution restricts borrowing to 10 percent of the previous year's net revenue. At the other extreme, Colorado's constitution prohibits the state from issuing any full faith and credit debt.

A second type of debt limit restriction requires that debt be issued only for certain public purposes. Generally, those purposes must be related to capital projects. In Florida, for example, the state constitution states

that state bonds pledging the full faith and credit of the state may be issued only to finance or refinance the cost of state fixed capital outlay projects.

A third type of debt limit restriction is one that requires voter approval in order to exceed certain dollar limits for debt or to simply issue any debt. In Kentucky, there are no constitutionally imposed limits on debt, but all debt financing must have prior approval by the state's General Assembly, which sets the limits on the volume of bonds issued. In Florida, full faith and credit bond issuance is generally subject to voter approval.

Nonguaranteed Debt

Nonguaranteed debt is payable solely from a specific pledged source, as opposed to general obligation bonds, where the full faith and credit and taxing power of the issuing state are pledged for the repayment of the debt. Nonguaranteed debt is financed primarily through revenue bonds. They are secured by user fee repayments (revenue generated from the project itself) or earmarked revenues. In case of default, the issuing state does not have a legal liability to pay the debt from general tax revenues. Its liability only extends to the specific revenue pledged to repay the debt. In fiscal year 1986, state nonguaranteed debt represented over 73 percent of all long-term debt for the 50 states.

The principal advantages of revenue bonds over general obligation bonds are that they normally do not require voter approval, and they generally are not subject to constitutional or statutory debt limitations. Other advantages are the capital projects are usually paid for by user fees, and bond issuers can adjust their rate structure to keep up with inflation and pay operating costs. The major disadvantage is that revenue bonds are issued for a long time period in order to provide a safe margin for covering costs and debt charges. This extended maturity increases the bond interest rate.

There are three broad categories of revenue bonds. Government enterprise bonds, the traditional category of revenue bonds, are used to borrow funds for constructing or improving facilities, such as utilities, airports, and bridges. In such instances, utility payments, landing fees, and bridge tolls provide revenues to fund the debt service.

Public bonds for private purposes are issued to support activities such as housing, economic development, construction, industrial pollution control, student loans, or other activities. The private beneficiaries of

the bonds' proceeds repay the debt through lease payments or other kinds of periodic payments which cover debt service over the life of the bonds.

A third category of revenue bonds, government lessee bonds, differs from the previous two types in that repayment is usually from taxes, not revenue-producing activities. In these cases, one state entity with borrowing authority issues bonds and uses the debt proceeds to acquire facilities for another state entity. The two entities enter a lease agreement which requires the entity using the facility to make lease payments to the entity that issued the bond. The lease payments are usually funded by tax revenues and are used to liquidate the debt.

Revenue bonds are issued by a state or public authority. For example, Florida's state government had \$605 million in revenue bonds outstanding at the end of fiscal year 1987. These bonds financed roads, bridges, and other capital projects and will be paid from revenue sources other than state taxes. In Kentucky, which has not issued any general obligation bonds since 1965, revenue bonds are used to finance capital projects. These bonds are secured by revenue from the projects financed, not the full faith and credit of the state or state taxes.

In addition, revenue bonds may also be issued by a political subdivision of a state, referred to as a "public authority." A public authority is a public bond-issuing entity generally established by statute to finance public facilities that have not or cannot be financed by an existing state agency or that can be better financed by an authority. Authorities usually do not have taxing power, but accomplish their financing with revenue bonds.

There are several different types of public authorities. Some authorities are established to finance public projects that can be repaid with user fees. Others are set up as building corporations to issue debt for constructing state offices and other facilities and repay the debt from leases to the state. A third type of authority provides an interest subsidy (tax-exempt status) to a private activity defined as being in the public interest (for example, health facilities authorities).

The actions of a public authority can affect a state's credit, regardless of whether the authority's issues are backed by the state. Furthermore, public authorities are viewed by some as a means of "back-door financing" because they are normally beyond the control of voters and legislators.

In the nine states we visited, we found that such authorities are used to finance specific projects. For instance, New Jersey has 13 public authorities, which had outstanding debt of almost \$15 billion at the end of 1986. On August 31, 1987, five Illinois state authorities had outstanding debt totaling over \$700 million. Colorado also makes extensive use of public authorities, and their cumulative indebtedness as of 1985 was nearly \$3 billion. New York has 29 major authorities which had \$24.1 billion in outstanding revenue and nonrecourse bonds at the end of 1986.

Another type of nonguaranteed debt is "moral obligation bonds." Typically, these bonds are issued by state agencies under legislation that implies that the state will secure the debt if default is threatened. Usually, the issuing agency must establish a debt service fund from bond sale proceeds. The agency will then use income from its normal sources to meet debt service costs as they become due. However, if this income is not sufficient to meet costs, money is advanced from the debt service reserve fund to make payments. The state, in turn, may then make appropriations to restore the debt service fund.

Moral obligation bonds are not enforceable against the legislature, and the legislature has the legal right to elect to forego such payments. On the other hand, it is assumed that, because the state legislature authorized such debt under these terms, it incurred a "moral obligation" to meet the revenue shortfalls needed for debt service. New York's public authorities, for example, had \$15.4 billion in moral obligation bonds outstanding at the end of September 1986.

As stated above, state debt limits do not apply to nonguaranteed debt, because state debt limits are either silent on the issue, and such debt is generally not considered a legal obligation of the state, or specifically exclude this type of debt from constitutional limitations. As a result, nonguaranteed debt is occasionally used to circumvent or avoid a state's debt limit requirements. Indeed, officials in several of the states we visited indicated that they relied heavily on nonguaranteed debt, partly because it was easier to issue since they did not have to follow the states' legislative limitations regarding debt.

Linkage Between Borrowing Maturity and Asset Life

The nine states we visited generally do not directly link the financing method and borrowing maturity to a capital asset or its useful life. It is sometimes held that linking debt maturity to estimated asset life assures that those who benefit from the asset will be the ones who help pay for it (through their annual taxes used for debt service). However, the states we visited link the type and maturity of the financing more directly to factors other than asset life, such as prevailing market conditions, the states' desire to achieve the best economic results, the need to maintain a high quality bond rating, legislative limitations on the type and amount of debt, and other considerations.

In our review, Kentucky was the only state that attempts to match an asset's useful life to the financial life of its debt. In that state, useful life is determined according to capitalization and depreciation procedures. User agencies advise the financing agency and the budget office of the useful life based on their maintenance and obsolescence experience. However, there are no written state guidelines for determining useful life.

Two of the nine states—Pennsylvania and New York—statutorily require that the life of the project be longer than the project's financing. Although their laws require that the bond life be shorter than the project life, market conditions and the need to keep interest rates as low as possible actually determine the life of bonds issued for capital projects in these two states. Virginia state officials said that financing terms are designed to provide the best economic result for the state and are not tied directly to the individual asset. However, these officials added that financing is not undertaken where the life of the asset would not at least match or exceed the term of the financing.

Generally, we found that the nine states we visited do not link borrowing maturity to a specific asset's life. In Pennsylvania, for example, there is no attempt to associate a specific type of financing with specific assets. Debt issues are usually influenced by general bond market conditions, and they are tied to state programs rather than to specific capital assets. In Georgia, general obligation bonds are the only long-term financing used. According to a Georgia budget official, many factors influence the decision to finance certain assets with debt. These factors include overall fund availability, amount of other commitments or agency requests, market factors, the useful life of the assets, the specific nature of the assets being financed, the size of the bond package, and the legislative attitude about bonds.

Although the nine states generally are not linking borrowing maturity to asset life, some states are using a form of financing known as certificates of participation, where specific assets or a pool of assets are used to secure the debt. The certificates are usually issued for a relatively short period of time, normally 5 years. More importantly, they are not a full faith and credit obligation of the state because the capital assets financed are security for the certificates.

New Jersey is one state that uses certificates of participation, primarily to finance equipment purchases. The state is consolidating all outstanding equipment lease purchase agreements under certificate of participation arrangements. In 1987, for example, New Jersey issued certificates of participation which would give the certificate holders a proportionate share of lease payments that would be made for certain items of equipment, such as computers and helicopters. The certificates' security is the equipment itself, which is specified in detail in the offering prospectus.

Florida also uses certificates of participation, but its process varies somewhat from New Jersey's. Florida's certificates are being used to create a financing pool which can be drawn down as needed for equipment acquisition. However, the certificates' security remains the equipment itself or more directly the "program rental" that will be paid by state agencies for the equipment's use. The equipment that can be acquired under Florida's program is described as "computers, copiers and office equipment, office automation/word processing equipment, typesetting equipment, tractors, telecommunications or telephone system equipment."

New York is also using certificates of participation. However, it imposes a statewide limit of \$160 million. The governor recommends that agencies use certificates of participation for funding the installment or lease purchases of real and personal property.

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