

INFORMATION BRIEF

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Capital Investment and State Bonding

One of the ways the state pays for projects is to borrow money by issuing bonds, which are promises to repay the money borrowed at a specified time and interest rate. There are two main types of bonds: general obligation (G.O.), backed by the full faith, credit, and taxing powers of the state, and revenue bonds, backed by revenues other than from a statewide tax. The state constitution limits the purposes for which G.O. bonds may be issued and requires certain procedures. This information brief describes the law governing state bonding and also compares local bonding authority to state bonding authority.

General Obligation (G.O.) Bonds	2
All State G.O. Bonds	2
Bonds to Acquire and Better Public Land and Buildings	2
Other Constitutionally Authorized Uses of G.O. Bonds	3
Revenue Bonds	4
Other Capital Funding	4
Capital Investment Guidelines	5
State Debt Capacity Forecast	5
State Bond Ratings	6
Capital Appropriation Cancellations	6
Role of Bond Counsel	6
Origination Clause	7
Use of State Bond-Financed Property	7
Nonstate Match Requirements	7
Other Topics Relating to State Bond-Financed Projects	8
Comparison of State Bonding and Local Bonding	9

General Obligation (G.O.) Bonds

All State G.O. Bonds

All state G.O. bonds have certain common requirements. They must be for a public purpose, specified in law, authorized in the constitution, and mature in not more than 20 years.

Public purpose. Under the state constitution, all expenditures of state funds, including bond proceeds, must be for a public purpose. There is a public purpose if the expenditure can reasonably be expected to achieve a legitimate public goal or benefit, even if private interests also benefit. In determining whether the purpose is “public,” one must look at both historical and contemporary standards. The legislature is given great deference in determining a purpose to be “public.” *Visina v. Freeman*, 252 Minn. 177, 184, 89 N.W.2d 635, 643 (1958).

Authorized in the constitution. The state constitution lists the purposes for which G.O. bond proceeds may be used, and G.O. bond proceeds cannot be used for purposes not included in the constitution. [Minn. Const. art. XI](#), § 4. (“The state may contract public debts for which its full faith, credit, and taxing powers may be pledged at the times and in the manner authorized by law, but only for the purposes and subject to the conditions stated in section 5. Public debt includes any obligation payable directly in whole or in part from a tax of state wide application on any class of property, income, transaction, or privilege, but does not include any obligation which is payable from revenues other than taxes.”) This means, for example, that G.O. bond proceeds cannot be used to pay judgments.

Specified in law. “Each law authorizing the issuance of bonds shall distinctly specify the purposes thereof and the maximum amount of the proceeds authorized to be expended for each purpose.” [Minn. Const. art. XI](#), § 7. This may be done by describing the project in some detail or by referring to a governmental program established in statute.

Mature in no more than 20 years. The maximum term of state bonds is 20 years. [Minn. Const. art. XI](#), § 7. However, bonds often mature in less than 20 years, consistent with the useful life of the assets paid for with the bond proceeds and market conditions.

Bonds to Acquire and Better Public Land and Buildings

The principal purpose for which state G.O. bonds are issued is to acquire and better public land and buildings and to make other public capital improvements. [Minn. Const. art. XI](#), § 5, para. (a). The authority to issue public debt to acquire and better public land and buildings and other public improvements of a capital nature was added to the state constitution in 1962.

Capital project. A capital project, in general, is to acquire or improve fixed assets, such as land or buildings. The fixed asset must be long-lived; bond counsel has suggested that the useful life be at least ten years. The improvements must be substantial, extend the useful life or substantially increase the value of the fixed asset, and not be predictable or recurring (as repairs would be). For example, a study or planning is not capital in nature, but design work for a site-

specific capital project is. An option to buy real property is an intangible asset and not eligible for bonding.

Publicly owned. Bonds issued under the capital improvements provision may only be for publicly owned projects, whether state or local. “Publicly owned” includes projects of the Minnesota Historical Society, but not projects owned by public radio, public TV, Indian tribes, or the federal government, or private sewage systems even if they will serve the public.

Three-fifths vote. A law to authorize the issuance of state G.O. bonds for capital improvements must be enacted with at least a three-fifths vote of the House and the Senate. [Minn. Const. art. XI](#), § 5, para. (a). Absent any court decision to the contrary, a law to amend an authorization or appropriation of bond proceeds requires the same super-majority vote. A law to *repeal* an authorization requires only a simple majority vote.

Other Constitutionally Authorized Uses of G.O. Bonds

Under other provisions of the state constitution (included since the dates indicated), state G.O. bond proceeds may also be used:

- ▶ to repel invasion or suppress insurrection (1857);
- ▶ to borrow temporarily through certificates of indebtedness (1962);
- ▶ to refund outstanding bonds of the state or its agencies (1962);
- ▶ to establish and maintain highways subject to constitutional limitations on highway bonds (1924) (see “Trunk highway bonds” below);
- ▶ to promote forestation and prevent and abate forest fires (1924);
- ▶ to construct, improve, and operate airports and other air navigation facilities (1944);
- ▶ to develop the state’s agricultural resources by extending credit on real estate (1922);
- ▶ to improve and rehabilitate public or private railroad rights-of-way and other rail facilities up to \$200 million par value (1982); and
- ▶ as otherwise authorized in the constitution.

[Minn. Const. art. XI](#), § 5, paras. (b) to (j).

Not all of these purposes are capital in nature, and the constitution does not require a three-fifths vote to authorize issuance of bonds for these purposes.

Trunk highway bonds. Bonds issued for trunk highways are G.O. bonds, but payable from the trunk highway fund (with a statewide property tax as backup). Trunk highway bond proceeds pay for state-owned capital projects that are part of, or functionally related to, the construction, improvement, or maintenance of the state trunk highway system. Trunk highway projects may not be paid for with G.O. bond proceeds that are payable in the first instance from the general fund. [Minn. Const. art. XIV](#), § 11; [art. XI](#), § 5, para. (e).¹

¹ See also “Minnesota Management and Budget Guidance Relating to Permitted Uses of State Trunk Highway Bond Proceeds,” Minnesota Management and Budget, memo, December 8, 2008.

No reimbursements. State G.O. bonds are generally tax exempt. Federal tax law severely limits the use of tax-exempt bond proceeds to reimburse costs paid from other funds and failure to follow federal law can result in jeopardizing the tax-exempt status of the bonds, adversely affecting the bondholders. Before any bond fund recipient considers using the money for that purpose, it must consult with Minnesota Management and Budget (MMB) to determine if it is possible.

Revenue Bonds

The constitution neither specifically authorizes nor prohibits issuance of revenue bonds. As with any expenditure of public funds, revenue bond proceeds must be used for a public purpose. A significant limitation on the issuance of revenue bonds is whether the revenue to repay the bonds is sufficient to make the bonds marketable.

Various state agencies have authority to issue revenue bonds. For example, the Minnesota Housing Finance Agency may issue mortgage revenue bonds, and the Minnesota Public Facilities Authority may issue revenue bonds to finance municipal wastewater treatment and other public infrastructure projects.

Other Capital Funding

General fund. Capital projects may be financed with a general fund appropriation and if they are, they are not subject to the same limitations as projects funded with G.O. bond proceeds. However, the general fund capital appropriations are typically still subject to the capital appropriation cancellation law described below.

Agency appropriation bonds. In a few instances, the legislature has enacted a standing appropriation to pay to another public entity each year an amount sufficient to pay the debt service due for the year on bonds issued by that other entity. For example, the legislature enacted a standing appropriation of state general fund money for the University of Minnesota to pay off a portion of the bonds issued by the university for the new Gopher football stadium and another standing appropriation to pay for the biomedical science research facilities. Another example is the standing appropriation to the Minnesota Housing Finance Agency from the state general fund of up to \$2.4 million a year to pay off bonds the agency issued for nonprofit housing.² These are sometimes called “appropriation bonds.” Although each of these laws create a standing appropriation, they also specifically state that the standing appropriation is subject to repeal and unallotment.

State appropriation bonds. In 2011, the legislature authorized issuing state appropriation bonds to refund tobacco revenue bonds issued to pay the debt service on G.O. debt due during the biennium. [Laws 2011, 1st spec. sess. ch. 7](#), art. 11. The attorney general had questioned the

² [Minn. Stat. §§ 137.50 to 137.60](#) (stadium); [Minn. Stat. §§ 137.61 to 137.65](#) (biomedical science research projects); [Minn. Stat. § 462A.36](#) (nonprofit housing bonds).

constitutionality of state appropriation bonds and so the law required the state to bring a lawsuit to test their validity. The state supreme court held that appropriation bonds are not “public debt” within the meaning of the constitution and the state’s full faith, credit, and taxing powers are not committed to their repayment. Therefore, the state may issue appropriation bonds, and those bonds are not subject to the limitations in the state constitution that apply to general obligation bonds. *Schowalter v. State*, 822 N.W.2d 292 (Minn. 2012). In November 2012, the state issued \$656.22 million in state general fund appropriation refunding bonds.

Master lease program. State statute authorizes MMB to issue certificates of participation relative to a master lease in order to acquire capital equipment for state agencies. [Minn. Stat. § 16A.85](#). The statute states that the leases are not debt and payment is subject to appropriations for payment on the leases. It is a way for the state to borrow for capital equipment.

Capital Investment Guidelines

There is no constitutional or statutory limitation on how much debt the state may incur (with the exception of debt for railroads), but since 1979 MMB has had guidelines for issuing debt. MMB adopted new guidelines December 22, 2009, intended to be consistent with measures used by credit rating agencies and allow for easier comparison with other states.³ They are also intended to recognize all tax-supported debt obligations⁴ and continue the state’s conservative financial management practices. Under these new guidelines:

- ▶ total tax-supported principal outstanding shall be 3.25 percent or less of total state personal income;
- ▶ total principal, both issued and authorized but unissued, for state general obligations, moral obligations, equipment capital leases, and real estate capital leases must not exceed 6 percent of state personal income; and
- ▶ 40 percent of G.O. debt must be due within five years and 70 percent within ten years, if consistent with the useful life of the financed assets and market conditions.

State Debt Capacity Forecast

MMB prepares a debt capacity forecast each February and November. The forecast provides a point-in-time status report on the state’s debt in relation to the capital investment guidelines. The governor and the legislature use the forecasts in the capital budget process. Forecasts of the cost of debt service are also made at the same time. [Minn. Stat. § 16A.105](#).

³ <http://www.mmb.state.mn.us/doc/bonds/invest-guide/12-20-09.pdf>

⁴ “Tax-supported debt obligations” includes all state G.O. bonds, appropriation bonds, and the standing appropriations to pay debt service on the University of Minnesota bonds for the new stadium and biomedical science research projects, the Housing Finance Agency’s nonprofit housing bonds, certificates of participation, and lease-purchase financing for equipment and real estate.

State Bond Ratings

State bond ratings are a measure of the risk to investors who buy the bonds, reflecting the state's capacity to pay interest and repay principal. A good rating reflects lower risk and therefore reduces the interest rate the state has to pay. The rating agencies look at the overall economy and financial health of the state and the state's financial management.

Through the 1980s and early 1990s, the state's bond ratings from the national rating agencies, Standard & Poor's Ratings Group, Fitch Ratings, and Moody's Investors Services, Inc., were high but not the highest from all three. The state achieved the highest rating from all three national rating agencies in August 1997 and maintained it until June 2003, when the state was dealing with a massive deficit. In June 2003, Moody's Investors Services, Inc. downgraded the state's rating slightly to Aa1. According to Moody's, issues rated Aa demonstrate very strong creditworthiness and the "1" indicates that the bonds rank at the higher end of the Aa category. In July and September 2011, the other two rating agencies downgraded the state's rating from AAA to AA+. Both rating agencies pointed to what they viewed as the state's failure to address the structural imbalance and an ongoing reliance on nonrecurring measures to balance its budget.

As each bond sale statement says, these ratings are subject to change or withdrawal by the rating agencies at any time.

Capital Appropriation Cancellations

By January 1 of each odd-numbered year, MMB must report to the chairs of the Senate Finance Committee, the House Ways and Means Committee, and the House Capital Investment Committee on the cancellation of general fund and bond-financed projects authorized more than four years before January 1. The unobligated, unencumbered, or unspent project balances included in the report are canceled effective July 1 unless specifically reauthorized by law. [Minn. Stat. § 16A.642](#).

Role of Bond Counsel

While there is some guidance from the courts on the constitutional requirements for and limitations on state bonding, bond questions rarely reach the courts. In order for bonds to be sold, attorneys for the state—called bond counsel—are asked to provide an unqualified legal opinion approving the issuance of the bonds. Without a good opinion, no one will buy the bonds. Thus, the primary guidance the legislature has on what is "bondable" and how the law must be written comes from bond counsel. The state attorney general is bond counsel and also retains private legal counsel to serve as bond counsel.

Under state statute, bond counsel is paid based on time, knowledge, and experience but cannot be paid a fee based primarily on a percentage of the amount of the bonds sold. [Minn. Stat. § 481.21](#).

Origination Clause

Among issues bond counsel considers is whether the law authorizing the issuance of the bonds was properly enacted. Although there is no Minnesota court decision on point, because the state constitution requires imposition of a statewide property tax in the amount needed to repay any state general obligation bonds, bond counsel has advised that it would not be unreasonable for a court to determine that a bill containing a bond sale authorization is a bill to raise revenue, which must originate in the House of Representatives. [Minn. Const. art. XI, § 7](#); [Minn. Stat. § 16A.641](#), subs. 1, 10, 11, and 12.

Use of State Bond-Financed Property

As explained above, state bond-financed property must be publicly owned and be for a public purpose. At times, the best way to provide the public purpose or program is through a nonpublic entity. When that is so, the public owner of a state bond-financed project may enter into an agreement to have a private entity manage the facility and operate its public program with oversight by the public owner. That agreement is subject to approval by MMB. [Minn. Stat. § 16A.695](#).

A public entity that enters into a use agreement with a nonpublic organization for operation of a state bond-financed facility is ultimately responsible for the operation of that facility. Even if the nonpublic operator cancels or walks away from the use agreement, the public entity remains responsible for operating the public program. Unlike general fund appropriations, a public entity is not a “fiscal agent” or pass-through agency for state bond funding. The public entity must have the authority to provide the public program for which the state bond-financed property is acquired or built.

State bond-financed property is subject to the laws governing state bond-financed property for a time period equal to 125 percent of its useful life or until the property is sold as provided in law.⁵ The useful life of the property is determined according to generally accepted accounting principles.

Nonstate Match Requirements

In many cases, additional financing is needed to complete a project above and beyond the amount of the state appropriation, plus matching requirements named in the appropriation bill. In these cases, the grantee must demonstrate that all financing is in place to complete the project. [Minn. Stat. § 16A.502](#).

⁵ Section 3.04 of the “Fourth Order Amending Order of Commissioner of Finance: Relating to Use and Sale of State Bond Financed Property,” Minnesota Management and Budget, commissioner’s order, July 30, 2012. This order implements [Minnesota Statutes, section 16A.695](#).

A nonstate contribution may be cash, a federal funding commitment, a local commitment to issue bonds or levy, or pledged payments that have been deposited into a segregated account or multiyear pledges that are converted into cash or cash equivalent through a loan or irrevocable letter of credit from a financial institution. [Minn. Stat. § 16A.695](#), subd. 6.

Since 1992, state capital appropriations for the University of Minnesota and the Minnesota State Colleges and Universities (MnSCU) have required a nonstate contribution. This has not included appropriations for Higher Education Asset Preservation and Replacement (HEAPR). For the University of Minnesota, the appropriations are intended to cover approximately two-thirds of the cost of each project and the remaining costs must be paid from university sources. For MnSCU, the legislature typically appropriates the full cost of a project and then the MnSCU board of trustees pays the debt service on one-third the principal amount of state bonds issued to finance the projects.

Other Topics Relating to State Bond-Financed Projects

Predesign review and building requirements. The State Architect's Office (within the Department of Administration) must review the predesign documents of most capital projects before design work can begin. [Minn. Stat. § 16B.335](#). In addition, capital funding recipients must not go on to prepare final plans and specifications for any construction, major remodeling, or land acquisition until the agency that will use the project has submitted project information to the legislature for comment.⁶ Also, to ensure that all new state buildings and major renovations of state buildings initially exceed the state energy code by at least 30 percent, all state building capital projects must comply with sustainable building design guidelines developed by the Departments of Administration and Commerce.⁷ [Minn. Stat. § 16B.325](#).

Percent for art. Up to 1 percent of the total appropriation for a state building project of \$500,000 or more may be used to acquire works of art for the building. The art must be accessible to the public. The program is administered by the Minnesota State Arts Board in cooperation with the Department of Administration. If the amount available for art is not used for the state building project, it is available to the board to acquire art for state buildings existing before 1983. The percent for art is not available for landscaping or state correctional facilities. [Minn. Stat. § 16B.35](#).

Use of bond funds for state agency staff costs. MMB adopted a formal policy, developed in consultation with bond counsel, governing use of state bond funds to pay the capital costs of staff directly attributable to the capital project or projects funded with bond funds.⁸ MMB adopted the formal, written policy in response to the December 2008 internal control and compliance audit of G.O. bond expenditures by the legislative auditor. State agencies are still strongly encouraged to charge the time of state employees working on capital projects to nonbond funding sources

⁶ There are exceptions to this requirement. [Minn. Stat. § 16B.335](#), subd. 1(b).

⁷ The Minnesota Sustainable Building Guidelines (MSBG) are available online at <http://www.msbg.umn.edu>.

⁸ "Policy Regarding Use of General Obligation Bond Proceeds to Fund Staff Costs," Minnesota Management and Budget, policy statement, October 20, 2009.

because of the undesirable practice of amortizing such salary costs over the 20-year life of state G.O. bonds.

The 2010 capital investment act was the first law that expressly authorized agencies to use bond funds for staff costs in accordance with this policy.⁹ Without the express authority, otherwise eligible expenditures cannot be made. The legislature may exclude any particular project or agency from this authorization. As part of the 2010 act, MMB “must report by January 15 of each year to the chairs and ranking minority members of the house of representatives and senate committees with jurisdiction over capital investment, finance, and ways and means on the amount and percentage of each agency’s capital appropriation that is used to pay for the costs of staff directly attributable to capital programs or projects funded with state general obligation bond proceeds. The report must also include information on agencies’ compliance with the commissioner’s policies governing the use of general obligation bond proceeds to pay staff costs and any changes to the commissioner’s policies.” [Minn. Stat. § 16A.501](#) (b).

Comparison of State Bonding and Local Bonding

There are four significant differences between state and local government with regard to issuing G.O. bonds: whether voter approval is required, whether there is any limit on the amount of debt, whether nongovernmental entities may own property acquired with the bond proceeds, and the purposes for which the bonds may be issued.

Referendum requirement. One of the main differences between state G.O. bonding and local G.O. bonding is the referendum requirement. In general, local G.O. bonding requires approval of the voters. See [Minn. Stat. § 475.58](#). There are numerous exceptions to that rule both in statute and in special laws. One is the exception for specific types of county, city, or urban town capital improvements that are in the local government’s adopted capital improvement plan. The capital improvement plan elements are specified in statute. Issuance of these bonds is still subject to a reverse referendum. [Minn. Stat. §§ 373.40, 475.521](#). Another exception is that a home rule charter may specify that bonds are not subject to referendum. [Minn. Stat. § 475.58](#).

Limit on net debt. The state has debt management guidelines but not a limit on how much G.O. debt it may have outstanding. In contrast, state statute limits metropolitan government and local debt. See generally [Minn. Stat. § 475.53](#). For metropolitan government, see various provisions of [chapter 473](#). In addition, the state constitution prohibits the legislature from authorizing a city, county, or town from issuing debt to aid railroads if the debt is more than 5 percent of the value of the taxable property within that jurisdiction. [Minn. Const. art. XI, § 12](#).

Public ownership. Under the state constitutional provision that the bulk of state G.O. bond proceeds are appropriated (for improvements to land and buildings), the bond proceeds only may be used for projects that are and remain publicly owned.¹⁰ Local G.O. bonds are not similarly

⁹ [Laws 2010, ch. 189, § 1](#).

¹⁰ Under other, less-used provisions of the state constitution, such as appropriation of bond proceeds for Rural Finance Authority programs and railroad improvements, bond proceeds may be appropriated for privately owned projects.

restricted. For example, G.O. tax increment financing (TIF) bonds may be used for privately owned projects.

Purposes. All public spending, state and local, must be for a public purpose. After that condition is met, however, there are some differences between state and local bonding purposes. As described above, the state constitution specifies the purposes for which state G.O. bonds may be issued. In contrast, the constitution does not address local government bonding.¹¹ Local governments are “creatures of the state” and only have the authority granted to them or necessarily implied by an express grant of authority. The legislature specifies whether local governments may issue bonds and for what purposes, and the legislature has authorized local governments to issue general obligation bonds for some things that would not be eligible for state G.O. bonding, including vehicles and information technology infrastructure. See [Minn. Stat. § 412.301](#).

For more information about debt and bonding, visit the government finance area of our website, www.house.mn/hrd/.

¹¹ Railroads are an exception. As a result of the fiascos of railroad loans soon after statehood, a local government’s aid for railroads is limited by the state constitution. “The legislature shall not authorize any county, township, or municipal corporation to become indebted to aid in the construction or equipment of railroads to any amount that exceeds 5 percent of the value of the taxable property within that county, township or municipal corporation. The amount of taxable property shall be determined by the last assessment previous to the incurring of the indebtedness.” [Minn. Const. art. XI, § 12](#).