Off-budget activities of local government: The bane of the tax revolt*

JAMES T. BENNETT

THOMAS J. DILORENZO*

George Mason University

1. Introduction

Between 1970 and 1980, thirty-two state governments enacted legislation which imposed limits on local government taxing and spending powers.[1] Similar restrictions have been imposed on several state governments, and 32 state legislatures have voted in favor of a convention to add a balanced budget and/or expenditure limitation amendment to the federal constitution. These developments have elicited a good deal of optimism among supporters of the 'tax revolt.' Hopes have been raised that apparently uncontrollable state and local government spending might be constrained. Numerous articles and books have been written on the topic of tax limitation since California's Proposition 13 passed in June, 1978, although, as one reviewer of this literature (Danzinger, 1981) has found, most of it lacks empirical content. In the case of California and other states imposing tax/expenditure limits since 1978, the data necessary to evaluate the impact of these measures are not yet available.

There have, however, been some preliminary empirical investigations of the effects of the tax revolt. The Advisory Commission on Intergovernmental Relations (ACIR) (1977a) conducted a statistical study of the effects of tax/expenditure limitations passed prior to 1976 and concluded that they have indeed led to a reduction in expenditure growth.[2] The ACIR (1981a) also projected that *per capita* state and local spending should be lower in 1981 than in 1978.

This paper provides evidence that state-imposed restrictions have not reduced local government spending to the extent that the preliminary findings indicate. Local governments have responded to tax and expenditure limitat-

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Department of Economics, George Mason University, Fairfax, VA 22030.

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ions by placing billions of dollars of expenditures off-budget, financing them through various 'off-budget enterprises' (OBEs).

Section 2 briefly describes the activities of OBEs at the local level of government and then shows how local governments in five states that enacted tax/expenditure limitations prior to 1975 have used the OBE device to evade these limitations. It is also shown that, on an aggregate level, state limitations on local government taxing and spending powers have resulted in billions of dollars of debt and expenditures being placed off-budget and beyond the direct control and scrutiny of taxpayers. Section 3 contains a summary and the conclusion.

2. Evading the tax revolt: Some empirical evidence

Voter preferences for fiscal restraint are often evaded at the local level of government by conducting many public sector activities through off-budget enterprises which are largely beyond the control and scrutiny of citizen-taxpayers. OBEs are corporations formed by one or more political jurisdictions and are often referred to as authorities, districts, commissions, agencies, and boards. There are thousands of OBEs at the local level of government in the U.S., including over 2,500 in Pennsylvania alone.[3] OBEs have no taxing power, by definition. Rather, their activities, which include the entire spectrum of local governmental activity from airports to water and sewer services, are financed by issuing nonguaranteed (and not voted on) revenue bonds. Since revenue bonds are not subject to voter approval, they are not backed by the taxing powers of any governmental unit but, theoretically, by user charges from projects to be financed. OBEs are thus in theory 'financially independent,' but in reality are heavily subsidized by other units of government. State legislation generally permits local (and state) OBEs to accept loans and grants from other governmental units. Since one of the major advantages of OBEs to the politician is the creation of patronage opportunities which do not appear on-budget, the politician has an incentive to subsidize OBEs, if possible, whenever user charges do not cover expenditures or when they are threatened with default. At the state level of government there are more OBEs in New York than alsewhere, and they are heavily subsidized with state appropriations. In 1980 accumulated state subsidies held by OBEs amounted to $2 billion, approximately $113 per capita.[4] Local governments also typically include subsidies to OBEs in their annual budgets. For example, the city of Chicago directly subsidizes the Chicago Transit Authority (CTA), an OBE, but the CTA still fell into default, despite aid from city tax revenues. The Illinois state legislature provided additional funds for the CTA, and created a regional 'transportation authority' with taxing powers to supplement the existing subsidies to the CTA.[5]

The federal government also subsidizes state and local OBEs through intergovernmental grants, and has done so since the 1930s when the Reconstruction Finance Corporation and the Public Works Administration were created for that purpose. The Advisory Commission on Intergovernmental Relations (1973) lists several dozen federal programs which distribute funds directly to OBEs, bypassing regular governmental units. Providing subsidies to state and local OBEs provides federal politicians with a means of dispensing benefits to their constituents without mandating accompanying on-budget local tax increases (as is often the case when matching grants are given to state and local governments).

The managers of OBEs are typically political appointees who enjoy far greater discretion than do managers of regular local governmental departments or of private industry. In most cases OBEs are exempt from compliance with civil service restrictions, pay no taxes or license fees, are granted monopoly status by legislative fiat, are not regulated by public utility commissions, are exempt from compliance with many state and federal regulations, and have powers of eminent domain which extend beyond the boundaries of the political entity which created the OBE (Walsh, 1980). The major difference between regular governmental departments and OBEs is that OBEs can raise and spend money without reference to the immediate wishes of the electorate, whereas a government can raise and spend money only in the amounts and manner specified by the electorate under the constitution and statutes of the state.[6] Of course, OBEs do serve the interests of concentrated customer groups, inasmuch as monopolies do satisfy their customers.

The principal reason for the establishment of OBEs in the U.S. has been to bypass the wishes of the electorate whenever the voters express a demand for fiscal restraint, as can be illustrated by OBEs in Pennsylvania.[7] During the the late nineteenth and early twentieth centuries, profligate borrowing practices by local governments led to frequent financial crises and defaults on debt payments. As lenders and taxpayers became more suspicious of public borrowing, the state legislature was induced to impose severe restrictions on municipal borrowing by limiting it to 7% of assessed property valuation. Pennsylvania voters were hopeful that their constitution could be used to constrain the irresponsible borrowing practices of local politicians, but in 1935 the state legislature passed the Municipal Authorities Act which exempted 'government-owned corporations' from municipal debt restrictions. Numerous OBEs were soon created to finance school buildings, airports, parking lots, recreation centers, and numerous other activities. Local governments were no longer effectively constrained by the immediate wishes of the voters or by the intent of the state constitution.

In the late 1940s, Pennsylvania voters began pressuring their state representatives for limits on local property taxes, much in the spirit of the 'tax revolt of the 1970s.' As a result, statutory property tax rate limits were enacted in 1949 which applied to cities, boroughs, townships, and school districts. The immediate response of local politicians and bureaucrats was to intensify the use of the off-budget mechanisms. The number of 'municipal corporations' created tripled in 1950, and the amount of nonguaranteed bonds issued increased by 465%, from $11.5 million to $65 million in just one year. Thirty-four 'school building authorities' alone were formed in 1950 compared to a total of fourteen in the preceding fifteen years. The amount of nonguaranteed debt issued by school building authorities increased by 583% in that year, from $2 million to $11.8 million. By 1975 the number of OBEs in Pennsylvania had risen to 2,456 with $4.8 billion in debt outstanding compared to $2 billion in voter-approved 'full faith and credit' local debt outstanding. As of 1975, 71% of total local debt outstanding in Pennsylvania was therefore not approved by and was beyond the control and scrutiny of taxpayers.

There are two types of OBEs in Pennsylvania (and elsewhere) – the 'lease-back authority' and the general operating authority. Most are lease-back authorities which do not operate public facilities; they issue revenue bonds and invest the proceeds in various projects which are then leased to local governments for specified rental payments that are paid from local tax revenues. This organizational structure provides local political decision-makers with an even greater degree of independence from the wishes of the electorate. For example, the state legislature has not yet granted municipalities the right to create lease-back electric utility authorities. Not to be constrained by either voters or their elected state representatives, local politicians have evaded this restriction by creating lease-back *water* authorities, selling their existing water systems to them, and using the proceeds of the sale to expand municipally-owned electric power systems. Furthermore, many municipalities sell existing facilities to specially created OBEs and then lease them back simply to place them off-budget and beyond the view of the voters.

Pennsylvania does not constitute a special case. The tax revolt of the 1970s

Table 1. Nonguaranteed local government debt in Indiana, Kansas, Minnesota, Montana, Wisconsin: 1962, 1972, 1978 (Millions of Dollars)

	1962		1972			1978		
State	Amount	% of total	Amount	% Change 1962-72	% of total	Amount	% Change 1972-78	% of total
Indiana	$459.1	52.8%	$966.4	110%	53%	$1,957.6	103%	68%
Kansas	160.0	25.6	444.8	178	44	1,161.5	161	56
Minnesota	175.3	16.5	391.8	124	14	1,421.9	263	33
Montana	35.7	27.5	63.4	78	37	376.4	494	70
Wisconsin	128.9	12.8	217.1	68	11	705.0	225	24

Source: *Compendium of Governmental Finances* (Washington, D.C.: Bureau of the Census, 1962, 1972) and *Moody's Municipal and Government Manual* (New York: Dun and Bradstreet Co. 1981).

has yielded a similar response notionwide. This can be seen by first examining the local governmental borrowing activity in five states which enacted tax or expenditure limitations on local governments during the early 1970s.[8] The five states, with the year in which tax/expenditure limits were enacted in parentheses, are: Indiana (1973), Kansas (1970), Minnesota (1972), Montana (1974), and Wisconsin (1973). Table 1 shows the amounts of nonguaranteed local government debt in these states in 1962, 1972, and 1978. In each state, both the amount of nonguaranteed debt and the ratio of nonguaranteed to total long-term local government debt increased substantially more during the 1972-78 period than during the 1962-72 period. The most dramatic increase occurred in Montana, where nonguaranteed debt increased by 494% between 1972 and 1978. The ratio of guaranteed to total long-term debt in Montana increased from 37.1% in 1972 to 70% in 1978. In both Wisconsin and Minnesota the ratio of nonguaranteed to total long-term local debt declined from 1962 to 1972, and then more than doubled in each state during the 1972-78 period. Indiana's nonguaranteed to total debt ratio remained approximately constant for ten years, and then rose from 53.2% in 1972 to 68% six years later. On average, the amount of nonguaranteed local government debt in these five states increased by 249% between 1972 and 1978 (compared to an average 112% during the previous decade).

In comparison, those states which had enacted no restraints whatsoever on local government taxing and spending powers prior to 1977 experienced a much slower increase in the amount of nonguaranteed debt issued, and had significantly lower nonguaranteed to total long-term debt ratios as Table 2 shows. These states had an average nonguaranteed to total debt ratio of 26.7% in 1978 compared to 50.2% in the 'tax-limitation' states. The null hypothesis

Table 2. Nonguaranteed local government debt in states without tax or expenditure limitations prior to 1977 (Millions of Dollars)

State	1962 Amount	1962 % of total	1972 Amount	1972 % Change 1962-72	1972 % of total	1978 Amount	1978 % Change 1972-78	1978 % of total
Arkansas	$ 88.6	34%	$ 517.0	574%	64%	$ 650.6	26%	60%
California	1,477.8	26	3,858.1	161	34	6,152.3	59	43
Connecticut	145.9	18	149.2	2	12	309.0	107	20
Hawaii	37.9	28	47.5	25	18	33.4	−30	10
Maine	41.1	35	31.5	−23	14	29.2	− 7	21
Massachusetts	373.3	30	296.9	−20	11	883.0	197	24
Tennessee	481.8	41	912.5	89	40	1,517.0	66	42
Vermont	3.2	7	8.6	169	7	22.6	163	19
Maryland	221.3	18	371.6	68	15	588.4	58	17
New Hampshire	12.7	14	29.2	130	12	41.3	41	11

Source: *Compendium of Governmental Finances, Moody's Municipal and Government Manual.*

that the mean ratio for the tax-limitation states is equal to that of the 'no-limit states' was tested against the one-sided alternative that the mean ratio in the former group exceeds that of the latter. The null hypothesis was rejected at the .025 level of significance. In addition, the ratio of nonguaranteed to total long-term debt increased, on average, by 5.6 percentage points in no-limit states and by 18 percentage points in tax-limit states during the 1972-78 period.

From the evidence it is clear that even though tax and expenditure limits may have reduced the growth of on-budget local expenditures in the five tax-limit states as the ACIR (1977a) claimed, billions of dollars of debt and expenditure have been placed off-budget through the OBE device, as described above.

Even though many consider the passage of California's Proposition 13 in June, 1978 to be the beginning of the 'taxpayer revolt of the 1970s,' the tax revolt was simmering throughout the 1970s. And, as shown below, so has the growth of the off-budget local public sector. The tax revolt has been gaining momentum at the local level of government throughout the past decade. Eleven states passed eighteen different initiatives during the 1970-73 period (ACIR, 1981b). Only three spending restrictions were passed in 1974 and 1975, but the tax revolt began to intensify in 1975 when voters passed only 29% of the total amount of bond issues subject to referenda compared to 62% in 1974.[9] The tax rebellion became much more pronounced in 1976. In 1976 and 1977, eleven states imposed tax or spending limits on local governments, followed by 16 more states in the following two years, including the infamous Proposition 13. Thus it appears that the tax revolt of the 1970s began in earnest in 1976, although it had been fermenting since 1970.[10]

That the tax revolt of the 1970s has elicited a massive amount of off-budget spending and borrowing activity at the local-level of government can be seen below in Figure 1 and in Table 3. Figure 1 plots the ratios of nonguaranteed to guaranteed (NG/G) and negotiated to competitively bid (N/C) municipal security sales.[11] Nearly all guaranteed municipal securities are sold through competitive bids among a number of competing underwriters. In contrast, OBEs generally negotiate with a single underwriter. Throughout the 1970s there has been a continuous increase in both the NG/G and the N/C ratios. A most striking feature of Figure 1 is the sharp increase in the NG/G ratio beginning in 1976, with the intensification of the tax revolt. After an average yearly increase of 19.4% for 10 years, the amount of nonguaranteed local debt issued in 1977 increased by 66%, from $17.2 to $28.6 billion. By 1980 nonguaranteed revenue bond sales had increased to $34.3 billion, while sales of voter-approved guaranteed municipal debt had fallen from $18.2 billion in 1976 to $14.1 billion, increasing the NG/G ratio from .95 to 2.43.

The N/C ratio also rose sharply with the intensification of the tax revolt. After increasing by an average 27% per year from 1966-1974, the volume of negotiated municipal security sales increased by 52%, from $6.9 billion to

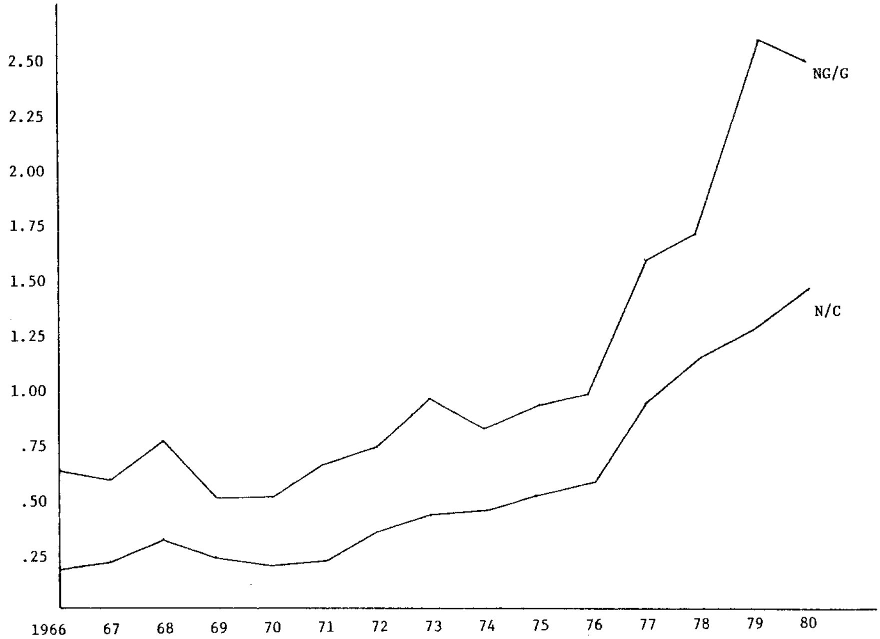

Figure 1. Ratios of negotiated/competitive (N/C) and nonguaranteed/guaranteed (NG/G) municipal security sales: 1966-80

\$10.6 billion in 1975. This is largely the result of the small percentage of guaranteed debt (29%) approved by voters during that year. Between 1975 and 1980, the volume of negotiated municipal security sales increased by 162%, from \$10.6 to \$27.8 billion, while competitively-bid sales remained at approximately \$19.5 billion. The N/C ratio rose from .42 in 1974 to 1.43 in 1980. Thus the tax revolt has incited a rapid increase in the growth of the off-budget local public sector, although this expansion may have levelled off since 1979, as shown in Figure 1.

As a final piece of evidence consider the pattern of new issues of state and local government securities, by type, as shown in Table 3. The category 'Special District/Statutory Authority' is the Census Bureau terminology for off-budget enterprise, and lists the nonguaranteed debt of OBEs at the local *and* state levels of government. Even though these data are incomplete, since some states do not even gather data on OBE activity at the local level of government, they nevertheless show a striking increase in OBE debt beginning, once again, in 1975. Since 1975 OBE debt has been the largest and fastest-growing type of state and local government debt issued. OBE debt increased by 172% between 1974 and 1980, while the voter-approved debt of municipalities, counties, and townships combined increased by 44%, and the guaranteed debt issued by state governments actually declined by 9%.

Table 3. New issues of state and local government securities: 1970-1979 ($ billions)

Item	1970	1972	1973	1974	1975	1976	1977	1978	1979
All Issues	18.2	23.7	24.0	24.3	30.6	35.3	46.8	48.6	43.5
Guaranteed	11.9	13.3	12.3	13.6	16.0	18.0	18.0	17.9	12.1
Nonguaranteed	6.1	9.3	10.6	10.2	14.5	17.1	28.7	30.7	31.3
Type of Issues									
State	4.2	5.0	4.2	4.8	7.4	7.1	6.4	6.6	4.4
Special District/ Statutory Authority	5.6	9.5	9.5	8.6	12.4	15.3	21.7	24.2	23.4
Municipalities, Counties, Townships	8.4	9.2	10.2	10.8	10.7	12.8	18.6	17.7	15.6

Source: *Statistical Abstract of the U.S.* (Washington, D.C.: U.S. Bureau of the Census, 1980), p. 300.

Overall, new issues of nonguaranteed debt continued to increase through 1979, although not as rapidly as during the 1974-77 period, while guaranteed debt issues fell steadily from 1976 to 1979. The sharp decline in guaranteed debt from 1978 to 1979 is mainly responsible for the fact that *total* state and local debt issued fell in 1979 for the first time in ten years. Thus, it appears that the tax rebellion elicited a dramatic increase in off-budget spending and borrowing in 1977, and continues to do so, but at a slower rate.

In summary, these data show that local (and state) politicians and bureaucrats have responded to the tax revolt of the 1970s by placing billions of dollars of debt and expenditure off-budget and beyond the control and scrutiny of the voters. Reports that the tax revolt has reduced the burden of taxation at the local level of government are therefore uncertain. Although data on property taxes may indeed show a relative slow-down, the true opportunity cost of government is not measured by explicit taxes, as Friedman (1978) asserted, but by government spending. And there is no conclusive evidence that local government spending has been reduced; its *rate* of growth may have been reduced somewhat, and much of it has merely been concealed.

3. Summary and conclusions

This paper has demonstrated that the tax revolt of the 1970s has not been as successful in reducing the level of state and local government expenditure as preliminary empirical findings indicate, and that the rate of increase in state and local public spending is likely to be far greater than previously believed. The evidence presented here shows clearly that constitutional and statutory limitations on the taxing and spending powers of local governments have led to a massive amount of off-budget spending and borrowing. The debt issued by off-budget enterprises is larger and growing at a much faster rate than the voter-approved debt issued by state and local governments, and has been since 1975. Thus, even though statistics on property taxation and expenditure may indicate a slow-down in the growth of local taxation, the true cost of local government may continue to increase at previous rates, although this is an empirical question which we are not yet able to address. Off-budget enterprises are heavily subsidized by local, state, and federal governments. These subsidies represent a hidden tax liability to present and future generations of taxpayers. In addition, the debt and expenditures of OBEs contribute substantially to the crowding-out of private spending and investment.

NOTES

1. See the Advisory Commission on Intergovernmental Relations (ACIR) (1981b) for a taxonomy of these limitations.
2. Although many believe that the tax revolt began with California's Proposition 13 in June, 1978, there existed 32 state-imposed restrictions on local government taxing and spending powers prior to 1970, and 31 more were added between 1970 and 1977.
3. See Walsh (1980) for a discussion of the organization of OBEs, which she refers to as 'public authorities.'
4. See New York State, Office of the Governor (1981). Politicians often remove these subsidies from their budgets. For example, in 1962 Governor Rockefeller altered the accounting laws in New York State so that state subsidies to OBEs would not be included in the annual budget. These laws have since been repealed.
5. See Walsh (1980: 158).
6. The expenditures, employment, and debt of OBEs are not included in the statistics reported by the political jurisdiction which created the OBE. For this reason, all reported statistics on the size of local (and state) governments are seriously understated.
7. This discussion is based on Schlosser (1977).
8. ACIR (1977a).
9. ACIR (1977b: 74).
10. In 1969, James Buchanan and Marilyn Flowers (1969) anticipated the tax revolt of the 1970s and developed an 'analytic setting for a taxpayers' revolution.'
11. Data on municipal securities sales were obtained from the Public Securities Association (1981).

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