POLICY REPORT

Volume IV Number 4 | A PUBLICATION OF THE CATO INSTITUTE | April 1982

Off-Budget Operations and Fiscal Responsibility

By James T. Bennett and Thomas J. DiLorenzo

The "tax revolt" of the 1970s, the election of President Reagan, whose commitment to lower taxes and reduced federal spending struck a responsive chord, and public opinion polls all reveal that American taxpayers are disillusioned with paying more in taxes and receiving less in services from the public sector. In the tradition of the nation's founders, Americans have turned to constitutional and statutory constraints on governmental powers to limit both the size and scope of government at all levels. Since 1970, 32 states have imposed legal limitations on local government taxing, spending, and borrowing powers; similar restrictions exist for a number of state governments. In an effort to restrain the fiscal operations at the federal level, 30 state legislatures have voted for a convention to adopt a balanced budget amendment to the Constitution.

Evidently, there is considerable faith in the ability of balanced budgets and tax/expenditure limitations to induce government to become more efficient and responsive. Unfortunately, the historical evidence on such restrictions at the state and local levels reveals that this faith is based on fantasy rather than fact. For nearly a century, state and local politicians have easily evaded fiscal restraints — both constitutional and statutory — by the simple expedient of redefining the budget. Politicians can routinely ignore expenditure and debt controls that apply to the public sector by creating "off-budget enterprises" (OBEs), which are beyond the control and scrutiny of taxpayers. At the federal level, off-budget operations have grown at an astounding rate in the past several years and, as pressures for a balanced budget mount, can be expected to play a major role in circumventing the taxpayer's desires for a fiscally responsible federal sector.

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"The loan guarantees administered by the FFB constitute 'backdoor financing' of additional government control and regulation of the private sector."

Government Evades the Tax Revolt

OBEs are corporations created and owned by one or more political jurisdictions and are often referred to as authorities, districts, commissions, agencies, and boards. OBEs are formed by a public statute that defines their powers. In over two thirds of the states, local politicians establish OBEs by ordinances of various types, within the terms of general enabling legislation adopted by the state legislature. In most states, all that is required is the filing of a corporate charter, but in a few states, such as New York, OBEs must be chartered by special acts of the legislature. There are thousands of OBEs at the local level, including over 2,500 in Pennsylvania alone.[1]

OBE activities, which include the entire spectrum of local governmental activity from airports to waste water treatment, are financed by issuing nonguaranteed 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 fees from the OBE's activity. Because OBEs typically do not receive appropriations, their spending and debt do not appear on government budgets. Thus, OBEs are in theory financially independent, but in reality are heavily subsidized by other units of government. The managers of OBEs are generally patronage 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 and many state and federal regulations, pay no taxes or license fees, are not regulated by public utility commissions, and have powers of eminent domain, which can extend beyond the boundaries of the political entity that created the OBE.[2] Moveover, the expenditures, borrowing, and employment of OBEs are not included in the reported statistics of the political jurisdiction (or jurisdictions) that forms them.

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, but the constitution and statutes of the state constrain the amounts and the manner that regular governmental departments can raise and spend money. In fact, the principal reason for the establishment of

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EDITORIAL

The "New Federalism"?

President Reagan's "New Federalism" is not new. We've seen other "new" programs — the New Deal, the New Frontier — that were seriously flawed. We've also seen other misguided variations on federalism, including Creative Federalism, Cooperative Federalism, Picket-Fence Federalism, and Marble-Cake Federalism.

The two articles in this issue examine two critical policy areas (finance and energy) to see how responsibly and efficiently state and local governments can be expected to perform their duties. President Reagan claimed that his New Federalism will cut through waste and abuse with "one bold stroke." The evidence, however, indicates otherwise.

The New Federalism initially calls for transferring the food stamp and Aid to Families with Dependent Children programs to the states while Washington would assume responsibility for the entire Medicaid program. Presumably Washington would then begin transferring to the states at least 40 other programs costing more than $30 billion dollars a year. The federal government would continue to support these programs through a $28 billion trust fund financed by federal excise taxes. This funding would be phased out between 1987 and 1991. By 1991 the states would be fully responsible for the programs and could either expand, reduce, or kill them. Most likely, however, new funding would be established soon after 1987.

Contrary to common opinion, big government is not confined to Washington. Both state and local governments are growing. State government is already larger and continues to grow at a faster pace than the federal government. State governments employ more people, spend more money, and have chalked up larger deficits in 7 out of the past 10 years than the federal government — total state deficits hit $119 billion in 1980.

Gregg Easterbrook, writing in the January, 1982 *Washington Monthly,* has provided a number of illuminating facts for examining how well state governments avoid the boondoggles so prevalent at the federal level. Thirty-two states now have agencies modeled after the U.S. Environmental Protection Agency that issue edicts contradictory to EPA's and those of neighboring state agencies. Thirty-five states have agencies modeled after the federal Department of Transportation. The same number now have "cabinet government." Not all agencies, however, are based on federal models; the states have ingeniously developed some of their own, like the Colorado Board of Abstractors and the Dormitory Authority of New York.

How bad is waste and abuse at the state level? Take a look at Reagan's home state of Illinois, in "To be governed . . ." Illinois is hardly an aberration. In Wisconsin, there is an agency created in 1973 called the Solid Waste Recycling Authority, created to issue bonds for recycling projects. It has never issued a bond but somehow managed to spend $1.5 million dollars. One of New York City's many boondoggles is the Westway project. It provides a good indication of what to expect from the New Federalism. Westway is federally funded but administered by the state and city. This four-mile stretch of road cost at least $2.2 billion — that's $550 million per mile, more expensive than any highway — or subway — ever built.

Reagan also wants to limit fraud, well documented in federal programs, and not uncommon among state and local officials. For example, 120 current and former county commissioners have been found guilty in Oklahoma's highway kickback scandal; 130 more are expected to be prosecuted. In Tennessee three of Governor Ray Blanton's top aides were arrested on charges of selling state pardons for money. One aide told investigators that he would sell a pardon to any criminal except one who had "molested a minor child." Easterbrook provides us with one more example that illustrates the extent of possible fraud. Daniel Gonzales Roman was the director of the Miami Cruz Outreach Center in Florida, a federally funded, state-supervised community facility. Roman put himself on the payroll twice under two names — Daniel Roman, director and Daniel Gonzales, clerk-typist. When discovered, Roman claimed he deserved both salaries since he did his own typing.

State and local bureaucracy is as entrenched as the federal government's. There is overwhelming evidence that state and local regulatory personnel are not willing to act against their self-interest and cut waste and abuse. These people have an incentive to resist change unless it involves spending more money. To expect them to fight abuse and inefficiency and to stem waste is as unrealistic as expecting responsible behavior out of Congress.

If Ronald Reagan was really serious about eliminating programs rife with fraud, abuse, corruption and inefficiency, he could do it. And he could do it with "one bold stroke" — by eliminating those programs entirely. This would be indeed a bold move and a needed one. ■

OBEs in the U.S. has been to subvert the wishes of the electorate whenever the voters express a demand for fiscal restraint on the part of local political decision-makers. This can be illustrated by looking at OBE's in Pennsylvania.[3]

During the late 19th and early 20th 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 various other activities. Local governments no longer had to be concerned with either the immediate wishes of the voters or with 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, in 1949 statutory property tax rate limits were enacted that 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" tripled in 1950, and the amount of nonguaranteed bonds 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 14 in the preceding 15 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. This meant that 71% of total local debt outstanding was beyond the taxpayer's control.

Two Kinds of OBEs

There are two types of OBEs — the "lease-back authority" and the general operating authority. Most Pennsylvania OBEs are lease-back authorities that 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 paid from local tax revenues. This organizational structure provides local political decison-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 state representatives, local politicians have evaded this restriction by creating lease-back *water* authorities, to which they sell their water systems and use the proceeds 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 is not a special case. In 1980, of the total long-term municipal security sales in the U.S. of approximately $48.4 billion, fully $34.3 billion, or 71%, were nonguaranteed revenue bonds. This compares to 48% in 1975 and 34% in 1970.[4] In addition, since 1975 the nonguaranteed debt of "public authorities and special districts" has been the largest single source of new state and local government security sales, comprising $23.4 billion in 1979; in contrast, guaranteed (and voter-approved) debt in that year totaled $4.4 billion for state governments and $15.6

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POLICY REPORT
ISSN: 0190-325X

Published by the Cato Institute, *Policy Report* is a monthly review that provides in-depth evaluations of public policies and discusses appropriate solutions to current economic problems.

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Subscriptions and correspondence should be addressed to: *Policy Report*, P.O. Box 693, Englewood, CO 80151. The annual subscription rate is $15.00 (12 issues). Single issues are $2.00 per copy. *Policy Report* is published monthly by the Cato Institute, 224 Second Street SE, Washington, D.C. 20003. Second-class postage paid at Washington, D.C.
POSTMASTER: Send address corrections to P.O. Box 693, Englewood, CO 81501.

Off-Budget Operations (Cont. from p. 3)

billion for municipalities, counties, and townships combined.[5] As a percentage of total state and local government security sales, special districts and public authorities were responsible for 54% in 1979 compared to 31% nine years earlier. The investment activity of off-budget enterprises is massive, more than that of regular units of government, and rapidly increasing as a result of state-imposed local government tax and expenditure limitations.

Off-budget enterprises flourish at the state level as well. New York has the most; consequently, voters in that state cannot effectively control government spending by either constitutional means or by referendum requirements. New York's constitution does have a referendum requirement for all proposed general obligation borrowing of the state, which is backed by the "full faith and credit" of the state government. However, bond referenda in the state have placed no constraints whatsoever on government borrowing.[6]

In 1956 voters rejected a $100 million housing bond issue for the third time; Governor Rockefeller created the Housing Finance Authority, which issued massive amounts of nonguaranteed debt, at one point in excess of the entire guaranteed debt in New York State. In 1961 voters rejected a $500 million higher education bond issue for the fourth time; the governor created the off-budget State University Construction Authority. In 1965 the voters rejected, for the fifth time, a housing bond issue; and the governor created the Urban Development Corporation. By 1975, 81% of the total debt outstanding of New York State was the nonguaranteed debt of OBEs. In the areas of health and higher education, voter-approved debt stood at $283 million compared to approximately $5.8 billion in nonguaranteed debt outstanding for these functions. From 1964 to 1975 the state's own debt for construction programs increased by $2 billion. Although the state's OBEs are theoretically financially independent, they are heavily subsidized by the state and federal governments. In 1980 accumulated *state* subsidies in the coffers of OBEs was about $2 billion, approximately $113 per capita.[7] Obviously referendum requirements have little effect since billions of dollars of debt are placed off-budget to finance a myriad of often extravagent projects, including horse breeding farms and "space development." OBE activity in New York State is not atypical, and federal sponsorship of OBEs at the state and local level has been widely felt and nonpartisan.

"The principal reason for the establishment of off-budget enterprises has been to subvert the wishes of the electorate."

The implications for taxpayers are ominous: Constitutional or statutory restrictions on state and local government taxing, spending, and borrowing have never been effective; politicians have been able to ignore all fiscal constraints by simply moving large segments of the public sector off-budget. There is much cause for concern that similar actions will be taken by the federal government.

Off-Budget Federal Outlays

The Congressional Budget and Impoundment Control Act of 1974 has been praised by *U.S. News & World Report* as "a revolutionary budget reform intended to give Congress a tighter grip on the nation's purse strings."[8] The Budget Reform Act emerged from a recognition that existing budgetary procedures generated a bias toward overspending and budget deficits. Prior to 1974 the total amount of federal spending was the product of many individual appropriations decisions; no decision was ever made regarding the total amount of public expenditure. The Budget Reform Act created a Budget Committee for each house responsible for setting overall targets for revenues, expenditures, and the resultant deficit or surplus. The Congressional Budget Office was created to assist in this process.

The main impact of this act is to make taxing, spending, and deficit levels explicit; the act itself does nothing to curb spending. In keeping with traditions established at the state and local levels of governments, the "up front" requirements of the law have elicited a good deal of "backdoor" federal spending, with numerous federal agencies placed off-budget and immune from any appropriations process. Estimated 1981 federal outlays by agency include the following: Federal Financing Bank ($23.1 billion), Rural Telephone Bank ($200 million), U.S. Postal Service Fund ($200 million), U.S. Railway Association (−$300 million). Total off-budget federal outlays have grown by an astounding 23,100% since 1973, increasing from $100 million to $23.2 billion. Most recently, both the Strategic Petroleum Reserve and the Synfuels Corporation were placed "off the books."

The Federal Financing Bank (FFB) is by far the most active off-budget agency.[9] The FFB, a part of the Treasury Department, does business with both on- and off-budget federal agencies. The major activity of the FFB is the purchase of agency debt from funds obtained by borrowing directly from the Treasury. FFB borrowing is not, however, included as part of the Treasury's budget outlays; interest payments from the FFB to the Treasury are, nevertheless, counted as deductions from Treasury outlays. Consequently, FFB borrowing activity actually results in a reduction in outlays reported by the Treasury Department. In essence, the FFB serves as an intermediary, which permits the spending of federal agencies to be placed off-budget.

A second type of FFB activity is the purchase of agency loans and loan assets. When a federal agency sells a loan to a private entity, the loan is considered repaid for budgetary purposes. Loan sales are afforded the same treatment when the FFB is the purchaser. Proceeds from the sale are counted as loan repayments rather than as a means of financing, and thus are an offset to the agency's gross expenditures. An agency's *on*-budget loan can therefore be converted to an *off*-budget loan by selling it to the FFB. In 1981 about 90% of all federal agency loan and loan asset sales will be to the FFB.

Rather than selling actual loans, an agency can sometimes pool its loans and issue securities backed by the pooled loans. These securities, known as "Certificates of Beneficial Ownership," can be sold to the FFB, which places them off-budget.

The FFB also purchases guaranteed loans. Typically, a loan guarantee occurs when a federal agency sanctions a loan between a private lender and a private borrower. The result is an interest subsidy to the borrower at no explicit cost to the Treasury, unless the borrower defaults. Frequently, however, an agency will ask the FFB to act as the private lender and purchase the borrower's note. In this case the loan guarantee becomes, in effect, a direct loan from the government, which is not reflected in the budget. In 1981 FFB purchases of loan guarantees are estimated to be $10-20 billion and are likely to have major allocative and distributive effects on capital markets. With an increase in guaranteed borrowing (both on- and off-budget), there is a relative reduction in the supply of funds available for nonguaranteed borrowing. The competition for the reduced supply of funds bids up the interest rate charged and contributes to the crowding out of many investment projects. Economist Herbert M. Kaufman of Arizona State University estimated that for every $1 billion in loan guarantees, between $740 million and $1.32 billion in investment is crowded out, which results in slower

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Briefs

☐ The Department of Energy recently spent several thousand dollars to revise an advance version of its briefing book so that President Reagan's plans for the agency can now be described as "reorganization" rather than "dismantlement." Under Secretary Guy Fiske explained that reorganization "is more descriptive of what we're trying to do." Meanwhile, Alan Dean, who had been the coordinator of President Nixon's plan for restructuring the government, said that "even if the Energy Department were disabled it would only yield minor savings." Harold Seidman, a budget official under both Kennedy and Johnson, noted that, "Whatever modest savings might be achieved by dismantling the overhead structure of the Department of Energy would be more than offset by the measurable and immeasurable costs of reorganization." Seidman added, "Tangible savings are produced by the elimination of programs, not by moving organizational boxes around."

☐ A study of previous budget deficits has revealed that, more often than not, Presidential budget estimates have been overly optimistic. In the last 19 years, revenues were underestimated nine times, outlays were underestimated 11 times, and deficits, 12 times. The Carter administration holds two of these records — the highest revenue overestimate ($55 billion in fiscal 1978) and the highest outlay underestimate ($45 billion in fiscal 1980).

☐ The recent failure of Freddie Laker's famed Laker Airways has left the Export-Import Bank with a series of claims against Laker totaling $147 million. This sum is secured only by a first mortgage on five of Laker's aircraft — considered to be of doubtful value in today's market. Laker's debts arise from an $86 million loan that the Bank approved just two years ago as well as an Ex-Im guarantee of $61 million that Laker borrowed from a private export funding consortium.

☐ Francois Mitterand's socialist government in France recently fulfilled a number of its campaign promises when its nationalization bill became law. Under the bill, five major industrial groups, two steel companies, two financial holding companies, 39 French banks, and large segments of the armament and aerospace industries came under complete state control.

☐ Oil experts claim that one of President Reagan's chief devices for holding the 1983 deficit under $100 billion is unworkable and will produce far less revenue than expected. The president estimated that the Interior Department will collect $18 billion from offshore oil and gas royalties and drilling fees. However, such a sum is 230% higher than what this source is expected to yield this year. Senate staffer D. Michael Harvey pointed out: "There is a long history at the Office of Management and Budget of pumping up the OCS [Outer Continental Shelf] revenues to make budget figures look good." The question is not ". . . whether it's inflated, there's no question about that. But inflated by how much?"

☐ A study by the American Public Welfare Association concluded that the Reagan administration changes in the Aid to Families with Dependent Children program will only save the federal government $434 million in fiscal 1982, instead of the $1.026 billion savings that Reagan had expected. The study attributed the difference to slow state implementation of the changes, inaccurate and outdated data used in federal calculations, the current recession, and a systematic underestimation of the number of families who are eligible or will become eligible for benefits. ■

State Petroleum Regulation Reconsidered

By Rob Bradley, Jr.

Current debates over energy policy are almost exclusively relegated to the federal level. Questions about natural gas price decontrol, standby emergency allocation authority, federal land lease policy, oil company mergers, synfuel subsidization, and the crude oil windfall profits tax preoccupy the day. Forgotten, however, are the myriad of state laws governing oil and gas production called "conservation regulations." Although some are not as restrictively employed as they once were, they remain on the books and lie in waiting should the oil market go from a "sellers' market," as it has been since 1972, to a "buyers' market," as it was prior to this time.

Today, 40 states have conservation laws, 32 of which produce oil and gas. All regulating states with significant production are members of the Interstate Oil Compact Commission, a quasi-governmental agency established in 1935, once described as "the most powerful powerless organization in the world." The IOCC, with the blessing of Congress, serves as a clearinghouse to recommend and coordinate policies among its member states.

There are three aspects of conservation regulation: The prevention of external damage by wells, the control and restriction of oil and gas production, and mandatory cooperative production.[1] These correspond to the goals of conservation law: The abatement of surface nuisances, the prevention of natural resource waste, and the protection of correlative rights between reservoir co-owners.

Historical Setting

The "necessity" of conservation law, reflecting the myth that market competition based on the "rule of capture" inherently created conditions of overproduction and waste, requires a detailed, documented discussion that cannot be undertaken here.[2] Suffice it to say that in the early days of the industry, before production could be based on the principles of reservoir mechanics, operators believed that more wells and open-flow production recovered more "rock oil" than fewer wells with restricted rates of flow. This production technology, unbeknown to producers,

> **"Economists have generally concurred that petroleum conservation law has bloated industry costs and raised prices for consumers."**

created the "wastes" of overdrilling and lowered recoverability. In the middle of the late 1920's, when the oil community realized this they saw the need to coordinate production within commonly owned reservoirs to build fewer wells (to minimize costs) and lower withdrawal rates (to maximize discounted profits). This proved to be difficult. In addition to the usual resistance to such a radical change in production philosophy, government policies discouraged the transformation to "pooled" or "unitized" production. State and federal antitrust laws prohibited associations from forming to restrain output (and thus increase price). Moreover, operators feared that pooled or unit operations would become associations taxable as a corporation. And finally, pooling and unitization were prohibited on federal land.

Then in the midst of the Great Depression the 211-square-mile East Texas oil field was discovered, the largest in the contiguous United States. With national output almost instantaneously doubled, demand for crude products falling, and town-lot promoters sinking wells and pulling out oil as fast as possible, prices declined radically. Rather than allow weak, inefficient companies to declare bankruptcy or initiate distress mergers — a consolidation that was sorely needed to get the industry on a fewer well/delayed production basis — martial law was declared in well zones in Texas and Oklahoma by the state governors, followed by shutdowns and tight production regulations. In other words, a legal damper was placed on the market processes of consolidation and firm exit. The year was 1931, and modern conservation regulation, replacing the "self-help" alternative, came of age.

The Prevention of External Damage

The earliest aim of conservation law was to protect fresh water from oil and salt water brine. Laws were passed requiring the casing of wells in progress and the plugging of wells once abandoned. Since that time, the laws have become more rigorous in intent and comprehensive in scope to include well-site safety. The proposed 1982 model statute of the IOCC recommends that states "require . . . the drilling, casing, operating and plugging of wells in such manner as to prevent . . . the escape of Oil and Gas out of one Reservoir into another, . . . the pollution of fresh water supplies by Oil, Gas, or salt water, and blowouts, cavings, seepages, and fires." Today, all 36 IOCC members and two nonmembers, Missouri and Virginia require drilling permits, and 31 members and Missouri and Virginia require compliance bonds to ensure proper well casing and plugging.

These regulations are the least controversial and restrictive of all conservation law. Although before-the-fact regulations are not to be preferred over a property rights system that emphasizes provable damage as invasion subject to restitution, the regulations for the most part are least restrictive when compared to what self-interested business behavior would be in their absence.

Rob Bradley, Jr., is writing a book on the history of energy regulation.

The Control and Restriction of Production

The most severe production restriction of a conservation agency is the well, pool, or field *shutdown*. The "oil holidays," legally possible when waste is perceived to be occurring, give the authorities time to devise a regulatory program while preventing "waste" in the interim. Shutdowns have been rare in recent years and have occurred most frequently with individual wells. Virtually every regulating state has authority in this area.

Well-spacing regulations, the first of which was passed by Texas in 1919, dictate minimum distances between wells, wells and property lines, and wells and certain structures (such as roads and houses). Early laws were passed to reduce fire hazards and pollution; later, well-density restrictions were devised, primarily to prevent "unnecessary" well construction and drainage competition between common-pool owners. Twenty-nine states currently have well-spacing regulations between wells, the most common density being one oil well per 40 acres and one gas well per 640 acres. Nine states, including Alaska and California, rely solely on spacing statutes to regulate production; the other 20 states use spacing rules in conjunction with other restrictions that will be discussed below.

While most states have adhered to their spacing rules, forcing cooperation when necessary to form the minimum spacing unit, Texas has liberally granted spacing exceptions to small-tract drillers. This has not only reflected the political strength of the small producer and royalty owners but the favoritism given to the well service and supply companies centered in the state. By keeping prices high, the Texas Railroad Commission has insured that the Texas economy is helped — at the expense, of course, of the states importing Texas oil.[3]

Crude oil production can be restricted by limiting output to a maximum technically efficient rate (MER), a maximum gas-oil ratio, or a predetermined "market demand."

MER regulation, limiting withdrawals to a rate consonant with maximum recoverability from a reservoir, began with World War II planning and has since been adopted by 18 states. Specifying a barrel per day (B/D) maximum, the MER allowable can be established per hearing or published in proxy form

> **"Conservation regulations lie in waiting should the oil market go from a 'sellers' market,' as it has been since 1972, to a 'buyers' market,' as it was prior to this time."**

in a "depth-acreage" chart. Although touted as a purely engineering and geological determination, the allowable has often reflected both political and economic factors. Bonus ("discovery") allowables are usually allowed for new discoveries. Higher allowables are granted for deeper production regardless of reservoir characteristics to maintain incentive for deep drilling. Further, wells of settled production producing under a specified B/D, better known as "marginal" or "stripper" wells, are exempt from MER restrictions. Although the MER intervention has not been as restrictive to operators as other crude oil regulations to be discussed, it has promoted inefficiency by encouraging high cost (deeper) wells and risky wildcat well drilling at the expense of wells in proven areas.

A sister regulation to the MER allowable is the gas-oil ratio (GOR), first passed by California in 1929. The maximum cubic feet of gas that can be produced per barrel of oil is intended to increase crude oil recoverability by preserving the reservoir's natural energy — in this case the casinghead gas that lifts crude oil to the surface. Approximately 15 states currently have gas-oil ratios, commonly set at 2000 cubic feet of gas per barrel of oil. For ratios beyond the maximum, states generally penalize the producer by lowering the well's oil allowable. As an alternative to the penalty, operators may reinject (cycle) the gas back into the reservoir. Historically, GOR regulations have been the basis for major field shutdowns and expensive forced reinjection. But as technology improved and industrial and commercial demands increased, the regulation's costly impact has lessened.

The third method of controlling crude oil production, restraining output to "market demand," has been the most restrictive and controversial of all state petroleum statutes. Periodic hearings, usually monthly, are held where crude purchasers present sworn estimates ("nominations") of the amount of oil they expect to purchase in the next selling period.[4] The total represents state demand. Exempt production (from stripper wells and other favored properties) is then subtracted from demand to arrive at the figure available for nonexempt wells to produce. If this demand is equal to or greater than aggregate MER ceilings, a *market demand factor* of 100% is assigned; if demand is less than MER levels, a percentage is calculated to evenly distribute the demand among nonexempt wells. For example, if post-exempt well demand is 1.5 million B/D and MER capacity is 2 million B/D, then a factor of 75% of MER will be assigned to each nonexempt well as an output ceiling.

Seven states, accounting for over one half of U.S. output, practice market-demand prorationing, including Texas, Louisiana, and Oklahoma. In the 1950s and 1960s, these states often held production below 50% of MER levels.

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✓Washington Update

President Reagan has unveiled his proposed 1983 spending outline for federal health care programs — expenditures which now account for $1 out of every $10 the government spends. Under the Reagan plan, Medicare and Medicaid will increase about $4.4 billion, to $68 billion, a 7% jump instead of the scheduled 15% increase. Most of this difference is accounted for by cuts in grants to state governments and reimbursements to hospitals for Medicare treatments. In addition, $619 million will be raised by imposing the Medicare portion of the Social Security tax on federal employees, who would then be eligible for Medicare.

The Reagan administration has announced plans to cut the funding of subsidized loans to Third World nations, which are offered through multilateral development banks. The reduction, from $1.537 billion in fiscal 1983 to $1.139 billion in fiscal 1987, will primarily affect such institutions as the World Bank and the Inter-American Development Bank. Treasury Under Secretary Beryl Sprinkel noted in support of the cuts: "There's little value in throwing money at these (poor) countries unless they adopt the necessary macro- and micro-economic policies to make them work."

After a seven-month study of monetary theory and policy, the U.S. Gold Commission tentatively voted against a return to the gold standard, on the grounds that it was impracticable, would increase instability in financial markets, and would not improve money management. However, the commission did agree that Congress and the Federal Reserve should study the merits of some sort of monetary rule designed to slow the rate of growth of the money supply and reduce inflation. The commission also voted to create a new gold coin — perhaps called an American Eagle — to be sold by the Treasury Department at a small markup over its gold content. Such a coin would be exempt from both capital gains and sales taxes but would not be legal tender. The 17-member commission, chaired by Treasury Secretary Donald Regan, will send its final report to Congress at the end of March. A few days earlier, the Council of Economic Advisors had also issued a report opposing a return to the gold standard.

Sen. Robert Stafford (R-Vt.), chairman of the Senate Environment and Public Works Committee, recently reported that after 14 months of study and negotiations his panel had made little progress in revising the Clean Air Act of 1970. This slow pace is at least partially due to Stafford's pledge to oppose any amendments that would substantially weaken the law. Perhaps the biggest issue facing the committee is whether to relax clean air standards for auto emissions.

The International Trade Commission has ruled that most of the European steel imports covered by complaints filed by U.S. steel manufacturers may have been responsible for substantial domestic economic injury. Although only 38 of the 92 complaints were accepted, these complaints cover over 85% of the imports under question. These cases now go to the Commerce Department, which will determine whether the imports were either sold here at less than "fair value" or were subsidized. If either of these charges is validated, the matter will be returned to the ITC by next fall for a final injury test.

Most of the Office of Management and Budget-proposed cuts in the National Aeronautics and Space Administration (NASA) budget have recently been restored by President Reagan. NASA's new proposed 1983 budget of $6.6 billion now includes the space shuttle (one of Reagan's favorite projects) as well as $92.6 million to continue development of the Jupiter-orbiting Galileo satellite and additional funds to allow NASA scientists to continue monitoring the Voyager 2 spacecraft as it heads toward Uranus.

In an attempt to raise an additional $2.5 billion in revenue for fiscal 1983, the Reagan administration is instituting a system of "user fees" for several federal services. These services include: Maps and charts provided to owners and operators of aircraft and vessels, Coast Guard licenses and inspections, commercial nuclear waste disposal, the use of the National Mediation Board and the Federal Mediation and Conciliation Board, and federally operated recreation facilities.

As part of a move to boost America's sagging agricultural sector, the Reagan administration is urging farmers to reduce their 1982 plantings of wheat, feed, grains, cotton and rice by 10-15% in order to increase prices. In addition, the Department of Agriculture is expected to announce an acreage-reduction program similar to those of the 1960s and 1970s. Although such a program would be labeled "voluntary," farmers who did not participate would be ineligible for federal subsidies and price-support loans.

Interior Secretary James Watt has extended his moratorium on oil and gas leasing in wilderness areas until after this year's congressional elections so that campaigning Republicans will not be stigmatized by Watt's controversial policies. Previously, the moratorium was due to expire on 1 June 1982. However, Watt still has until 31 December 1983 to issue wilderness oil leases before 80 million acres of land become permanently protected. ■

Petroleum Regulation (Cont. from p. 7)

Among the undesirable consequences of this policy have been the prevention of lower crude oil prices for consumers, overdrilling, the subsidization of uneconomical wells, the penalization of flush wells, a misdirection of market shares between states, and an increased dependence on lower-cost foreign crude. With the supply crisis of 1973, the states set their market demand factors at 100%, where they have remained, with one notable exception, ever since.[5]

Natural gas output has been restricted by banning certain end-uses (such as venting or stripping), by setting an arbitrary percent-of-open-flow ceiling, and limiting withdrawals to "market demand."

Along with prevailing external damage, prohibiting open air discharges of natural gas was one of the early aims of conservation law. Today, virtually every regulating state forbids venting (flaring) as well as stripping gas. (The latter is where the gas is "stripped" of its condensate to make gasoline before it is vented.)

Beginning in 1924 when Louisiana passed a law limiting gas well output to a percentage of maximum flow, states have regulated natural gas "overproduction" in this way. Twelve states currently use this method, including the major gas-producing states of Louisiana, Texas, and Oklahoma.

Prorating natural gas to "market demand" is different from crude oil prorationing because crude oil is easier to transport and store. Consequently, the "market demand" for gas is calculated for each field rather than the state as a whole. Full production is allowed if demand, set at an unmentioned but assumed to be constant price, covers output.[6] If demand is less than the field's capacity, the demand is equally divided among the wells to protect the correlative rights of the producers, and the wells are limited to this amount to prevent any surplus from being vented or dumped at "distress" prices. Today, 16 states have authority to regulate gas

(Cont. on p. 11)

Regulatory Watch

ENVIRONMENTAL PROTECTION AGENCY

EPA regulations that would extend average lead content requirements for gasoline to cover small refineries have been suspended until a general study of the problem is completed. Currently, small refineries are subject to far less stringent requirements for gasoline content. The EPA is considering not only applying its general .5 grams of lead per gallon standard to all refineries but is also considering relaxing or rescinding the standard altogether. The increasing use of unleaded gasoline is the primary reason why the EPA is considering phasing down its rules.

The EPA has recently approved a number of state programs designed to reduce sulfur dioxide levels in the air as required by Title I of the Clean Air Act. Among the states involved are Alabama, Michigan, and New York. The Office of Management and Budget has exempted this ruling from President Reagan's directive that all new regulations be subject to a cost-benefit analysis.

Regulations for EPA financial assistance to state and local environmental programs are being revised in order to eliminate "unnecessary requirements" and develop consistency across programs for all remaining requirements. The revisions will be published as an Interim Final Rule in April 1982 and opened to comments. Final changes will be issued in time for the negotiation and awarding of 1983 grants.

The EPA has reaffirmed its previous waiver of certain Clean Air Act provisions for California so that the state may enforce its "Specifications for Fill-Pipes and Openings of Motor Vehicle Fuel Tanks" as they apply to motorcycles. The waiver was initially granted because it could not be proved that California standards were inconsistent with the Clean Air Act, but was reconsidered after a study of the technological feasibility of applying the standards to motorcycles. However, a follow-up study concluded that most of the compliance costs were either "negligible" (less than $100 million) or would fall upon foreign manufacturers.

Regulations dating from 1979 that established "best conventional pollutant control technology" (BCT) effluent limitations for 41 industrial subcategories have recently been withdrawn. The EPA claims that its BCT standards require higher levels of pollution control than are consistent with its BPT ("best practicable control technology currently available") limitations. New BCT standards are expected to be issued after a study of BCT methodology.

The EPA has eliminated the need to establish maximum permissible levels for sulfuric acid residues in or on potatoes — regulations which would otherwise be required by the Federal Food, Drug, and Cosmetic Act. Sulfuric acid is often used by farmers to kill certain vines, but it is known to leave a slight residue on the potatoes. This decision reflects an EPA judgment that no serious danger is involved with present residual levels of the acid.

The EPA has granted requests made by Alabama and Kentucky that the ozone attainment status of several counties be changed from "unclassifiable" to "attainable." These counties were previously unclassified due to lack of information on their content, a situation that was changed by extensive state and local studies. ■

Off-Budget Operations (Cont. from p. 5)

productivity growth and subsequently, higher inflation.[10]

In addition to making billions less available for private investment, the loan guarantees administered by the FFB also constitute a kind of backdoor financing of additional government control and regulation of the private sector, since most guarantees are contingent upon the recipient's compliance with various social policies such as minority hiring quotas, environmental impact statements, and occupational safety and health regulations. Thus, once a firm becomes dependent on financial assistance from the government, the assistance is used as a lever to impose additional controls.

Summary and Policy Implications

With the advent of the tax revolt in the 1970s, Americans have turned to constitutional and statutory constraints on governmental powers to limit the size and scope of government at all levels. There appears to be considerable faith in the ability of balanced budget and tax/expenditure limitation requirements to induce government to become more efficient and more responsive to constituents' demands. However, history reveals that for nearly a century, nonfederal politicians have easily evaded restrictions on their taxing, spending, and borrowing powers by redefining the budget. The proliferation of off-budget enterprises is ample evidence that limitations on the growth of government have been ignored. It is therefore unlikely that the tax limitation movement will be met with much, if any, success at the state and local levels. OBE activities should be placed on-budget and subjected to taxpayer scrutiny. The same is true at the federal level of government. ■

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[1]Donald Schlosser, *Municipal Authorities in Pennsylvania* (Harrisburg, Pa: Department of Community Affairs, 1977).

[2]Annmarie Walsh, *The Public's Business: The Politics and Practices of Government Corporations* (Cambridge: MIT Press, 1979).

[3]Schlosser, *Municipal Authorities.*

[4]Public Securities Association, *Statistical Yearbook of Municipal Finance* (New York: Public Securities Association, 1981), p. 124.

[5]U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the U.S.* (Washington, D.C.: U.S. Government Printing Office, 1981).

[6]New York State Moreland Act Commission, *Restoring Credit and Confidence: A Reform Program for New York State and its Public Authorities* (Albany: State Printing Office, 1976).

[7]Office of the Governor, *New York State Budget for 1980-81* (Albany: State Printing Office, 1980).

[8]As quoted in James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Legacy of Lord Keynes* (New York: Academic Press, 1977), p. 156.

[9]For a detailed discussion of the FFB, see Congressional Budget Office, *Loan Guarantees: Current Concerns and Alternatives for Control* (Washington, D.C.: CBO, 23 January 1979).

[10]Herbert M. Kaufman, "Loan Guarantees and Crowding Out," in Congressional Budget Office, *The Economics of Federal Credit Activity* (Washington, D.C.: CBO, April 1980), pp. 35-39.

GOVERNMENT RECEIPTS MONITOR

A quarterly feature of *Policy Report*, the "Government Receipts Monitor" summarizes the latest levels and sources of the federal government's income.

RECEIPTS (annual rates in millions of $ unless otherwise stated)

	1981 4th Quarter	1981 3rd Quarter	1981 2nd Quarter	Average for Last Year
Total Receipts	588,764	626,848	634,108	618,753
Surplus or Deficit	-207,148	-58,780	64,964	-82,293
Total Individual Income Taxes	286,104	320,272	434,840	337,639
Gross Corporate Income Taxes	63,592	60,632	116,816	75,104
Employment Taxes and Contributions	165,712	167,200	188,308	173,319
Social Insurance Tax and Contributions	183,224	191,648	222,212	196,629
Unemployment Trust Fund	8,892	16,528	26,780	15,559
Excise Taxes	41,808	46,580	47,724	44,042
Highway Trust Fund	6,816	6,788	6,164	6,602
Estate and Gift Taxes	7,532	7,432	6,652	7,000
Customs Duties	9,344	9,296	8,284	8,586
Miscellaneous	17,536	16,224	13,560	14,927
Holding of Public Debt Securities (current total)	1,028,729	997,855	971,174	987,064
Holding of Agency Securities (c.t.)	5,987	6,086	6,176	6,174
Federal Securities Held by Public (c.t.)	830,055	794,434	775,973	790,978

SOURCE: Monthly Treasury Statement of Receipts and Outlays of the United States Government.

Petroleum Regulation (Cont. from p. 9)

reservoir production, i.e., limit gas output to "market demand."

Mandatory Cooperation

Mandatory cooperation, first upheld by state courts in the 19th century for water projects, was first used for oil and gas in 1927 when a city ordinance was passed in Oxford, Kansas requiring adjacent property owners to share costs and revenues to limit drilling within city limits. In the next decade statewide statutes were passed to force owners to *pool* their oil and gas interests to comply with spacing requirements. These laws were then followed by mandatory *unitization* laws, which extended the "cooperation" to cover the entire reservoir rather than a single spacing unit.

Every producing state except Kansas has passed a forced pooling statute. (Texas did so in 1965 after decades of allowing exceptions to their spacing law.) Twenty-six states have a compulsory unitization law, the majority applying to both primary and secondary production, subject to a typical proviso that the royalty owners and operators of 75% of the acreage voluntarily agree to it. Of all the major producing states, only Texas does not have a unitization statute. Nonetheless, over 1100 unitization agreements have been made in the state, dramatically demonstrating that self-interest, not only compulsory action, can be used to minimize costs and combat reservoir misuse.

Policy Conclusions

Economists specializing in energy regulation have generally concurred that the historical practice of petroleum conservation law has bloated industry costs and raised prices for consumers.[7] But these same scholars, convinced that rule-of-capture competition created the problems of overproduction and waste, have accepted conservation law in principle while prescribing reform within the framework of police power. The most common recommendation has been to implement a nationwide mandatory unitization statute as the regulatory centerpiece while removing favorable treatment of marginal wells.[7] Admittedly, this would remove many inefficiencies associated with state intervention in petroleum; but if unitization really lowers costs and increases well values, why is it necessary to *force* entrepreneurs to maximize profits? Some unitization plans have been rejected since operators believed they could operate more efficiently than the controlling company.[9] Should they be subject to a "tyranny of the majority"? Further, could politics and majority abuse be kept out of such state control? For example, could the bigger landholders use the threat of compulsion to gain advantageous concessions for the smaller interests? Lastly, there is the question of basic property rights. Does not every oil entrepreneur have an *equal* right to make decisions that he feels are in his best interests? It is true that without mandatory unitization some errors and waste would occur. Yet this is true of all business enterprise, and the market contains incentives to minimize such error by the means of not only cooperative agreements but buy-outs and sell-outs.

> **"Controlling crude oil production by restraining output to 'market demand' has been the most restrictive and most controversial of all state petroleum statutes."**

State level energy policy should be reformulated to allow individual freedom of action and market processes full reign in properly producing, allocating, and pricing oil and gas. All laws controlling and restricting production-well spacing, MERs, GORs, and particularly market-demand prorationing, should be repealed state-by-state. Prorationing statutes have been dead letters since the early 1970s, and now is an opportune time to remove them from the books. Furthermore, the many laws specifying drilling practices should be relaxed in favor of the more general legal emphasis that damage to another person's property is illegal and subject to restitution. Mandatory cooperation should be repealed as should any legislative impediments to voluntary associations. And lastly, on the federal level, Congress should pass a "Withdrawal of Consent" to revoke the charter of the Interstate Oil Compact Commission. This agency mainly has served as cartel agent for the production restrictions of its member states. It now has little useful function and should suffer.

A free market in energy is as imperative on the state level as it is on the national level. Given the unsatisfactory history of conservation law and its market alternative, a strong effort toward this end should have high priority. ■

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[1]State distribution regulations, a peripheral part of conservation law, will not be examined here.

[2]This will be treated at length in my forthcoming book, to be published in late 1983, *Government and Energy: The U.S. Experience,* chap. 3.

[3]For a history of the politics surrounding well spacing policy in Texas, see David Prindle, *Petroleum Politics and the Texas Railroad Commission* (Austin: University of Texas Press, 1981), pp. 44-45 and 73-81.

[4]Prices are not mentioned at the hearings. This forces crude purchasers to anticipate what the price will be and enter their demands accordingly.

[5]From December 1976 until February 1977, the Texas Railroad Commission set the market-demand factor between 98% and 99% to protest federal energy policies, especially crude price controls.

[6]All gas production is under price control, largely eliminating the pricing alternatives for purchasers.

[7]For example, see M.A. Adelman's classic article, "Efficiency of Resource Use In Crude Petroleum," *Southern Economic Journal* 31 (October 1964), pp. 101-109, 116-122.

[8]See Stephen McDonald, *Petroleum Conservation in the United States* (Baltimore: The John Hopkins Press, 1971) chap. 11; and Melvin deChazeau and Alfred Kahn, *Integration and Competition in the Petroleum Industry* (New Haven: Yale University Press, 1959), pp. 252-253.

[9]William Murray, "Engineering Aspects of Unit Operators," *Third Annual Institute on Oil and Gas Taxation* (New York: Matthew Bender, 1952), p. 13.

"To be governed . . ."

As part of *Policy Report's* focus on the New Federalism, "To be governed . . ." concentrates this month on the doings of state and local officials.

Bouncing on the safety net

New Jersey has just compared names and Social Security numbers of people on welfare and receiving food stamps with income tax statements sent to Trenton quarterly by employers. And what do you know, 31,575 "hits" turned up in which names matched, suggesting that working folks had either told the welfare office they were unemployed or had understated their incomes. That's a little over 15% of the families receiving social assistance.

—*Wall Street Journal,* Feb. 23, 1982

Well, when you put it that way

District of Columbia agencies would accept only cash or cashiers' checks from citizens paying traffic tickets or any other fees less than $50, under a regulation proposed by D.C. Controller Alphonse G. Hill.

Hill said he realizes that the new regulations might inconvenience many citizens, particularly those who handle routine permit transactions by mail . . . "Do you want us to have a big problem for the city or a little problem for the individual citizens?"

—*Washington Post,* Feb. 13, 1982

Any relation to Huey Long?

A federal grand jury yesterday indicted the president of the Louisiana Senate, his law partner and three other people on charges of participating in a $6 million fraud scheme.

—*Washington Post,* Feb. 13, 1982

Capitalist pigs

A D.C. Superior Court judge has ordered District Mayor Marion Barry and city housing officials to provide heat and hot water immediately in four rundown public housing projects where some tenants said they have lacked these services for four years.

—*Washington Post,* Feb. 13, 1982

Running a close race with the feds

Consider that state spending accounted for 8 percent of our Gross National Product in 1950 — and that, by 1975, when Reagan was stepping down as governor of California, it was up to 15 percent. Last year state government broke the $1,000 barrier, averaging $1,010 per person nationwide. (Spending is even higher in many bedrock conservative states — North Dakota, for example, spends $1,307 per resident.) To finance their spending sprees, states have borrowed at a furious pace. Total state deficits hit $119 billion in 1980; the percentage increase in state deficits has run ahead of the federal deficit seven of the last 10 years.

States have also imitated one of Washington's worst flaws by sheltering their workers in the civil service bunker: Some 75 percent of those 3.5 million state employees have "merit" protections, meaning they cannot be fired regardless of how they perform. And as the White House staff has ballooned in recent years, so have its 50 miniature counterparts, the staff of governors.

In Reagan's home state, Illinois, the Department of Public Aid has been leasing office buildings for more per year than they would cost to buy. In one case the agency paid $750,000 in rent for a building that was appraised at just $90,000, an investigation by the Better Government Association found.

Meanwhile, James Jeffers, director of the Illinois Division of Vocational Rehabilitation, took $250,000 from a handicapped-education fund to purchase "psychocybernetics" training sessions. Psychocybernetics is a self-actualizing encounter system devised by a plastic surgeon. Records show the psychocybernetics sessions were attended mainly by members of Jeffers' staff.

While that group was groping itself at taxpayers' expense, Vincent Toolen, Illinois' chief purchasing officer, was using state money to buy himself $11,000 worth of office furniture, including a $600 chair and a $2,300 African mahogany credenza. "I needed a desk,' Toolen explained. To top it off, Toolen took his money from the wrong fund. Remember, this is the guy in charge of purchasing.

—*Washington Post,* Jan. 31, 1982

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