Policy Analysis

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Executive Summary

By now nearly everyone is aware of the financial debacle created by the Washington Public Power Supply System (WPPSS), or "Whoops" for short. WPPSS is responsible for the largest default in the history of municipal finance, having reneged on payments of $2.25 billion in bonds issued to finance two nuclear power plants in the state of Washington. Few, however, know of the root of the WPPSS default: The spending and borrowing of off-budget enterprises (OBEs) such as WPPSS do not appear in the budgets of the governmental entities that created them. OBEs raise funds not by direct taxation but by ssuing revenue bonds that are not approved by voters. Consequently, OBEs such as WPPSS are detached from the scrutiny and control of taxpayers (at least until serious financial problems arise), and are exempt from many of the checks and balances that exist for other firms in the public and private sectors. The lack of incentive that plagues public enterprises generally because the profit motive and other market constraints are absent is amplified in OBEs because of the further lack of political market constraints.

The main point of this paper is that the root cause of the WPPSS default is neither simply mismanagement nor a series of avoidable mistakes but rather the fact that, as an OBE, WPPSS is inherently inefficient and not accountable to taxpayers. And furthermore, WPPSS is just one of many off-budget boondoggles; throughout the nation are thousands of other OBEs, threatening to bankrupt more state and local governments.

The Tip of the Off-Budget Iceberg

Many of the thousands of OBEs in the United States are in lamentable financial condition.[1] OBEs provide a bewildering array of services, ranging from airport-building to zoo maintenance, and they are currently expanding in both size and scope.[2] They are popular among politicians, for they provide an opportunity to preach fiscal conservatism while practicing fiscal profligacy off the books. OBEs represent a hidden tax liability for the taxpayer, who must ultimately pay the bill for these activities.

It is very difficult to "reform" or, preferably, to abolish OBEs such as WPPSS because of the powerful and well-organized special interests that such organizations generate. Evidence of this is found, once again, in the WPPSS experience. Frustrated ratepayers in the Northwest succeeded in placing on the November 1981 ballot a referendum initiative that would require voters' approval of future WPPSS bonds, thereby placing it on budget. The initiative passed by a wide margin, despite a well-organized and well-financed campaign against it by contractors, investment bankers, and WPPSS management. The taxpayers soon lost out to these interests, however, for a district court judge ruled the referendum unconstitutional, claiming that it interfered with federal energy policy as carried out by the

Bonneville Power Administration.

To illustrate the mechanics of off-budget enterprise, it is useful to briefly trace the chain of events in off-budget activity at the state and local levels of government. In general, the parties involved include: the politicians who create the OBE, the managers of the enterprise, those who provide financing, the suppliers of inputs, and (in some cases) the recipients of services.[3]

The Politician

Off-budget enterprises appeal to politicians primarily when limitations on debt restrict borrowing or when recalcitrant voters have rejected bond referenda at the polls. Even in the absence of these two roadblocks, there are politically attractive reasons for operating off budget. While politicians are interested in furnishing patronage jobs for their supporters and contributors, civil service regulations and public-sector unions make it difficult for officials to use the spoils system. However, the encumbrances of civil service regulations do not apply to OBEs. Thus an official can appoint political allies to boards of directors or management and get them hired as workers in such organizations.

A key feature of all OBEs is their freewheeling style of operation -- with few of the checks and balances that have evolved in general government to protect the taxpayer. For example, competitive bidding on contracts is a standard feature of virtually all regular governmental units, implemented to assure the bidders of equal access and to assure the public of the lowest prices. In contrast, OBEs are permitted to negotiate with suppliers, so contracts can be awarded on the basis of political considerations rather than economic factors. Basically, the politician views the OBE and its not-so-public operations as a tool for achieving political goals.

The procedure for establishing an OBE is relatively straightforward. A unit of local government or the state government enacts an ordinance or a piece of legislation specifying the legal functions of the corporation; a corporate charter is issued, a board of directors is appointed, and the OBE is created.

Boards and Managers

In contrast to the private corporation, where members of the board of directors are (in theory) responsible to and elected by shareholders, OBEs are led by appointees. At the state level the governor usually appoints members of the boards of OBEs and in municipalities the mayor or the city council appoints the directors of OBEs. In the public corporation there are no shareholders with a financial stake who must be satisfied; rather, board appointees are responsible to political interests and depend on the good will of elected officials for reappointment when their terms expire. The notion of board members concerned solely with service to the public and immune from political pressure is a myth. Although rarely is a salary paid for serving on a board, directors' fees and expenses are not uncommon.

Board members are usually politically active individuals in the business community, selected to provide the "business expertise" -- but only on a part-time basis. The major function of these business people is to lend their prestige to the undertaking so that it appears to prospective lenders that competence and expertise are at the helm. Often business activities of board members such as banking, and construction, may be directly related to those of the OBE.

Although conflict of interest provisions may prevent outright financial gain on the part of the board members, they may be able to direct the business dealings of the organization inconspicuously to benefit political supporters of the board members' patron. It is much easier to manipulate contract awards when competitive bidding is not required, as is the case with OBEs; campaign contributions and support in election contests can influence the dealings of a political organization. Having accepted an appointment to an OBE board, a prestigious businessman benefits by having the organization "succeed" in achieving its stated purpose -- and in furthering his own business and political objectives by judiciously awarding contracts and placing supporters in patronage positions. In no way is the board member directly responsible to the voter or taxpayer, and once appointed to a term in office, he is quite secure in that position -- politicians rarely remove directors from OBE boards. There is, then, considerable latitude for the board member to pursue his own self-interest, whether the taxpayer approves or is well served or not.

The manager of the OBE controls the agenda presented to the board for approval. The manager is the full-time expert upon whom the board depends heavily for advice. Because of his intimate knowledge of the organization's operations and finances, a manager can influence the board's decisions on policy matters. The manager is responsible for the day-to-day operations of the OBE -- operations supposedly carried out under the policies set by the board. However, since parttime board members have little time or inclination to become intimately involved in the details of the operation, in practice the manager enjoys considerable discretion.

The critical yardstick by which management is judged is whether the OBE is financially viable. As long as the OBE can generate revenues to cover its operating costs and debt service, it will remain financially independent and insulated from the controls of the government entity that created it. An OBE in financial straits, on the other hand, may have difficulty in the credit markets and will have to return to the sponsoring governmental unit to seek grants and subsidies. At that point, the operations of the OBE come under legislative scrutiny, the efficacy of management may be probed, and questions may arise about management practices -- a most undesirable state of affairs. For this reason, there are pressures on OBE management to avoid risky undertakings that may be "unprofitable"; there are strong incentives to "cream the market" by engaging only in activities that generate large amounts of revenue relative to the costs, regardless of the consequences for the public interest. For example, undertakings like constructing toll roads and bridges are remunerative, but massive congestion is the result when toll roads feed city streets ill equipped to handle large volumes of traffic. An OBE is judged primarily by its financial health, not by how useful it is to the community.

It is a widely believed myth that OBEs have all the advantages of private-sector efficiency and none of the disadvantages of public-sector inefficiency. OBEs, in short, are supposed to be "businesslike." However, the manager of the OBE enjoys benefits that any private-sector manager would greatly envy. When it is established, each OBE is granted -- by legislative fiat -- a monopoly on its product or service. Off-budget electric utilities, for example, do not have competitors. There are, of course, monopolies in the private sector, but these are always heavily regulated: Such matters as reviewing rate changes are conducted openly before regulatory commissions that seek, or at least permit, public input. OBEs are exempt from regulatory review and do not bear the costly expense of preparing cases for rate hearings. Because of their quasi-public status, they pay no taxes or license fees and post no performance bonds; they are also exempt from much of the paperwork and regulatory red tape that is a costly burden on the private sector. The OBEs labor under no legal restrictions on collective-bargaining arrangements. Many are empowered to override local zoning and building ordinances. Thus OBEs operate free of most strictures.

Some of the prerogatives accorded to OBEs range far beyond any allowed to private or on-budget government enterprises. For example, in Pennsylvania a municipal OBE may be granted a right of eminent domain extending beyond the boundaries of the municipality that created it and specifically exempt from antitrust laws regarding price fixing. Although their authority varies from state to state, all OBE managers are able to operate in secrecy. In many cases they are not even subject to legislative review on a regular basis.

Some can preserve their secrecy with impunity. As head of the Port Authority of New York, Robert Moses succeeded in refusing the demands of Congress for access to the books of the organization. Thus not only does the taxpayer, who directly or indirectly supports these off-budget operations, have no explicit control over the management of the enterprise; even elected officials, as taxpayers' representatives, may exert only limited influence.

Despite their exemptions and privileges, however, OBE managers clearly understand that their positions ultimately depend on the good graces of the board members, who in turn respond to political pressures. It is in the best interests of managers to accommodate politicians by providing patronage positions. Managers have ample incentives to expand the operations of the OBE so as to create job opportunities. Expanding the operations, of course, also serves to increase cash flow to the organization. After operating expenses and debt-service charges have been paid, the excess revenue is held internally (generally no "profits" are paid to the sponsoring unit of government) and may be used by management for perquisites.

Thus there are compelling reasons for OBE managers to be "growth oriented" and to expand their "empires" rapidly, even if that means interpreting the mission of the organization quite broadly. Over a period of decades, Robert Moses built the Port Authority of New York into a financial giant and had enormous sums of money at his disposal. Few are aware that this entity has vast real estate interests, including the World Trade Center in New York City, as well as control over airports, bridges, toll roads, restaurants, and harbor facilities. Whether the public benefits from the growth orientation of OBE managers is questionable. It is certain, however, that OBE managers have considerable latitude in their decisions and are influenced at least to some extent by political pressures.

The Financial Participants

As with any economic entity, the financial arrangements are of critical importance to the OBE. It must have access to the bond markets as a source of capital or the organization will be doomed. Ultimately, the board and managers must satisfy the bondholders, who are private individuals, as well as institutional investors, e.g., banks and pension funds.

The bondholders have claims only to the repayment of the principal and to interest on the OBE's debt. Bondholders can lay no claim whatsoever to any excess revenues generated. Nor do investors have any control over the activities of managers or directors, nor any voice in who is selected. The interests of the bondholders are protected by an indenture agreement (basically a contract between the OBE and bondholders) that is administered by a bank serving as trustee for the bondholders. Indenture agreements on OBE operations are documents that impose conditions designed to protect the financial interests of bondholders. These documents may specify accounting procedures, conditions on reserve-fund balances, maintenance levels, prices, and even new projects. An OBE stands to lose much of its vaunted flexibility if the indentures specify very restrictive terms.

The bank receives income for its services as a trustee; it may also be able to sell its services as financial advisor to the entity. Because trustees' income rises as the volume of debt issued by OBEs increases, bankers have incentives to encourage both new projects and new issues of debt. Clearly the banking community has a vested interest in seeing that off-budget enterprise continues to grow.

When bonds are issued, underwriters perform the function of middlemen between the OBE (the borrower) and lenders. The underwriters purchase bonds in wholesale lots at a discount and sell them to private investors. The difference between the wholesale price of the bonds and their selling price forms the income that goes to the underwriters. For government agencies, the spread is determined by competitive bidding among underwriters. An OBE, however, may place the bonds with a given underwriter or a group of underwriters on a noncompetitive basis. This practice leads to higher spreads. In underwriting, a great deal of money can be at stake in the placement of even a single bond issue. Also, as the volume of debt issued rises, so does the income of underwriters. Clearly underwriters also have an economic interest in expanding the debt of existing OBEs and in creating new ones.

The legal profession is also actively engaged in the financial machinations of OBEs. Attorneys acting as "bond counsels" are paid for reviewing the specifications of the indenture and for issuing an opinion on whether the bond issue conforms to the requirements that make it exempt from federal taxation. Here again, the amount of payment received for legal services depends upon the volume of debt issued. Income rises as the OBE borrows.

Suppliers of Services

OBE debt is issued to obtain capital to build some facility such as a power plant, an airport, a water-supply system, or a highway. Because most OBEs are operating organizations that lack their own construction capabilities, in a capital construction project the work will be awarded to consultants, architects, engineers, excavators, building contractors, and a whole range of specialists in such fields, to complete the project. These consultants and contractors in turn employ workers and use the products and services of numerous suppliers. All of these groups have a vested interest in seeing off-budget activities expand, for such projects mean profits for employers and work for employees.

As is the case in financing OBEs, no competitive bidding is required on contracts to providers of goods and services. Offering the lowest price on a bid (if there is one) is no guarantee that a given firm will be awarded a contract. Often OBE managers can award contracts for goods and services on a quid pro quo basis. The contractor who assists the OBE manager the most will be favored over others. Contracts are awarded at least in part on the basis of political considerations, for those who benefit from the OBE can help the OBE manager obtain political favors in the form of grants and

subsidies from the legislature. Labor unions representing construction workers, for example, are politically active and very well financed.

Those who receive services from off-budget enterprises can also bring political pressure to bear. Many localities have established off-budget housing authorities to build subsidized low-income housing. People eligible for low-income housing assistance have a strong incentive to encourage the construction of additional units, and these citizens have organizations that lobby for such favors.

As the discussion above demonstrates, no off-budget entity exists in isolation; each cooperates with other groups to carry out its mission. Internally there are pressures for expanding the OBE, and externally every OBE has interest groups that also benefit from ever-expanding OBE activity. The benefits are concentrated among interest groups that have strong incentives to support the OBE in its search for tax subsidies and grants. However, the costs of expansion are dispersed among all taxpayers, who have little financial incentive to organize in opposition to the growth of OBEs.

The experience of New York State under the governorship of Nelson Rockefeller furnishes a brief example of how OBEs are used to evade the wishes of voters. During his terms of office, from 1959 to 1974, Rockefeller became the nation's foremost architect of OBE schemes. He became expert at using them to greatly expand his welfare-state policies.[4] After voters had thrice rejected a housing bond issue for $100 million, Governor Rockefeller created the Housing Finance Authority, which issued large amounts of nonguaranteed debt. At one point such debt exceeded the entire guaranteed debt of the state. In 1961 voters rejected a $500 million bond issue on higher education for the fourth time; consequently Rockefeller created the off-budget State University Construction Authority. In 1965, after the voters rejected a housing bond issue for the fifth time, Rockefeller created the Urban Development Corporation. By 1975, 81 percent of the total outstanding debt of New York State was the nonguaranteed debt of OBEs -- and the state was on the verge of bankruptcy. 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 those purposes. From 1964 to 1974 the state's own debt of construction programs increased by $2 billion, while the nonguaranteed debt of OBEs increased by $8 billion. Although theoretically the state's OBEs are financially independent, they are heavily subsidized by both the state and the federal government. In 1980, accumulated state subsidies in the coffers of OBEs was about $2 billion -- approximately $113 per capita. Evidently referendum requirements do little to inhibit borrowing by New York State, since billions of dollars of debt are placed off budget to finance myriad projects -- including horse-breeding farms and a nebulous undertaking labeled "space development."

Rockefeller may have been an aberration. Still, New York State's experiences with off-budget spending are by no means a special case, as will be seen.

The Rest of the Iceberg

It is virtually impossible to gauge the total amount of off-budget state and local spending. Many governments, for obvious reasons, do not even compile statistics on such activities. We have estimated, however, that the off-budget public sector, both state and local, rivals the on-budget sector in size. One way to view the growth of state and local spending that is off budget, however, is to monitor the issuance of revenue bonds (the primary source of OBE revenue).

Table 1 shows new issues of state and local government long-term debt, by type, from 1960 to 1982. As shown there, in 1960 revenue bonds issued by OBEs composed about 30 percent of total long-term debt issued. Since 1960, althoug both on-budget and off-budget borrowing have increased, off-budget borrowing has steadily replaced on-budget debt issuance. At present, about 69 percent of all debt issued is in the form of non-voter-approved revenue bonds. A significant feature of table 1 is the very sharp increase in the volume of OBE debt during the late 1970s, as the "tax revolt" began to ferment and taxpayers throughout the country demanded greater fiscal restraint. Even more striking, the allocation for revenue bonds issued during 1982 increased by $20.4 billion, a 65-percent increase in just one year. This recent surge in off-budget borrowing may be due to threats of reduced federal aid (some of the threats have been carried out).

In sum, the data in table 1 show that the off-budget public sector is continuing to grow, and is now responsible for nearly three-fourths of all borrowing. The financial problems and mismanagement inherent in OBEs are likely to crop up much more frequently in the future unless this trend is reversed. Local government, considered by many to be the most "responsive" to the taxpayers, is rapidly getting out of control at a cost to taxpayers of billions of dollars more each year.

Table 1 New Issues of State and Local Government Long-Term Debt, 1960-82				
Year	Total Debt Issued	General-Obligation Debt	Revenue Bonds	Revenue Bonds Percent of Total
	(Millions of Dollars)			
1960	7,230	5,035	2,195	30%
1961	8,360	5,762	2,598	31
1962	8,558	5,892	2,666	31
1963	10,106	6,069	4,037	40
1964	10,544	6,887	3,657	35
1965	11,084	7,445	3,639	33
1966	11,089	7,013	4,076	37
1967	14,288	9,192	5,096	36
1968	16,374	9,611	6,763	41
1969	11,460	8,047	3,413	30
1970	17,761	11,803	5,958	34
1971	24,370	16,240	8,129	33
1972	22,941	14,121	8,820	38
1973	22,953	12,827	10,126	44
1974	22,824	13,031	9,793	43
1975	29,326	15,003	14,323	49
1976	33,845	16,916	16,929	50
1977	45,060	17,887	27,173	60
1978	46,215	17,894	28,321	61
1979	42,261	12,615	29,646	70
1980	47,133	16,347	30,786	65
1981	45,323	13,921	31,402	69
1982	74,877	23,006	51,811	69

Source: Moody's Municipal and Government Manual (New York: Dun and Bradstreet, 1983), p. a6.

Table 2
Debt of States and Local Governments. 1981

(Table Omitted)

Source: Moody's Municipal and Government Manual (New York: Dun and Bradstreet Co., 1983), pp. a2-a5. Table 2 presents a cross-sectional look at off-budget borrowing by state and local governments in 1981, the latest year for which data are available. There are four states -- Arizona, Iowa, Nebraska, and Wyoming -- in which all state government debt is off budget and therefore not approved by voters. In eleven states -- Colorado, Idaho, Indiana, Kansas, Kentucky, Missouri, Montana, New Mexico, North Dakota, Oklahoma, and South Dakota -- off-budget borrowing exceeds 90 percent of total outstanding debt. At the local level of government, there are 24 states in which off-budget debt amounts to more than half of the total outstanding debt. The state of Washington is generally considered to be the worst off in terms of off-budget borrowing because of WPPSS. However, by several different measures there are other states that are in worse shape. Consider these examples. Four states -- New York, Texas, California, and Pennsylvania -- have more total off-budget debt outstanding than Washington. There are three states -- Alaska, Nebraska, and Wyoming -- with more off-budget debt per capita and six more states -- Kentucky, Nebraska, New Mexico, North Dakota, South Dakota, and Wyoming -- with a greater percentage of their debt off budget.

Besides WPPSS, there are many other OBEs in the electric-power industry -- OBEs that have been created by combinations of municipal utilities. Among the largest, with debt outstanding as of May 31, 1981, are the Municipal Electric Authority of Georgia ($1.08 billion), the Texas Municipal Power Agency ($850 million), the North Carolina Municipal Power Agency No. 1 ($775 million), the Massachusetts Municipal Wholesale Electric Company ($773 million), the Intermountain Power Agency of Utah ($600 million), and the Platte River Power Authority of Colorado ($332 million).[5] There may well be similar financial debacles brewing elsewhere.

Conclusions

The WPPSS default can be considered a warning shot across the bow of the municipal bond market. At the state and local levels of government there now exists an "underground government," consisting of OBEs like WPPSS, which rivals the on-budget public sector in size. Nearly three-fourths of all state and local borrowing is now conducted off the books, and is not approved by voters. One implication of this trend is that now local government, long considered to be the most "responsive" to taxpayers, is largely out of control and beyond the scrutiny of the voters. Financial failures can be expected to crop up in states other than Washington -- especially in states that have even greater amounts of off-budget spending and borrowing.

Another reason for alarm is that the federalism proposals of the Reagan administration and others, should they be implemented, are not likely to serve the interests of the taxpayers very well. The New Federalism would simply shift various functions from the federal bureaucracy to local bureaucracies and off-budget fiefdoms. The only true governmental reform would be to privatize the hundreds of functions now performed by all levels of government when the functions could be provided more efficiently and more equitably by private, competitive firms.[6] Government has no place in the nuclear-power business, or any other business. Government involvement is invidious, especially when it conducts such activities behind the backs and in spite of the protests of those who in theory are to benefit from them -- namely, the American taxpayers.

FOOTNOTES

[1] There are tens of thousands of OBEs in the United States, including more than 2,500 in Pennsylvania alone. See James T. Bennett and Thomas J. DiLorenzo, Underground Government: The Off-Budget Public Sector (Washington, D.C.: Cato Institute, 1983).

[2] Among the services provided by OBEs are cemeteries, school buildings, parking lots, fire protection, highways, hospitals, libraries, flood control, parks, sewers, water supply, electric power, gas supply, transit facilities, horse-breeding farms, and "space development," to name just a few.

[3] The following is based on Bennett and DiLorenzo, chap. 3.

[4] Bennett and DiLorenzo, chap. 4.

[5] Victor Zonana, "Dispute Flares on Financing Joint Agencies," Wall Street Journal, October 13, 1981, p. 35.

[6] See James T. Bennett and Manuel H. Johnson, Better Government at Half the Price: Private Production of Public Services (Ottawa, Ill.: Caroline House Publishers, 1981), for an examination of the theoretical and empirical issues regarding privatization.