quire that the President impose a surtax if it appears that a deficit is likely to occur or impound funds if an expenditure limitation is exceeded. Even in proposals requiring super majorities for enforcement, the President would have the option of vetoing the legislation.

Finally, to the extent that a prohibition was effective in preventing deficits or limiting expenditures, responsibility for many public programs would likely shift from the federal to the state and local sectors. State and local governments--with their greater reliance on hidden taxation--have been able in the past to increase the revenue burden to cover additional expenses. If the bias toward a larger public sector still existed after the enactment of a federal prohibition, it might, therefore, cause states and localities to pick up the slack. Many of the proponents of the limitations, however, would probably prefer growth at the state and local level if growth has to occur.

APPENDIX A.

98-379 O - 82 - 9

APPENDIX A. LESSONS FROM STATE EXPERIENCE

Many American state governments operate under deficit and/or debt prohibitions or limitations. This appendix discusses the evidence about the effectiveness of the state statutory and constitutional limitations. On the plus side, state governments do appear to balance their operating budgets. In a study conducted for the Congressional Budget Office, the consulting firm of Peat, Marwick, Mitchell and Company (PMM) recast the 1978 year-end financial status of four states--California, Illinois, Maryland, and New York--in the budget format used by the federal government; conversely, the study recast the federal government's financial statements for fiscal year 1978 into the budget formats of the four states. The state surplus and the federal deficit remain regardless of budget presentation. Thus, it does not appear that the surpluses of these four states are the artificial creations of accounting differences.

On the negative side, state debt has been increasing at a more rapid rate than federal debt over the past 20 years. Moreover, states faced with statutory and constitutional limitations on debt appear to have avoided the limitations successfully by creating various authorities that are allowed to issue "moral obligation" bonds. This appendix includes an essay by Allen Schick of the Congressional Research Service that sets out the negative evidence on the state record.

POSITIVE EVIDENCE

All but two states--Connecticut and Vermont--are governed by either a constitutional or legislative limitation on operating budget deficits (see Table A-1). These limitations take various forms: limit the amount or type of debt a state may incur (25 states); require that appropriations do not exceed estimated revenues (20 states); require that the Governor submit a balanced budget (18 states); require that expenditures be reduced if a short-fall appears imminent (19 states); require that a tax be levied the following year to pay off any debt (4 states). In addition, 18 states limit nonoperating budget debt; four require a referendum to incur debt, seven have a flexible limit that is tied to revenue collections or property values, five have a dollar

TABLE A-1. SUMMARY OF LIMITATIONS ON STATE DEFICITS

Type of Provision	Number of States With Deficit Limitations That Are: Prohibitive	Constraining Only	Total
Constitutional	33	6	39
Statutory Only	6	3	9
None	--	--	2
Total	39	9	50

SOURCE: National Association of State Budget Officers, Limitations on State Deficits (Lexington, Kentucky: Council of State Governments, 1976).

limit that can only be exceeded by a referendum, and two require an extraordinary majority of three-fifths to three-fourths of the legislature to incur debt.

Have these requirements prevented the states from running persistent and large deficits? The answer appears to be both yes and no.

On the affirmative side, most of the states run surpluses most of the time--especially in their operating budgets. Even when the various budgets that make up a state's total financial picture are grouped together as if they were part of a unified budget, states either run a surplus or a very small deficit. In the Peat, Marwick, Mitchell and Company study, the budgets of California, Illinois, Maryland, and New York were recast into a unified budget following the federal budget format. As can be seen in Table A-2, the surplus/deficit picture is improved in three out of the four states. This occurs because the surpluses in the state retirement system trust funds are so large that they

TABLE A-2. CONVERTING SAMPLE STATE BUDGETS TO THE FEDERAL FORMAT: SUMMARY OF ADJUSTMENTS (In millions of fiscal year 1978 dollars)

Adjustment or Step	California	Illinois	Maryland	New York
Published Financial Results	5,346	-156	153	4
Elimination of Prior Year Deficit (+) or Surplus (-)	-3,389	163	-64	0
Annual Surplus or Deficit, Adjusted	1,957	7	89	4
Addition of Net Appropriated Funds Not Included in General Fund	1,181	71	33	175
Addition of Net Off-Budget Activities Comparable to On-Budget Federal Activities	--	22	60	-206
Elimination of Net Bond Proceeds and Debt Repayments	-106	-218	-606	-103
Addition of Retirement Funds, Net	1,997	480	276	1,734
Other Adjustments, Net	--	--	-118	301
Revised Surplus or Deficit	5,029	362	-266	1,905

SOURCE: Peat, Marwick, Mitchell, and Company, A Comparative Analysis of Federal and Selected State Financial Data, Exhibit II-1, p.13.

counteract the negative effect of bringing off-budget agencies and capital budget borrowing onto the unified budget. 1/

State and local limitations on capital borrowing have helped control total debt accumulation. Between 1970 and 1975, for example, the state and local bond issue elections required by many of the limitations gave voters the opportunity to reject 48.7 percent of the indebtedness requested by the various state and local legislatures.

On the other hand, it is also true that state and local debt has been accumulating at a faster rate than federal debt since World War II. In recent years, moreover, states have established special authorities (for toll roads, college dormitories, housing, office buildings, etc.) that are empowered to issue bonds to finance construction. These revenue bonds are not backed by the full faith and credit of the state; rather, they are considered moral obligation bonds.

These authorities not only allow the states to circumvent their statutory and Constitutional restraints on debt accumulation, but they also hide many state expenditures from the public scrutiny that would exist if they were included in the operating or capital budgets. These authorities are examples of the off-budget techniques that can be adopted to avoid an expenditures limitation.

1/ It should be noted that most states restrict the use of these trust fund surpluses. Thus their existence cannot be used, in itself, to determine the financial health of a state government.

NEGATIVE EVIDENCE: THE EFFECT OF CONSTITUTIONAL RESTRICTIONS ON STATE DEBT 2/

During the first months of the 96th Congress, numerous constitutional amendments have been introduced to require a balanced federal budget. While the various proposals differ in wording and detail, their common objective is to prohibit (or restrict) deficit spending by the Federal Government. Total federal expenditures would be limited to available revenues, thereby obviating the need for new long-term debt. The proposed amendments are thus similar in purpose to provisions in state constitutional limitation as evidence that American governments can be prevented from incurring debt by these kinds of limitations.

This brief report presents data on the indebtedness of state governments. Only long-term debt is included inasmuch as short-term indebtedness (less than one year's duration) might be permitted even if deficit spending were banned.

Although the constitutions of more than three-quarters of the states prohibit or restrict long-term indebtedness, the plain fact is that every state has incurred such debt. Table A-3 shows the amount of long-term debt outstanding in each state as of June 30, 1977. The debt is divided into two categories: (1) general obligations for which the "full faith and credit" of the state is pledged; and (2) nonguaranteed debt, the payment of which usually is derived from specific revenues. The finding that no state has been completely stopped from borrowing by constitutional limitations has been noted by a number of scholars. In his compendious 1941 study of state debts, B.U. Ratchford commented that:

> after a [constitutional] limitation has been imposed there are usually many attempts to evade or circumvent it. As the conditions which prompted the limitation recede into the background, there is frequently a tendency for these efforts to increase while the defense of the limitation weakens. 3/

2/ An essay by Allen Schick, Congressional Research Service.

3/ B.U. Ratchford, American State Debts (Duke University Press, 1971), p. 7.

TABLE A-3. LONG-TERM INDEBTEDNESS OF STATE GOVERNMENTS, JUNE 30, 1977 (In millions of dollars)

State	Full Faith	Non-guaranteed	Total	Percent Nonguaranteed
Alabama	111.9	885.3	997.1	88.8
Alaska	530.0	358.3	888.3	40.3
Arizona	-	101.1	101.1	100.0
Arkansas	-	140.4	140.4	100.0
California	5,704.0	1,001.0	6,710.0	14.9
Colorado	-	197.3	197.3	100.0
Connecticut	2,407.6	764.0	3,171.6	24.1
Delaware	408.7	332.9	741.7	44.8
Florida	433.7	1,569.7	2,003.4	78.3
Georgia	368.8	899.7	1,268.5	70.9
Hawaii	1,165.5	302.7	1,468.2	20.6
Idaho	1.1	49.8	50.9	97.8
Illinois	1,632.0	2,252.4	3,884.4	58.0
Indiana	-	577.6	577.6	100.0
Iowa	-	124.0	124.0	100.0
Kansas	-	402.8	402.8	100.0
Kentucky	331.3	1,709.9	2,040.6	83.8
Louisiana	1,298.2	466.0	1,764.2	26.4
Maine	274.9	289.2	564.1	51.2
Maryland	2,066.7	984.4	3,051.1	32.3
Massachusetts	3,203.4	1,345.2	4,548.6	29.6
Michigan	739.5	1,150.7	1,890.2	60.8
Minnesota	746.3	450.1	1,196.4	37.6
Mississippi	725.6	84.1	802.6	10.5
Missouri	79.1	361.4	440.4	82.0

(continued)

TABLE A-3 (continued)

State	Full Faith	Non Guaranteed	Total	Percent Nonguaranteed
Montana	7.4	94.0	101.4	93.1
Nebraska	-	59.3	59.3	100.0
Nevada	36.3	18.3	54.6	33.3
New Hampshire	223.9	118.3	363.2	32.5
New Jersey	1,680.9	2,274.8	3,955.7	57.9
New Mexico	25.0	186.9	211.9	88.2
New York	3,715.7	14,978.9	18,694.6	80.1
North Carolina	633.0	174.0	807.0	21.6
North Dakota	15.1	52.2	67.3	77.6
Ohio	1,991.1	1,079.2	3,070.3	35.1
Oklahoma	174.2	762.8	973.0	79.6
Oregon	2,412.2	19.1	2,431.2	0.8
Pennsylvania	3,848.2	2,376.7	6,224.9	38.2
Rhode Island	273.9	364.4	638.3	57.1
South Carolina	502.7	781.1	1,283.9	60.9
South Dakota	-	218.4	218.4	100.0
Tennessee	691.8	404.6	1,096.4	36.9
Texas	885.9	1,239.1	2,125.0	58.3
Utah	85.0	60.5	145.5	41.4
Vermont	252.9	201.4	454.3	44.3
Virginia	41.0	715.8	756.8	94.6
Washington	1,119.2	292.6	1,411.8	20.7
West Virginia	858.4	456.8	1,315.2	34.7
Wisconsin	1,210.7	464.0	1,674.7	27.7
Wyoming	-	73.3	73.3	100.0

SOURCE: Bureau of the Census.

Heins came to a similar conclusion in 1963, noting that

> when constitutional restrictions stood in the way of borrowing for public purposes, state legislatures improvised methods of borrowing which were, hopefully, beyond constitutional bans. When courts, in the face of taxpayer suits, ruled debt proposals to be unconstitutional, state legislatures altered their proposals until they achieved the sanction of the courts. 4/

Constitutional restrictions have not stopped the issuance of debt because states subject to the limitations have developed financing procedures which circumvent the restrictions. One form of circumvention is to earmark state revenues to service the debt; another is to provide that the debt is to be secured by certain revenues but not by the full faith and credit of the state. After some resistance in the 19th century and early decades of the 20th century, state courts generally have adhered to the "special fund doctrine" under which revenue bonds are not deemed to be obligations of the state, and hence are not subject to constitutional limitations. In a leading case, the supreme court of South Carolina upheld a scheme in which the State issued "certificates of indebtedness" to be paid from the proceeds of the gasoline tax but with an additional guarantee of the full faith, credit, and taxing power of the state. In upholding this obviously circumventious arrangement, the South Carolina court reasoned that "this pledge of the faith, credit, and taxing power of the state is merely a pledge of honor, because the State cannot be sued for an enforcement thereof without its consent." 5/

Once this breach in the constitutional provision was sanctioned, South Carolina embarked on widespread earmarking of revenues for debt service to the extent that its constitutional "debt limitation has been completely nullified by court interpretation and legislative action." 6/ Thus, half a dozen years after the landmark decision sanctioning special funds, the South Carolina Supreme Court declared: "This court has also held that bonds issued by the State which are payable out of special funds do not

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4/ A. James Heins, Constitutional Restrictions Against State Debt (The University of Wisconsin Press, 1963), p.13.

5/ State v. Moorer, 152 S.C. 527 (1929).

6/ Ratchford, op. cit., p.454.

create debts of the State . . . although the full faith, credit, and taxing powers of the State . . . are pledged for payment of the same." 7/

Nonguaranteed bonds have proliferated as a means of evading state constitutional controls. In 1949, this special form of debt was only 15 percent of the total long-term indebtedness of state governments; at the present time, more than half of the outstanding debt of state governments lacks a full faith and credit guarantee. In fact, nonguaranteed debt exceeds full faith and credit obligations in 28 states, as the data in Table A-3 show. Nine states (such as Indiana, South Dakota, and Wyoming) rely on nonguaranteed debt.

There is a definite correlation between constitutional restrictions and recourse to revenue bonds and other forms of nonguaranteed debt. In states where the legislature is unfettered by constitutional restraints on borrowing, nonguaranteed debt amounts to less than one-third of total indebtedness; in states subject to constitutional limitations two-thirds of the debt is of the nonguaranteed variety. 8/

Because states have been able to evade constitutional controls by means of nonguaranteed debt, one analyst concludes that "governmental units with relatively restrictive debt limitations have issued just as much debt as less restricted or unrestricted units. Debt limitations have merely changed the composition and increased the cost of financing capital expenditure." 9/

The issuance of nonguaranteed debt represents much more than a shift in the form of indebtedness. Nonguaranteed obligations usually carry a lower credit rating than full faith and credit obligations, and therefore bear higher interest charges. Although they are not deemed by courts to be state debt, nonguaranteed

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7/ Clarke v. South Carolina Public Service Authority, 177 S.C. 427 (1935).

8/ The classification of state constitutional restrictions is derived from Heins, op. cit., Chapter 3.

9/ William E. Mitchell, "The Effectiveness of Debt Limits on State and Local Government Borrowing" (New York University, Graduate School of Business Administration Bulletin, October 1967), p. 48.

bonds often are considered "moral obligations" of the state, and there is an expectation that the state will act to prevent default.

The issuance of nonguaranteed debt is associated with another method for evading state constitutional restrictions. Many states establish special corporations with authority to issue their own--usually nonguaranteed--debt. A state-by-state listing of the number of agencies and corporations authorized to issue debt is provided in Table A-4. The more stringent the constitutional restriction against borrowing, the greater the number of agencies or corporations authorized to borrow.

The proliferation of public corporations and "quasi" governmental units with authority to borrow has made it difficult to secure accurate and comprehensive data on the amount of state debt. The statistics in Table A-3 are derived from U.S. Census reports but they differ in many instances from the listing furnished by Moody's. Where there is a discrepancy between these two sources, Moody's--which lists every outstanding bond issue--usually shows a higher level of total debt. As might be expected, the discrepancy usually occurs in the amount of nonguaranteed debt, for it is precisely this type of obligation which is issued by special corporations. Thus, in 1977, the Census reported $450 million in nonguaranteed debt for the State of Minnesota, whereas the individual issues listed in Moody's totaled $665 million.

Although most states are restricted in their borrowing practices, total state debt has been rising more steeply than that of the Federal Government which is not encumbered by constitutional restrictions.

Table A-5 shows that the states now account for a larger share of total public debt in the United States than at any other time since World War II.

Conclusion

State experience offers meager support for the expectation that constitutional restrictions will constrain governmental borrowing. While one ought to be wary about generalizing from state to federal budgeting, the budgetary practices of the Federal Government offer little encouragement for the long-term effectiveness of constitutional limitations. Even in the absence of such limitations, the Federal Government has authorized tens of billions of borrowing by "quasi" or "non-governmental" agencies outside the statutory debt limitation currently in effect.

TABLE A-4. STATE AGENCIES AUTHORIZED TO ISSUE NONGUARANTEED OBLIGATIONS

State	Number of Agencies	State	Number of Agencies
Alabama	27	Montana	2
Alaska	5	Nebraska	4
Arizona	5	Nevada	1
Arkansas	9	New Hampshire	3
California	8	New Jersey	14
Colorado	4	New Mexico	2
Connecticut	6	New York	20
Delaware	5	North Carolina	13
Florida	10	North Dakota	9
Georgia	11	Ohio	16
Hawaii	3	Oklahoma	7
Idaho	3	Oregon	0
Illinois	13	Pennsylvania	10
Indiana	8	Rhode Island	11
Iowa	3	South Carolina	1
Kansas	9	South Dakota	6
Kentucky	7	Tennessee	4
Louisiana	19	Texas	12
Maine	5	Utah	2
Maryland	4	Vermont	6
Massachusetts	15	Virginia	7
Michigan	6	Washington	5
Minnesota	6	West Virginia	6
Mississippi	2	Wisconsin	5
Missouri	5	Wyoming	1

SOURCE: Moody's.

TABLE A-5. PERCENTAGE DISTRIBUTION, GROSS PUBLIC DEBT

Year	Federal	State	Local
1940	67.9	5.7	26.4
1950	91.4	1.9	6.7
1955	86.1	3.5	10.4
1960	80.4	5.2	14.4
1965	76.1	6.5	17.4
1970	72.1	8.2	19.7
1975	70.7	9.6	19.8

SOURCE: Tax Foundation.

The way in which constitutional provisions can be affected by "creative budgeting" is amply demonstrated by reference to the constitutional prohibition that "no money shall be drawn from the Treasury but in consequence of appropriations made by law." Despite this provision which has remained unchanged since 1787, hundreds of billions of dollars have been spent without prior appropriation. Agencies have been authorized by Congress to "borrow" from the Treasury--or the public--without first obtaining an appropriation. This technique seems to satisfy the letter of the constitutional requirement, even though the intent has not been fully honored. Other creative techniques are likely to issue from federal budgeters and legislators if they are confronted with restraints on borrowing similar to those which have been evaded by state governments.