POLICY report

Goldwater Institute

No. 249 | August 30, 2012

Cutting up the Credit Cards: Seven Ideas to Reform the Culture of Debt in State and Local Government

Stephen Slivinski, Senior Economist of the Goldwater Institute

EXECUTIVE SUMMARY

Arizona's constitutional drafters early in the 20th century were averse to public debt and to the tendency of government to use subsidies favor certain private interests. As a result, Arizona has a constitutional debt limit that limits state debt to $350,000—roughly $8 million in today's dollars. But that limit is not effective at actually limiting debt. Today, state-level bonded indebtedness equals $13.7 billion. All levels of government in Arizona have outstanding debt in one form or another in the combined amount of at least $44 billion and possibly as high as $51 billion.

The courts have interpreted the debt limit to apply only to a specific type of debt: the "full, faith, and credit" debt (also known as "guaranteed" debt, or general obligation debt). As a result, politicians are able to commit current and future taxpayers to paying off a number of debt instruments—usually called "nonguaranteed" debt—that are not subject to the constitutional limit and do not require voter approval.

Arizona ranks 25th in the nation with around $7,500 in per person debt load, above the national median of around $6,800. Debt-service payments were the fastest growing category in Arizona's noncapital budget for state general expenditures between 2002 and 2009, growing by 170 percent in less than a decade. For Arizona's local governments, debt service was the fifth largest expenditure category behind spending on schools, police, electricity systems, and road maintenance. In Arizona, roughly 23 percent of all state and local debts are for projects that primarily benefit private interests.

Arizona policymakers need to pay down debt and all future debt should be forced under a strict cap. After giving the state a reasonable period of time to pay off existing debt, a new debt cap of no more than 6 percent of net assessed value of private property in a state would limit all future debt. The same sort of cap should apply to cities and counties as well.

Additional reforms to get debt under control include:

- Require voter approval of all debt at the local level.
- Forbid issuance of government-grade, tax-exempt bonds by non-elected bodies.
- Require that the maturity schedule of a bond be equal to or shorter than the life of the asset being purchased or financed with the bond.
- Require transparency of all state and local debt.
- Encourage municipalities to save for future projects that can be paid for with cash instead of debt.

Arizona can reclaim its historic title as a state forged in the understanding that excessive public debt can trap future generations. Overcoming the political culture of debt may take some time, but it is possible, and present and future taxpayers will benefit both fiscally and economically.

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Introduction

Imagine a city of more than 290,000 people during a seven-year boom in property values, population growth, and tax revenue. Those boom years were great for the city—a sports arena was built for a hockey team and so were new retail centers, office buildings, and parking garages, all using government-backed bonds.

Now, imagine that the city is facing bankruptcy this year. Property values have plummeted, forcing a massive hole in the city budget, and the police and fire forces have been cut by around 30 percent. The new city hall—which never officially opened—has been repossessed after bond defaults by the city. A few new parking garages have also been repossessed by bond holders. The arena—mainly a home to the local minor league ice hockey team—is underbooked for the foreseeable future. The city has dwindling reserves and is expected to run a budget deficit of around $26 million this year.

That city is real: Stockton, California. In June 2012, the city council voted to enter Chapter 9 bankruptcy to reorganize the hemorrhaging balance sheet. Stockton is the biggest American city to ever declare bankruptcy.

Arizona policymakers need to pay down debt and all future debt should be forced under a strict cap.

The story of Stockton is also a cautionary tale to cities across the nation that took on excessive debt during the boom years. The example closest to home is Glendale, Arizona. Those witnessing Glendale's rapid debt accumulation should be nervous.

The city of Glendale, which is about three-quarters the size of Stockton, has made similar sorts of gambles—particularly on projects like retail centers and sports arenas. In both cases, much of the government spending was fueled by public debt. Glendale's overall long-term debt load in 2011 was just over $1 billion, according to data from the Arizona Department of Revenue. That is $4,341 per resident. By contrast, Stockton's debt was around $700 million, or around $2,400 per resident—just a bit over half of Glendale's per capita debt load. Glendale also had a very fast run-up in that debt number. In 2003, the city's per capita debt was only $1,695. In other words, Glendale ran up its debt faster than the population grew and succeeded in increasing the per resident debt load by 156 percent.

Of course, there are plenty of differences between the two cities. But it is important to note that for many cities across America avoiding the fate of Stockton might be simply a matter of making sure they do not overcommit themselves during a boom period in the first place. Constitutional debt limits can provide such protection. Yet, in Arizona as in most other states with limits, those limits have been eviscerated by judicial interpretation. This lack of effective debt limits has allowed a culture of public debt to flourish in the legislature and, more particularly, in city halls across the state. Reversing this trend will require overcoming the public debt culture and instituting real limits on state and local indebtedness.

The Culture of Public Debt

To understand what it will take to overcome the culture of public debt in Arizona, we should first survey the effects of the present debt levels, as well as the institutional mechanism by which the states and the localities got to this level of indebtedness.

According to the most recent Department of Revenue estimates, Arizona had $44 billion in state and local long- and short-term debt outstanding last year.[1] That debt is around $7,500 per person in the state. When Mark Flatten, Goldwater Institute investigative reporter, tried to track down all of the state's outstanding debt, he discovered that the total was closer to $51.5 billion in debt of one sort or another (but not including unfunded pension liabilities). His research, included in the investigative report *Debt and Taxes,* means that the share is around $8,500 per person.

Arizona has a constitutional debt limit that caps state debt at $350,000. But the obvious problem with Arizona's constitutional debt limit is that it does not work well in limiting the actual indebtedness because state courts have interpreted the debt limit to apply only to a specific type of debt – the "full, faith, and credit" debt (also known as "guaranteed" debt or general obligation debt). As a result, politicians obligate current and future taxpayers to pay nonguaranteed debts that do not have constitutional limits or require voter approval.

The bankruptcy of Stockton, California is a cautionary tale to cities across the nation that took on excessive debt during the boom years.

Most other states evade whatever debt limits they have in the same way. Thus, the overall debt levels in Arizona—indeed in any state—can be seen as a reflection of what might be considered a debt culture that has permeated state and local politics. It is a culture that breeds acceptance of the idea that government costs can be passed into the future. Sometimes the type of projects that are funded with government-grade, tax-exempt debt can be influenced by representatives of private interests who try to persuade policymakers to leverage future taxpayers for a project that will benefit primarily a real estate developer or a specific business. Without debt limits and requirements that taxpayers must approve the debt issued by government, this culture of cronyism can thrive.

The best source of information for comparisons between the states—in other words, a way to see how pervasive the debt culture is in each state—is the U.S. Census Bureau. Most state and local bonded indebtedness is accounted for in the data that the Census Bureau publishes annually. According to this data, state and local per capita long-term debt grew from $4,568 in 2000 to $7,587 in 2009, an increase of 66 percent. Comparing states by per capita state and local long-term debt load in 2009 (the most recent complete year available), the Census Bureau ranks Arizona 25th in the nation, with around $7,500 in per person debt load. That figure still puts the state above the median of around

Table 1. Per Capita State and Local Long-Term Debt, 2009

Rank	State	Dollars	Rank	State	Dollars
1	New York	$14,883	26	Indiana	$7,575
2	Massachusetts	$14,748	27	Virginia	$7,390
3	Alaska	$14,452	28	Nebraska	$7,254
4	Rhode Island	$10,988	29	Missouri	$7,083
5	Connecticut	$10,492	30	Wisconsin	$7,076
6	New Jersey	$10,164	31	Vermont	$7,055
7	California	$10,079	32	New Mexico	$6,976
8	Colorado	$10,018	33	South Dakota	$6,803
9	Illinois	$9,992	34	Maryland	$6,723
10	Washington	$9,957	35	Montana	$6,438
11	Nevada	$9,446	36	Utah	$6,365
12	Kentucky	$9,440	37	Ohio	$6,205
13	Delaware	$9,231	38	North Dakota	$6,116
14	Pennsylvania	$9,210	39	Maine	$5,797
15	Texas	$8,998	40	Tennessee	$5,695
16	Oregon	$8,708	41	Georgia	$5,382
17	Hawaii	$8,519	42	Alabama	$5,378
18	Kansas	$8,388	43	West Virginia	$5,315
19	New Hampshire	$8,316	44	North Carolina	$5,279
20	Minnesota	$8,175	45	Iowa	$5,075
21	Florida	$7,872	46	Oklahoma	$4,931
22	Michigan	$7,718	47	Mississippi	$4,507
23	South Carolina	$7,671	48	Arkansas	$4,378
24	Louisiana	$7,591	49	Wyoming	$4,097
25	Arizona	$7,587	50	Idaho	$3,758

Source: U.S. Census Bureau (2011).

The overall debt levels in any state can be seen as a reflection of what might be considered a debt culture that has permeated state and local politics.

$6,800. Note that this debt load does not include other forms of debt, such as future unfunded liabilities, that heap thousands more onto the per person debt cost. This study will not include an analysis of such costs, although they are substantial.[2]

These numbers include both guaranteed and nonguaranteed debt. The latter is where the real action in bond finance has been centered for the past two decades. Classic examples of nonguaranteed debt are bonds issued to help pay for the construction of sports stadiums or shopping malls and that are collateralized by the revenue those projects are expected to generate.

The explicit cost of all of this off- and on-budget debt can be large. Over time, the costs of servicing the debt may grow faster than other budget categories and can "crowd out" spending on essential or traditional government operations. Debt-service payments were the fastest growing category in Arizona's noncapital budget for state general expenditures between 2002 and 2009, according to U.S. Census Bureau data, clocking in at around 170 percent.

The growth rate for localities (45 percent) was not as fast as the state's. But that is because local government already had a high debt-service budget—around $900 million, which was almost five times the size of the state's debt-service expenditures of $186 million in 2002. Total local government debt-service expenditures in 2009 were $1.3 billion compared to the state's debt-service expenditures of roughly $500 million. For local governments, debt service was the fifth largest expenditure category behind spending on schools, police, electricity systems, and road maintenance.[3]

Almost a Quarter of Arizona's Debt Fuels Projects for Private Benefit

Some of this debt service—for example, to service the debt on road construction—may go to pay interest on bonds that genuinely generate public benefits that will outweigh the costs of the debt in the long run. Those benefits certainly need to be stacked up against the costs of the debt in an overall comparison, and such considerations need to be made by voters and policymakers before they approve the issuance of bonds. But when a substantial enough share of state and local debt actually finances projects that benefit mainly private interests, there is little likelihood that the overall public benefit for all projects financed by debt will outweigh both the explicit and implicit costs.

Debt-service payments were the fastest growing category in Arizona's noncapital budget for state general expenditures between 2002 and 2009, according to U.S. Census Bureau data, clocking in at around 170 percent.

Moreover, if a state or local government were relatively unhindered—at least by law—in its ability to issue nonguaranteed debt, we might expect it to more frequently use this nontraditional debt because the cost can be hidden or the government can be declare that the debt will not affect taxpayers or the municipal balance sheet. At that point, we might also expect that policymakers will then be able to issue more debt or to create ways to use taxpayer backing to benefit private interests, particularly in off-budget categories or with nontraditional debt instruments.

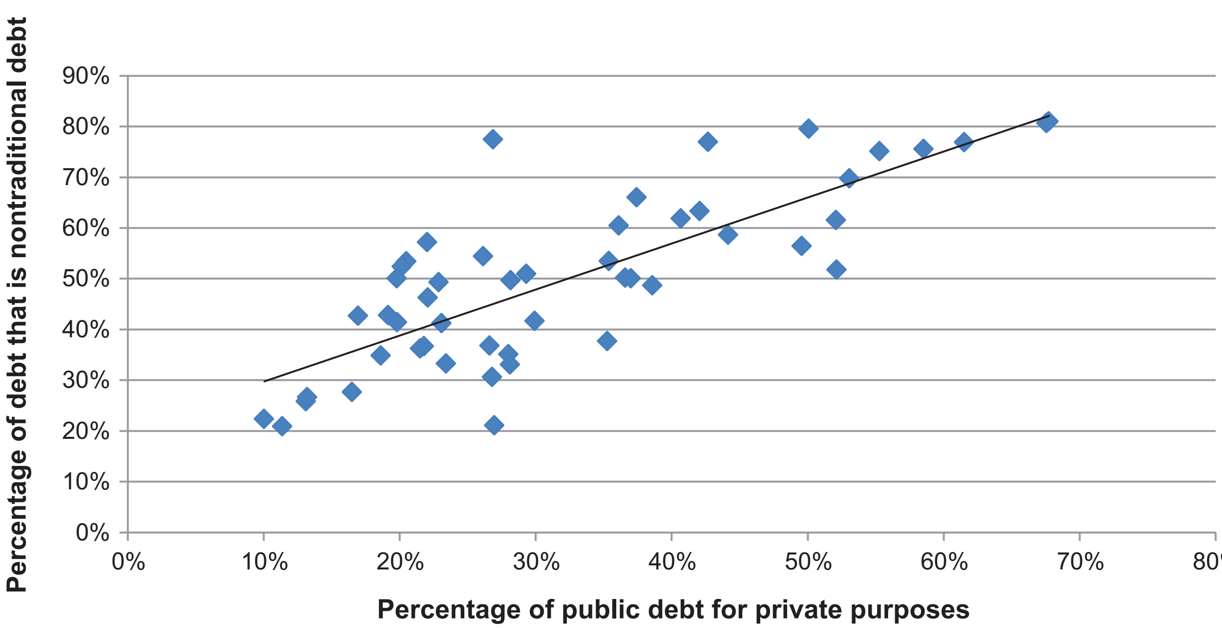
In fact, this appears to be just what has happened. A substantial share of state and local debt goes to finance projects that mainly benefit private interests. You can see the connection by looking at data for what the Census Bureau classifies as "public debt for private purposes." Census defines this commitment as debt issued to finance industrial and commercial development projects, pollution control projects, housing and mortgage loans subsidies, private hospital facilities, sports stadiums, convention centers, and shopping malls. To illustrate the scope of this type of activity, the Census Bureau tallies up virtually all forms of this indebtedness for both the state and local level.[4]

Comparing the "public debt for private purposes" to the amount of nonguaranteed debt that state and local governments have can show the mechanism that drives this culture of debt: political decision-makers who try to use the government's ability to issue tax-free bonds for the purpose of creating risky "economic development" projects or currying favor with a particular special interest group.

The connection is illustrated in Figure 1, which shows a very strong correlation between the share of long-term state and local debt that benefits private interests and the share of long-term nonguaranteed debt in a state, most of which is considered to be outside constitutional debt limits or to be off budget. This comparison suggests that at least a portion of state and local government debt is driven by the fact that the governments are able to issue more non-debt; to keep that debt outside of a debt cap and off the budget; and, as a result, to fund more projects that benefit primarily private interests.

The data come from the Census Bureau's Census of Governments, which is conducted every five years. The most recent available data, which is used in the figure, are from 2002. In addition, to avoid skewing the result, debt for traditional government purposes such as road building and utility operations was subtracted

Figure 1. Higher Non-debt Levels Correlate with More Debt-Funded Projects that Benefit Primarily Private Interests



Source: "Census of Governments," U.S. Census Bureau (2002).

from the Census data to illustrate the most blatant forms of political favoritism that are encouraged by a culture of public debt. This correlation holds up and remains robust even after subjecting it to a series of control variables to account for demographic, economic, political, and fiscal differences between states.[5]

To see the scope of such behavior in each state, examine Table 2. It shows that more than 20 states devote at least one-third of their total state and local debt to projects that primarily benefit private interests. Arizona ranks 31st by this standard, with around 23 percent devoted to such projects. The median among states is around 30 percent.

Table 2. Percentage of Overall State and Local Debt that Primarily Benefits Private Interests, 2009

Rank	State	Percentage	Rank	State	Percentage
1	Montana	66	26	Wisconsin	29
2	Wyoming	65	27	Iowa	28
3	South Dakota	55	28	North Carolina	27
4	Idaho	48	29	Utah	24
5	New Hampshire	47	30	Illinois	24
6	Rhode Island	45	31	Arizona	23
7	West Virginia	44	32	Minnesota	22
8	Vermont	42	33	Virginia	22
9	Delaware	40	34	New York	22
10	Maine	39	35	Michigan	22
11	Kentucky	39	36	Texas	21
12	Missouri	38	37	Oklahoma	20
13	Ohio	38	38	New Jersey	18
14	Alaska	38	39	Tennessee	18
15	Pennsylvania	38	40	Nebraska	18
16	Maryland	37	41	Oregon	16
17	North Dakota	36	42	Mississippi	16
18	Massachusetts	36	43	Florida	15
19	Louisiana	35	44	South Carolina	14
20	Arkansas	33	45	Washington	14
21	Kansas	33	46	Georgia	12
22	Colorado	30	47	California	11
23	New Mexico	30	48	Alabama	8
24	Indiana	30	49	Nevada	8
25	Connecticut	29	50	Hawaii	4

Source: U.S. Census Bureau (2011).

A substantial share of state and local debt goes to finance projects that mainly benefit private interests. More than 20 states devote at least one-third of their total state and local debt to projects that primarily benefit private interests.

There is good reason to believe that using public debt to subsidize private projects in this way causes real economic harm. If experience is a guide, many of those projects would likely not have been profitable without the favorable public debt financing tied to the project. So, the presence of public debt financing can artificially route scarce capital resources away from privately funded projects by offering a higher private return. Such projects would otherwise have had a lower rate of return and might not have gotten off the ground. Government action that reroutes productive capital to less productive projects creates an implicit economic cost.

The Congressional Budget Office (CBO) has used its macroeconomic model to estimate an implicit annual cost to the U.S. economy of $22 for every $1,000 in debt issued to support such projects.[6] The CBO arrives at this estimate by using a common methodology used in most economic models. The methodology is based on historic relative rates of return between industries. It calculates the differences between the rates of return of (a) private projects that are funded with traditional private debt or stock issuance and (b) those private projects (typically exhibiting lower rates of return) that are financed with tax-free, government-issued debt. When the estimated coefficient is applied to the 2009 amount of "public debt for private purposes" as measured by the Census Bureau (which is $611 billion), the result indicates that this debt causes an implicit annual average economic cost of $13.4 billion nationally.

Legislators and municipal policymakers are able to issue debt instruments—which they insist are not debt—to fund projects that often are not approved by voters. The debt instruments are issued far in excess of the constitutional limit and often serve the main purpose of subsidizing private interests at the explicit and implicit expense of the public.

Because state and local governments in Arizona account for about 1.8 percent of the total national outstanding debt of this sort, the implicit economic cost would also be 1.8 percent of the national estimate: $242 million. Or, in other words, an estimate of the implicit cost of public borrowing to benefit private interests specifically in Arizona is an average of $242 million each year in foregone productive private economic activity as a result of all levels of government issuing bonds to finance less-productive private activity. In addition, if you add this expense to the explicit cost of all debt service at the state and local levels, the total fiscal and economic cost of all state and local debt amounts to just over $2 billion each year.

So, in Arizona today, legislators and municipal policymakers are able to issue debt instruments—which they insist are not debt—to fund projects that often are not approved by voters. The debt instruments are issued far in excess of the constitutional limit and often serve the main purpose of subsidizing private interests at the explicit and implicit expense of the public. In 1912, the crafters of Arizona's state constitution were worried about excessive public debt and about the government's favoring some special private interests above others—both a consequence of and a driver of a permissive and pervasive culture of public debt. Two of the most important clauses written into the constitution to protect state taxpayers along such lines were the debt limit and the "gift clause" that forbids subsidies to private industry.

In the case of public debt, we are certainly far afield from the vision of Arizona's founders. In the sections ahead, this study will explain how the political culture of debt blossomed over the past 100 years and what we can do to wean the state off the debt levels we have seen to date by creating, once and for all, a debt limit that actually limits debt. Such limits can create an environment in which the culture of public debt will have a hard time thriving and, over time, will result in a much more modest debt level that supports only projects that truly benefit the public at large. In addition, a debt limit should also encourage policymakers to experiment with ways to finance infrastructure and construction projects on a pay-as-you-go basis or through other means that require little or no debt.

The Constitutional Debt Limit and Why It Does Not Limit Debt Anymore

If we have a constitutional debt limit at both the state and local level and a simple reading of the state constitution would convince anyone we do—why does the state of Arizona have so much debt in excess of the limit? Past and current judicial interpretation has defined the limit as applying only to general obligation debt. Other sorts of borrowing are not subject to this limit and are deemed to be non-debt.[7]

Judicial interpretation has defined the constitutional debt limit as applying only to general obligation debt. Other sorts of borrowing are not subject to this limit and are deemed to be non-debt.

Sadly, this arrangement is common in most other states with constitutional limits that are defined in the same way and interpreted much too narrowly by the courts. And, not surprisingly, the public indebtedness that grows is the sort that is defined as non-debt. Ample empirical evidence in the academic literature illustrates how debt limits that do not apply to all sorts of debt fail to restrain state and local total real indebtedness.[8]

To illustrate how poorly the current constitutional limits work, we can look at total per capita indebtedness in Arizona's cities, which are also subject to a constitutional debt limit. The debt limit for cities depends on the type of project and the type of debt (for example, general obligation debt for essential services such as sewer construction) and ranges from 6 percent to 20 percent of net assessed value of all property within the cities' boundaries.

Now imagine that all city debt, not just the general obligation debt, was subject to the 6 percent limit. Table 3 shows for cities in Maricopa County with more than 100,000 residents, how far above the debt limit each city's per capita debt load is. Think of it as the amount of debt that would not exist if the debt limit were construed as a hard constraint on borrowing.

Table 3. Per Capita Debt Load in Excess of Constitutional Limit—Major Cities in Maricopa County, Arizona, 2011

Phoenix	$4,473
Glendale	$4,414
Tempe	$3,799
Scottsdale	$3,725
Mesa	$2,676
Gilbert	$1,970
Chandler	$1,765
Peoria	$1,713
Surprise	$263

Source: Author's calculations based on data from the Arizona Department of Revenue.

The ranking here may not be surprising. Glendale is a heavily leveraged city partly as a result of the commitments it has made to the Phoenix Coyotes ice hockey team. The Phoenix numbers are bolstered by "municipal property corporation" bonds—those types of instruments will be explained later—to finance wastewater and sewage facilities. The other single biggest item is debt issued to finance operations at Phoenix Sky Harbor International Airport. Even if the limit were raised to 20 percent of net assessed value, all large Maricopa cities except Surprise would still be above the limit.

The drafters of the Arizona Constitution were wary of government debt and for good reason. They had seen the history of boom-and-bust cycles that brought many states and cities in the East to the brink of fiscal disaster and tipped many over the edge.

The drafters of the Arizona Constitution in 1912 were wary of government debt and for good reason. They had seen the history of boom-and-bust cycles that brought many states and cities in the East to the brink of fiscal disaster and tipped many over the edge.

Before 1800, many public works projects were modest and were financed by very little debt. Most of the funding came from current tax revenues, subscriptions, donations, lotteries, and sales of public lands.[9] After the turn of the 19th century, states began to use debt to finance public works projects such as canals, which was usually done by "conduit financing." States today often rely heavily on modern versions of that approach as we'll see later in this study. In conduit financing, a government entity issues bonds, and the bond proceeds are used by or on behalf of a nongovernmental, sometimes private, entity.[10] Ohio and Maryland used conduit financing to construct canals for the Ohio River and the Chesapeake Bay, for instance. In 1825, New York used it to construct the Erie Canal.[11] The financial collapse of 1837 halted the canal construction projects of that era and drove nine states—Arkansas, Florida, Illinois, Indiana, Louisiana, Maryland, Michigan, Mississippi, and Pennsylvania—into bankruptcy or near insolvency.[12]

Many states adopted state-level constitutional barriers to indebtedness after those debacles. Before 1840, no states included debt limits in their state constitutions. By 1855, 19 states had added them.[13]

Following the Civil War, local governments, which were at the time not encumbered by the debt restrictions put into place earlier on state governments, got into the act and led the charge to issue debt to finance railroad construction. As municipal bond historian Dr. William P. Kittredge explains,

> *This effort usually entailed some sort of merging of public and private credit. Municipalities guaranteed railroad securities or issued municipal bonds and used the bond proceeds to purchase stock in a railroad company. During the 1830s, the City of Baltimore, for example, loaned more than $4 million to the Baltimore and Ohio Railroad, the Baltimore and Susquehanna Railroad, and the Susquehanna Canal, thereby increasing its outstanding debt from less than $1 million to more than $5 million.*[14]

By the time Arizona was considering statehood, those experiences influenced the drafters of the state's constitution. They had their own homegrown examples as well. Between 1863 and 1912, the territory of Arizona took on debt of nearly $1 million, or just over $23 million in today's dollars. To avoid the sort of debt levels they had seen in other states, the drafters of the Arizona constitution looked to other state limits adopted in the mid-18th century as a guide.[15]

Debt allows financing of consumption today but defers the costs to tomorrow. That deferral may make sense for infrastructure projects that may benefit future generations. But policymakers often favor the form of government financing that makes government seem the cheapest to current voters and taxpayers.

The idea was to force the state to operate basically on a cash, pay-as-you-go basis. The debt limit of $350,000 was included at that level as a concession to the realities of budgeting: to allow a small amount of debt in the event of a recession or revenue decline to keep paying the bills of the state on time. Long-term indebtedness of any sort, however, was anathema to Arizona's constitutional authors.

The Arizona constitutional view might be called a classical view of the danger of debt. This view appears in histories of political thought, goes past the expansions in public debt encouraged by the federal government with its New Deal infrastructure projects, and even extends into the modern era in the analysis of some public finance scholars, including that of Dr. James Buchanan, who won a Nobel Prize in economics for pioneering achievements in the field of public choice and political economy.[16]

Aside from the usual concerns about a state or city overleveraging itself and defaulting on its bonds, this approach also highlights the degradations in political accountability when governments are either free to issue debt or able to circumvent restrictions—such as voter requirements to issue debt—that are meant to keep such indebtedness to a minimum and related mainly to the proper functions of government.

Debt, by definition, allows financing of consumption today but defers the costs to tomorrow. That deferral may make sense for infrastructure projects that may benefit future generations. But policymakers often favor the form of government financing that makes government seem the cheapest to current voters and taxpayers. Forcing future taxpayers and voters—who may not yet be born and certainly can't vote or register their disagreement—to pay off bonds is usually the preferred option in this scenario. As such, this approach can encourage growth in government in excess of what might exist if policymakers were fully accountable for the true cost of government.

Even the traditional assumption that debt can be used to create long-term infrastructure improvements that may benefit future generations isn't always true. Long maturities on bonds can burden future generations by forcing them to pay for assets they may never actually use. Or, to put it another way, they may be saddled with payments on bonds that were used to finance projects that are no longer providing benefits for them. Think of a decrepit road or a once-shiny baseball stadium that lasted only 15 years yet each was financed with bonds that didn't mature until 20 years later.

Additionally, debt service on bonds and other debt instruments crowds out other spending in the budget in the near term. If a state or city overleverages itself, which is easy to do with weak limits on the power to issue debt, the amount of money needed to make interest and principal payments on bonds will mean less money for other essential government functions. A recent example of this phenomenon is the city of Glendale's current situation. Built into its annual budget is a debt-service load (about $57 million in 2011) on a number of debt instruments related to the Phoenix Coyotes' ice hockey arena and a surrounding retail center. This wedge in the budget makes it hard to make ends meet, especially in an economic downturn. Because of the city council's unwillingness or inability to reduce the debt, as well as the economic downturn, the city has had to cut the budget of the public works office and police.[17]

Is It Debt?

Anyone who looks at the financial report of a major municipality will notice phrases such as "revenue bonds," "certificates of participation," or "municipal property corporation." They seem so foreign and exotic. But the easiest way to refer to each of those instruments is by a simple, classic description: debt.

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Each device creates indebtedness of a government to someone who purchases a certificate or warrant that entitles that person to a claim on some sort of revenue source—the classic definition of a bond.[18] For instance, a revenue bond is a claim that a bondholder has on some form of nongeneral fund revenue—usually a specific revenue source such as excise taxes or fees—in exchange of money today to fund a project that will generate revenue that serves as collateral for the bond. Yet, as we'll see, those types of revenue bonds are not currently limited under the constitutional debt cap and most don't require voter approval.

Municipal property corporation bonds are issued by nonprofit corporations to finance projects, which are then leased to the political subdivision. Those bonds are secured by lease revenue that the municipal jurisdiction pays. This form of debt is not subject to voter approval either, nor do judges construe such debt as falling under the constitutional debt limit because the bonds are issued by the nonprofit corporation and not by the political subdivision.

Certificates of participation are best described as yet another form of debt. Those shares of a building lease are sold to investors in exchange for principal and interest payments. Typically, the source of the payments is annual government appropriations of rent for the space that the government is using. Issuing such certificates does not require voter approval. And they aren't seen by policymakers or judges as bonds either, even though the government or district will receive the proceeds of investor purchases of those certificates in exchange for paying what even they refer to in government balance sheets as "principal and interest."

Policymakers and judges see all of these financial arrangements as non-debt forms of financing. But such non-debt can be very expensive.

Lease–purchase agreements should also be seen as debt and should work in a similar way. In such arrangements, a government provides lease payments for a service. Those payments are used to pay down debt that was used to purchase or construct the building or project that produced the leasable item. To see how such an arrangement can produce revenue in the near term and an obligation in the long term, take a look at the most high-profile example: In 2010, the state government "sold" the Arizona capitol building to a holding company, used the proceeds from that sale to plug a budget hole, and then signed an agreement with the company to make lease payments over time until a designated period in the future when the state would repurchase the building.[19] Imagine that the capitol building is simply a piece of paper called a bond, and this arrangement doesn't seem fundamentally different from traditional debt.

Two other forms of indebtedness are "impact aid" and "special assessments." The first is tied to federal money sent to the state for a specific project. The latter is a form of revenue bond, but it funds projects that generally benefit a specific group of property owners within an established geographic area or district. The projects are secured by assessments (or taxes) that are levied against property located within the district.

Policymakers and judges see all of these financial arrangements as non-debt forms of financing. This view has been fleshed out in judicial case law as the "special fund" doctrine. For things such as revenue bonds, the debt service "is payable solely from the revenues or earnings derived from the operation of a revenue-producing enterprise with the proceeds of such bonds."[20] And, by this logic, because the government is *not* expected to look beyond that dedicated revenue source to repay the bonds, then no debt is really created.

Such non-debt can be very expensive. As Table 4 shows, those supposedly non-debt instruments make up close to 75 percent of all outstanding long-term indebtedness of state and local governments in Arizona. The more than doubling of overall state indebtedness is a direct result of those debt instruments, which the court and policymakers insist are not actually debt.

Table 4. State and Local Long-term Debt and Non-debt

	2001	2011	Percentage Growth
General obligation	$7,266,751,009	$10,844,268,717	49.2
Revenue	$10,398,171,472	$20,343,437,535	95.6
MPC	$579,462,871	$7,147,855,360	1,133.5
COP	$746,306,888	$3,911,045,567	424.1
Impact aid	$0	$38,245,000	-
Special assessment	$281,290,659	$508,758,187	80.9
TOTAL	**$19,271,982,899**	**$42,793,610,366**	**122.1**

Source: Arizona Department of Revenue (2012).
Note: MPC = municipal property corporation; COP = certificates of participation.

The more than doubling of overall state indebtedness is a direct result of supposedly non-debt instruments.

The fastest growing type of non-debt was municipal property corporation bonds. A far second is certificates of participation. Yet, even with this growth, together they account for only about 26 percent of the total. Growth in those categories may simply be a consequence of policymakers becoming more familiar with those debt instruments as well as the occasional recognition—usually prompted by bond market realities and by rating warnings from a municipal bond agency—that the revenue base of other types of bonds may be stretched too thin and that these instruments are simply a more convenient resort.

The Government's Favorite Form of Non-debt: Revenue Bonds

This brings us back to the favored form of so-called non-debt: revenue bonds, which have fairly consistently accounted for around 50 percent of all Arizona state and local indebtedness for the past 10 years—even though there was a slight drop-off to 47 percent in 2011. If you look at only non-debt instruments, however, revenue bonds account for 63 percent.

Revenue bonds are often tied to some kind of excise tax—such as fuel or cigarette levies—or to revenue from some type of fee for services. Many revenue bonds can even be tied to the same revenue source that could create pressure by bond rating agencies to downgrade the debt because the bond coverage by the revenue stream is being stretched too thin.

Revenue bonds are the most common debt at the state level—of the total $13.7 billion in long-term debt outstanding for Arizona, about $10 billion, or 76 percent, is in the form of revenue bonds. More than half of that debt, however, is for projects that revenue bonds are typically issued for, such as highway projects or university construction where the bond collateral is fuel tax revenue or tuition payments, respectively.[21]

Revenue bonds are also common at the county level. Of $1.3 billion in total long-term debt outstanding for Arizona counties, revenue bonds compose 59 percent. At the city level, revenue bonds made up around 28 percent of the $16.6 billion in long-term debt for 2011.[22]

Revenue bonds are considered nonguaranteed because they are not backed by general fund revenue the way general obligation debt is. Instead, they are backed by money generated by a specific revenue stream such as cigarette taxes or tolls or fees. Construction projects, such as parking garages, are often financed by bonds that are backed by future revenue flows from the fees charged to those using the structure once it has been completed. Because the projects are tied to a tax revenue stream that is not part of general revenue, government documents frequently repeat the argument that the government and general taxpayers will not be on the hook if the project goes belly up (for example, because of cost overruns or a flagging economy that dries up the revenue stream on which the bonds were based). Yet, it is not entirely clear whether that argument is always true.

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How Revenue Bonds Can Imperil Municipalities and Taxpayers

Revenue bonds are often used to finance and underwrite projects that have an uncertain future or are subject to cost overruns, including even conventional projects. In fact, two of the biggest municipal bond defaults in modern American history involved revenue bonds. Such defaults can imperil both municipalities and taxpayers.

The default of the Washington Public Power Supply System (WPPSS) in 1989 was, at that time, the biggest municipal bond default in U.S. history. Set up as a municipal corporation in 1957, the WPPSS issued revenue bonds starting in 1971 to underwrite the construction of five nuclear power plants across the state of Washington. The bonds' collateral was the revenue to be generated once the plants were operating and supplying energy to customers. By 1982, after millions of dollars in cost overruns, runaway inflation, and the accompanying economic downturn, as well as a souring in the nuclear electricity market because of the partial meltdown at Three Mile Island in Pennsylvania, the WPPSS decided to scrap two of the reactor projects and defaulted on more than $2 billion in revenue bonds. This action meant that the project's partners (state utility companies) were responsible for the debt—which, in turn, meant that the electricity customers were ultimately the ones to pony up the money because the costs were passed along to them. In some communities, the rate payers were socked with charges in excess of $12,000 per customer.[23]

The next municipal default to set a record occurred in 2009 when Jefferson County, Alabama, began to default on a number of its bonds. One of the biggest portions was the $3.1 billion default of the county's sewer enterprise district revenue bonds.[24] Although there were a number of reasons for the deplorable state of the county's finances—including the economic downturn and the corruption of county officials that is still being investigated by federal officials—the sewer district example is typical of what can precipitate large-scale default of revenue bonds.

The Jefferson County example is a vivid illustration of the consensus that revenue bonds are often viewed as a way of circumventing constitutional debt limits. As the *New York Times* reported in late 2011, "Like many places, it used newfangled instruments to circumvent constitutional limits on how much debt it could legally issue. In Alabama, counties are required to hold a referendum before issuing any general-obligation bonds. So Jefferson County has not issued such bonds since the 1950s. Instead, it issues warrants, which look nearly identical but do not require the referendum."[25]

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The examples of Jefferson County and the WPPSS may not matter much to a policy maker who is convinced that revenue bond defaults do not affect the creditworthiness of the municipality or quasi-governmental entity that issues the debt. But that assumption—which is widely shared—can breed a false sense of security. It is largely true that, on paper, most cities do not commit the "full faith and credit" of the municipal government to repayment of revenue bonds. In fact, most state statutes, including those in Arizona, claim that such debt does not necessarily obligate the city to repay the bonds with other revenue.

Yet there are examples in which default of non-debt revenue bonds have indeed affected the credit rating of cities even though those governments contended that their general-fund taxpayers would not be harmed directly or indirectly. In 1998, the city of Spokane, Washington, allowed the Spokane Downtown Foundation, a nonprofit corporation, to build a parking garage for the River Park Square Mall. The foundation—created by the mall's developer when the city declined to issue its own revenue bonds to fund the project—issued $31.5 million in revenue bonds, which, at the time, were understood to have the nonbinding "moral" backing of the city and a pledge of parking meter revenue if the revenue from the parking lot fell short.[26]

When the garage revenue did fall short of projections in 2001, the foundation defaulted on the bonds. At that point, the bondholders expected the city to pay off the bonds even though it was not the one defaulting. The city argued in court filings that it could not contribute or lend any money to the foundation. The city said it could not have credibly made the pledge because the foundation was unlikely to be able to pay the money back.

Far from agreeing with the city's arms-length stance on this issue, the bond markets rebelled. Moody's quickly downgraded the city's general obligation debt and its water and sewer debt. "We just think that the city's general credit has been weakened by its lack of willingness to pay on its obligation related to the parking garage," said Kenneth Kurtz, a senior vice president at Moody's.[27]

Bondholders sued the city. When all was over, a $31.5 million bond issue ended up costing the city—once legal costs and unpaid interest were included—about $34 million dollars.[28]

In light of such examples, it is doubtful that any municipal government could ever credibly commit to avoid making payments on revenue bonds that were issued by a special district or entity—even if the government did not explicitly pledge to do so. Of particular concern are revenue bonds issued for essential services such as sewer or water service. Several city officials in Arizona have acknowledged that they don't know what would happen to the municipality's general obligation debt rating if a community facilities district in their city defaulted on its revenue bonds.[29] Even the Maricopa County Debt Management Division acknowledges in its annual capital management plan that "all debt, regardless of the source of revenue pledged for repayment, represents some sort of cost to taxpayers or ratepayers."[30] In its annual plan, the division further notes the rating agency practice of including other debt obligations when calculating a city's or county's debt ratios.

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Bond specialists in the rating agencies share a similar view: cities are probably not likely to escape scot-free in the case of such a revenue bond default.[31] The text of bond rating reports from Moody's and Standard and Poor's frequently refers to the overall debt load by city governments—not to mention the state of a city's general fund finances—when explaining the credit rating awarded to the revenue bonds. For example, when Moody's downgraded close to half of the city of Glendale's overall total debt and non-debt load, the downgrade wasn't caused by just the increased payments to the National Hockey League to keep the bankrupt Phoenix Coyotes from decamping. While still maintaining a credit rating for those bonds in the AA to A range—a notch or two from the top rating of AAA—the rating agency noted in its report that it also had expressed concerns about "significant leveraging of excise tax revenues, which are also the general fund's largest resource."[32] As a result, the agency also lowered its outlook for the city from "stable" to "negative." Because Glendale had indeed explicitly pledged some of the revenue from its general fund, the bond rating agency was certainly warranted in looking at the overall state of the city's finances when developing its rating.

Bond buyers are clearly basing at least some of their decisions to purchase the revenue bonds on an assumption about how willing and able a municipality might be to making good on those bonds by dipping into general revenue or other forms of revenue. When this expectation is frustrated, there is a real and substantial risk that the municipality's credit rating will take a hit.

Granted, revenue bonds as a general class of debt are often the most defaulted-upon type of bond.[33] As a result they tend to carry a higher interest rate than does most general obligation debt.[34] Through the higher interest rates, the market imposes a check on how much leverage a city can have when issuing revenue bonds. Nevertheless, as illustrated by the behavior of the city of Glendale, revenue bonding can become like a drug—it can hook city officials into issuing more debt backed by the same revenue sources than they might have otherwise. As foreseen by Arizona's founders, the temptation to shift the cost of borrowing to the future is simply too great for many politicians to avoid. They overextend the public's credit when there is no constitutional check, whether it be a cap or approval by voters, on the amount of debt they can limit.

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Alternatives to Debt Financing: Pay-As-You-Go and Public–Private Partnerships

One thing that gets missed in discussions about municipal and state debt is that bond financing is not the only way to accomplish the goals of infrastructure improvement and long-term projects. Although financing projects on a pay-as-you-go basis has fallen out of favor, such an approach is not impossible.

The commonwealth of Virginia in the late 1920s, under the encouragement of Governor Harry Flood Byrd, was predominantly a pay-as-you-go state for financing roads.[35] The logic was that the roads would be built only if the government had enough gas tax revenue to undertake the project. During Byrd's tenure as governor, the commonwealth was able to build more than 1,500 miles of road without issuing a single bond.

Modern construction projects may indeed require more technology and, hence, require higher costs—not to mention the federal standards that need to be met. Financing big-ticket items entirely on a pay-as-you-go fashion may not always be practical. But more modest projects can be financed this way. And they have been quite recently in Arizona. The city of Phoenix did not issue any bonds when it undertook the construction of a new courthouse (which cost $340 million) or a jail improvement project (which cost nearly a half billion dollars). During the past 10 years, Phoenix saved about $350 million in interest charges just by avoiding debt.[36]

Another alternative to bond financing are public–private partnerships. In those arrangements, a private company bids for the right—or concession—to build and operate a road or other infrastructure project. The private company takes on the risk and the expense but receives the cooperation of the government in nonfiscal ways.

A modern example—and indeed one of the most aggressive public–private partnership efforts in the world—comes from Puerto Rico. The commonwealth's governor, Luis Fortuño, pushed for a law to create the Public–Private Partnership Authority to coordinate the effort. As Reason Foundation's Leonard Gilroy writes, "That law, Act No. 29, is now bearing fruit. It authorized government agencies to enter into public–private partnerships (PPPs) with private firms for the design, construction, financing, maintenance, or operation of public facilities, with a set of priority projects that include toll roads, transit, energy, water/wastewater facilities, solid waste management, and ports."[37]

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In 2010, a massive road project was approved. The private company that won the bid will "pay the Commonwealth an upfront payment of $1.136 billion, will invest $56 million in initial safety upgrades, and will make an estimated $300 million in additional investment in highway maintenance over the life of the concession."[38] The commonwealth will not issue debt to pay for any of this project. The privatization of the San Juan's Marin International Airport is expected to proceed in a similar way.

Far from being impossible without debt, such projects are likely to be more efficient because the private sector is bearing the burden for cost overruns. It is further proof that, in the modern world, debt is not inevitably an essential ingredient to infrastructure improvements. What is missing in most states is the existence of a firm debt limit that creates an incentive not only to keep debt under control but also to seek innovative ways to make needed infrastructure improvements without resorting to debt to finance all or most of it.

How to Incentivize Prudence: Proposals to Reform Arizona's Debt Culture

In order to bring Arizona's debt levels under control and reform the debt culture, changes must be made to both the state and city debt limits currently in the state constitution. Additionally, steps need to be taken in the short term to increase transparency of existing debt, particularly at the local level. Only by having strong institutional barriers to more debt can we hope to alleviate the debt burden in Arizona.

Reform 1. Reform and Strengthen the State Constitutional Debt Limit

The first and most important step in reforming Arizona's political debt culture is to strengthen the constitutional debt limit. As a strict rule, all state-level debt should be subject to the cap, not just general obligation debt. Thus, a new constitutional definition of "debt" needs to be formulated. If written correctly, it would ideally stand as a limit that cannot be gamed. It should explicitly state that debt is any agreement, contract, or other instrument currently recognized or later to be determined to have the effect of creating a functionally irrevocable long-term commitment of government revenues, directly or indirectly.

In order to bring Arizona's debt levels under control and reform the debt culture in this state, changes must be made to both the state and city debt limits currently in the state constitution.

Second, the debt cap needs to be redefined both (a) to create an incentive so policymakers will pay off debt in the near term and (b) to keep debt manageable in the future. An idea that has been previously proposed by Robert Burns, former president of the Arizona Senate, was to strike the dollar amount limit of $350,000 and to replace it with a limit that is tied to the net assessed value of all private land. That new standard should be the basis for the new debt limit. A three-year rolling average of property values may be used to avoid abrupt declines in the debt limit that could wreak havoc with pre-existing debt contracts and could hurt the state's credit rating. Yet the new standard would still encourage the state to remain well below the cap so as to provide a buffer between outstanding debt and the limit.

Third, as a matter of necessity, the cap needs to be raised in the near term to accomplish the goal of fitting all current state debt under the cap. A cap of around 20 percent of net assessed property value would be high enough to fit all state debt currently in circulation. The cap, however, cannot and should not stay that high indefinitely. Keeping the cap at that level would provide no incentive for the state to pay down much, if any, of the debt and would cement current debt levels into the future. So, over a 15-year period, the percentage rate needs to decline by roughly 1 percentage point each year until it finally rests at around 6 percent of the net assessed value of all private land in the state. That figure will then be the new debt limit for the future.

A cap that declined for 15 years would effectively create a requirement that some portion of the debt be paid off every year. It would also discourage issuing new debt until the current debt load was whittled down to a manageable size. A declining cap would also encourage—in fact, might even require—that the state legislature put aside a share of revenue each year in an account to pay off debt. A deposit of about 4 percent of the general fund budget each year might be sufficient. The amount in the account would be used to make principal repayment on the bonds. Additionally, to discourage the legislature from playing games with the fund by taking some of the money for current operations and issuing IOUs instead, any IOUs would be subject to the debt limit too.

If a debt limit of 6 percent—which amounts to around $4 billion in debt—were in place and abided by today, Arizona would have one of the lowest per capita debt loads in the nation. Yet, it would also be high enough to accommodate highway projects that are under way and to build expansions in the university system. In other words, a tight cap will not restrict the ability to issue debt if necessary, but it would discourage needless debt.

Reform 2. Strengthen the City and County Debt Limit

Currently, cities are subject to a constitutional debt limit of either 6 percent or 20 percent of net assessed value. The limit that applies is contingent upon what type of project the debt is funding. For instance, bonds to finance solid waste disposal operations go under the 6 percent cap, and bonds for airport authorities or certain types of water and sewer projects go under the 20 percent cap. Counties have a debt limit of 15 percent of property values.

If a debt limit of 6 percent of the net assessed value of all private land in Arizona—around $4 billion—were in place and abided by today, Arizona would have one of the lowest per capita debt loads in the nation.

Just as at the state level, an incentive needs to be built into the existing debt limit for municipal governments to both pay off current debt and control future debt. This goal can be accomplished under the current limit requiring cities, counties, and all subgovernment entities, including special districts, to be brought under the current caps and to be subject to the same all-inclusive definition of debt as the state. However, their existing debt can be classified by project, as it is under the current system. So, a currently off-budget sewer project that is funded by revenue bonds, for example, would be moved on-budget and under the applicable debt cap.

As it stands now, most local governments would have no problem fitting all their debt under this new debt cap. The notable exceptions are the cities of Glendale and Phoenix, which will likely have most of their debt reclassified into the 20 percent category. And they will likely hit that cap very quickly. However, as a practical matter, to avoid breaching the appropriate cap, those cities can be allowed to use the unused bonding allowance in the 6 percent category to cover only current debt from the 20 percent category and only after a two-thirds supermajority of the governing body votes to do so. This would keep a tight cap on new borrowing by those cities until they pay off some of their existing debt.

The new debt limit could include a phasedown of the 20 percent debt limit, over time turning the two-tiered system into a single debt cap of 6 percent of assessed value to match what exists at the state level. However, many cities have issued so much debt, the phasedown may need to take longer to avoid violating existing debt contracts. If that is the case, a 20-year phasedown may be appropriate.

Reform 3. Require Voter Approval of All Future Debt at the Local Level

Once all local debt is brought under the cap, all future debt at the county and city levels should be subject to voter approval. This requirement would likely minimize issuing local debt for projects that are not essential or at least not deemed important by voters of those jurisdictions, all of whom are likely to be harmed in one way or another by high debt levels.

When local governments obtain voter approval for new debt, they also need to be required to explicitly state whether issuing the new bonds requires borrowing from the other category of debt allowance. For instance, if a city has reached its 20 percent cap but wants to issue bonds that are classified as having to fit under that cap, the city needs to obtain a two-thirds supermajority voter approval to issue the bond and use that allowance. (If a debt issue does not breach the applicable debt cap, however, it may be passed by a simple majority of voters.)

Once all local debt is brought under the cap, all future debt at the county and city levels should be subject to voter approval.

In addition to being explicit about what issuing the new bond entails, the municipality should be required to be equally explicit about the trade-offs. For example, if a bond for a new sports stadium is being voted on, the ballot language needs to specify that those bonds are being issued using an allowance from the other (6 percent) bond category, which will, by definition, decrease the bonding authority available for any essential improvements that might require bonds, such as those for sewer and road projects.

Reform 4. Forbid Issuance of Government-Grade, Tax-Exempt Bonds by Non-Elected Bodies

Various special districts have been created over the years that have the ability to issue government-grade, tax-exempt bonds. Sports authorities and industrial development authorities are prime examples. The oversight boards of those entities are often appointed by elected officials, and certain seats might be reserved for elected individuals. However, accountability is blurred and is too far removed from the people who may ultimately be responsible for redeeming those debt instruments: taxpayers. Therefore, only elected bodies that are directly accountable to the people should be able to issue government-grade debt that carries with it the benefit of tax deductibility.

Reform 5. Require That the Maturity of the Bond Be Equal to or Shorter Than the Life of the Asset Being Purchased or Financed with the Bond

This provision would discourage policymakers from issuing debt to pay for activities that could be financed on a pay-as-you-go basis. For instance, issuing a 15-year bond to purchase new school buses that may last only five years would be forbidden. A 15-year bond could, however, finance the construction of a highway that would last in excess of 15 years. This provision would guard taxpayers against paying interest on capital assets that have long since outlived their usefulness. In addition, if a bond were to be refinanced, the bond maturity date would be limited by the time left in the capital asset's life.

Reform 6. Enhance Transparency of All State and Local Debt

The Arizona Department of Revenue produces an annual report that shows the amount of debt of school districts, cities, towns, counties, community college districts, state agencies, and some special districts. The Arizona Joint Legislative Budget Committee produces a state debt report that includes at least a nod to deferred payments to state agencies or subdivisions (otherwise known as rollovers). But balances of debt issued through some government-chartered entities, such as industrial development authorities, often are not known—even by the authorities themselves. This lack of transparency must be remedied with a comprehensive debt transparency requirement for all levels of government and quasi-government bodies, particularly the Industrial Development Authorities (IDAs), which have been exempted from reporting requirements since 2005.

The lack of debt transparency must be remedied with a comprehensive debt transparency requirement for all levels of government and quasi-government bodies, particularly the Industrial Development Authorities (IDAs), which have been exempted from reporting requirements since 2005.

Reform 7. Allow the Creation of Sinking Funds for Governments Already Subject to Expenditure Limits

A local government subject to a spending limit might be encouraged to issue debt to pay for a project that would normally fall under that limit. So, to prevent the existing spending limit from encouraging debt financing, governments should be allowed to create dedicated "sinking funds" wherein the governments can save for a large, lump-sum expenditure in the future. Deposits to the funds would count toward the spending limit, but large, lump-sum withdrawals from that fund to finance the specific project would not be counted toward a spending limit.

The following example might most easily help people understand this approach. Suppose a county wants to build a $20 million building. Under the current spending limit, a cash expenditure of $20 million might exceed the spending limit even though the $20 million was saved over a period of years. This proposal would count the deposits—for instance, $2 million a year—toward the spending limit each year. But after 10 years (ignoring interest earnings), the saved $20 million could be spent without counting toward the spending limit.

Conclusion

To get public debt under control in Arizona, the culture of debt that has emerged over the past 100 years must be reformed. To do that, it is essential that we have institutional rules that are hard to change and that cannot be evaded. The lack of effective institutional rules to limit debt has helped encourage and facilitate the debt levels we see today. Only reform of those rules can change the patterns of policy makers. The reforms outlined herein create all the right incentives for policy makers—encouraging debt retirement and exploration of pay-as-you-go financing and public–private partnerships—while squelching all the wrong incentives. In the process, voter input and putting a stop to at least a few decades-worth of political end-runs around taxpayers—both present and future—can once again help Arizona reclaim its historic title. That title is one of a state forged with the understanding that excessive public debt can trap future generations and that such debt can create an incentive to continually expand government and to pass the costs to Arizonans voters who haven't even been born yet. Overcoming the political culture of debt may take some time, but it is possible, and will benefit present and future taxpayers.

The reforms outlined create all the right incentives for policymakers while squelching all the wrong incentives. Overcoming the political culture of debt may take some time, but it is possible, and will benefit present and future taxpayers.

ENDNOTES

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3. See U.S. Census Bureau, "State and Local Government Finance Summary Report," 2002 and 2009, http://www.census.gov/govs/estimate/.

4. For Census Bureau debt definitions, see "Government Finance and Employment Classification Manual: Descriptions of Debt Categories," http://www.census.gov/govs/www/class_ch9_desc.html.

5. The percentage of state and local debt that benefits private interests was used as the dependent variable in an ordinary least squares regression. The independent variables were the percentage of nonguaranteed debt (minus highway and utility debt), median age of the state, region in which a state is located, real per capita personal income, percentage of the voting population registered as Republican (to control for ideological preferences of a state), and dummy variables to indicate whether a state has constitutional limits on debt or not (which came from the Kiewiet and Szakaly paper cited in this note). The results indicate that the variables in the regression explain about 67 percent of the variation between states (i.e., the *r*-squared equals 0.67). Those control variables are often used in regression analysis of state and local debt, particularly in D. Roderick Kiewiet and Kristin Szakaly, "Constitutional Limitations on Borrowing: An Analysis of State Bonded Indebtedness," *Journal of Law and Economics and Organization* 12, no. 1 (April 1998): 62–97.

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