

NATIONAL CENTER FOR POLICY ANALYSIS

THE NATION'S LARGEST MUNICIPAL BANKRUPTCY:

THE TIP OF THE OFF-BUDGET ICEBERG

by

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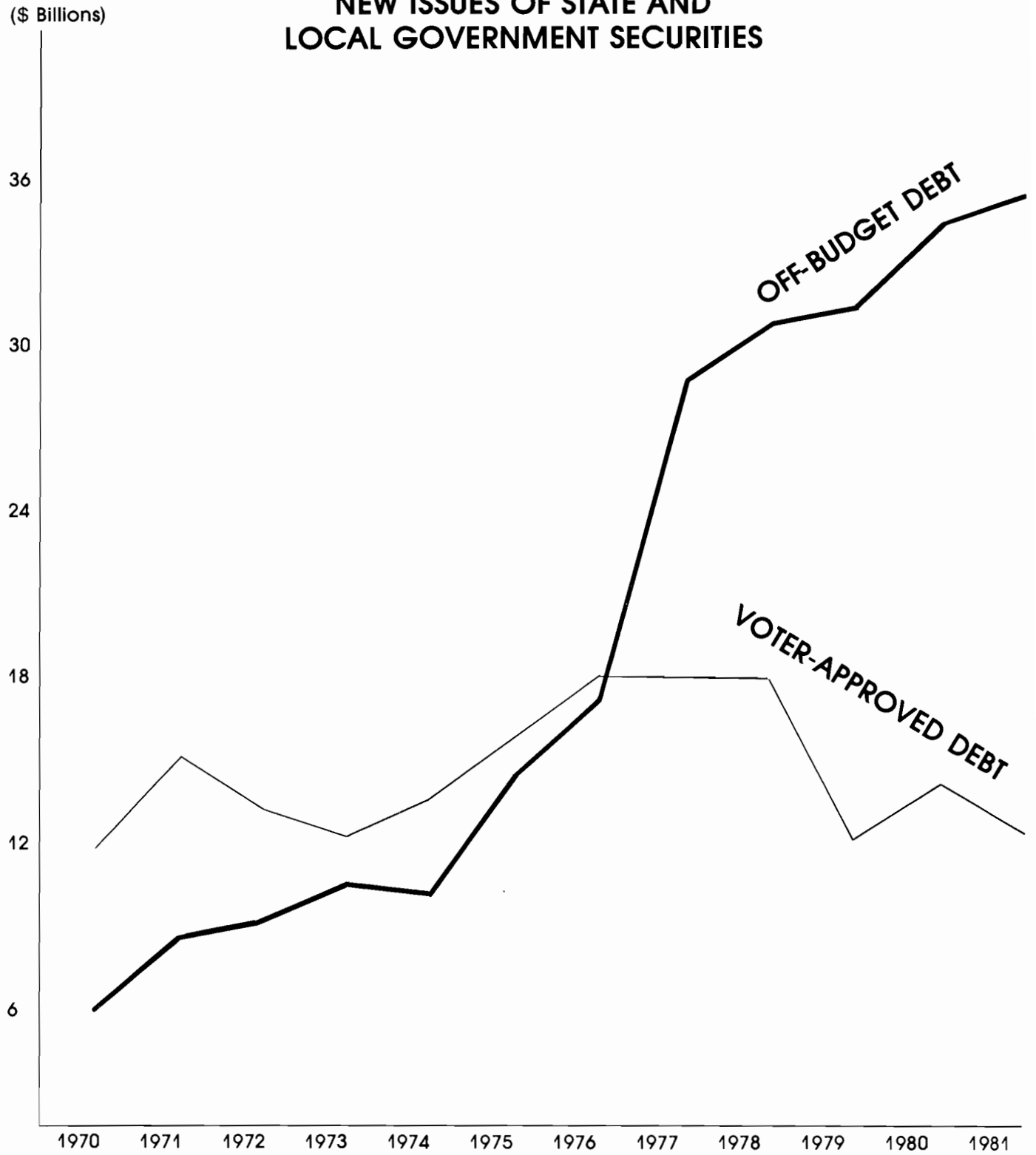
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For a more general analysis of off-budget government activity and its historical development, see James T. Bennett and Thomas J. DiLorenzo, Underground Government: The Off-Budget Public Sector, (Washington, D.C.: Cato Institute, 1983).

NEW ISSUES OF STATE AND LOCAL GOVERNMENT SECURITIES



Source: National Center for Policy Analysis

THE WHOOPS BANKRUPTCY

A recent article in Fortune magazine has the eye-catching title, "Nuclear Fiasco Shakes the Bond Market." The fiasco is not a meltdown, but what the article describes as the "squalor and fantastic waste" of the Washington Public Power Supply System. On July 25, WPPSS, known throughout the Northwest as "Whoops," defaulted on a \$2.25 billion debt. It was the largest municipal default in U.S. history.

WPPSS was created in 1957 by 23 publicly owned utility companies. It has the authority to produce, finance and sell electric power. Originally, the corporation had planned to construct five nuclear power plants by 1977 at an estimated cost of \$4.1 billion. Last year that cost estimate had soared to \$24 billion, and WPPSS was forced to scrap two partially constructed plants. The action left WPPSS with the \$2.25 billion in outstanding debt--and no possibility of the plants ever producing a single kilowatt of electricity.

The worst may be yet to come. Two of the remaining three plants have been mothballed indefinitely. Only one of the five plants is slated to be completed, and that will be seven years behind schedule. So thus far, although it has issued more than \$8 billion in debt WPPSS has produced no electricity to show for it.¹

Chartered by the state, WPPSS is a government entity, a municipal corporation of the state of Washington. Its bondholders are entitled to tax-exempt interest, if and when interest is paid. Yet, spending by WPPSS does not show up in the official budget of Washington state, nor in the budget of any local government. No elected official directly oversees its activities, and the taxpayers of Washington never got to approve one dime of the more than \$8 billion in outstanding debt. The reason? WPPSS is an "off-budget" enterprise, one of thousands created by states and localities across the country.

CAUSES OF THE WHOOPS BANKRUPTCY

To no one's surprise, irate taxpayers are organizing and demanding an end to WPPSS and an answer to the question, "How did we get into this mess?"

1. "WPPSS Default on \$2.24 Billion in Bonds Is Record for Municipal Debt; Suits Seen," Wall Street Journal, July 26, 1983, p. 3.

The answer lies in the fact that off-budget enterprises, or "public corporations" such as WPPSS, are a lot less accountable to the voters than on-budget government enterprises, which are subject to more direct taxpayer control and whose managers must face reelection.

Off-budget enterprises (OBEs) masquerade under a variety of guises. They are called districts, boards, authorities, agencies, commission, corporations and trusts. Regardless of their title, the essential feature of all off-budget enterprises is that they do not appear in the budget of the governmental unit or units that created them. Thus, legislators have been able to make part of the public sector disappear simply by forming separate entities and taking them off-budget. Even though OBEs engage in millions of dollars worth of borrowing and spending activities, their budgets are subject to neither voter scrutiny nor voter approval.

The on-budget public sector is constrained by literally hundreds of regulations designed to protect the "public interest." Virtually none of these apply to an OBE. For example, Civil Service regulations do not apply, so it is easier for politicians to create patronage jobs in off-budget agencies. There also are no requirements for competitive bidding procedures on off-budget contracts. As a result, a greater opportunity exists for elected officials to pay back campaign contributions with contract awards to loyal supporters.

In addition, the boards of directors of every OBE are political appointees who are not elected or responsible to the voters, so it is unlikely that a recalcitrant bureaucracy could frustrate their efforts. Finally, OBEs are given wide powers by law. Often they are granted what amounts to a monopoly franchise. They often have powers of eminent domain, can override zoning ordinances, and are exempt from regulations and paperwork which strangle private firms. Typically, they have no legal restrictions on collective bargaining agreements and often are exempt from anti-trust laws regarding price-fixing.

As a result, OBEs such as WPPSS make decisions that do not flow from efficiency and equity considerations. Their decisions instead are based on maximizing political support, voter appeal and campaign contributions. Among other things, WPPSS spread its work around by using several dozen general contractors and as many as 50 cranes for each job site, practices which led to a carnival-like atmosphere at the job sites, hopeless confusion, delays and escalated costs. By comparison, Commonwealth Edison, a low-cost private producer of nuclear power plants, generally uses about three general contractors and nine to ten cranes per job site.²

2. Washington State Senate Energy and Utilities Committee, WPPSS Inquiry, (Seattle: Senate Energy and Utilities Committee, January 12, 1981), p. 26.

The comments of one WPPSS supply system director reveal just how deep the disregard for cost-effectiveness was. "Whenever cash was low, we'd just toddle down to Wall Street," he said.³ Cost overruns were financed simply by more and more borrowing, to be paid for later by hapless Washington electricity users. WPPSS' casual approach to costs should come as no surprise, for it is typical of what happens whenever the responsibility for action is divorced from the action itself.

Outraged over skyrocketing utility bills and the stories of bureaucratic bungling at WPPSS construction sites, Washington state voters approved a referendum in November 1981 to require voter approval of any future WPPSS borrowing, thereby placing the system "on budget." The ratepayers of the Northwest appear to be fighting a losing battle, however. A district court judge recently ruled the referendum unconstitutional! Apparently the judge went along with a U.S. Department of Justice suit claiming that the referendum "interfered with federal energy policy." (It was the federal government's Bonneville Power Administration which initiated the creation of WPPSS.)

WHO PAYS FOR WHOOPS?

General obligation or "on-budget" bonds issued by governments are "full faith and credit" debt. This kind of debt is generally approved by voters in a referendum with repayment guaranteed by the government's power to levy taxes. OBEs, on the other hand, issue nonguaranteed debt which has not been approved by voters. While it might seem that voters have nothing to fear from the issuance of nonguaranteed debt, this assumption is in fact quite wrong.

OBEs are often monopolies which provide essential services such as electricity to the public. When an OBE is unable to pay its debt, strong political pressures arise to provide additional funds either through an increase in taxes or through an increase in the rates users pay. This occurs despite the fact that the voters and ratepayers never approved the debt in the first place.

3. Peter W. Bernstein, "A Nuclear Fiasco Shakes the Bond Market," Fortune, February 22, 1982, p. 110.

About two-thirds of the recently defaulted \$2.25 billion WPPSS debt was secured through investments from 88 municipally-owned utilities throughout the Northwest. If these utilities are forced to make good on their obligations, citizens throughout the region will face sharp increases in utility rates. On June 15 the 88 utilities convinced a Washington State Supreme Court judge that they really never had the authority to enter into the agreements, and therefore they shouldn't have to pay. The issue apparently is headed for the federal courts and may take years to resolve.⁴

In the meantime, Washington ratepayers have experienced a 478 percent increase in utility rates over the last three years.⁵ Moreover, there has been repeated talk about various bailout plans at the federal and state level--all of which would place the ultimate burden back on the voters who will be forced to pay off an enormous debt they never approved.

THE GROWTH OF OFF-BUDGET DEBT IN OTHER STATES

OBEs are far from new; state and local legislators began using them in the late 19th century as a device to evade spending limits. These limits had been imposed through state constitutions and statutes as a response to numerous defaults and repudiations of debt by fiscally irresponsible politicians.

The growth and popularity of OBEs has surged in recent years. Governor Nelson Rockefeller of New York, during his terms of office from 1959 to 1974, masterfully orchestrated the use of OBEs in order to sidestep taxpayer opposition to his ambitious spending plans. For example, when voters rejected a \$100 million housing bond issue for the third time, Governor Rockefeller created the Housing Finance Authority, which issued massive amounts of nonguaranteed debt that at one point exceeded the entire guaranteed debt of New York state. In 1961, when the voters rejected a \$500 million higher-education bond issue for the fourth time, the Governor created the off-budget State University Construction Authority. In 1965, when the voters rejected another housing bond issue for the fifth time, the governor created the Urban Development Corporation. By the time Rockefeller resigned from office in 1973, 14 months before the state faced default and bankruptcy, New York's OBE debt had quadrupled. At \$13.3 billion, the debt was approximately four times more than the amount of guaranteed, voter-approved borrowing, and the debt of the Housing Finance Authority alone exceeded the entire guaranteed debt of the state by 50 percent!

4. "WPPSS Default," Wall Street Journal, July 26, 1983, p. 3.
5. David L. Shapiro, "Whoops and the Hodel Connection," Wall Street Journal, May 20, 1983.

New York state and WPPSS are just the tip of the off-budget iceberg. There are tens of thousands of agencies, systems, boards, commissions, corporations and authorities across the country that constitute an "underground government." Although the statistics are known to be incomplete, the latest estimates from the U.S. Bureau of the Census show that in 1982 there were 28,733 off-budget enterprises nationwide.⁶

In addition to WPPSS, there are a great many OBEs in the electric power industry which 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 (\$1.07 billion), Texas Municipal Power Agency (\$850 million), North Carolina Municipal Power Agency No. 1 (\$775 million), Massachusetts Municipal Wholesale Electric Co. (\$773 million), Intermountain Power Agency of Utah (\$600 million outstanding and \$8.1 billion in planned expenditures), and Platte River Power Authority of Colorado (\$332 million).⁷

Financial disasters similar to WPPSS are sure to be brewing elsewhere, and they are not limited to the electric power industry. Consider the fact that:

- Between 1970 and 1981, new issues of voter-approved debt grew by only four percent. New issues of off-budget debt (mainly issued by OBEs) grew by 579 percent.⁸
- In 1981, 74 percent of all new debt issues by state and local governments was off-budget.⁹
- In 1981 55 percent of all outstanding state and local debt was off-budget.¹⁰

6. Statistical Abstract of the U.S. (Washington, D.C.: U.S. Bureau of the Census, 1982-83), p. 294.

7. V. Zonana, "Dispute Flares on Financing Joint Agencies," Wall Street Journal, October 13, 1981, p. 35.

8. Statistical Abstract of the U.S. (Washington, D.C.: U.S. Bureau of the Census, 1982-83), p. 300.

9. Ibid.

10. Data taken from Moody's Municipal and Government Manual, (New York: Dun and Bradstreet Co., 1983.)

The state of Washington may be considered the "worst case" in terms of off-budget borrowing. However, by several different measures many other states are in worse shape than Washington. In 1981, Washington had \$9.8 billion in off-budget debt outstanding. This represents 74 percent of Washington's total debt and amounts to \$2,332 per capita. Yet, as Table I and II show:

- There are four states--New York, Texas, California and Pennsylvania--which have more total off-budget debt than Washington.
- There are three states--Alaska, Nebraska and Wyoming--which have more off-budget debt per capita than Washington.
- There are seven states--Arkansas, Kentucky, Nebraska, New Mexico, North Dakota, South Dakota, and Wyoming--which have a greater percentage of their debt off-budget than Washington.

New York, with \$27 billion in off-budget debt outstanding, has a total obligation that it is almost three times the size of Washington's. Alaska's \$8,442 off-budget debt per capita is 3.6 times the size of Washington's.

Finally, consider these facts:

- In five states--Arkansas, Arizona, Iowa, Nebraska and Wyoming--100 percent of the state government debt is off-budget (non-guaranteed) debt.
- In 11 more states--Colorado, Idaho, Indiana, Kansas, Kentucky, Missouri, Montana, New Mexico, North Dakota, Oklahoma and South Dakota--more than 90 percent of all state government borrowing is conducted off-budget.

CONCLUSION

The borrowing of all OBEs, including WPPSS, is not voter-approved; their expenditures, debt, and employment do not appear in official statistics of sponsoring governments; their managers are appointed, not elected; and they often have powers which regular units of government do not. Further, the inefficiencies found in most public bureaucracies are magnified by OBEs. If any semblance of fiscal responsibility in government is to be achieved, these entities should, at a minimum, be carefully scrutinized and controlled by the taxpayers. Ideally, their off-budget status should be eliminated altogether.

Note: Nothing written here is to be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder passage of any bill before Congress or before any state legislature.

TABLE I

OFF-BUDGET (NONGUARANTEED) STATE AND LOCAL DEBT, 1981*

(Millions of Dollars)

STATE	AMOUNT	PERCENT OF TOTAL DEBT
New York	\$26,733	56.65%
Texas	12,266	54.47
California	12,166	46.33
Pennsylvania	10,943	56.29
Washington	9,835	74.27
Florida	8,145	64.79
Illinois	7,487	45.37
New Jersey	7,447	52.39
Kentucky	6,364	85.13
Georgia	4,826	70.17
Ohio	4,804	42.63
Michigan	4,795	40.92
Louisiana	4,329	49.95
Nebraska	3,826	80.73
Massachusetts	3,647	33.94
Minnesota	3,620	45.73
Alaska	3,478	66.56
Arizona	3,423	64.02
Indiana	3,204	73.16
Virginia	3,163	50.63

Alabama	3,106	67.44
Missouri	3,030	66.52
Colorado	2,859	64.21
Kansas	2,758	69.26
Maryland	2,708	32.02
Oklahoma	2,661	68.91
Tennessee	2,621	40.11
South Carolina	2,505	61.36
West Virginia	2,479	67.00
New Mexico	2,337	86.74
Connecticut	2,303	35.89
North Carolina	2,159	43.18
Arkansas	1,831	78.67
Wisconsin	1,706	27.93
Rhode Island	1,560	67.82
Utah	1,521	70.05
Iowa	1,491	62.30
Oregon	1,412	16.92
D.C.	1,259	46.57
Wyoming	1,201	78.90
South Dakota	1,034	91.50
Montana	1,006	45.85
Delaware	869	49.60
Nevada	761	54.39
New Hampshire	709	47.90
Mississippi	692	32.00
Maine	668	46.22

North Dakota	616	75.30
Hawaii	535	24.94
Idaho	507	64.66
Vermont	412	48.24
United States	\$195,817	55.40%

* Latest available statistics on a nationwide basis.

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

TABLE II

STATE AND LOCAL DEBT PER CAPITA, 1981 *

STATE	OFF-BUDGET DEBT PER CAPITA	VOTER-APPROVED DEBT PER CAPITA	TOTAL DEBT PER CAPITA
Alaska	\$8,442	\$4,240	\$12,682
Wyoming	2,441	652	3,093
Nebraska	2,426	579	3,005
Washington	2,332	808	3,140
D.C.	1,995	2,288	4,283
New Mexico	1,760	269	2,029
Kentucky	1,738	303	2,041
Rhode Island	1,637	776	2,413
Delaware	1,453	1,477	2,930
West Virginia	1,270	626	1,896
Montana	1,269	1,498	2,767
Arizona	1,225	688	1,913
Kansas	1,157	514	1,671
New Jersey	1,006	914	1,920
Louisiana	1,005	1,006	2,011
Utah	1,002	428	1,430
Colorado	964	537	1,501
North Dakota	936	307	1,243
Pennsylvania	922	716	1,638
Nevada	901	755	1,656
Minnesota	884	1,049	1,933

Georgia	866	368	1,234
Oklahoma	858	387	1,245
Texas	831	694	1,525
Florida	800	435	1,235
Vermont	798	857	1,655
Arkansas	797	216	1,013
Alabama	793	383	1,176
South Carolina	791	498	1,289
New Hampshire	757	824	1,581
Connecticut	735	1,313	2,048
Illinois	653	787	1,440
Maryland	635	1,349	1,984
Massachusetts	632	1,229	1,861
Missouri	613	309	922
Maine	590	686	1,276
Indiana	586	215	801
Virginia	583	568	1,151
Tennessee	568	848	1,416
Hawaii	545	1,641	2,186
Oregon	533	2,614	3,147
Idaho	529	289	818
Michigan	521	752	1,273
Iowa	514	311	825
California	503	582	1,085
Ohio	446	600	1,046
North Carolina	363	477	840
Wisconsin	360	928	1,288

Mississippi	273	581	854
United States	\$854	\$687	\$1,541

* Latest available statistics on a nationwide basis.

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