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OFF-BUDGET SPENDING: THE GROWTH OF UNDERGROUND GOVERNMENT

by

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INTRODUCTION

The distinguishing characteristic of the welfare state is that, over time, the distribution of wealth and the allocation of resources in society are increasingly controlled by government rather than by voluntary exchange in the marketplace. Inevitably, wealth and resources are directed toward their highest valued political uses instead of toward their highest valued economic uses. The problem of reform is widely perceived to be the adoption of an appropriate set of rules to limit the powers of government. The power of the welfare state and its burden on the private sector have been identified with public sector expenditure which has increased dramatically over the past decades in both the United States and the rest of the industrialized world. Thus, reform has centered on efforts, particularly in the U.S., to restrict by constitutional amendment the ability of government to borrow, tax, and spend. Revenue is regarded as the lifeblood of the public sector so that, if public sector income is limited, the intrusiveness and burden of government can be controlled.

There is no question that reform is urgently needed and long overdue. Taxpayers throughout the world are becoming increasingly disenchanted with government as is evidenced by the existence of very large and rapidly growing "underground economies." Stated simply, the underground economy is a direct response to the burden of taxation and may be viewed as the ultimate form of the "tax revolt." The flat refusal to declare income and pay taxes also indicates that taxpayers have lost faith in the ability to achieve positive change at the ballot box – one set of rascals in public office always seems to be replaced with another, and campaign rhetoric is rarely translated into reality. Reform cannot be achieved by electing or appointing the appropriate individuals to public office. Instead, many believe that new rules must be adopted to alter government as an institution.

Although such a prescription may be appealing, there is ample evidence that statutory and even constitutional limitations will be, at best, only a temporary and partially effective restraint on the welfare state. Certainly, it will by no means be a panacea. There is no "self-enforcing constitution" and every rule requires interpretation and implementation. Political and bureaucratic entrepreneurs have every incentive to subvert any limitations on their freedom of action and history shows that in the U.S. and elsewhere these entrepreneurs have found ways to bypass constitutional and statutory constrains on a wide scale. Elected officials do not passively accept citizen demands for fiscal restraint, but merely exploit loopholes in order to disguise taxes, expenditures, and debt.

In effect, there is a public sector "underground" that is the direct counterpart of the underground private sector. Constraints on budgets and borrowing have been systematically subverted by redefining the budget so that much of the public sector's activity is moved off-budget, beyond the control and scrutiny of the taxpayer. The use and abuse of off-budget devices to create an underground government is the focus of this paper.

The discussion proceeds as follows: First, the political motivation for public expenditure and debt are briefly explored. Second, an historical perspective on constitutional constraints on fiscal activities of state and local governments in the U.S. is provided to show that such limitations have existed for more than a century. Third, a survey is given of off-budget activities at the local, state, and federal levels of government in the U.S. and some examples are offered of similar activities in other nations. Finally, some implications of the analysis for reform of the welfare state are drawn.

THE POLITICAL ECONOMY OF PUBLIC EXPENDITURE AND DEBT

One of the principal actors in the drama of the welfare state is the politician whose motivations and political objectives play a major role in shaping public policy. For the politician, income, prestige, power, and perquisites are derived from only one source: tenure in public office. This observation has two important implications. First, the major goal of every politician is to remain in office, and second, the planning and performance of the politician are geared primarily to success in the next election contest so that there is an innate bias toward a short-term horizon. The ultimate success or failure of elected public officials is determined in the political arena, i.e., at the ballot box, rather than in the marketplace. To remain in office, the politician must appear to satisfy the needs of his constituents by providing benefits which are concentrated among his supporters while the costs are widely dispersed among all taxpayers and, preferably, deferred in time.

Politicians are very well aware of voter/taxpayer attitudes toward government which may be best described as a "love-hate" relationship: The public loves the services provided, but hates to pay for them via taxes. National surveys of citizens have repeatedly shown that Americans are strongly in favor of reductions in taxes but at the same time support existing welfare-transfer programs and even the extension of these programs, particularly in the area of health care.[1] Apparently, taxpayers are strong believers in the "free lunch" – if attitude surveys are taken seriously – and politicians who appear to be able to provide "something for nothing" are likely to be highly successful at the ballot box.

Every candidate in an election has a strong incentive to appeal to the voters' craving for a free lunch. Campaign promises proliferate in every contest, and most are inevitably broken – a fact which has contributed significantly to the distrust and suspicion that now is directed toward government programs and public institutions. One promise that is rarely made (by a victorious candidate) is that taxes will be raised substantially in order to pay for benefits provided. Once in office, however, the public official must deliver in some way on pledges made during the campaign or risk being

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1 For a discussion and a summary of such surveys, see Semour Martin Lipset and William Schneider, "Lower Taxes and More Welfare: A Reply to Arthur Seldon," IV Journal of Contemporary Studies (Spring, 1981), pp. 89-94.

discredited by an opponent in the next election. At this point, the ideal politician becomes a magician who is able to produce something from nothing. Namely, increases in the quantity or quality of public services without corresponding increases in taxes can be achieved by borrowing.[2]

Public debt permits large amounts of spending to occur immediately (i.e., during the politician's current term of office) with the problems associated with repayment spread over a long period in the future (perhaps even when someone else is in office). Additionally, deferred payments are always attractive to elected officials. Witness the fact that pension plans in the public sector are typically far more generous than in the private sector. The budgetary impact of increased pension benefits for current employees does not fully occur until many years in the future. An outright wage increase for public employees, by contrast, produces an immediate effect on government outlays.[3] There is, then, a strong political rationale for substituting improved pension benefits for higher wages and salaries. Expenditure financed by debt provides an ideal strategy for ambitious politicians and has been the principal source of public sector profligacy.

HISTORICAL LIMITATIONS ON DEBT AND EXPENDITURE

Constitutional and statutory restrictions on expenditures, taxation, and debt are by no means new or innovative, despite the highly publicized endorsement of a constitutional amendment requiring a balanced federal government budget in the U.S. In the 1820s, a great drive was undertaken to provide internal improvements to the economic infrastructure of the states by building roads and canals and by establishing banks. State governments took a very active role in financing these projects by issuing mammoth amounts of debt. Indeed, public sector involvement in private sector activities was mandated or encouraged by the state constitutions adopted in the 1820s, for these directed or permitted the legislature to take an active role in furthering internal improvements. The debt was to be repaid from investment income. But mismanagement, fraud, and abuse were so common that many investments were unprofitable.

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2 It is also possible that the governmental entity could have a budget surplus so that the same level of taxation could provide more or better services. Budget surpluses are rare and, to politicians, potentially dangerous as well. The Proposition 13 movement in California was undoubtedly fueled by the existence of a large surplus (about $5 billion) at the state level which some individuals had proposed using for rather dubious purposes, e.g., a state space program.

3 The chickens do, eventually, come home to roost. The pension plans of New York City had become so overly generous in the extreme that the city was (and, many would argue, still is) on the verge of financial collapse. See, for example, Wyndham Robertson, "Going Broke the New York Way," Fortune (August, 1975), pp. 144-149, 212-214.

The borrowing bubble burst in the panic of 1837. Many states defaulted and others simply repudiated their debts. Investors both at home and abroad were concerned about the profligate borrowing by state governments—not to mention the taxpayers whose taxes were raised dramatically. To avoid future excesses and soothe taxpayer frustrations and to restore investor confidence in their bonds, constitutional limits on debt were imposed at the state level. As new states were formed, debt limits were also incorporated in their constitutions so that bond offerings of these new entities would not be at a competitive disadvantage in the capital markets.[4]

As a result of this experience, stringent limitations on borrowing still exist which appear to be more than adequate to prevent politicians from plundering the taxpayer's purse. Moreover, there are constitutional as well as statutory bounds on operating deficits. More than half the states have legal provisions that require spending reductions if there is a shortfall in revenue. At least seven states go even further and constitutionally mandate that taxes must be increased to offset any operating deficit.[5]

These restrictions still exist at the state and local levels of government in the U.S. Thus, it would appear that various checks have long existed to allay taxpayer fears about the abuse of public financing. Politicians and public employees have become quite adept at developing and exploiting loopholes in the law. Despite the explicit checks and balances that have existed for decades, public officials have found little difficulty in overcoming constitutional constraints and statutory restrictions on spending and borrowing.[6]

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4 See George Rogers Taylor, The Transportation Revolution; 1815-1860 (White Plains, New York: M. E. Sharpe, Inc., 1951), p. 373; and, Ernest Ludlow Bogart, Economic History of the American People (New York: Longmans, Green and Co., 1936), p. 326.

5 Albert Fishlow, American Railroads and the Transformation of the Ante-Bellum Economy, (Cambridge: Harvard University Press, 1965), p. 190; and, Edward C. Kirkland, A History of American Economic Life, 3rd. ed., (New York: Appleton-Century-Crofts, Inc., 1951), p. 277. Additional information relating to this fiscal fiasco may be found in B. U. Ratchford, American State Debts (Durham, NC: Duke University Press, 1941), Chapters IV and V and in Lennox L. Moak and Albert M. Hillhouse, Concepts and Practices in Local Government Finance (Chicago: Municipal Finance Officers Association, 1975), p. 262. Further, see Albert M. Hillhouse, Municipal Bonds: A Century of Experience (New York: Prentice Hall, Inc., 1936), esp. Chapter VII.

6 This should come as no surprise to the student of constitutional law. Bernard Siegan, in his recent book, Economic Liberties and the Constitution (Chicago: University of Chicago Press, 1980) documents how, for decades, legislatures have passed laws which effectively abolish many of the economic liberties embodied in the federal constitution. And, as Siegan illustrates, the Supreme Court has upheld most of these changes since the mid-1930s.

OFF-BUDGET SPENDING: STATE AND LOCAL GOVERNMENTS

On the surface, it would seem that tax revolts and fiscal constraints in the form of statutory or constitutional restrictions on taxation, spending, or debt pose major problems for ambitious politicians. After all, fiscal limitations of any sort restrict the freedom of action of policymakers in the public sector to pursue their own political goals. When public opinion supports constitutional or statutory limits on taxes, expenditures, and borrowing by government, the politician who ignores the will of the voter does so at his own peril. Elected officials are also aware that a favorable impression can be made on voters by advocating the reduction in the size and scope of government and the improvement in the efficiency of the public sector.

For elected officials, however, continued expansion of the public sector and the associated patronage which can be dispensed to supporters are key elements of success. Ideally, the politician would like to preach fiscal conservatism to his constituents while simultaneously increasing the size and scope of the public sector. One way spending limitations can be avoided is by redefining categories of expenditure. Tax limitations often can be avoided by the expedient use of "user fees." The evasion of restrictions on public debt is more difficult to accomplish and it requires a more novel approach than is the case with taxes and expenditures.

Off-Budget Enterprises (OBEs)

The solution was disarmingly simple. Separate corporate entities were created by state and local governments which could issue bonds that were not subject to the legal restrictions on public debt. These entities masquerade under a variety of guises; they are called districts, boards, authorities, agencies, commissions, corporations, and trusts. Regardless of their title, an essential feature of all these organizations is that their financial activities do not appear in the budget of the governmental unit or units that created them. Thus, politicians have been able to make part of the public sector disappear simply by forming separate entities—off-budget enterprises (OBEs)—to conduct borrowing and spending activities.

The historical roots of off-budget organizations can be traced back at least as far as early eighteenth-century England where toll bridges were financed by "revenue bonds." Bonds were issued to pay for the construction of toll bridges and toll revenues were pledged to repay the principal and interest on the bonds. One distinguishing characteristic of OBEs is that their operations, at least in theory, are not financed from taxes, but from revenues generated by their activities. The facts, as shown below, differ greatly from the theory. Because the taxpayer is not deemed to be liable for the financial obligations of OBEs, voter approval is not required for the debt issued by such organizations and, more importantly, debt restrictions do not apply. The first American OBE obtained judicial approval from the

Supreme Court of Maine in 1899 and, as the political maxim contends, "as Maine goes, so goes the nation."[7]

The prototype for all off-budget authorities in the U.S. is the Port Authority of New York and New Jersey (modeled after the Port of London Authority) created by Congress in 1921. The widespread adoption of the concept did not occur until the 1930s when the federal government actively encouraged all units of government to go off-budget on an unprecedented scale. Since then, federal sponsorship of off-budget activity has continued, prodded by the promise of various forms of largess from the national Treasury in the form of grants-in-aid and subsidies.

Unfortunately, it is simply impossible to obtain accurate data on the number of OBEs that exist or on their activities. Most states do not keep statistics on the number of corporations established by local governments. Indeed, for politicians, an important part of the intrinsic appeal of the OBE device is that its operations are not publicized. One thing is known with certainty. There are thousands of OBEs throughout the nation engaging in a bewildering variety of activities. In the state of Pennsylvania alone there were 2,456 municipal OBEs in operation as of July, 1976 and, collectively, these OBEs had almost $5 billion in debt outstanding.[8]

The Growth of OBE Debt

Some statistics are collected by the U.S. Bureau of the Census and, although these are known to be incomplete, the data indicate that almost 26,000 off-budget enterprises were operating nationwide in 1977—this number exceeds the number of on-budget, general purpose units of government in existence.[9] One measure of the scope of off-budget activity is the debt issued by these entities. General purpose (or "on-budget") governments issue only "full faith and credit" debt which has been approved by the voters in a referendum, with repayment guaranteed by the power to levy taxes. OBEs issue nonguaranteed debt which has not been approved by voters. By 1978, the amount of outstanding long-term nonguaranteed state debt issued by OBEs stood at $61.1 billion, whereas voter-approved state debt was only $48.3 billion. At the local level of government, nonguaranteed OBE debt outstanding was $85.8 billion in 1978, and the comparable figure for voter-approved debt was $97.1 billion.[10]

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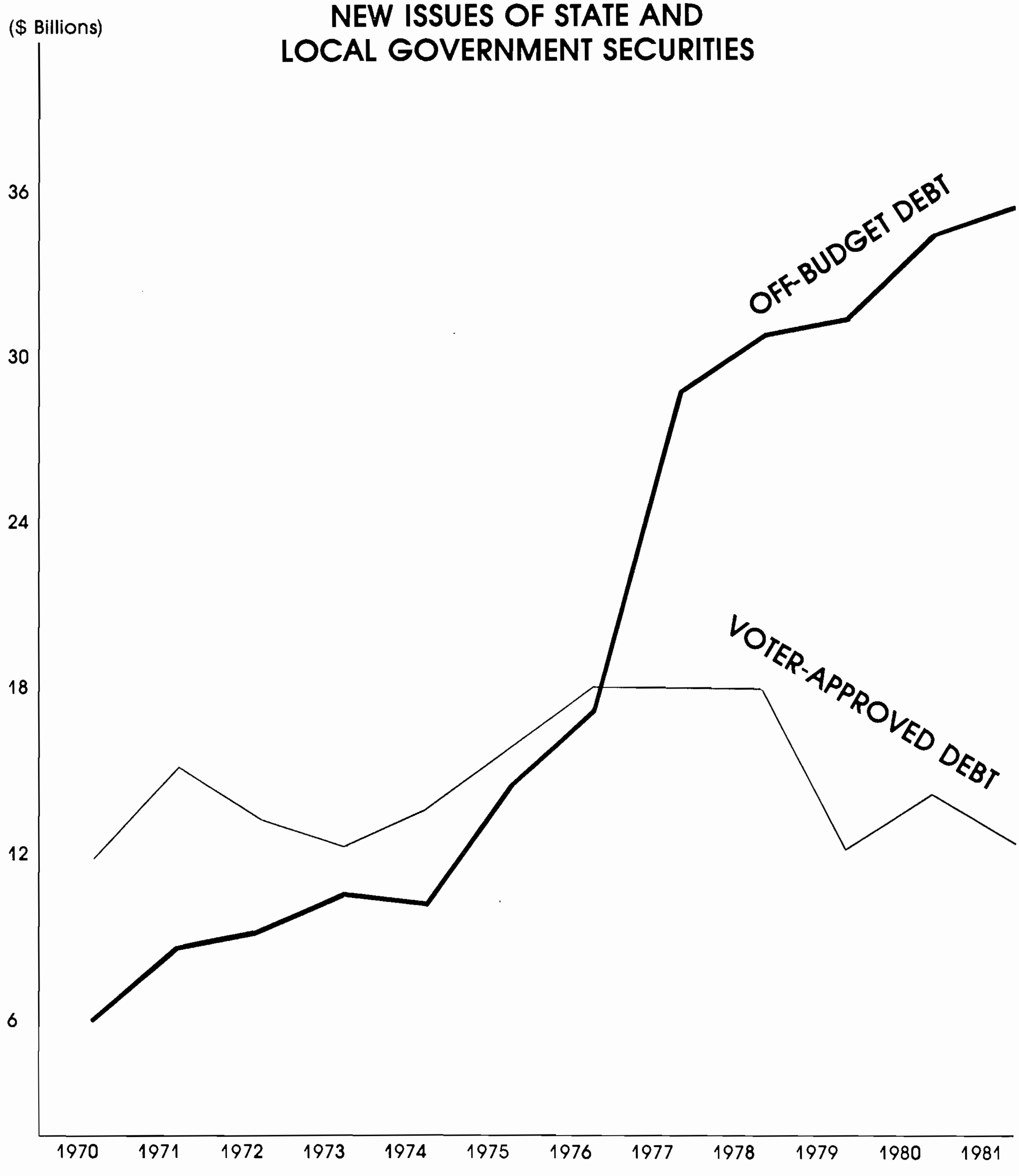
7 C. Robert Morris, "Evading Debt Limitations with Public Building Authorities: The Costly Subversion of State Constitutions," 68 Yale Law Journal (December, 1958) pp. 234-245.

8 D. Schlosser, C. Hoffman, A. Bauer and G. Coleman, Municipal Authorities in Pennsylvania (Harrisburg, Pennsylvania: State of Pennsylvania Department of Community Affairs, 1977).

9 U.S. Department of Commerce, Bureau of the Census, Census Governments, various issues.

10 These data are taken from Facts and Figures on Government Finance (Washington, D.C.: Tax Foundation, Inc., 1979), p. 221 and p. 253.

NEW ISSUES OF STATE AND LOCAL GOVERNMENT SECURITIES



Source: National Center for Policy Analysis

Throughout the decade of the 1970s, the trend toward more and more off-budget borrowing has been alarming. New issues of OBE debt, which were only 31 percent of all new state and local debt in 1970, had surpassed the combined total of all new voter-approved debt by the end of the decade. OBE debt has been the fastest growing type of state and local debt issued. Between 1970 and 1980, OBE debt increased by 232 percent. Over the same period, voter-approved local debt increased by 86 percent, while voter-approved issues of state governments increased by only five percent. Thus, in terms of debt, government has gone off-budget in wholesale fashion in response to fiscal constraints.

OBEs Circumvent Political Reforms

Even if debt restrictions did not exist, politicians would benefit from off-budget activities. The public sector is constrained by numerous regulations designed to protect the "public interest." Virtually none of these apply to any OBE. For example, civil service regulations do not apply, so it is easier for politicians to create patronage jobs off-budget. There are no requirements for competitive bidding procedures on contracts, so campaign contributions can be obtained and loyal supporters can be rewarded. The members of the boards of directors of every OBE are political appointees, not elected or responsible to voters, so the will of politicians cannot easily be frustrated by a recalcitrant bureaucracy. OBEs are given wide powers by law. They are granted monopoly franchises, may have powers of eminent domain, can override zoning ordinances, are exempt from regulations and paperwork that strangle private firms, and are often specifically exempted from anti-trust laws regarding price fixing.

The creation of an off-budget entity automatically generates a number of special interest groups who lobby for the expansion of its activities: The employees, suppliers, contractors (and their unions), and those who participate in marketing the entity's debt such as bond underwriters, banks that act as trustees, and bond attorneys. In each case, the individuals in these interest groups tend to be concerned with their private self-interest first and foremost.

The "public interest" is a term without substantive content and impossible to specify. Although OBEs are touted as existing to further the "public interest," such an assertion still does not explain why the "public interest" should be fostered off-budget where voters do not elect the directors of the enterprise and have no control over the issuance of debt or the rate of spending. The array of activities undertaken by OBEs is nothing short of amazing. These include the finance of school buildings, airports, parking lots, recreation centers, courthouses, marketing, shipping and transportation terminals, subways, bridges, tunnels, highways, parks and playgrounds, lakes, sewer systems, landfills, steam heating plants, flood control projects, hospitals and health care centers, industrial development subsidies, water supply systems, sports arenas, electric utilities, and housing, to name a few. Indeed, many of the activities undertaken off-budget by government compete directly with taxpaying private firms. The question is then not so much should these activities be conducted off-budget, as should they be conducted by the public sector at all?

The myth that off-budget finance should not require voter approval because the projects are self-supporting has been repeatedly shattered by the fact that billions of tax dollars are used to subsidize and support OBE activity. The taxpayer, in reality, is carrying the burden of off-budget operations while the politicians reap the political benefits, as shown in the following examples.

Case Study: New York

As Governor of New York, Nelson Rockefeller orchestrated off-budget finance like a maestro during his terms of office between 1959 and 1974. The state constitution contains strict limitations on the issuance of debt. Since 1846, a referendum requirement had mandated voter approval of state borrowing. Rockefeller raised taxes rapidly (at an annual rate of 12.6 percent during his first term), but the revenues were hardly sufficient to support his grandiose spending schemes. Voters frequently turned down bond referenda, but opposition to Rockefeller's spending plans was repeatedly ignored by the governor throughout his tenure by simply financing various projects through off-budget enterprises. For example, after voters rejected a $100 million housing bond issue for the third time in 1956, Governor Rockefeller created the Housing Finance Authority, which issued massive amounts of nonguaranteed debt, at one point in excess of the entire guaranteed debt of New York State. After voters rejected a $500 million higher-education bond issue for the fourth time in 1961, the Governor created the off-budget State University Construction Fund. After the voters rejected, for the fifth time, a housing bond issue in 1965, the Governor created the Urban Development Corporation.

In 1962, Rockefeller's fourth year as governor, there were 125 OBEs in New York State, 26 of them statewide, with a total outstanding debt of $3.3 billion. By the time he resigned from office in 1974, fourteen months before the state faced default and bankruptcy, OBE debt had quadrupled. At $13.3 billion, the debt was approximately four times 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 about 50 percent! The constitutionally imposed referendum requirement for the issuance of state debt obviously placed no effective constraint whatever on the ambitious spending plans of Rockefeller and other state politicians.

One would be hard pressed to assert that the debt and expenditures were undertaken in the "public interest," unless one is willing to assert that the dictates of the voters expressed at the ballot box are irrelevant in determining what is "best" for society. Repeated attempts by taxpayers to seek redress through the courts have only met with failure. Eventually, so much nonguaranteed debt was issued that investors became suspicious and refused to purchase it. These suspicions were allayed when the "moral obligation" bond was invented. Although the legislature was not legally bound to repay principal and interest on nonguaranteed debt, it was morally obligated to do so under the indentures of "moral obligation" bonds. Thus, the pyramid of debt continued to grow and the taxpayers have been left on the hook.

Unfortunately, Rockefeller's antics in New York provided a model for other state politicians and the off-budget device has been used with a vengeance. As the tax revolt progressed through the 1970s, OBEs proliferated at the state level of government as did their borrowing and spending. A rough approximation indicates that off-budget enterprises at the state level spent about $106 billion in 1980, whereas on-budget state governments expended about $143 billion in that year.

Case Study: Pennsylvania

New York's neighbor, Pennsylvania, is one of the states where OBEs proliferate at the local level of government. The Pennsylvania legislature had imposed constitutional restrictions on municipal borrowing by limiting it to seven percent of assessed property valuation. However, in 1935, the state legislature enacted the Municipal Authorities Act which exempted "municipal corporations" from municipal debt restrictions. Numerous OBEs were created to finance school buildings, airports, parking lots, recreation centers, as well as other activities.

In the late 1940s, Pennsylvania voters began pressuring their state representatives for limits on local property taxes, much in the spirit of the "tax revolt of the 1970s." As a result, in 1949, statutory property tax rate limits were enacted which applied to cities, boroughs, townships, and school districts. Local politicians responded by rapidly increasing the use of off-budget mechanisms. The number of "municipal corporations" created tripled in 1950, and the amount of nonguaranteed bonds issued increased by 465 percent, from $11.5 million to $65 million in that year. Thirty-four "school building authorities" alone were formed in 1950, compared to a total of fourteen in the preceding fifteen years, and the amount of nonguaranteed debt issued by school building authorities increased by 490 percent from $2 million to $11.8 million in 1950 alone.

By 1975 the number of OBEs in Pennsylvania had risen to 2,456 with $4.8 billion in debt outstanding compared to $2 billion in voter-approved "full faith and credit" local debt outstanding. As of 1975, 71 percent of total local debt outstanding in Pennsylvania was therefore not approved by the taxpayers. In response to every fiscal limitation, politicians at the local level of government immediately responded by moving activities off-budget. Neither expansion of the public sector nor its appetite for resources was reduced, only its form was altered.

OFF-BUDGET SPENDING: THE FEDERAL GOVERNMENT

Although widespread at the state and local levels of government, off-budget borrowing and expenditure has, in the past, played a relatively minor role at the federal level. Federal politicians have not been constrained by constitutional or effective statutory limitations on borrowing and the federal government has virtually unlimited access to credit markets. Prior to 1973, none of the activities of federal agencies was conducted off-budget. The Congressional Budget and Impoundment Control Act of 1974, which created a budget committee for each house responsible for setting targets for total expenditures, revenues, and the resultant deficit (or surplus) has induced federal politicians to place outlays off-budget. Off-budget federal outlays increased from $100 million in 1973 to $23.2 billion in 1981—an increase of more than 23,000 percent in less than one decade.

There are three basic ways in which federal spending is hidden and kept off the budget. First, numerous agencies have simply been deleted from the budget. Second, the government has extended off-budget loan guarantees to specially privileged individuals, businesses, and governments. Third, there are many privately-owned, but federally-sponsored and controlled, enterprises such as the Federal National Mortgage Association which are also off-the-books borrowers. In addition, federal politicians have increasingly recognized that, in principle, anything that can be accomplished through taxing and spending can also be accomplished by regulation. All of these activities must be taken into account to assess accurately the role of the federal government in the economy.

The list of federal agencies which have been taken off-budget since 1973 includes such entities as the U.S. Postal Service, the Pension Benefit Guarantee Corporation, the Federal Financing Bank, the Rural Electrification and Telephone Revolving Fund, and the Synthetic Fuels Corporation. The move toward "back door" spending appears to have universal appeal. It was the Reagan administration that placed the Strategic Petroleum Reserve off-budget.

A great deal of consternation was created by the Congressional actions that granted New York City and Chrysler Corporation several billion dollars in highly publicized loan guarantees. Nevertheless, the Chrysler and New York City loans pale in comparison with the off-budget guaranteed loans administered by over 150 federal agencies. These loan guarantees are reflected in the budget only if the borrower defaults. In that case, the federal government is liable for part or all of the principal and interest on the loan. Although not reflected in the budget, loan guarantees serve the same purpose as direct, tax-financed appropriations. They provide a subsidy for select groups at the expense of the general public.

Loan guarantees have become the largest component of federal credit activity. In 1982, the amount of loans guaranteed by the federal government was a staggering $101.5 billion—almost four times the volume of direct, on-budget loans. The major costs of federal loan guarantee programs are indirect. They are borne by less-favored borrowers who are crowded out of the credit market or who must pay higher interest rates on the loans that are obtained. It is very difficult to gauge the extent of this crowding out, but some preliminary estimates have been made by economist Herbert M. Kaufman of the University of Arizona. Kaufman estimates that for every $1 billion in loan guarantees, between $736 million and $1.2 billion in private investment is crowded out.[11] Roughly then, each $1 in federal loan guarantees tends to reduce private investment by $1.

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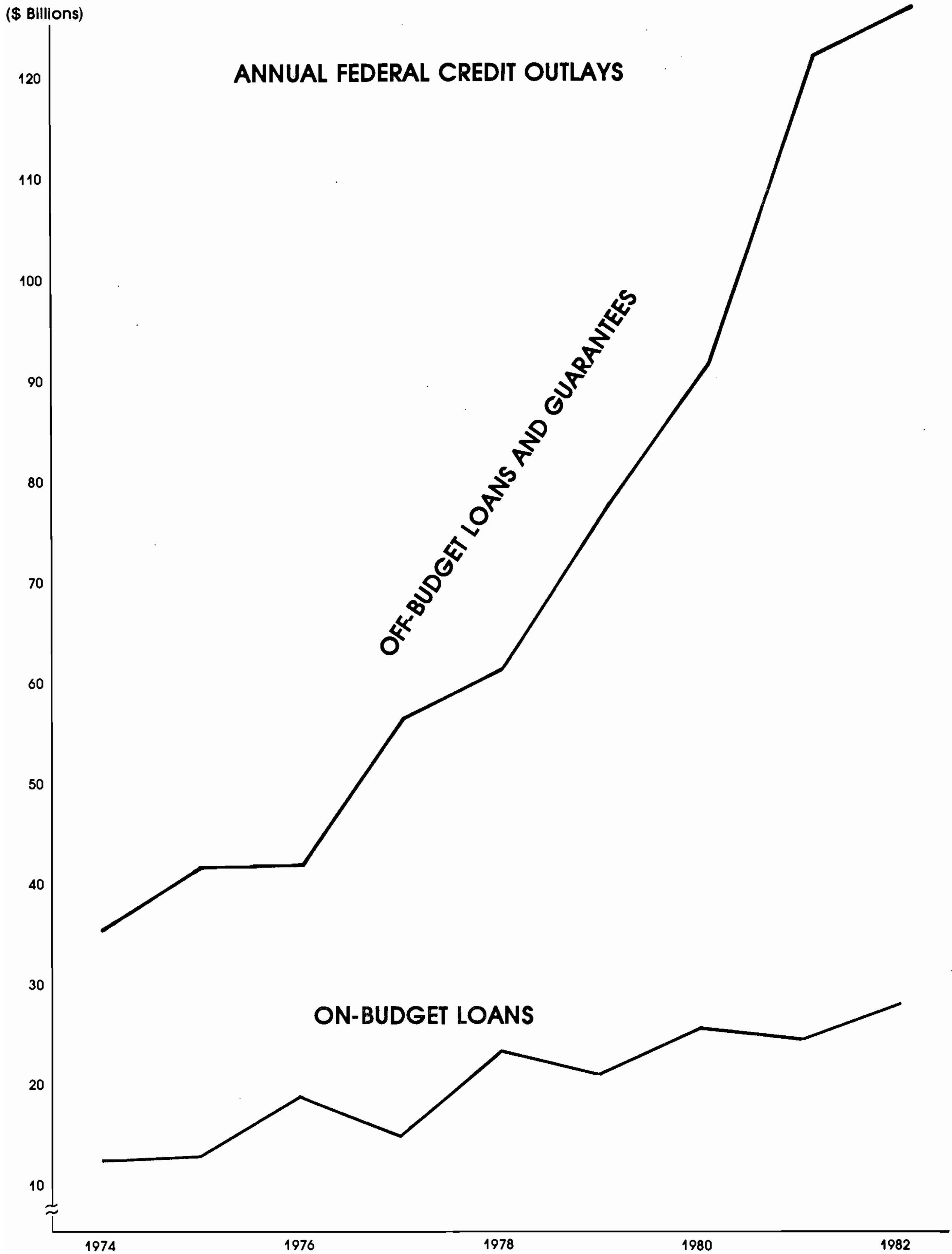
11 Herbert M. Kaufman, "Loan Guarantees and Crowding Out," Economics of Federal Credit Activity (Washington, D.C.: Congressional Budget Office, April, 1980), pp. 35-39.



Source: National Center for Policy Analysis

A third category of federal off-budget operations is "government-sponsored enterprises," most of which engage in credit activity. Included are the Federal National Mortgage Association (FNMA), the Farm Credit Administration (FCA), the Federal Home Loan Bank (FHLB), the Federal Home Loan Mortgage Corporation (FHLMC), and the Student Loan Marketing Association (SLMA). These agencies were at one time on a budget, but their large and rapidly expanding borrowings became an embarassment to some members of Congress and they were omitted from the budget in 1968.[12] Originally chartered by the federal government, these agencies are now privately owned. They are, however, still subject to government supervision. In addition, many of their board members are presidential appointees, and various decisions must be cleared by other government agencies as well as by the Treasury. Thus, federally-sponsored agencies are private in name only, and are yet another way in which the federal government directs the allocation of billions of dollars credit without being subject to the federal budget review process.

The advent of the Budget Reform Act of 1974 and the taxpayer revolt of the 1970s, has led to a tremendous expansion in the off-budget activities of the federal government. Off-budget credit outlays have been growing at over twice the rate of on-budget loans. Of total credit outlays of $155.8 billion in 1982, fully 82 percent ($127.7 billion) were not reflected in the federal budget. In addition, borrowing by "government-sponsored enterprises" is estimated to be $50 billion for 1982. As a result, the federal government borrowed over 40 percent of all credit advanced in the capital market that year, compared to 11 percent in 1969.[13]

OFF-BUDGET SPENDING: AN INTERNATIONAL PERSPECTIVE

Britain: Off-budget governmental activities are not restricted to the United States, but are quite common in several other countries as well. OBEs in Great Britain are referred to as "Quangos," an acronym for "quasi-autonomous nongovernmental organizations." Quangos are established either by acts of Parliament or by ministerial fiat.[14] The managers of Quangos are usually appointed by parliamentary ministers. There are six different categories of Quangos which perform a wide variety of tasks. First, there are the regulatory bodies such as the General, Medical, Optical, Dental, and Nursing Councils which engage in occupational licensing activities. The second category is the "spending agencies" which are given the responsibility of distributing block grants of public money at their own discretion. The

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12 "Borrowing and Debt," Budget of the U.S. Government, Special Analyses, 1982, Appendix E.

13 "Federal Credit Programs," Budget of the U.S. Government, Special Analyses, 1982, Appendix F, p. 6.

14 Phillip Holland, The Quango Explosion (London: Conservative Political Centre, 1978). Also see Oliver Pritchett, "How To Survive the 'Quango' Hunting Season," Sunday Telegraph, May 24, 1981.

third category consists of "local bodies" such as water authorities, regional planning councils, new town development corporations, port authorities, health authorities, and so on which are similar to the American OBEs described above. Fourth, there are the "consumer bodies" which are supposed to represent "consumer interests" in matters regarding the operation and activities of public monopolies in industries such as gas, electricity, coal, transport, and the postal service. The fifth category consists of the so-called "supervisory bodies" which are established with the intention of enforcing various laws passed by Parliament, although their effectiveness at this task has been questioned by several ministers. The Bureau of Office Location, for example, was established in 1963 to encourage the decentralization of office employment in central London and spent £2,011,506 doing so up to 1977. Then, with increasing rates of urban unemployment, the Bureau reversed its goals and strategies, which required a doubling of its yearly budget to £5,210,000. In only four years the Bureau will have spent as much encouraging centralization as it had spent encouraging decentralization during the previous fourteen years.

The sixth category of Quango is the "quasi-judicial body," comprised of such entities as the Equal Opportunities Commission, the Commission for Racial Equality, and the Central Arbitration Committee. Like many similar government agencies in the U.S., these committees do not pursue "equal opportunity," but rather preferential treatment for the various interest groups which they represent.

At an aggregate level, Parliamentary Minister Phillip Holland estimated that nationwide, there were 800 to 900 Quangos in the U.K. in 1978. As is the case in the U.S., both socialist and conservative governments have expanded the use of these off-budget entities. Since the conservative Thatcher government came to power, at least 55 new Quangos have been established, including the Scottish Seed Potato Development Council and the Working Group on Rickets. Even if the Thatcher government is successful at reducing the growth of government spending and the burden of taxation, it is likely that the off-budget public sector will continue to expand and to tax the nation's wealth.

Japan: The Japanese Ministry of Finance has developed a scheme whereby savings accounts established at post offices and other trust funds deposited with the government are placed into a so-called "second budget," known as the Fiscal Investment and Loan Plan (FILP).[15] The FILP was created in 1953 when it comprised 33.4 percent of the budget of the national government and 4.5 percent of the GNP. FILP funds are used to finance the activities of Japan's off-budget enterprises, which are also subsidized through the general account budget. The major type of OBE in Japan is the "special legal entity" (SLE). SLEs range from construction enterprises such as the Japan Housing Corporation and the New Tokyo International Airport Corporation to corporations engaged in social welfare activities, agriculture, energy development, and space development. In 1973 the 113 SLEs spent 80 percent of the FILP budget. The remaining 20 percent of the FILP was used to finance the activities of 6,246 "local public entities," OBEs

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[15] This discussion is based on Chalmers Johnson, Japan's Public Policy Companies (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1978).

which are created by local politicians. In summary, ever since the end of the Second World War Japanese politicians have been successful at assimilating the American and British penchant for back-door spending. OBEs in Japan "compete" with regular units of government and with private industry in the economy and spend, each year, an amount equivalent to approximately half the federal budget.

Israel: In Israel, numerous off-budget "public corporations" are owned wholly or partly by the national and local governments. Scores of other corporations are owned by the Histadrut, the labor union federation, which is legally distinct from the government, but retains close ties with it and has exerted much influence over it. "Government corporations" in Israel are created by Parliamentary ministers as a means of evading budgetary and civil service restrictions.[16] There are hundreds of such corporations owned by the national government, such as the Israel Aviation Corporation which employs over 16,000 workers, Israel Chemical Corporation, and Israel Coin and Metals Corporation. Similar OBEs exist at the municipal level of government, including at least twelve in Jerusalem and 27 in Tel Aviv. Israel's public corporations can be created or eliminated by the government's purchase or sale of shares in various companies. When the conservative Likud party came to power in 1977 after nearly 30 years of rule by the socialist labor parties, it was committed to reducing the size and scope of the public sector, which entailed liquidating government holdings in various corporations. However, the Likud party soon found that such a task was nearly impossible, since most of the public corporations are a means of off-budget financing of subsidies to the constituents of Parliamentary ministers. After a year and a half, the Likud party had not sold any more shares than had the previous labor party government, and had only one company on its For Sale list.

The Histadrut owns over 2,000 corporations which employ about 23 percent of the Israeli work force and account for 20 percent of net national product. These corporations are heavily subsidized and influenced by the national government, and partake in a wide range of activities, including manufacturing, banking, pension fund management, hospitals, and agricultural cooperatives, among others. Since Histadrut corporations provide a means of off-budget financing of jobs and other benefits, political parties compete quite intensely in national elections for places on the national council of the Histadrut.

Another form of off-budget enterprise activity in Israel is the foundations which are run by politicians. The Jerusalem Foundation, for example, was established by the mayor of Jerusalem, who controls it as a means for avoiding governmental spending constraints. Funds are solicited to finance projects which had previously been rejected by voters, such as swimming pools, sports stadiums to be used on the Sabbath, archeological excavations, art studies, and numerous others. The Jerusalem Foundation is also subsidized by the national government.

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16 Ira Sharkansky, Wither the State? (Chatham, NJ: Chatham House Publishers, 1979).

In summary, the off-budget activities of government corporations have ominous implications for the Israeli taxpayer. A huge portion of the nation's resources are allocated by various public managers who are isolated from any electoral constraints. The fact that the Histadrut alone owns over 2,000 corporations which produce 20 percent of NNP implies that the off-budget public sector in Israel is not likely to be diminished and will confound any attempts to reduce the burden of taxation in Israel, which is the highest of all democratic countries in the world.

This brief survey of off-budget operations in various nations is suggestive of the size and scope of the problem, but certainly not exhaustive. Such entities exist in France, Australia, Italy, and South Africa, as well as other developed nations. Even politicians in underdeveloped countries have adopted this form of "shadow government" to achieve political goals. Apparently, the forces of political self-interest are not only timeless, but also transcend geographical and cultural differences as well.

THE IMPLICATIONS FOR REFORM

In democratic societies, political self-interest encourages public officials to borrow and spend in order to reward constituents and special interest groups. The costs of public programs are then dispersed among all taxpayers and, if possible, deferred in time by issuing debt. The propensity of politicians toward profligate use of private sector resources is well-known. The problem of reform of the welfare state has often been viewed as the specification of appropriate constitutional constraints to control the public sector expenditure, debt, and the burden of taxation. The record shows, however, that constitutional restraint has been tried as a reform device without great success. The welfare state has continued to burgeon, but off-budget rather than on-budget. Little has changed except that the public sector has altered its form in order to subvert the fiscal limitations. The off-budget operations of government are deeply disturbing, for the voter has no control over much of its fiscal activity, and the directors and managers of off-budget enterprises are not directly responsible to the electorate which they purportedly serve. Unless we recognize the limitations of supposed constitutional restraints, the prospects for reform by instituting fiscal restraints on politicians are by no means propitious. The specification of new rules is no panacea for long-term reform, but only a short-term palliative.[17]

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17 Indeed, new rules may be totally ignored. In 1978 and again in 1979, Congress passed laws mandating a balanced federal budget in fiscal year 1981. No enforcement powers were included in the laws, and Congress has failed to abide by its own dictates, an ominous omen for the future of government reform efforts.

History has shown that public sector entrepreneurs seek out legal loopholes and develop imaginative techniques to subvert constraints imposed on their actions. A statutory or constitutional limit is likely to produce modified behavior toward reform only so long as it is not nullified by such maneuvers. One role of the economist in the reform of the welfare state is to anticipate the actions of the public sector entrepreneurs in circumventing the restraints that are imposed on their actions and then to devise even more effective rules. The same analytical powers which economists have so assiduously applied to the investigation of market activity to ferret out "second and third order" effects must now be focused on governmental actions.

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 the passage of any bill before Congress or before any state legislature.

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