

## **Off-budget activities of local government: Comment**

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### **1. Introduction**

Economists are not surprised when private entrepreneurs adjust behavior and contractual relationships in order to avoid or minimize the effects of externally imposed constraints. The evidence provided in a *Public Choice* article by James T. Bennett and Thomas J. Dilorenzo (1982) indicates that we should not be surprised that public entrepreneurs adjust their behavior and modify the institutional structure of local government when tax and spending limitations are imposed by the state or voters. Bennett and Dilorenzo (hereafter B-D) show how tax and spending limitations may have had an unforeseen effect on the structure of local governments. The limitations caused a proliferation of independent operating authorities, and other special purpose units of government, since local government structure was altered in order to mitigate the effects of externally imposed fiscal restrictions. Offered as evidence for this structural change was the rapid expansion of revenue bonds, the type of bond usually issued by independent authorities and other special districts, in states that had imposed limitations.<sup>1</sup> The authors conclude that effects of limitations on spending are not as great as other studies might suggest.

The purpose of this comment is not to challenge the main conclusion of the B-D paper that fiscal limitations induced an increase in the number of units of local government. Rather, the implication of this induced change in government structure will be explored. To be specific, the effects of this change on fiscal illusion and on the accountability of local public officials to voters will be investigated. A conclusion of this analysis is that the proliferation of governments caused by limitations may very well lead to an improvement in the local fiscal constitution. That is to say, more rational, more efficient, outcomes are obtainable with the induced change in institutional organization.

The paper will proceed by examining the effects of 'off-budget' activities

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at the federal level and comparing the effects of 'off-budget' activities at the local level. The ability of fiscal illusion to be increased by debt creation will be discussed as well as the ability of voters to monitor local government activities. The improvement in institutional structure will be analyzed in terms of both democratic and nondemocratic models of government.

## **2. Fiscal illusion and debt**

There has been a significant increase, as B-D indicated, in the level of local government debt. Public debt has long been recognized as a means of generating fiscal illusion and hiding the cost of government (Buchanan, 1967; Blewett, 1981). At the federal level in the U.S., the creation of the Federal Financing Bank has allowed the level of the federal deficit to be obscured. While the Bank was established to facilitate the marketing of debt from various agencies, the result has been the deficit financing of 'off-budget' expenditures. Via arcane accounting procedures, expenditures and debt can be hidden and placed beyond the scrutiny of Congress (Fialka, 1981).

The creation of new local units of government can allow a general purpose government to place some expenditures and debt 'off-budget.' However, this is not at all analogous to what happens at the federal level with the Federal Financing Bank. One reason the analogy breaks down is that the expansion of debt at the local level is not, strictly speaking, deficit spending since it represents capital expenditures and not current expenditures. In fact, if limitations cause the debt financing of capital projects that would have been financed as current expenditures, fiscal illusion may be decreased. The tax payments for the projects may better match the streams of services over the lives of the projects and thus would offset *asset illusion*. As James M. Buchanan (1967: 265) pointed out some time ago, 'public debt issue may be chosen as an appropriate part of the over-all "constitution" of a fiscal structure, provided that limitations are imposed to insure debt financing be restricted to projects that yield benefits over time.'

Lease-back authorities are units of government created to debt finance capital goods and move the debt 'off-budget.' These authorities build capital facilities or purchase equipment using revenue bonds, and the facilities and equipment are then leased back to the unit of government that controls the authority. Although the debt is transferred 'off-budget,' the leases that pay off the bonds are on the budget and usually paid out of general revenues. Fiscal illusion is not increased and may be decreased since asset illusion is offset by the leases. The creating of a lease-back authority is merely a financial arrangement. It would be equivalent to a municipality leasing the equipment or facilities from a private firm under a long-term con-

tract. Instead of a private firm holding the debt (and paying higher interest charges), a nominally separate unit of government holds the debt. The ability to create lease-backs authorities gives local governments an alternative to leasing from private firms. Capital expenditures may be easier to finance, but fiscal illusion is not increased.

The revenue bonds created do not require voter approval. However, it should be remembered that if it were not for the relative ease with which special purpose units of government can issue debt, many of these governments would never have been created (Andrew and Sacks, 1975). The next section will examine some other benefits derived from creating additional governmental units – benefits that would not be as obtainable if it were not for revenue bonds.

### **3. Accountability and voter control**

Traditional public finance analysts have long held that a proliferation of special districts and other units of government leads to confusion among voters and this confusion results in less responsive governments. Such analysts have called for limitations on the formation of governments and greater consolidation of local government.

The public choice approach to public finance has emphasized the beneficial effects of a number of ‘competing’ governments. Having alternative units of government improves monitoring and may lower public service costs (Martin and Wagner, 1978; Dilorenzo, 1981). Increased units of government may also allow for alternative levels of public services (Tiebout, 1956; Buchanan, 1965) and increases in consumption efficiency (Buchanan, 1970; Bradford and Oates, 1974).

This paper follows the latter approach to analyzing the local public sector. This section will indicate how a proliferation of special purpose governments may cause voters less confusion and actually lead to more responsive, more accountable, local governments. Although these governmental units may not directly compete with one another, they may provide for the equivalent of local government earmarking. The structural change caused by local governments placing expenditures ‘off-budget’ to another unit of government represents a shift away from the general fund financing of general purpose governments. At the local level of government, ‘off-budget’ activities have precisely the opposite effect as they do at the federal level.

Earmarking refers to the use of designated taxes to finance specific public services (see Buchanan, 1967: Ch. 6). The payments to a special purpose government (often fees and charges) are automatically earmarked for the services that the special purpose government provides. With a general purpose government, tax payments usually go into a general fund and the

taxpayer is aware of only the total cost of 'bundle' of services. He is uncertain as to the cost of any particular service. Unless it is assumed that voters are informed concerning the intricacies of the municipal budget process, the services of a special purpose government may be the only services for which voters know the amount they are paying. With separate units of government, voter information and control is increased because the possibility for the public sector equivalent of a 'tie-in-sale' is less.

Many special purpose governments have a popularly elected governing body. The accountability of their public officials should be increased as they are now held responsible for delivery of a specified service rather than the overall delivery of a whole bundle of services. Many other 'independent' governments have governing boards that are appointed by a general purpose government and thus are not directly controlled by voters. While leaseback authorities are not by any stretch of the imagination independent, other 'independent' operating authorities have varying degrees of autonomy.<sup>2</sup> However, the institutional arrangements of multiple governments with appointed boards is still preferable to a single general purpose government. The elected officials who review the authority can still be held accountable by the voters. It may be easier to remove a board member of an 'independent' agency than an entrenched bureaucrat operating within a general purpose government. After all, the special purpose units are in most cases exempt from compliance with civil service regulations.

Placing expenditures 'off-budget' that were previously those of a general purpose government also improves the monitoring of local government and can result in more efficiency. Rational, self-interested bureaucrats will not desire to transmit information that may be detrimental to their goals (Tullock, 1965). Replacing departments in general purpose governments with special purpose governments would allow comparisons among different departments. The increase in information available to voters and other decision makers may result in more efficient, less costly government (Dilorenzo, 1981).

An example may help illustrate these concepts. At the time of this writing, Chicago's Mayor Byrne is under pressure to fire the head of the allegedly mismanaged Chicago Housing Authority (CHA). It would not be any easier to effect the dismissal if the CHA were a department within the city government. Also, because the CHA was a separate unit of government, its financial mismanagement could be more easily detected. The CHA's problem could not be hidden in the City's general budget.

Subsidies from a general purpose government to a special purpose government may indeed obscure the actual cost to taxpayers. However, these 'subsidies' for particular services are certainly not any less apparent than if they are mixed up in the total budget. For example, B-D mention that the city of Chicago subsidizes the Chicago Transit Authority (CTA).

The expenses of the CTA would not be any more apparent if they were hidden in various parts of the City's total budget. As was the case with the CHA, the CTA's problems became more apparent because it was a separate governmental unit. They could not hide the financial mess in a general budget.

*The Power to Tax* by Geoffrey Brennan and James M. Buchanan (1980) provides a theoretical rationale for imposing fiscal constraints on government. They point out that in a democratic setting, 'voters or their representatives are likely to choose outcomes more rationally, more efficiently, if they can compare costs and benefits for each activity rather than for a multicomponent budget (p. 152).' In a nondemocratic, Leviathan model of government, the authors reach a similar conclusion concerning the desirability of earmarking that reinforces the arguments above. Earmarking taxes reduces exploitation of taxpayers by inducing government to utilize revenues for the spending desired, assuming there is a complementarity between the tax base and the services desired. The fees and charges often used by operating authorities provide such a complementarity. After all, 'it is unlikely that there could be tax bases for a good more complementary than the good itself (p. 150).'

#### **4. Summary and conclusion**

Bennett and Dilorenzo have provided evidence that limitations on taxes and spending induce a proliferation of special purpose local government. They conclude that the effects on spending were less than originally supposed. Whatever the effects on total spending, a very important effect on the limitations is an induced change in the fiscal constitution of local government. Using a public choice approach, this institutional change was found to have certain desirable features.

Decreased fiscal illusion and increased accountability is obtained by separating the functions of government and their sources of revenue. This is done by placing general purpose government expenditures 'off-budget' and on to a separate special purpose government budget. In effect, the proliferation of governmental units allows for the earmarking of revenues. This allows for more rational decisions in a democratic setting and also limits the exploitation of taxpayers in a nondemocratic setting. The proliferation of governments also allows for more competition among governments and lower public service costs. In addition, alternatives in public services levels may increase consumption efficiency.

The conclusion of this analysis is that tax limitations have brought about an unforeseen improvement in the structure of local government. While the actual implementation in particular cases may not always lead to desirable

results, there is hope for improvement. The important consideration is not whether spending is at some particular optimal level, but whether the fiscal constitution has changed so as to generate more rational outcomes. As Professor Buchanan has emphasized, economists should be 'process-oriented' rather than 'outcome-oriented.' This paper has presented analysis to indicate that the fiscal processes of local government may well have been improved in an unexpected manner.

## NOTES

1. The authors do not precisely define 'off-budget enterprises.' Given their discussion and their evidence concerning revenue bonds, it is assumed that these enterprises include special districts and various authorities. In the present work, these will be referred to as special purpose governments in order to distinguish them from general purpose governments.
2. It is difficult to rationalize why self-interested public authorities would diminish their power, influence and authority by moving activities 'off-budget' to a truly independent unit of government.

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