Would a State Constitutional Amendment Promote Public Authority Fiscal Reform?

By Scott Fein

Recent interest in the reform of State public authority borrowing practices has increased discussion about the need for a constitutional amendment to place limits on the ability of the State to borrow in the absence of voter approval. The growth of the number of State and local public authorities in New York, now numbering more than 600, and the fact that State public authorities are responsible for 85 percent of the State's infrastructure and 93 percent of the State's indebtedness incurred outside of the constitutionally mandated voter approval process, has fueled the discussion. This article examines the background of the issue and the likelihood that a new constitutional provision limiting the role of authority borrowing could make any meaningful change in the State's fiscal practices.

Background

Although public authorities do not fit neatly into the framework of government, most commentators believe that they play an important role in ensuring that there are sufficient revenues to support key government functions, and that those functions are managed and operated outside of political influence and electoral cycles.

Public authorities have a long and celebrated history. Despite popular perception, public authorities were not created primarily as a means to circumvent New York State's constitutional requirement for voter approval of State debt. Public authorities or their precursors have roots that extend back more than 500 years. European monarchs realized that they did not have the revenue to prosecute and defend wars, underwrite global exploration, and live in high style. They turned to Crown Corporations, essentially private corporations chartered by the monarch, to manufacture weapons, liquor, snuff, textiles and underwrite exploration. At the behest of financially struggling sovereigns, these private corporations agreed to undertake exploration, including the provisioning ships and paying seamen, in exchange for a monopoly on trade from any newly discovered lands. The sovereign would extend the realm and the charted corporation would use trade revenue to pay off the incurred debt and enjoy profit. The Dutch East India Company, Hudson Bay, and Plymouth Bay Company were among the more noteworthy of these private-public partnerships.

In the early 1800s, the United States was dealing with unprecedented industrial expansion and western migration. Railroads and canals needed to be constructed, banks established, and infrastructure created. Government turned to the public authority model (chartered private corporations) to raise debt to finance the improvements and then apply revenue generated by the new infrastructure to defray the debt. Unfortunately, in several notable instances the revenue earned by the public authorities proved insufficient to pay the debt, and default and bankruptcy of the authority followed. At about the same time a nationwide recession was ongoing, causing State governments to default on a significant percentage of their debts. The financial chaos prompted voters in many states to impose limits on state borrowing. In New York, this limitation took the form of an amendment to the State Constitution, which provided that no debt will be contracted on behalf of the State, unless such debt shall be authorized by law for some single purpose and shall be approved by a majority of the votes cast by the electorate. In large measure the amendment achieved its objective. The public became cautious in its approval of expenditures and by the turn of the century New York State was on stable fiscal footing. However, beginning in the 1920s and through the Depression, public authorities in New York and elsewhere became increasingly popular. During World War I, they were relied upon to construct and operate a merchant fleet, acquire and sell sugar and grain, and pay for housing. In the 1930s the Public Works Administration, Tennessee Valley Authority, Federal Deposit Insurance Corporation, and the Federal Savings and Loan Corporation were just of few of the entities formed. In New York, the Port Authority of New York and New Jersey and the New York Power Authority were added to the list. In the late 1930s, a New York State court found that, despite what had been represented by the Legislature, the liability of a public authority constituted the liability of the State. In response the State Constitution was amended to provide additional control over public authorities, including an express statement that public authority debt was not to be an obligation of State or local government.

Public authorities in New York through the 1930s were largely revenue neutral entities that performed important public services, charged tolls, fees and rents and obviated the need to materially increase taxes. Robert Moses, a government urban planner, saw public authorities as money generating machines which, properly harnessed, could be used to create parks and recreation areas, expand transportation infrastructure and power generation and enhance urban renewal. Using the revenue generated by the Triborough Bridge and Tunnel Authority and other transportation improvements, he largely remade the transportation and recreation infrastructure of New York City and Long Island.

With the 1940s came a further expansion on the use of public authorities. To raise the considerable revenue necessary to participate in World War II the federal government turned to new public authorities, including the Defense Plant Authority which owned over 2,000 factories. In 1944, New York State entered into the first lease-purchase financing agreement with the Dormitory Authority. The Dormitory Authority was obliged to issue bonds for the construction of dormitories and the State would annually appropriate money to pay the debt service. Since the State was not deemed bound to pay the debt service, it was, on its face, lawful.

Beginning in the 1960s, Governor Rockefeller's administration promoted new debt practices which materially expanded the manner in which authorities could operate. The Governor upon taking office confronted a State university system that lagged behind those of other large states, urban blight, and a deteriorating transportation infrastructure. Rockefeller, seeking to honor the State Constitutional provision requiring voter approval of new debt, proposed a number of public referenda to raise money to fund improvements. In relatively short order, the public rejected on five separate occasions a proposal to raise money for housing, on two occasions for transportation and on four occasions for higher education. The Governor's staff, with the assistance of John Mitchell, developed an innovative approach to the issuance of public authority debt which would allow the authorities to operate outside the State budget and, without any need to seek public approval, raise money to pay for the improvements …even for matters that had been rejected in earlier public referenda. To make the debt more attractive to investors, the State fashioned the bonds as tax exempt instruments and agreed that the State would have a moral obligation to pay the debt service if the public authority defaulted on the obligation. A moral obligation was not deemed the equivalent of a State debt requiring voter approval.

The most recent expansion of Authority borrowing has proven to be the most unsettling and has sowed the seeds of the current movement for a third State constitutional amendment to constrain public authority debt. Throughout the late 1970s and 1980s, State and local elected officials confronted the imperfect storm. There was an increased demand for services, opposition to additional taxes and continuing rejection of public referenda necessary to fund the improvements (in New York, since 1946, voters were asked to approve 34 bond proposals; 22 passed and 12 failed). The public's misgivings about bond proposals so alarmed the legislators that they were reluctant to place such proposals on the ballot. Faced with unfunded needs, the New York State Governors and Legislators increasingly used authorities to supplement the State's general fund by using a scheme not so fondly referred to as "State supported public authority debt," also known as "appropriation backed debt." Unlike most of the earlier versions of public authority debt which relied upon revenue generated from tolls, fees or other payments, and the actual construction or lease of an improvement of some sort, State supported debt requires public authorities, at the Legislature's and Governor's behest, to simply issue debt. Typically, a large State authority directed by the Legislature and Governor to issue bonds, without approval of the electorate, for purposes that often have little relationship to the mission of the authority. The proceeds of the bonds are used to pay for a capital costs that historically would be paid from the State budget. The State then pays the debt service on the bond issued by the public authority using annual appropriations.

Appropriation backed borrowing has become increasingly popular. When pressed for a justification, the Legislature asserts that most of the authority bond revenue is used for improvements that are intended to last 30 years or more and the upfront cost would, if paid from the State's general fund, make it almost certain that the budget would not be in balance as required by State law. However compelling the Legislature's rationale, appropriation backed borrowing which occurs in the absence of voter approval has become the single largest source of the State's funds, and the use of the funding mechanism for both capital and operations needs is largely uncontrolled.

It bears note that New York State is not alone in its use of public authorities to supplement the general fund. It is estimated that nationwide there are more than 35,000 state, local and federal public authorities. Internationally, the concept has also taken root. Japan has more than 3,000, Germany 5,000, Canada more than 400. It is difficult to find a country that in one form or another has not embraced public authority financing to supplement the traditional tax based budget.

The Need for a Constitutional Amendment

The common concern expressed by reform groups and commentators is that the State supported public authority bonding process has so dramatically increased the State's accumulated debt, in the absence of voter approval, that something must be done. Absent a constitutional amendment to eliminate State supported borrowing or provide for the imposition of a rigid cap on public authority debt, the electorate will have lost all control over State borrowing and State finances.

It is difficult to take issue with the concerns raised by the proponents of a constitutional amendment. The issue is not only that appropriation backed public authority debt supported by appropriations taken from personal income tax reserves (referred to as PIT bonds) has grown dramatically. But of equal concern, the investment community grades PIT bonds higher, that is require smaller interest payments, than the State's conventional public approved debt, referred to as General Obligation (GO) State debt. This alone encourages the State to emphasize the use of PIT bonds. Currently, GO debts constitute 12 percent of State supported debt while appropriation backed debt constitutes 23 percent of the State's debt. Legislators have increasingly looked to appropriation backed bonds for short term operational needs, in addition to capital projects, and short term borrowing for school districts and support of localities.

In 2000, recognizing that the State's debt practices needed to be controlled, the Legislature enacted a Debt Reform Act (Chapter 59 of the Laws of 2000). The Act sought to cap new State debt at a specific level and provided that debt could only be used for capital works or purposes and could not have a maturity longer than 30 years. The Act had one glaring weakness. The Legislature omitted appropriation backed public authority debt from the definition of "debt" in the Act. Because appropriation backed public authority debt constitutes the largest component of State debt, the omission undermined the effectiveness of the Act.

In the face of uncontrolled growth in debt, commentators have suggested that the State Constitution should be amended to (i) establish to impose new numerical limits on State and municipal debt, and (ii) limit the issue of appropriation back borrowing by State public authorities absent voter approval. The details of the proposed amendment differ from commentator to commentator but, generally, call for an affordability analysis of State and municipal indebtedness by an independent board. The objective would be to establish rolling, multiyear limits for debt based upon fiscal resources, trends, needs, and patterns of debt by analogous jurisdictions.

While the proposal is attractive, the question is whether even if enacted it is likely to effect a material change in the manner and scope to which the legislature uses public authorities to issue debt. Two prior constitutional amendments restricting non-voter approved borrowing and prohibiting the State from assuming financial liability for public authority borrowing have largely been ignored by the Legislature. Moreover, as discussed in the following section, the State courts have evidenced a disinclination to enforce the two prior constitutional amendments in any circumstance in which the decision might unsettle the State's finances.

The Courts' Reluctance to Enforce Certain Constitutional Limitations

Theoretically, the two existing Constitutional provisions prohibiting State borrowing in the absence of public approval are unambiguous and self executing. No further clarification or implementing legislation is required to give the provisions force and effect. Yet, that is not the reality.

In the mid-1800s public debt to support large infrastructure projects had increased, including debt to pay for the Erie Canal. This increase, together with an economic recession beginning in 1837, resulted in a decline of State investments and in certain instances default on State debts. New York, and other states, sought to mitigate the problem by enacting limitations on the manner in which the State could issue debt, particularly as would pertain to State chartered entities. Article VII, Section 9 was amended to provide, "the credit of the State shall not, in any manner, be given or loaned to or in aid of, any individual, association, or corporation." In addition, Section 12 of the same article of the State Constitution provides that, "no such law which creates debt shall take effect until it shall at a general election have been submitted to the people and have received a majority of all the votes cast for and against it at such election." In 1938, responding to a concern about the increasing number of public authorities, and the State's liability for public authority debt, the 1938 State Constitution was amended to provide that public authorities were to be created by a special act of the Legislature, required the State Comptroller to supervise the accounts of public authorities, and stated that public authority debts were not an obligation of the State or local governments. The collective import of the 1837 and 1938 Constitutional amendments was unambiguous.

Despite the constitutional provisions, New York State courts over the years have with some consistency declined to enforce the Constitutional restrictions limiting public authority bonding. A handful of cases decided by the State's highest court, the Court of Appeals, reflect the judiciary's antipathy about meddling with legislative action involving public authority bonding.

In 1955, the City of Elmira agreed to pay the debt service for the Elmira Parking Authority. The agreement was challenged as contravening of the State Constitution. The Court of Appeals, affirming the arrangement, concluded, "We should not strain ourselves to find illegality in such programs. The problem of a modern city can never be solved unless arrangements like this are upheld, unless they are patently illegal." "Since the city cannot itself meet the requirements of the situation the only alternative is for the State, in the excise of police power, to provide a method of constructing the improvements and financing their cost."

In 1971, the voters rejected a proposed $2.5 billion transportation bond issue. The following year the Legislature directed the Thruway Authority to issue bonds, the proceeds of which would reimburse the State for the same expenditures previously rejected by the voters. The State would then appropriate money to pay for the debt service on the bonds. The New York State Comptroller opined that "the financing scheme is thinly veiled indebtedness of the State." "If the form of the scheme prevails and the indebtedness is treated as that of the Thruway Authority, it is quite clear that State tax revenues will be the source of payment of the obligations issued by the Thruway Authority, raising question of the constitutionality (of the action)." Despite the opinion, when confronted with the implications of nullifying the Thruway bond issuance the Comptroller relented and supported the bond issue. The decision to issue the bonds was subsequently affirmed by the Courts.

In 1975, in the midst of the fiscal crisis, New York City was unable to raise money in the capital markets. To ensure there were funds available to the City, the State created the Stabilization Reserve Corporation (SRC). The SRC was directed to sell over $580 million in bonds and turn the money over to New York City. The creation of the SRC was challenged as contrary to the State Constitution. The courts concluded that the SRC was lawful.

In 1981, voters rejected a $500 million bond referendum for prison construction. Given the expanding prison population, the Governor and Legislature concluded that the rejected referendum could not be the final word. Choosing the public authority revenue-raising model, they turned to the Urban Development Corporation (UDC) to finance the prison construction. The UDC was directed to issue tax exempt bonds to pay for the prison construction. The constructed prisons would be leased to the State Department of Correctional Services. Annual appropriations from the Legislature would pay the UDC's debt service. The use of the UDC for these purposes was challenged in court as a violation of the State Constitutional requirement that State debt be subject to voter approval. The State Court of Appeals affirmed the legislative decision, holding that, "(w)here as here we are called upon to deal with an intricate scheme of public financing or for public expenditures designed to meet a public interest…the Court must proceed in its review with much caution. It is the Legislature which is mandated to make policy decisions in such areas and the court may not invalidate its decision, enacted into law, out of a mere preference for a different more restrained approach."

Finally, in 1993, the State enacted a four-year, $20 billion program designed to enhance transportation and the related infrastructure. The Thruway Authority and Metropolitan Transportation Authority were directed to issue bonds to be supported by State appropriations. The financing approach was challenged as allowing debt to issue in the absence of voter approval in violation of the State Constitution. The Court of Appeals, appearing to ignore the reality of the situation, concluded that there could not be a violation of the Constitution because the enabling statute prepared by the Legislature stated that there was no requirement for the Legislature to make an appropriation to satisfy the debt service. That statement of legislative intent, although inconsistent with the actual financing arrangement, was, for the Court, dispositive of the matter.

While it is true that New York Courts have a poor record of defending the constitutional requirement of voter approval of debt, New York's courts are not alone. Many other states have adopted statutory and constitutional requirements that prohibit debt from issuing in the absence of voter approval. In virtually all of these states, the courts have declined, in the context of public authority debt issuance, to enforce the provisions of law. Whether in Massachusetts, Wisconsin, California, Texas, Michigan, Maine, or North Carolina, courts have not been inclined to defend debt limits or the growth of public authorities.

The courts' hesitancy is not the product of political pressure; rather it is an expression of the courts' concern that tinkering with a financing scheme could destabilize a state. The courts confronting fiscal reality strain to find legality.

A second factor may influence the judicial perspective. Cases may take more than a year to wind their way to a State's highest court. Often, if the legislative directive is not stayed by a lower court, public authority bonds will issue and revenue will be received before the highest court has the opportunity to opine. The prospect of a court overruling a legislative action and directing that the bonds be clawed back and proceeds returned can dissuade the boldest judge from wading in to the fray. The most noteworthy example occurred in the 1981 UDC litigation. The UDC had already sold nearly $300 million in bonds for prison construction before the case contesting the sale reached the State Court of Appeals. Mindful of the delay, the Court noted any adverse judicial action at this point would '"cause unacceptable disorder and confusion."

The Alternative

It appears the value of a new, the third, State Constitutional amendment to constrain public authority borrowing is questionable. The unrelenting pressure on the legislature to use public authorities to fill budget gaps and the courts' disinclination to question the legislative prerogative, renders it unlikely a constitutional amendment would address the commentators' concerns and restore to the public primary debt approval authority. Rather it might well give birth to more creative and less transparent financing schemes which would take years to unravel.

In New York, appropriation backed public authority debt is the current reality and likely here to stay. It is an imperfect and suspect financing mechanism, but no one has identified a suitable alternative to address the State's needs. If the capital markets conclude that in the absence of appropriation backed public authority debt the State cannot meet its obligations, the market could close its doors to the State as it did to the City of New York in 1975. The result could be catastrophic. An alternative to extinguishing appropriation backed public authority debt is to adopt statutory changes to provide for greater transparency, more careful coordination of the debt and evaluation of the projects. For the past twenty years, a number of statutory reforms have been suggested which, individually and certainly collectively, would introduce sunlight into the process and perhaps give birth to new reforms not now contemplated. The statutory reforms that have been suggested include:

- Placing State supported public authority debt within the definition of State debt for purposes of and future cap or financial reforms.
- Ensuring the Executive budget details the nature, amount and justification for State supported public authority debt.
- Prioritizing potential issuance of debt in a comprehensive five-year capital plan.
- Confirming that public authority debt is coordinated with State agencies to minimize duplication.
- Providing a thorough review of the candidate projects to ensure they are, to whatever extent feasible, financially self sustaining.
- Centralizing the issuance of public authority debt to take advantage of market conditions.
- Continuing to ensure that public authorities are making available to elected officials and the public performance and fiscal measures.

Endnotes

Constitutional Provisions

N.Y. Const. art. VII, §§ 9, 10, 11, 12.

Statutory Provisions

N.Y. Pub. Auth. Law §§ 1675 *et seq.* (2009); N.Y. Unconsol. Law §§ 6251 *et seq.* (2009); Priv. Hous. Fin. Law §§ 40 *et seq.* (2009).

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