

**HAWAII
CONSTITUTIONAL
CONVENTION STUDIES
1978**

**Article VI:
Taxation and Finance**

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Foreword

Act 1, Session Laws of Hawaii 1977, the act making appropriations to the legislative branch, directed our office to prepare and publish a taxation and finance manual for the use of the 1978 constitutional convention. This study is the result of that legislative direction.

We assigned the project of writing the manual to Newton N. S. Sue, with the research assistance of Thomas W. Wong and William Nagashima. Mr. Sue and Mr. Wong had co-authored the 1968 constitutional convention study of taxation and finance and had worked closely with the 1968 Taxation and Finance Committee. Mr. Nagashima had served on the staff of the Committee on Finance of the House of Representatives. Together, they would bring to the study a sense of perspective of old and new issues.

The study team wishes to extend its thanks to Dr. Thomas K. Hitch, chairman of the 1968 Taxation and Finance Committee; Mr. Fred Bennion, executive director of the Tax Foundation of Hawaii; and the many public officials who offered advice on the issues of the day. The team also thanks Yoshie Hoshino, who composed the final manuscript; Chiyoko Koito, who prepared the final layout; and Evelyn Kanja and Beverly Kimoto, who proofread the final copy.

We, in turn, hope that the study will be of some use to the delegates of the 1978 constitutional convention, and we wish them well in their deliberations.

Clinton T. Tanimura
Legislative Auditor
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June 1978

Chapter 1

OVERVIEW OF THE TAXATION AND FINANCE ARTICLE

Compared with provisions in other state constitutions, Hawaii's constitutional article on taxation and finance is a model in simplicity. By and large, it deals with fundamental questions and is free of detailed prescriptions and restrictions, thereby providing the executive and the legislature with substantial latitude and flexibility in formulating taxation and finance policies.

In many other state constitutions, the taxation and finance provisions are among the most badly battered and cluttered, and the amendment cycle is seemingly unending as detailed restrictions, which do not stand the test of time, beget more detailed restrictions.

There are at least two reasons why taxation and finance receive such detailed treatment in constitutions. One is historical: among the states, there have been widespread abuses in the conduct of financial affairs, particularly in the 19th century, and the response was to include in state constitutions detailed provisions to prevent financial mismanagement and to curb executive and legislative authority. Apart from the effort to formulate constitutional protection from the actual and potential abuses of government, there is a second, less noble, reason for the proliferation of taxation and finance provisions. Powerful interest groups have frequently sought to advance their financial interests through constitutional provisions, and to the extent that they have succeeded, the result has been not merely cluttered constitutions, but, more seriously, the insidious promotion of private

gain and the insulation of special interest from the overall public interest.

To the credit of the 1950 and 1968 drafters of Hawaii's Constitution, the taxation and finance article reveals no excesses in checking executive and legislative authority or provisions designed to shield any particular interest group. It is salutary that the kinds of provisions found in some state constitutions, which give special economic favors to influential interests, have never even been discussed in two constitutional conventions. Whatever may be their defects or weaknesses, the existing constitutional provisions have their origins in the public interest.

The Structure of the Taxation and Finance Article

The taxation and finance article consists of seven independent sections:

Section 1 states that the taxing power is inalienable and shall never be surrendered, suspended, or contracted away.

Section 2 prohibits the use of public money, property, or credit except for a public purpose.

Section 3, the longest section of the article, prescribes the debt limits of the State and counties and the kinds of bonds which can be excluded from the debt limit.

Section 4 assigns budget preparation responsibilities to the governor and establishes a biennial budget system.

Section 5 requires the legislature to make biennial appropriations and to pass the operating budget bills before passing other appropriation bills.

Section 6 requires the legislature to establish a system for controlling the rate of expenditures and for reducing expenditures under prescribed conditions.

Section 7 establishes the post-audit function and assigns the function to an official appointed by the legislature.

Some of the sections have been remarkably durable. Sections 1, 2, 6, and 7 remain unchanged from their original 1950 language. In 1968, Section 3, dealing with debt, was substantially changed, and Section 4 on the budget and Section 5 on appropriations were amended only to the extent of accommodating biennial budgeting. Also, in 1968, a section dealing with uniformity of taxation as between residents and non-residents was deleted in its entirety because of its redundancy, substantial equality of taxation being already guaranteed by the equal protection clauses of the U.S. and State Constitutions. Since 1968, there has been only one constitutional amendment to the taxation and finance article, a minor one to correct what was apparently a typographical error.¹

The Issues

Changing times make for new issues. The first decade of statehood was largely a prosperous period for Hawaii and, thus, in the last convention, there was no discussion of what now appears to be the burning issue in taxation and finance here and elsewhere, the issue of limits to government spending. Also, full government coffers meant that the executive branch could spend virtually all that the legislature

appropriated, whereas, under the leaner times of recent years, executive—legislative fiscal relations have been strained in a collision of the legislative power to appropriate funds vs. the executive power to restrict appropriations.

Private enterprises—the utility companies, hospitals, housing developers, and, perhaps, others—are looking for ways to use the State's credit to finance the construction of facilities and will certainly press for amendments to permit government borrowing on their behalf. Those supporting conformance of the state income tax laws to federal income tax laws will want an amendment so that the legislature will have the flexibility to act on the matter.

In addition, there are a number of old issues. The 1968 convention made a start in developing a more rational debt limit formula, but, as events have proven, the limits have been ineffectual and of little influence in the development of borrowing policies. The search for a rational debt formula continues. The counties will press for increased taxing powers as they did in 1950 and 1968, and the constitutional provisions which assign the post-audit function to the legislative auditor will probably be reviewed in the context of the continued conduct of auditing by the executive branch.

These and other issues are discussed in this study under the chapter headings of executive—legislative fiscal relations, fiscal restrictions, state and local debt, county taxing powers, and governmental auditing.

¹Senate Bill 1947-72 was passed by the legislature in the 1972 Regular Session and ratified by the voters in the 1972 general election. The 1968 amendment to Section 3 stated that no other appropriation bills shall be passed until "such supplemental appropriation bills" shall have been transmitted to the governor, although the obvious intent was to have just one supplemental appropriation bill. The 1972 amendment corrected the error.

Chapter 2

EXECUTIVE—LEGISLATIVE FISCAL RELATIONS

In the second decade of Hawaii's statehood, no single issue has affected the relationship of the executive branch with the legislative branch more than the continuing conflict over the power of the legislature to make appropriations vs. the executive power to execute them. The issue goes no less than to the basic question of the fundamental powers of each branch of government, and how, if a system of separation of powers continues to be provided for by the Constitution, the conflict can be resolved—if at all—without impairing the independence and responsibilities of each branch. This chapter traces the origins of the conflict, reviews the unsuccessful legislative efforts to redress a balance which has been tipping heavily in favor of the executive, and summarizes the issues and alternatives in budget preparation and budget execution and expenditure controls. Finally, the chapter discusses the issue of control over federal funds, an issue which has increasingly captured the attention of other states but which has not yet reached a flash point in Hawaii.

The Ascendancy of Executive Power

In the development of representative government, the central struggle between legislatures and executives has been concerned with control over policies in the raising and spending of revenues. The struggle appears to have evolved full circle from (1) dominance of the sovereign when representative assemblies

first began to appear in Europe around the 13th century; (2) increasing influence of legislative bodies in granting or withholding their consent to expenditures of the king; (3) a period of exertion of legislative power by American state legislatures and European parliaments in the 19th century; and (4) a return to executive ascendancy in the 20th century with the development of complex, technological societies.¹ The dominance of the executive is manifest in many ways, but perhaps in no more forceful and continuing way than in its control over the proposal and execution of spending policies.

The executive budget. Among state legislatures, the traditional legislative control over the purse, long held to be their most important source of power and authority, began to slip away in the first quarter of the present century with the emergence of the executive budget movement. The reform conceived by its advocates was not designed specifically to undercut legislative bodies (although it ultimately did have that effect) but to bring the fragmented spending practices of government under the responsibility and accountability of a single person—the chief executive.

Prior to the development of the executive budget, and during the period when legislatures were dominant in financial affairs, budgeting

¹Charles R. Adrian, *State and Local Governments* (McGraw-Hill Book Co., New York, 1976), p. 290. See also the 1960 edition, pp. 286–287.

and spending had these characteristics: (1) no central official was empowered to review or revise the spending requests of the various agencies or to make budget recommendations to the legislature; (2) each department's estimates were submitted separately to the legislature, often at different times during the session; (3) each agency classified its accounts in its own way; (4) agency requests were often presented in lump sums and were not supported by data and justifications; (5) the requests were not related to projected revenues or overall expenditures; (6) agencies dealt separately with legislative committees and received separate appropriations; and (7) departmental spending was controlled by little or no central supervision.²

Under the executive budget reform movement, budget preparation authority in a majority of states was vested in an administrative board, comprised of the governor and other administration officials, or in an executive-legislative commission, but when these initial arrangements proved unsatisfactory, governors became the chief budget authorities for the states.³ The executive budget movement had such a profound influence in the shift of power from the legislature to the governor throughout the United States that, today, 45 states have an executive budget under the governor's control, and, in two others, an executive board prepares the budget.⁴

State legislatures went along with the establishment of executive budget systems, although perhaps not without some reservation. One leading authority on the development of budgeting explains the acquiescence of state legislatures from the following perspective:

"It was not easy for state legislatures to yield portions of their power of the purse to the executive. Perhaps more than any other, this power had been regarded as the mark of legislative vitality and independence. It was over this power that the long struggles were waged between Parliament and the Crown in England and between legislature and governor in the colonies. The decisive language of the U.S. Constitution--'No money shall be drawn from the treasury, but in

consequence of appropriations made by law'--is echoed in most state constitutions. In nineteenth century practice, this power of appropriations meant that there was no intermediary between the legislature and the spending agencies, no authoritative executive budget that might constrain legislative action. But as it was conceived by the leading reformers, the executive budget would have forced a radical shift in fiscal power from the legislature to the chief executive. Yet legislators could not resist the tide of reform; they too wanted to do something about the incessant rise in public spending, and they were frustrated by the loose financial arrangements that weakened their legal control over spending. . . ."⁵

In Hawaii, the principle of the executive budget was firmly established in territorial government even before the reform movement took hold elsewhere in the United States. The Organic Act, which was passed by Congress in 1900 and which was to serve as the Territory's fundamental law for the next 59 years, placed the power of budget preparation in a Washington-appointed governor, rather than in an elected territorial legislature, by stating simply and clearly: "...the governor shall submit to the legislature, at each regular session, estimates for appropriations for the succeeding biennial period."⁶

When the drafters met in 1950 to frame the original State Constitution, they noted that the trend in governmental budgeting had been definitely in the direction of the executive budget and that the Territory had followed the practice of leadership by the chief executive in developing spending proposals. The Taxation

²Allen Schick, *Budget Innovation in the States* (The Brookings Institution, Washington, D.C., 1971), pp. 14-15. The work of this author, a frequent consultant to the Hawaii legislature and to the state administration, holds special interest for its treatment of budget developments in Hawaii.

³*Ibid.*, pp. 17-18.

⁴Adrian, *State and Local Governments*, pp. 236-237.

⁵Schick, *Budget Innovation in the States*, p. 18.

⁶Section 53, Organic Act, An Act to Provide a Government for the Territory of Hawaii, June 14, 1900.

and Finance Committee regarded the executive budget as being "of utmost importance in financial planning and control."⁷ Therefore, the executive budget principle was accorded constitutional status in the clause, "the governor shall submit to the legislature a budget setting forth a complete plan of proposed general fund expenditures and anticipated receipts of the State for the ensuing fiscal period. . . ."⁸

In 1968, not only was the principle of the executive budget upheld but executive power was furthered by specifying that the governor would submit a two-year budget and by requiring the legislature to make appropriations for a two-year period, even though the legislature would continue to hold regular sessions each year. While the trend among the states had been running strongly in the direction of annual sessions and annual budgets, Hawaii became uniquely one of the few states with annual sessions but with biennial budgets and biennial appropriations.⁹

While the Constitution requires the legislature to enact a general appropriations bill covering two years in the regular session of each odd-numbered year, it also allows the governor to submit, and the legislature to enact, a supplemental appropriations bill to amend any appropriation for operating expenditures of the current fiscal biennium and to amend any appropriation act or bond authorization act of the current fiscal biennium or prior fiscal periods. There have been four general appropriation acts since biennial budgeting and biennial appropriations went into effect in 1971, and the legislature has found it necessary to amend each such act with a supplemental appropriations bill in the even-numbered year. Thus, while the State is on a biennial appropriations system, there are still characteristics of annual appropriations with respect to operating expenditures and particularly with respect to capital investment appropriations.

That a change to biennial budgeting, and particularly biennial appropriations, had vast political implications and would further

erode the legislature's power of the purse did not appear to weigh too heavily on the 1968 deliberations. Rather, the 1968 convention seemed to have been persuaded by the state administration, which made a strong push for biennial appropriations, that the annual budgeting process was taking up too much time and that extending the fiscal period from one to two years would result in economies. There was little appreciation of the view that the exercise of legislative power to approve, modify, or deny budget proposals of the governor was virtually the only effective check against complete executive supremacy, and that by requiring appropriations to be made for two-year periods rather than annually, this, in effect, would reduce the frequency of confrontation between the legislature and the executive branch over the whole budget, free the executive from financial dependence on the legislature for longer periods, and thus advance executive power.

Expenditure controls. The power of the chief executive in budget preparation tells only half the story of the dominance of governors in fiscal affairs. Of perhaps even greater force is the power of the governor to execute the budget and other appropriations after they are passed by the legislature—to grant or withhold funds, to transfer funds from one program to another, and to otherwise modify the appropriations made. This power developed during the Great Depression when many states accumulated large deficits and it became apparent that

⁷State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii, 1950*, Vol. I (Honolulu, 1960), p. 192.

⁸State of Hawaii, *The Constitution of the State of Hawaii, 1950*, Article VI, Section 4.

⁹The Council of State Governments, *State Legislative Appropriations Process* (Lexington, Kentucky, 1975), p. 57. With the 1968 constitutional amendment, Hawaii joined Georgia as states with annual sessions and biennial budgets. There are now eight other states with annual sessions and biennial budgets, but this is the result of the states' shifting from biennial sessions to annual sessions while retaining biennial budgets, rather than a change from annual budgets to biennial budgets.

complete adherence to legislative intent and legislative appropriations could not work under conditions of uncertainty and high government spending. Thus:

"The solution was to equip the governor with expanded powers over expenditures, enabling him to force agencies to adjust to unforeseen circumstances and to hold their spending below the levels specified by the legislature. In particular, the governor was empowered to control the transfer and allotment of funds and to superintend the execution of the budget. By means of this new power, governors became controllers in their own right, no longer mere agents of legislative control. This transformation was abetted by the enlargement of central budget staffs in which were lodged the routine administrative controls over expenditure."¹⁰

Section 6 of the present Taxation and Finance article provides the constitutional basis for the establishment of a system for expenditure controls. It states: "Provision for the control of the rate of expenditures of appropriated state moneys, and for the reduction of such expenditures under prescribed conditions, shall be made by law." It is a section which has its origins in the 1950 Constitution and was not amended in 1968. Initially, the 1950 Taxation and Finance Committee proposed to confer directly to the governor the power to curtail expenditures, but the proposal was defeated and a substitute proposal was adopted to provide for more general language requiring the legislature to establish a system of expenditure controls.¹¹

The laws enacted by the legislature regarding expenditure controls comprise what is known as the allotment system.¹² The legislature has declared its policy that its appropriations are *maximum* amounts and that the governor and the director of finance have the power to reduce expenditures "in order that savings may be effected by careful supervision . . . and by promoting more economic and efficient management of state departments and establishments." In addition, if the director of finance determines at any time that the probable receipts from taxes or any sources for any appropriation will be less than antici-

pated, the director can, with the approval of the governor, reduce the amount allotted or to be allotted after giving notice to the department concerned.

While the governor has the constitutional power to use the item or reduction veto to delete or reduce appropriations, that power has not been used, except in rare instances, to correct errors. The deletion or reduction of appropriations can more easily be done through the allotment process as a matter internal to the executive branch. Therein lies one of the reasons for executive-legislative conflict.

Revenue estimates. Combined with budget preparation and expenditure controls, revenue estimating can also be a source of power, inasmuch as it governs the overall spending policies of state governments. Here, the executive is again dominant. Among the states, 20 state legislatures must or do rely only on executive sources for revenue estimates, usually the revenue departments or budget offices, or both. In West Virginia, the legislature is constitutionally required to rely only on the governor's estimates. Only Arizona reports relying on legislative estimates. The remaining 29 states report using both executive and legislative estimates.¹³

Hawaii's Constitution assigns to the governor the responsibility for submitting to the legislature a complete plan of proposed expenditures *and* anticipated receipts. Thus, the governor has the responsibility to make revenue estimates. Nothing in the Constitution

¹⁰ Allen Schick, "Review and Evaluation Can Focus Light On Legislative Reform," in *Yearbook of the National Conference of State Legislative Leaders* (Milwaukee, November 1971), p. 8.

¹¹ State of Hawaii, *Proceedings of the Constitutional Convention, 1950*, Vol. I, pp. 194-195, 328.

¹² Sections 37-31 to 37-42, Hawaii Revised Statutes.

¹³ The Council of State Governments, *State Legislative Appropriations Process*, pp. 38, 99-100.

requires the legislature to be bound by those estimates, but, in practice, the executive's estimates heavily influence the legislature's financial plan and its establishment of overall appropriation levels.

The credibility of the governor's estimates is probably enhanced by the practice of using a revenue-estimating committee, drawing on sources outside of government to assist in making the estimates. The governor is not required to adhere to the estimates of the revenue-estimating committee, which has no legal status. Over the years, individual legislators have complained that the estimates have been low (some say deliberately low to constrain the legislature in its expenditure policies), but their quarrel is probably less with the revenue-estimating committee than with the estimates themselves as they ultimately appear in the executive budget.

Table 2.1 shows the estimated general fund tax revenues as they were presented in the executive budget for two previous bienniums, and compares them with the actual revenues each year.

Table 2.1

General Fund Tax Revenues—
Estimated vs. Actual
FY 1973–74 to FY 1976–77
(Thousands of \$)

Fiscal years	Estimated revenues	Actual revenues ^c	Difference
1973–74 . . .	\$428,579 ^a	\$472,848	\$44,269
1974–75 . . .	470,725 ^a	551,914	81,189
1975–76 . . .	580,407 ^b	604,313	23,906
1976–77 . . .	636,685 ^b	649,030	12,345

^aSource: *The Executive Budget for Fiscal Biennium 1973–75*, Vol. IV.

^bSource: *The Multi-Year Program and Financial Plan and Executive Budget for the Period 1975–1981 (Budget Period 1975–1977)*, Vol. I.

^cSource: Annual financial reports of the State of Hawaii, 1974–1977.

Under the system of biennial budgeting, the estimates for each of the two fiscal years of the 1973–75 biennium were made in late 1972 and the estimates for the two fiscal years of the 1975–77 biennium were made in late 1974. Thus, the time horizon which needs to be considered in making the estimates for biennial budgeting purposes extends over 30 months. One view of the forecasting problem is that it is “usually safe” to make forecasts for one or two quarters, but forecasts one year ahead present “hazards,” and two-year forecasts have “high risk” and carry the probability of “high” plus-or-minus errors.¹⁴

Executive—Legislative Conflict

Cognizant of growing executive dominance in fiscal affairs and its own diminishing control over the purse, the legislature in recent years has attempted to regain control, but it has managed to exert its influence in only two areas: (1) in specifying the details which need to be included in the executive budget submitted to the legislature; and (2) in insulating its own budget and the budget of the judiciary from the item veto and reduction veto powers of the governor.

Of the first, a change made by the 1968 Constitution opened the door to an active legislative role in the reform of the budget process. In place of the 1950 requirement of separate capital and operating budgets, the 1968 Constitution left the form of the budget up to the legislature. The result was legislative passage of The Executive Budget Act of 1970, an act which emphasized the planning focus in budgeting, or what is known in government circles as planning-programming-budgeting (PPB). It was a significant legislative accomplishment, in the view of one close observer of the Hawaii scene:

¹⁴*Ibid.*, p. 252.

"The most unusual and enlightening success story comes from Hawaii where the state legislature *disregarded the unwritten rule that budget innovation is the prerogative of the chief executive and seized the initiative in promoting and designing a comprehensive PPB system for the state.* To be sure, this assertive role led to some conflicts with the governor's office and with agencies which had to cope with multiple and diverse instructions. But it also made Hawaii the first (and probably the only) government in the United States to enact a budget law that specifies and mandates both the principles and forms of the PPB system . . .,"¹⁵

As to the second accomplishment, the legislature in the 1974 regular session initiated a constitutional amendment to exclude appropriations to the legislature and the judiciary from being subject to the item veto and reduction veto power of the governor. The legislature stated as its purpose: "The amendment is designed to safeguard the judicial and legislative branches from being dominated by a governor. At the same time, the principle of checks and balances is retained by allowing the governor to veto, as a whole, bills which appropriate funds to be expended by the judicial and legislative branches."¹⁶ The amendment was subsequently ratified by the people in the 1974 general election.

In the same session, the legislature further shielded the judiciary and the legislature and its service agencies from executive branch controls by passing a bill which clarified the relationship of executive agencies with the judicial branch and the legislative branch. The legislature declared as its findings and purpose:

"The Constitution of the State of Hawaii provides for three separate and co-equal branches of government, the executive branch, the judicial branch, and the legislative branch.

"The legislature finds that, although the Constitution incorporates the principle of separation of powers and the principle that no one branch of government shall dominate another branch, the Hawaii Revised Statutes are not completely consistent with these constitutional principles. This is particularly the case with respect to those statutes which appear to permit the executive branch to exercise various administrative controls over the judiciary and its courts and the legislature and its agencies. Such statutes

are in conflict with the constitutional status of the judicial branch and the legislative branch as separate and co-equal branches of government.

"The purpose of this Act is to clarify the Hawaii Revised Statutes and to bring the statutes into conformance with the separate and co-equal status intended by the State Constitution for the executive branch, the judicial branch, and the Legislative branch."¹⁷

The more important changes made by the bill now prevent the state comptroller from stopping specific expenditures of the legislature and the judiciary, allow the judicial branch to submit its budget directly to the legislature rather than through the Department of Budget and Finance and the governor,¹⁸ and vest in the chief justice ultimate authority for personnel appointments and other personnel actions of the judiciary.

However, the legislature's accomplishments in taking the initiative in budget reform and in insulating its budget and that of the judiciary from executive controls were virtually its only successes in the effort to regain control over the purse. In the crucial areas of financial policy-making, it lost ground. As discussed in Chapter 4, it had long before lost effective control over the capital improvements program. In more recent years, the legislature has seen its authority to make appropriations for operating and new programs being subordinated to the authority of the governor to implement them.

¹⁵Schick, *Yearbook of the National Conference of State Legislative Leaders*, p. 12.

¹⁶Senate Bill 1943-74, 1974 Regular Session.

¹⁷Act 159, Session Laws of Hawaii 1977.

¹⁸Previously, the judiciary was subject to all controls exercised by the Department of Budget and Finance over executive departments in the preparation of the budget. The central budget agency could--and often did--modify the judiciary's budget requests prior to their inclusion in the executive budget. Moreover, it was influential, if not decisive, in determining how the programs and budget categories of the judiciary were to be structured.

Budget restrictions. The administration's practice of restricting legislative appropriations had long nettled individual legislators. In 1976, following the legislative session, the simmering dispute erupted into open conflict following reports that the administration intended to reduce general fund spending in fiscal year 1976-77 by \$60 million. Particularly because the State had reported an \$83 million general fund surplus at the close of fiscal year 1974-75, the announcement provoked the ire of legislators. The chairman of the House Finance Committee summarized the legislature's case and related it to constitutional issues in this way:

"I question the administration's proposed restrictions on two grounds. First, they are wrong on their financial plan, and, second, if the governor disagrees with legislative appropriations, he should be using the item veto, where everything is in the open and the legislature has the opportunity to override the veto, rather than the administrative practice of restrictions.

"A year ago, they were doing the same thing in restricting funds, but we quickly learned how far off the mark they were. They estimated the 1975 surplus to be \$47 million, and it actually turned out to be \$83 million, an almost unbelievable error of \$36 million. They also underestimated tax revenues by \$22 million.

"... there is a constitutional solution to differences between the legislature and the executive branch on spending matters, but the administration has by-passed the constitutional machinery.

"By providing for the item veto, the State Constitution clearly intends that the governor should reduce or delete appropriations through the use of his veto power in those cases where he disagrees with the legislature. The use of the veto power is an open and visible process and because the legislature can sustain or override the veto, this preserves the checks-and-balances under our system of government. However, when the governor uses administrative restrictions to stop spending, this is subject to no checks at all. He can rewrite legislative budget acts at will, and I don't think that's what was intended by those who drafted our Constitution.

"... if a constitutional convention is called by the people, I will urge the delegates to review how to stop the governor's assumption of complete authority over appropriations and the erosion of the legislature's traditional power of the purse."¹⁹

Two legislators filed a suit in Circuit Court challenging the governor's authority to withhold funds, contending that the administration's actions were, in effect, item vetoes outside of the constitutional framework. Another suit was filed by the Legal Aid Society on behalf of clients challenging the withholding of \$105,000 which the legislature had appropriated for bilingual health aides.²⁰ With respect to the suit filed by the Legal Aid Society, the court upheld the administration's authority to make budget cuts, and, with respect to the suit filed by the legislators, the court dismissed the suit on the basis that they lacked standing to institute the action.²¹

Legislators would probably have a lesser quarrel with the administration if the administration merely reduced program expenditure levels under the changed condition of anticipated revenues being less than originally estimated at the time the appropriations were passed. Frequently, however, entire amounts for particular programs are withheld, as Table 2.2 shows.

Act 226 was the Supplementary Appropriations Bill passed in the 1976 legislative session. In addition to accommodating administration requests to amend the biennial budget which was passed in the 1975 session, Act 226 also appropriated funds for a number of programs and projects initiated by the legislature. The administration withheld the entire amounts of 51 legislative programs, totaling some \$3.2 million, and, on June 30, 1977, all of the appropriations for the 51 programs lapsed.

¹⁹Representative Jack K. Suwa, News Release, House Finance Chairman Attacks Budget Restrictions, June 15, 1976.

²⁰*Honolulu Star-Bulletin*, Lawmakers Sue Over Ariyoshi's Budget Cuts, September 14, 1976; *Honolulu Advertiser*, Two sue State over budget cuts, September 15, 1976.

²¹*Honolulu Star-Bulletin*, Ariyoshi's Cuts Ruled Legal, September 30, 1976; *Honolulu Advertiser*, Judge rejects challenges to cuts, September 30, 1976.

Table 2.2

**Programs and Appropriations Not Implemented
Act 226, S.L.H. 1976**

Program	Amount lapsed
Hawaii Transportation Services	\$ 119,000
Kauai Transportation Services	85,238
Maui Transportation Services	80,000
Achieve Selected Excellence for Viewership	78,000
Hamakua Pamakani Plant Project	50,000
Statewide Facility for Aquaculture	78,000
Grant to Habilitat	100,000
Maui Day Activity Program	50,000
Expand School Health Project	667,694
Honokaa Hospital Equipment	50,000
Grant to Molokai Hospital	130,000
Family Planning Service	300,000
Learning Disabilities Pilot Project	50,000
Hawaii Association for Retarded Children	70,000
Alternative Education Programs	153,460
Support Language Schools	90,000
Counseling and Guidance Teachers	167,000
Films Relating to Governmental Processes	75,000
Research Alternate Uses for Lava Rock	100,000
Outward Bound Program	60,000
Others ¹	629,103
Total	<u>\$3,182,495</u>

¹ 31 other programs, each under \$50,000.

Source: *Annual Financial Report of the State of Hawaii For the Fiscal Year Ended June 30, 1977, Supplemental Detail*, pp. 2-32.

The scope and frequency of restrictions on appropriations were apparently not foreseen by the drafters of the 1950 Constitution. In discussing its original proposal for expenditure controls, the Taxation and Finance Committee observed:

"... In order to keep reasonably close to the actual [revenue] collections, provision should be made for curtailment of expenditures by the governor. It can be reasonably expected that this power will be seldom used. Governors are responsive to public opinion, as is the legislature. The governor normally looks upon the appropriation as the proper amount for the department to spend. It will be only under extraordinary conditions that he will be called upon to reduce the spending level established by the legislature."²²

Transfers of program appropriations. In addition to the substantial power that can be wielded by the administration in the withholding or reduction of appropriations, the governor can also influence the execution of the budget in the transfer of appropriations from one program to another. Recent legislative history concerning the authority for appropriation transfers discloses that the legislature has attempted to strike some kind of balance between (1) according the governor some flexibility in executing the budget, and (2) trying to assure that legislative intent is met. It also shows that legislative efforts have not achieved the results intended.

Prior to 1970, legislative appropriation acts commonly gave to the administration the authority to transfer appropriations within a department, but they were qualified to safeguard legislative interests. For example, the General Appropriations Act of 1969 specified that:

"... transfer of funds between program appropriations within a department... may be made by the head of the department upon his certification, and approval by the director of the Department of Budget and Finance, that appropriation balances are or will be available for such transfers after the program objectives intended by the legislature have been accomplished and that such transfers are necessary to accomplish program objectives authorized by the legislature."²³

With the passage of The Executive Budget Act in 1970, appropriation transfers would ordinarily have been prohibited thereafter. Among the provisions included in the act was one which specified that no appropriation transfers or changes between programs can be made without legislative authorization. It also provided that, when authorized transfers or changes are made, they must be reported to the legislature.²⁴

²²State of Hawaii, *Proceedings of the Constitutional Convention, 1950*, Vol. 1, p. 195.

²³Section 13, Act 154, Session Laws of Hawaii 1969.

²⁴Section 37-74(d), Hawaii Revised Statutes.

However, in the General Appropriations Act of 1971, which provided for program appropriations for the first biennial budget as required by the 1968 Constitution, a provision was included which permitted the governor, or the director of finance if so delegated, to transfer appropriations made for research and development and operating purposes.²⁵ No conditions needed to be met, in effect allowing transfers anywhere within the operating budget. In 1973, the General Appropriations Act provided for the same general authority to the governor, except for the general limitation that the programs from and to which transfers are made must fall within the same major program area.²⁶

Recognizing that it had perhaps accorded to the governor too much authority to modify the budget acts,²⁷ the legislature moved in the 1975 session to regain a measure of control. It authorized the governor to transfer funds within a department, "provided that such transfer shall be with the concurrence of the President of the Senate and the Speaker of the House of Representatives."²⁸ In 1977, the legislature further strengthened that provision by specifying that the governor must obtain the *approval* of the presiding officers and that the approval must be obtained *prior to* effecting any transfer.²⁹

Whether the budget acts require concurrence or approval, it is apparent that legislative efforts to reassert control in the last two General Appropriation Acts have been ineffectual, since the governor, in effect, approves the transfers of appropriations and informs the legislature that they have, in fact, been made.³⁰

Other inconclusive legislative initiatives. In the last two years, three different approaches, in the form of three different bills, can be discerned in the efforts of the legislature to regain control, one originating in the Senate and two in the House of Representatives. All three efforts failed to complete the entire legislative process necessary for passage, and, in any event, they would have faced the possibility of a veto, given

the strong opposition of the administration to all three measures.

The Senate. In 1977, the Senate passed a bill which would have established a joint Senate-House controlling committee to oversee appropriations and authorize transfers of appropriations. It would have also provided for an emergency purposes fund, to be built up by all appropriations not allotted by the end of a quarter, with the controlling committee having the authority to make authorizations and expenditures from the fund.³¹

The bill was in part patterned after the system in the Oregon Constitution. The Oregon Constitution provides for a joint legislative committee, called the Emergency Board, with authority to allocate funds for emergency situations and unforeseen contingencies from funds appropriated to the joint committee. The Emergency Board has the authority to establish

²⁵Section 17, Act 68, Session Laws of Hawaii 1971.

²⁶Section 97, Act 218, Session Laws of Hawaii 1973.

²⁷On the opening day of the 1975 legislative session, the newly-elected President of the Senate, Senator John T. Ushijima, stated: "An assessment of past legislative sessions has seen the erosion of legislative control in the total concept of government Our position as architect of legislation and the overseer of the implementation process via the Executive Branch will be established. We have abdicated to the executive branch many of the inherent powers that were rightfully within the province of the legislature" *Journal of the Senate of the Eighth Legislature of the State of Hawaii*, Regular Session of 1975, p. 4.

²⁸Section 102, Act 195, Session Laws of Hawaii 1975.

²⁹Section 99, Act 10, First Special Session Laws 1977.

³⁰E.g., letter from the governor to the presiding officers of the legislature, dated June 30, 1977. The letter begins: "I have, on this day, approved the following transfer of funds" and closes with: "This transfer was made pursuant to Section 102 of Act 195, SLH 1975, General Appropriations Act." [Emphases added.] This particular letter announced the transfer of \$7,485,362 among programs of the Department of Education.

³¹Senate Bill 790, S.D. 1, 1977.

budgets for new programs or activities for which appropriations were not made, to increase expenditure limitations established by the legislature, and to review federal grant applications prior to their submission to the federal government. Thus, in the view of Oregon's legislative fiscal officer: "As a result of this constitutional authority, the Legislature has not found it necessary to provide the Executive Branch with the flexibility as to the administration of the state budget as would otherwise be the case."³²

Among the objections raised by the state director of finance, two were based on constitutional issues:

"... First, we believe that the provisions of this bill are in direct conflict with a fundamental principle of our democratic system of government; i.e., the doctrine of the separation of powers. The Constitution of the State of Hawaii clearly establishes this doctrine in the Hawaii governmental process. It provides for a Legislature as the law-making and policy-setting body; and it provides for an Executive Branch, under the direction of the Governor, responsible for the day-to-day administration of the affairs of the State. We believe that enactment of this bill would seriously jeopardize the functioning of State government as conceived by the Constitution for it places certain day-to-day administrative functions with a legislative 'controlling board' and severely erodes the powers of the Governor to effectively administer the Executive Branch of government as required by the Constitution.

"Secondly, we seriously question the constitutionality of: 1) a delegation of legislative authority which this bill provides to a select group of legislators and 2) the authority of any individual legislator or group of legislators to act in any capacity at a time when the legislature is not a formally constituted body (i.e., in session) as provided by law."³³

The Senate bill did not advance in the House, possibly because of the constitutional issues raised by the director of finance.

The House. The approach of the House of Representatives was to amend the allotment system statutes to reduce the discretionary authority of the governor and the director of finance in making restrictions, with shortfalls in revenues being the only condition under

which restrictions can be made. In addition, the House sought to reduce the power of the Department of Budget and Finance and assign the responsibility for making specific program reductions, if necessary, to the operating departments.³⁴ The House Committee on Finance explained the reasons for its proposal for a system of aggregate fiscal controls:

"The present system of allotment control extends to a fine level of detail. This control involves the approval, disapproval, or modification of specific objects of expenditure. Such a system poses no serious problems when the amounts allotted are the same as the amounts appropriated. However, in time of austerity when allotments are substantially below appropriations, the central budget agency, through the allotment system, exercises control over program execution decisions. In order to place the responsibility for such decisions where it rightfully belongs without any detraction from the central budget agency's responsibility to oversee and safeguard the overall financial condition of the State, this bill provides that when allotments are less than appropriations, the central budget agency would notify the various agencies of the aggregate reductions to be made but each agency would decide which program and which objects of expenditures are to be reduced."³⁵

This was not an original idea. It was evidently what the 1950 constitutional drafters had in mind when they wrote the original provision on expenditure controls:

"To avoid the reduction of expenditures item by item, the governor is given the authority to reduce expenditures and control the rate of expenditures only to the extent 'proper to effect economies.' Thus, in the opinion of your Com-

³²Letter, Floyd G. Gould to Senator Richard S. H. Wong, dated August 18, 1976.

³³Eileen R. Anderson, Director, Department of Budget and Finance, Testimony to the Senate Committee on Ways and Means on Senate Bill No. 790, March 3, 1977, pp. 2-3.

³⁴House Bill 9, 1977. A similar bill, House Bill 10, was passed by the House in the 1975 regular session, but it failed to pass the Senate.

³⁵House Standing Committee Report No. 159, March 1, 1977, on House Bill No. 9.

mittee, any reduction authorized by the governor would be in total sums by departments, agencies, etc., and the respective heads thereof would determine which expenditures under their jurisdiction would be curtailed, unless the legislature specifically authorizes more detailed budget control. This provision on control of expenditures is definitely in line with good financial management."³⁶

The chairman of the 1950 Taxation and Finance Committee amplified the committee's intent in this way:

"It's not proposed in here, and I think it's covered quite clearly in the report, that whatever legislation is enacted to implement this procedure could require that in making any reductions under those situations where the revenue falls below estimate that the governor would be limited in making those reductions to making them by amounts instead of by being able to tell a department head that he shouldn't be able to employ this man for this particular purpose or that he shouldn't buy this desk or that he shouldn't - he ought to put off the purchase of a typewriter until the following quarter, or something like that.

"I know that there has been some criticism of the present system due in part, in my humble opinion, to ineffective administration when the budget director goes to the extent of instructing the department head what items he should have and what items he shouldn't have, and I think the report is quite explicit on that. And, of course, it should be very - - the legislation should be very carefully drafted to make sure that that idea is carried out in the law."³⁷

Thus, the House bill could be viewed as an effort, albeit belated, to meet the intent of the 1950 drafters of the Constitution. However, the bill, opposed by the administration, did not pass the Senate. The position of the present administration is that it has already provided the operating departments with greater authority in determining specific program expenditure levels.

In the 1978 legislative session, the House attempted another approach.³⁸ The chairman of the House Finance Committee drafted a proposal patterned after the Federal Impoundment Control Act, which currently governs the relations of the President with the United States Congress. The federal act was enacted by

Congress for essentially the same reasons which prompted the introduction of a state version of the act. President Nixon had unilaterally impounded congressional appropriations through executive actions which the Congress believed were unconstitutional. While the Congress was supported in the courts, it also sought to resolve disputes with the President through the establishment of a formal system.

Staff comments on the House measure explained the purpose of the bill as follows:

"The purpose of this bill is to change the current practice whereby the governor exercises unilateral authority in determining how much of legislative appropriations should be expended or whether they should be expended at all. This authority is currently exercised by the governor through administrative processes which are not subject to full public view. The bill would change the current practice by requiring all proposed rescissions or deferments of appropriations to be subject to a formal and visible system of executive reporting and legislative review."³⁹

The following are the main features of the impoundment control bill:

1. All appropriations to be withheld by the governor, whether permanently or temporarily, must be reported to the legislature.
2. Proposed rescission or permanent withholding of appropriations must be released for obligation and expenditure if the legislature fails to approve the proposed rescission within 45 days.

³⁶State of Hawaii, *Proceedings of the Constitutional Convention, 1950*, Vol. I, p. 195.

³⁷State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii, 1950*, Vol. II (Honolulu, 1961), p. 195.

³⁸House Bill 1972-78, 1978.

³⁹Staff Comments on House Bill 1972-78 Relating to Impoundment Control, undated.

3. Temporary withdrawal or deferral of appropriations may be made if either the Senate or the House does not transmit to the governor a message disapproving the proposed deferral.

Predictably, the bill also ran into the opposition of the state administration. The director of finance argued on practical grounds that it has been necessary for the executive not to allot all of the appropriations authorized by the legislature in the past five years, because if it had done otherwise, the State would have incurred a cumulative deficit of \$245 million. In addition, the director objected on constitutional grounds:

"... it is our belief that the requirements for the concurrence by the Legislature in the allotment process as outlined... would not only dilute the budget execution authority and responsibility of the governor... but it also appears to us to be in conflict with the separation of powers doctrine of the Hawaii State Constitution. The allotment process is clearly an Executive Branch function, and inclusion of the Legislative Branch in the process would, in our opinion, constitute an infringement on the executive powers of the Governor as delineated in our Constitution."⁴⁰

The bill did not advance, and because of the constitutional questions which had been raised with respect to the impoundment control measure as well as the Senate bill, several key legislators saw the issue of executive-legislative fiscal relations as one for the constitutional convention to resolve.

Control over Federal Funds

Federal funds have come to assume an important part of state and local finances throughout the United States. In fiscal year 1976-77, the federal government channeled over \$73 billion in federal aid to state and local governments. Between 1960 and 1975, federal aid to the state and county governments in Hawaii increased by over ten times, the third highest increase among the states.⁴¹ With respect to state government only, Hawaii

received into its general and special funds a total of some \$326 million in federal funds in fiscal year 1975-76, or 25 percent of total state receipts.⁴²

In many states, federal funds escape the attention of state legislatures, because the federal grants are requested and obtained directly by executive agencies. Frequently, the first time that legislatures are aware of the federal funding of a program is when the federal funds are about to run out, and state funds are requested to keep the program going.

The National Conference of State Legislatures has been leading a movement for state legislatures to assert controls over federal funds. The national organization points out that, with federal funds, state agencies have been able to support programs and employees entirely outside legislative purview, and that very few state officials, from the governors to the legislators, have comprehensive information on current amounts of federal aid, let alone the state financial obligations resulting from the aid.⁴³

The Speaker of Minnesota's House of Representatives summarizes the case for legislative control over federal funds as follows:

"... Without legislative oversight, executive departments and agencies have the tendency to reach for whatever federal money they can obtain without considering the implication of bloated departments or state assumption of these programs

⁴⁰Eileen-R. Anderson, Director, Department of Budget and Finance, Testimony to the House Committee on Finance on House Bill No. 1972-78, February 14, 1978.

⁴¹National Conference of State Legislatures, *State Legislative Control of Federal Funds*, State Legislative Report (Denver, Colorado, March 1978), pp. 1, 4.

⁴²Department of Accounting and General Services, *Annual Financial Report of the State of Hawaii* (Honolulu, 1976).

⁴³National Conference of State Legislatures, *Program Announcement of Seminar on State Legislative Control of Federal Funds*, May 12-13, 1978.

when federal money expires. This fragmented approach usually leads to duplication and wasteful expenditure of dollars. Just like the average wage earner, states feel the pinch of inflation and are searching for ways to maximize every dollar going out of the treasury.

"That's why legislators have taken pains to become more professional in approaching today's complex problems, especially in budgeting. Yet, they are accountable to their constituents—the public. Unlike many bureaucrats, they are not concealed from public view, but are open to constant scrutiny. They are in the position to make judgments on where and how federal aid can best serve the interests of their community."⁴⁴

However, state legislatures have faced legal challenges in their attempts to assert control over federal funds. Often, the definition of "public funds" has been held to exclude federal funds. There is also the contention that a state may violate contractual obligations if the legislature denies funding for a particular program. The most serious challenge to legislative authority is that delegation of legislative appropriations authority to a committee has been judged unconstitutional in many states, thus making it difficult for legislatures, during the interim period between sessions, to authorize or deny the use of federal funds.⁴⁵

The landmark case to date appears to be in Pennsylvania, where, since 1976, the Pennsylvania legislature has appropriated federal funds. Its authority was upheld in a Commonwealth Court decision, *Shapp v. Sloan*, affirming the constitutional right of the legislature to appropriate all funds deposited in the state treasury.⁴⁶ The decision has been appealed.

While the states elsewhere seem to be steeped in executive-legislative conflict over the control of federal funds, the dispute has not emerged in full force in Hawaii, although for years individual legislators have complained about their lack of information and control over federal funds. There are probably two reasons why legislative control over federal funds has not erupted as a salient issue in

Hawaii. First, The Executive Budget Act of 1970 requires all sources of funding to be identified in the program appropriation requests contained in the budget, including all sources of federal funding, and the appropriation acts likewise identify federal funds wherever applicable. Thus, it gives the appearance, if not the reality, of the legislature having control over federal funds. Second, with the lack of effective legislative control over the execution of appropriations generally, the question of federal funds control is merely secondary.

As a practical matter, the legislature has little information as to the specific purposes for which certain federal funds will be used and there is, moreover, no certainty that the amount of federal funds identified in the various program appropriations will, in fact, be received. It could be more, less, or none at all. Current legislative policy seems to be to allow the executive branch to go after federal funds with the understanding that federal funds should be used to reduce state expenditures. Thus, the general appropriation acts routinely include the following provision:

"Where the Governor or any agency or any government unit is able to secure federal funds or other property made available under any Act of Congress or any funds or other property from private organizations or individuals, to be expended in connection with any program or works authorized by this Act, or otherwise, the Governor or agency with the Governor's approval shall have the power to enter into such undertaking with the proper offices or agencies of the federal government or private organizations or individuals. While most federal-aid allocations are known and local matching funds are provided in this Act, there may be programs for which federal-local cost sharing are not yet determined. In such cases, the

⁴⁴Martin Olav Sabo, "State Control of Federal Funds," *National Journal*, July 9, 1977, p. 1096.

⁴⁵National Conference of State Legislatures, *State Legislative Control of Federal Funds*, p. 3.

⁴⁶Winnie Austerman, "Can Legislatures Control Federal Funds?", *State Legislatures*, January/February 1978, p. 12.

availability of federal funds shall be construed as a reduction of State costs whenever possible.”⁴⁷

Should Hawaii’s legislature move in the direction of greater control over federal funds, as other state legislatures appear to be doing, constitutional questions could develop with respect to the powers of the executive vs. the powers of the legislature. This has been the experience in other states. Therefore, it may be appropriate to review the Constitution to determine whether the legislature has the authority, or should have the authority, to approve what kinds and amounts of federal funds should be pursued and to authorize the specific purposes to which they are to be applied.

Issues and Alternatives

Arguments. The ascendancy of the executive to the dominant role in financial affairs can be viewed from several perspectives. One perspective is that the dominance of the executive not only should be accepted but that it is absolutely necessary for the day-to-day conduct of financial affairs. The governor is the one single person who can logically be charged with the responsibility of preserving the fiscal integrity of the State along with overseeing the efficient use of state funds. The transfer of all or part of the governor’s discretionary authority to the legislature would be unworkable, as it is doubtful that a collective body would be willing to, or could, assume responsibility for preserving the fiscal integrity of the State on a day-to-day basis.

The second perspective is that, while there may be an imbalance between the executive and the legislature in the exercise of fiscal authority, that imbalance has been brought about—at least in part—by the legislature’s abdication of its powers. What has been given away legislatively can be returned legislatively, if the legislature has the determination to reassert its control. Thus, there should be no attempt to correct through the Constitution what might be corrected by statute and by a change in legislative policies and practices.

The third perspective is that a serious imbalance in executive—legislative fiscal relations has developed, an imbalance not intended by the Constitution. Inasmuch as legislative initiatives have been inconclusive and challenged on constitutional grounds, the Constitution should be reviewed to determine how to redress the balance and prevent further erosion of the legislature’s power of the purse. It should be done from the standpoint of correcting the balance by amending certain provisions, or at the minimum, assuring that legislative initiatives to correct the imbalance will find constitutional support.

Alternatives. If the reviewers of the Constitution adopt the first or second perspective, then little more needs to be said. It is only under the third perspective that alternatives emerge.

Among the alternatives are the following:

- . A return to annual appropriations.
- . A limitation on the power of the governor to restrict appropriations, ranging from a prohibition of executive impoundments to some degree of securing legislative approval.
- . A requirement that a system of aggregate fiscal controls be adopted, as originally intended by the drafters of the 1950 Constitution.
- . A formal mechanism for the making and revising of revenue estimates, under which the executive would be bound in preparing the budget and the legislature would be bound in making appropriations.
- . A method by which the legislature can delegate its powers to a board or committee of its establishment to oversee the expenditure of funds and authorize transfers of appropriations and other actions.

⁴⁷Section 106, Act 10, First Special Session Laws 1977. Other general appropriation acts contain similar provisions.

Even before any of the foregoing alternatives can be considered, some consensus would need to be reached that there is an imbalance in executive—legislative fiscal relations and it is one that should be corrected through the Constitution. Against that view would be the

perspective that the governor should rightfully play the leading role in the discharge of fiscal responsibilities, or the perspective that the legislature has not exhausted its efforts through changes in the statutes or changes in its appropriation practices.

Chapter 3

FISCAL RESTRICTIONS

All state constitutions restrict the taxation and finance powers of the respective states in some way, some much more extensively than others. Restrictions can be the only effect of constitutional provisions relating to taxation and finance, because a state constitution cannot augment the power of the state beyond what it already has as a sovereign state in the federal system. Under the United States Constitution, the states have all those powers not delegated to the national government. They cannot have more than that. But they can have less, if, through their state constitutions, they restrict themselves from the full exercise of their taxation and finance powers.

Constitutional restrictions directly affect the powers of the legislature, since it is the branch of government which authorizes the raising of revenues and the expenditure of funds. However, the executive branch is also affected, since restrictions against the legislature would constrain the governor's powers in proposing taxation and finance policies. Generally, the extensiveness and force of constitutional restrictions reflect the degree of trust that the people have in representative government, and particularly the amount of faith they have that the legislature will act responsibly in balancing government costs vs. taxpayer interests.

In other state constitutions, it is not uncommon to find prohibitions against certain kinds of taxes, the earmarking of tax revenues for specific purposes, or requirements for a specific process to be followed, such as the

referendum, before a financial decision can be authorized. In Hawaii's Constitution, the most extensive restrictions are the limitation on debt, which is treated as a separate subject in Chapter 4, and the requirement for biennial appropriations, which is discussed in the context of executive-legislative relations in Chapter 2.

This chapter covers the other restrictions in the taxation and finance article concerning (1) the public purpose clause and its relationship to new purposes of borrowing being advocated by various special interest groups, (2) the prohibition against the delegation of taxing powers and its implications should the legislature attempt to pass legislation to have Hawaii's income tax laws conform automatically to federal changes and amendments, and (3) the restriction on the legislative process which requires that priority be given to passage of the General Appropriations Bill in the odd-numbered year and the Supplemental Appropriations Bill in the even-numbered year. This chapter also reviews the notion of the balanced budget and the earmarking of revenues, and treats, as perhaps the leading contemporary issue in taxation and finance in Hawaii and elsewhere, the question of limitations on government spending.

Limitations on Government Expenditures

Spending limits were not an issue in the 1968 constitutional convention. Times were

good, the Islands were enjoying the economic boom of the first decade of statehood, and the state and county treasuries were being replenished to the extent that old programs could be enlarged, new programs could be started, and a considerable amount of cash could be spent on capital improvements. The national economy, although it was soon to feel the effects of the escalation of the Indochinese war, likewise appeared to be in a relatively good condition, with stable prices, cheap energy, and excess capacity holding out the promise that growth could be accelerated and unemployment decreased without stimulating inflation.

Times have changed, and the public's tolerance of government spending has changed. There are a number of reasons for the change in public attitudes. First, inflation has ravaged personal and family budgets, and, even as inflation decreases real income, government taxes, applied from all levels of government, continue to take larger bites from paychecks, larger in the absolute sense if not larger proportionately. Second, government is perceived to be the culprit for seemingly not being able to do anything about the large problems of inflation and unemployment, for spending money foolishly, and for having too little regard for the plight of taxpayers. Third, and this has specific application for Hawaii, spiraling welfare costs, the costs of unemployment compensation, the notoriety attached to pay raises for public officials, and the salary and wage demands of public employee unions under collective bargaining, all combine to raise public fears that government budgets are headed out of sight at the expense of business and individual taxpayers.

In Hawaii, most discussion has revolved around the issue of state spending limits rather than county spending limits. This is probably because the state government is much more visible and pervasive in both its collection of revenues and its expenditures and because it is by far the largest employer. However, most spending limit actions in other states have originated with state legislatures or state consti-

tutions and have been directed against local governments. California's Proposition 13, probably the most widely discussed tax limitation in the Nation this year, is an initiative which would directly affect the revenues of local governments by rolling back real property taxes drastically and limiting their increase thereafter.¹

A discussion on state spending limitations could just as easily be applied to local government spending limitations. Some would further insist that it is not logical to propose state spending limits only, because a state could shift functions and programs to local governments, impose higher financing burdens on them, and the net result would be the same.

Limiting expenditures vs. limiting revenues.

The first question that limitation advocates should pose for themselves is whether they propose limiting expenditures or whether they propose limiting taxes. Theoretically, either approach is possible. One study poses the issue in this way:

"... either approach to a limit will achieve the same result.

"Drafters may wish to restrict expenditures if they believe spending pressures are the catalyst. Since a growing level of appropriation must be matched with growing revenue sources, capping expenditures might seem the most logical mechanism for restraining taxes.

"On the other hand, it's spiraling taxes which are the source of concern for millions of citizens. [Taxpayers] might approve of public spending sprees if additional taxes were somehow not required to finance such outbursts. But more spending means more taxes. From this perspective, controlling revenues might have more appeal since it is a distaste for rising taxes which arouses taxpayer ire."²

¹California's voters were to have decided on Proposition 13 in an election on June 3, 1978. If approved by the voters and if it survives legal challenges, the measure would require that the property tax not exceed 1 percent of market value and the valuations would be based on 1975 prices. Also, subsequent increases would be limited to a maximum of 2 percent a year.

²Washington State Research Council, *State Tax and Expenditure Limitation* (Olympia, March 1978), p. 12.

Rather than the choice being almost equal, it would appear, however, that a limitation on tax revenues would pose a particular problem to the credit standing of a state or local government, as was actually experienced in Hawaii at one time. The subject of the relative strength of bonds is discussed more fully in Chapter 4, but with respect to its relationship to limitations on tax revenues, it can be summarized as follows.

The strongest credit instrument of a state or local government is the general obligation bond, because it carries the jurisdiction's pledge of security that it will use all of its taxing powers to assure that payments will be made on the principal and interest on the bonds. If that unconditional pledge of security is weakened, for example, by a constitutional limit on the amount of tax revenues that the jurisdiction could raise, then, conceivably, bonds issued by that jurisdiction could drop to a lower class of bonds, incur higher interest rates, and increase government expenditures.

Until 1963, when the legislature abolished statutory ceilings on real property tax rates, the general obligation bonds of the counties were classified by the municipal bond market as "limited tax bonds," a lesser grade of bonds than the unconditional general obligation bonds. This resulted from a dilution of the general obligation bond pledge of security, since a limitation on real property tax rates meant, in effect, that there was a limitation on tax resources available to make payments on the bonds.³ Thus, an effort to hold down real property taxes actually had the counterproductive effect of driving up interest rates on the bonds issued.

Therefore, as between a limitation on expenditures and a limitation on tax revenues, it would appear that the latter could have the direct effect of undermining a jurisdiction's credit standing.

Limitation on general fund expenditures vs. all expenditures. If a limitation on expendi-

tures, rather than a limitation on tax revenues, is considered, then limitation advocates must also determine whether they are trying to control general fund expenditures or all expenditures.

In Hawaii, the general fund supports those programs of state government which do not have special resources set aside for them. This embraces the vast majority of state programs. The most significant sources of revenues, such as the income tax and the excise tax, are entirely the realization of the general fund. Special revenue funds are used to account for revenues and expenditures for particular programs, and their most common characteristic is that the programs are capable of generating revenues which are applied against their expenditures. The more significant special revenue funds are those for airports, commercial harbors, highways, and hospitals. There is also the bond fund which is used to account for bond proceeds and expenditures for capital investment.

To the extent that the State Constitution already limits bond authorizations and therefore already limits bond fund expenditures, however ineffectually, it can be argued that limits already exist and that, if they need to be tightened, it should be handled as a separate issue in the context of alternative constitutional debt limit formulas. As for special revenue funds, it can be argued that most of the larger funds, such as those for airports and highways, are self-sustaining. On the other hand, there are some funds which are not self-sustaining and which do make demands on the general fund, such as those for hospitals and small boat harbors.

A limitation on only general fund expenditures could have the effect of shifting expenditures to special revenue funds, creating new special revenue funds (unless there is some constitutional restriction against their creation),

³Newton N. S. Sue and Thomas W. Wong, *Article VI: Taxation and Finance, Hawaii Constitutional Convention Studies* (Legislative Reference Bureau, Honolulu, July 1968), pp. 63-64.

or forcing those programs which are not self-sustaining to increase their own program revenues.

Within a limitation of general fund expenditures, there must also be considered whether the limitation should apply to all expenditures, including those financed by federal funds, or whether they should apply only to those expenditures supported by state revenue sources. There is the additional consideration whether a general fund expenditure limit should apply to expenditures for debt service or whether debt service should be controlled by some other formula.⁴ Finally, advocates of a limitation on general fund expenditures would need to consider whether there should be an exemption for emergencies. One organization advocating spending limits says that an exemption from limits for emergencies is absolutely necessary: "Sound public policy requires that an emergency provision be included in a limitation. In the face of a sudden disaster, it would be appalling to find the State's funds impounded by overly restrictive legal language. At the same time, an emergency clause must be drafted with care to avoid creation of a major loophole."⁵

Limitation proposals and enactments. Spending limitation proposals vary greatly in their details, but they all have the common characteristic of limiting the legislature's authority in some way. In forcefulness of restriction, these proposals range from rolling back government expenditures to some earlier and lower level; limiting the increase in the rate of spending to some economic measure, such as the cost of living, gross state product, or personal income; to requiring the legislature to establish for itself a spending limitation formula.

California. In 1973, Proposition One was advocated by Governor Ronald Reagan as a means to control spending. The initiative was a complex measure, affecting virtually all aspects of state and local finances, but, perhaps, its most important provision was to initially limit

expenditures from state tax revenues to their current percentage of state personal income and to require that this percentage decline by 1/10th of 1 percent each fiscal year. When the limitation reached 7 percent of personal income, the legislature could, by a two-thirds vote, choose to stop further decreases in the expenditure ceiling. The proposition was voted down, some say, because it was embroiled in the governor's campaign for the presidential nomination.⁶

More recently, a proposed alternative limitation for California contains these provisions for limiting appropriations and refunding excess revenues:

"Control of appropriations. Commencing with fiscal year 1979-80, the annual appropriations of a unit of government during any fiscal year shall not exceed the appropriations, as adjusted, for the prior year, except for cost-of-living and population changes, unless the voters of such unit approve a different amount.

"Refund of excess revenues. From year to year, the governing body of each unit of government shall adjust tax rates to reasonably minimize the collection of revenues in excess of those which may be appropriated Should excess revenues accrue to a unit, such excess shall be refunded to the people in such manner as shall be determined by the governing body of the unit."⁷

New Jersey. In 1976, New Jersey adopted a statutory limit on state and local spending. With respect to the state, growth in the state budget is linked to growth in state per capita personal income. Exemptions from the limitation are extended to: state aid to counties, municipalities, and local school districts;

⁴The alternative of controlling debt by limiting annual debt service to a maximum of some percentage of the general fund is discussed in Chapter 4.

⁵Washington State Research Council, *State Tax & Expenditure Limitation*, p. 21.

⁶*Ibid.*, pp. 23-27.

⁷*Ibid.*, pp. 12-13.

expenditures of federal funds; and debt service on general obligation bonds. In 1977, an amendment was enacted which requires the governor to present a budget which conforms to the state limitation.⁸

Tennessee. In a referendum on March 7, 1978, the voters of Tennessee, by a 65 percent to 35 percent margin, approved a constitutional amendment limiting state spending. Among the provisions included in the amendment are the following:

- . A prohibition against deficit spending.
- . A prohibition against using debt to finance current operations.
- . A limitation that the growth of appropriations from state tax revenues shall not exceed the estimated growth of the state's economy as determined by law.
- . A requirement that no appropriation in excess of the limitation can be made unless the legislature, in a separate bill, specifies the dollar amount and the rate by which the limit will be exceeded.⁹

One organization supporting the Tennessee amendment has observed:

"... The limitations are really fairly lenient; the chief value of the proposal is the psychological effect it will have on legislators. If they choose to increase spending faster than the growth in the economy, they must go on record in favor of the dollar amounts and rate by which the limits will be exceeded. This will throw the spotlight of publicity on the pressure groups and legislators who endorse the continued growth of government v. the private economy."¹⁰

Hawaii. The expenditures of Hawaii's state government are unique, because it is responsible for functions which are normally local government functions elsewhere in the United States. Public schools, public welfare, libraries, community colleges, district courts, and hospitals are among those functions which Hawaii's state government performs but which

are usually under the control of local governments in continental America. Thus, it would be misleading to compare the per capita expenditures of Hawaii's state government with those of other state governments. A more reasonable comparison would be combined state-local per capita expenditures, and, here, the data shows that, in 1975, Hawaii ranked fourth behind, in descending order, Alaska, the District of Columbia, and New York.¹¹ The measure, however, tells little as to whether Hawaii's state government expenditures are reasonable or not.

Some advocates of state spending limits propose limiting increases in state spending to increases in the growth of the state economy, using some measure of economic health, such as gross state product or personal income. Table 3.1 shows the percentage increase of state general fund expenditures from the year of the last constitutional convention to 1975 and the corresponding increases in the gross state product and personal income.

For each of the years shown in Table 3.1, the data is inconclusive that state expenditures are increasing at a much higher rate than the gross state product or personal income, as critics of state spending contend. Overall, from 1968 to 1975, the data does show a somewhat higher increase in state expenditures, with expenditures in 1975 representing 2.30 times what it was in 1968, while gross state product increased by 2.06 times and personal income by 2.09 times. Part of the increase in state general fund expenditures is accounted for by the increase in expenditures financed by federal funds. Federal funds have come to comprise about one fourth of general fund expenditures, and the

⁸*Ibid.*, pp. 30-31.

⁹Article II, Section 24, *Constitution of Tennessee*.

¹⁰Letter, Tennessee Taxpayers Association to each Taxpayers Association and Expenditure Council, March 9, 1978.

¹¹Tax Foundation of Hawaii, *Government in Hawaii, A Handbook of Financial Statistics* (Honolulu, 1977), pp. 38-39.

Table 3.1
General Fund Expenditures, Gross State Product,
and Personal Income
State of Hawaii
1968 to 1975
(In millions of \$)

	General fund expendi- tures ¹	% in- crease prior year	Gross state product ²	% in- crease prior year	Per- sonal income ³	% in- crease prior year
1968	\$329.8	10.5%	\$3,350.7	11.2%	\$2,729	11.8%
1969	386.5	17.2	3,742.5	11.7	3,087	13.1
1970	464.6	20.2	4,164.7	11.3	3,523	14.1
1971	529.4	13.9	4,460.6	17.1	3,773	7.1
1972	577.2	9.0	4,935.4	10.6	4,124	9.3
1973	591.3	2.4	5,699.9	15.5	4,617	12.0
1974	683.4	15.6	6,318.7	10.9	5,177	12.1
1975	758.7	11.0	6,908.8	9.3	5,706	10.1

¹Source: Department of Accounting and General Services, *Report of the Comptroller, 1968-1975*.

²Source: Department of Planning and Economic Development, *Hawaii Income and Expenditure Accounts*, forthcoming.

³Source: Department of Planning and Economic Development, *Hawaii State Data Book, 1976 and 1977*.

amount expended in 1975 is about 2.5 times what was expended in 1968.

While the contention of some is that state spending should move as either the gross state product or personal income moves, there is a practical reason why it is difficult to base immediate spending policies on either economic measure. Both measures are derived from statistical gathering, they are subject to adjustments, and it usually takes some time before the data for the measures is available.¹² Thus, the reason why a more updated comparison cannot be shown in Table 3.1 is because the data for gross state product is not yet available for 1976 and 1977. It remains to be seen, then, whether the Tennessee constitutional restriction of limiting appropriations to the *estimated* rate of growth of the state's economy, let alone the actual rate of growth, will have practical force.

While numerous proposals have been introduced in the legislature to limit state tax

increases or state expenditure increases in some way, the only bill to receive any degree of attention was a proposed constitutional amendment in the 1974 legislative session, possibly because of the prestige associated with the bill's having been introduced by the chairman of the House Finance Committee.¹³ The amendment would have required the following:

The executive budget submitted by the governor could not exceed any general fund expenditure ceiling established by the legislature, unless the governor proposes additional revenue measures to meet the expenditures above the ceiling.

By a two-thirds vote, the legislature could establish a general fund expenditure ceiling, and the legislature could exceed the ceiling only by a two-thirds vote or by enactment of revenue measures to meet the expenditures in excess of the ceiling.

Thus, as in the constitutional amendment adopted in Tennessee, no limitation formula was to be established in the Constitution itself, but the legislature would have the authority to do so and the governor would be required to accept it. The major difference between the Hawaii proposal and the Tennessee amendment is that the Tennessee legislature is required to establish a limitation, whereas the Hawaii proposal would merely have permitted the legislature to do so. The proposed constitutional amendment was supported by a bill amending the statutes to establish a limitation based on some factor of the average of the revenues received into the general fund for the preceding two fiscal years.¹⁴ However, neither the proposed constitutional amendment nor the statutory amendment advanced in the legislature.

¹²As discussed in Chapter 4, efforts to tie state debt to gross state product or personal income would run into the same problems.

¹³House Bill 2094-74, 1974 Regular Session.

¹⁴House Bill 2094-76, 1974 Regular Session.

An indirect approach to the issue of spending limits emerged in the 1976 legislative session. Following reports that the state general fund had realized a surplus or fund balance of \$83 million at the end of fiscal year 1974-75, a constitutional amendment was proposed to require the legislature to provide for special tax refunds to state individual income taxpayers whenever a percentage of the state general fund balance exceeded a prescribed threshold. The amendment was designed to "guarantee that individual income taxpayers will receive benefits, in the form of special tax refunds, whenever there is a sizeable general fund balance."¹⁵ The proposed amendment was said to have three basic purposes:

- "(1) It adopts as a basic financial principle that taxpayers will be the beneficiaries of any sizeable tax windfalls.
- "(2) It removes from politics the question as to when special tax refunds are to be granted.
- "(3) It controls government spending to the extent that whenever large surpluses materialize, at least a portion of that surplus will be returned to the taxpayers."¹⁶

A bill which would have provided for tax rebates to 1975 income taxpayers passed the House but failed in the Senate. The proposed constitutional amendment likewise failed to advance. Those who opposed the special tax refund measure argued that excess tax revenues should be plowed into cash financing for capital improvements to lower debt service charges. As it turned out, the legislature did authorize the expenditure of cash for capital improvements, but the infusion of general fund cash did not appear to make any significant dent in borrowing levels.¹⁷

Issues and alternatives. The issues of a limitation on government expenditures seem clear enough: first, whether government spend-

ing needs to be controlled; second, whether the Constitution is the proper place to control government spending; and, third, if the Constitution addresses itself to the issue, whether a limitation formula should be placed in the Constitution itself or whether it should require the legislature to establish a limitation.

Arguments. Those who favor expenditure limitations, regardless of the specific form the limitations might take, would contend generally that there is real concern over the escalating costs of government and that the rate of growth in expenditures exceeds the rate of growth of the economy. They would argue that the present legislative process is not effective in controlling government spending, inasmuch as there is no real incentive for lawmakers to keep appropriations within the estimates of revenues available for expenditure. Therefore, an expenditure limitation expressed in the Constitution is necessary to constrain state elected officials and force them to address and resolve some of the fundamental questions leading to an over-expansion of government spending.¹⁸

Those who oppose constitutional limitations on spending would argue that the establishment of a limit would severely limit the ability of the state government and its elected officials to respond effectively and rapidly to the changing needs of the people. The benefits of government expenditures should be decided on their own merit and not on the basis of some artificial and arbitrary ceiling. Moreover, constraining the people's elected representatives runs counter to the fundamental principle of representative

¹⁵House Bill 2474-76, 1976 Regular Session.

¹⁶Norman Mizuguchi, Chairman, House Committee on Education, Summary of House Bill 2574-76 (undated).

¹⁷Table 4.5, Chapter 4.

¹⁸Tax Foundation of Hawaii, News Release, March 5, 1978.

government, which holds that elected representatives should be given the full authority and flexibility to act in the interest of the common good, including determining the level of state spending.¹⁹

The Notion of a Balanced Budget

Related to the issue of spending limits is the perennial and elusive issue of a balanced budget, the notion that, at some point, expenditures should not exceed revenues. The issue is elusive because it has never been too clear which budget is to be balanced.

In the budget preparation and budget execution process, there are three budgets which are identifiable and which may be said to represent, at a particular point in time, the total spending plan of the State. The first is the executive budget which the governor is required to submit to the legislature and which sets forth a complete plan of expenditures and revenues. The second is the budget passed by the legislature, together with miscellaneous appropriations. The third is the budget executed by the executive branch, the aggregate level of which may or may not be at the level authorized by the legislature and which is subject to adjustment throughout the budget execution period.

The significant variable (and under the current system an uncontrollable variable) is the revenue side of the budget. Since revenue estimates are just that—estimates which may or may not be accurate—budgets can be made to balance or they can be made to show a deficit. A governor wanting little change to the executive budget would submit a balanced budget or show a small deficit. A governor wanting to shift budget-cutting responsibilities to the legislature or to force a tax increase would show a significant deficit. A legislature wishing to justify a budget larger than the governor submitted would adjust the revenue estimates upward. A legislature wishing to justify large budget cuts would lower the revenue estimates.

Thus, the concept of a balanced budget is illusory, whether it is the executive budget submission, the budget authorized by the legislature, or the budget executed by the executive, unless (as discussed in Chapter 2) a formal system for revenue-estimating and -updating is established under which both the executive and the legislature would be bound.

Article VI, Section 4, of the present Constitution requires the governor to submit to the legislature “a budget setting forth a complete plan of proposed expenditures and anticipated receipts of the State,” and it also requires the governor to submit bills to “provide for such proposed expenditures and for any recommended additional revenues or borrowings by which the proposed expenditures are to be met.” This requirement is complemented by statutory provisions which require that: “Proposals for changes in the existing tax and non-tax rates, sources or structure shall be made in every case where the proposed, total state expenditures exceed the total state resources anticipated from existing tax and non-tax sources at existing rates.”²⁰

Although nowhere in the Constitution or in The Executive Budget Act is the term “balanced budget” used, the existing constitutional and statutory language points to the submission of a balanced budget.

If the balanced budget advocates believe that the present language is insufficient and that additional constitutional protection is required to safeguard the State from incurring large deficits, there is small comfort to be gained by inserting “balanced budget” language, given the current state of affairs with revenue estimates. A more direct approach would be to limit the magnitude of the deficit which the State could incur for any particular period.

¹⁹Eileen R. Anderson, Con: A State Spending Limit, *Honolulu Star-Bulletin*, March 28, 1978.

²⁰Section 37-71d(1)(B), Hawaii Revised Statutes.

Earmarking of Revenues

"Earmarking" is the term used to describe the automatic channeling of revenues from a specific tax to finance a particular government program. There are two ways by which the mandatory dedication of revenues can be accomplished. First, state constitutions can require that certain revenues be applied to certain programs, often with no legislative appropriation being required. Second, state legislatures can authorize the accumulation of certain revenues in special funds which are used to finance the expenditures of specific programs.

Usually, but not always, earmarking occurs when a program has the capacity to generate revenues, and the revenues, in turn, are used to support the program. This practice flows from the benefit theory of finance: that those who benefit from the program should pay for the program. It is the basis by which highways, for example, are supported by the users of highways through the taxes they pay for fuel and through other taxes and fees related to the use of motor vehicles. Earmarking is more defensible when there is a clear benefit-user charge linkage than when there is no such linkage and earmarking is used solely as a political shield to protect a program by providing it with an automatic means of support.

Earmarking, including constitutional earmarking, is used extensively among the states. At one time, 36 states earmarked revenues of various kinds through constitutional provisions.²¹ Constitutional earmarking is usually frowned upon, on the basis that it weakens executive and legislative controls over finances, insulates programs from the legislative appropriations review process, and contributes to an imbalance in resources. In its sixth model state constitution, the National Municipal League recommended the inclusion of a flat prohibition against even statutory earmarking, except when required by the federal government for state participation in federal programs (Article VII, Section 7.03). The Alaska

Constitution contains such a constitutional prohibition against earmarking (Article IX, Section 7). Hawaii's Constitution contains neither a prohibition against earmarking nor provisions which earmark funds to certain programs.

Such earmarking as exists with state revenues in Hawaii (and from all indications, earmarking is far less extensive than it is elsewhere) results from statutory authorizations. Table 3.2 compares the proportion of revenues commanded by the general fund with those channeled to special funds.

Table 3.2
General Fund and Special Fund Receipts
Comparison for 1968 to 1977
(In thousands of \$)

<i>Fiscal year</i>	<i>General fund</i>	<i>%</i>	<i>Special fund</i>	<i>%</i>
1968	\$339,831	79.2%	\$ 89,440	20.8%
1969	398,905	78.2	111,047	21.8
1970	463,708	77.8	132,146	22.2
1971	509,999	77.3	149,509	22.7
1972	546,250	76.0	172,790	24.0
1973	608,278	74.8	205,131	25.2
1974	708,252	75.6	228,795	24.4
1975	823,486	73.9	290,605	26.1
1976	908,236	71.0	371,429	29.0
1977	989,343	73.3	360,584	26.7

Note: Borrowing reported as receipts have been excluded for all years and both funds; no borrowing was recorded for the special fund in 1969.

Sources: Department of Accounting and General Services, *Annual Financial Report*; 1977 data provided by Accounting Division of the Department of Accounting and General Services.

As Table 3.2 shows, there has been no significant growth of earmarking in the last ten years. The slight increase of the proportion of special funds in relationship to the combined total of general and special funds is probably

²¹Sue and Wong, *Article VI: Taxation and Finance*, pp. 8-9.

due to increased revenues in two of the largest special funds, those for the airports system and highways, rather than the result of new earmarking. The legislature has generally resisted efforts to establish new special funds, for the reason that special fund programs do not receive the scrutiny that general fund programs receive. In the past ten years, there have been few significantly large special funds established, the notable exceptions being the special funds for hospitals and for recreational boating.

If there are special interests intending to make a case for some form of constitutional earmarking, their views have not yet been made public.

The Public Purpose Clause

Section 2 of the Taxation and Finance article states simply and with apparent finality that: "No tax shall be levied or appropriation of public money or property made, nor shall the the public credit be used, directly or indirectly, except for a public purpose." It also declares: "No grant shall be made in violation of Section 3 of Article I of this constitution," which prohibits the enactment of any law "respecting an establishment of religion or prohibiting the free exercise thereof" The issue of public aid to nonpublic schools is covered by the Legislative Reference Bureau's constitutional convention study on Article IX: Education.²² This chapter discusses the public purpose clause in the context of the various laws enacted or proposed to use public credit to assist various private enterprises or individuals.

Those laws enacted which have public purpose implications include a law authorizing the State to issue anti-pollution bonds to assist private firms to finance anti-pollution projects; a law authorizing the counties to issue anti-pollution bonds;²³ a law authorizing the counties to issue economic development bonds to finance the development of agricultural, industrial, commercial, or hotel enterprises; a

law authorizing the State to issue special facility bonds to assist airlines in constructing airline facilities; and a law authorizing the issuance of bonds to finance the conversion of residential leaseholds to fee simple ownership. Of the foregoing authorizations, only the law pertaining to the issuance of bonds for airline special facilities has been implemented.

Other legislative proposals, initiated but not enacted, include economic development bonds to be issued by the State to assist the same industries authorized to be assisted by county economic development bonds, bonds to assist the utility companies in constructing electrical or gas facilities, bonds to assist private health organizations to construct health facilities, and tax-exempt housing bonds to assist private developers.²⁴

Where the bonds, enacted or proposed, are revenue bonds, they face the problem, discussed in Chapter 4, of the Supreme Court having rendered a decision that the state anti-pollution bonds do not qualify as revenue bonds and, therefore, need to be counted against the debt limit. The second issue is whether any of the special purpose bonds, enacted or proposed, should be allowed or prohibited by the specification of public purpose in the Constitution.

State anti-pollution bonds. In 1973, the legislature enacted a law authorizing the State to enter into project agreements with private parties under which the State would issue revenue bonds for private parties to construct anti-pollution facilities and under which the

²²Lolan Ho-Wong, *Article IX: Education (Lower Education) Hawaii Constitutional Convention Studies* (Legislative Reference Bureau, Honolulu, April 1968), pp. 59-66.

²³Senate Bill 1342-77 was passed by the legislature in the 1978 Regular Session but had not yet been signed into law at the time of the writing of this study.

²⁴All of the legislative proposals to use state credit to assist the various private enterprises have been in the form of bills, with the exception of the proposal for housing bonds, which is in the form of a resolution directed to the 1978 constitutional convention.

private parties would reimburse the State in an amount sufficient to meet principal and interest payments on the bonds.²⁵ The rationale for this approach is that the private parties would be able to secure financing at a lower interest rate, by virtue of the tax-exempt status of state bonds,²⁶ and the State, in turn, would be able to pursue its anti-pollution program objectives.

In a test case before the state Supreme Court, the court held that the anti-pollution bonds were for a public purpose, 56 H. 566, 545 P. 2d 1175. Even though the bonds have not been issued because the court also found that they did qualify as revenue bonds excludable from the debt limit, the case holds interest from the standpoint of the court's approach to the question of public purpose. The court's principal considerations were the following:

"Determining what constitutes a public purpose is generally a question for the legislature to decide

"... Though the legislature's determination is not conclusive, it is given wide discretion and should not be voided by the courts unless it is manifestly wrong, i.e., the purpose involved is clearly a private one However, '[w]hen a constitutional question is properly presented, it is the duty of the court to ascertain and declare the intent of the framers of the Constitution and to reject any legislative act which is in conflict therewith The presumption, however, is in favor of constitutionality, and all doubts must be resolved in favor of the act.'

"A few jurisdictions have found acts similar to Act 161, which allowed financing or credit-lending arrangements by the state to private enterprises, for anti-pollution purposes, to be for other than public purposes despite the benevolent objectives of the acts. The vast majority of jurisdictions, however, have found a public purpose in such acts. Though the minority view presents persuasive reasoning, we are of the opinion that the purpose of Act 161 constitutes a public purpose as required in section 2, Article VI.

"Our opinion is premised upon several factors. First, during the 1968 State Constitutional Convention, the public purpose requirement of Article VI, section 2 was discussed by the Committee on Taxation and Finance in relation

to the issuance of industrial development bonds. The committee implied that they considered the issuance of industrial bonds to be for a public purpose but decided against trying to define 'public purpose' for fear of weakening the section. Although anti-pollution bonds were not considered at that convention, we believe that the obvious purpose of Act 161, which is to aid in the control of pollution, is as important as, or more so than, the encouraging of industrial development. Second, virtually every State appropriation, financing or lending of credit results in some private benefit. The crucial factor, we believe, is the ultimate objective of the Act; the fact that incidental benefits accrue to private interests is immaterial. The objective of Act 161 is to help private enterprises install facilities designed to fight air, water, sewage and other pollution. As pointed out by the court in *Farmers' Electric*, 'There will not be any increase in productive capacity or prolongation of the useful life of any private industrial facility.' The sole purpose of such facilities is to protect the health, safety and general welfare of the people of Hawaii.

"Third, as stated in a law review note on the public purpose doctrine and revenue bonds, . . . 'the exigencies of modern state government virtually compel the use of tax exempt financing as an incentive to publicly desirable activities in the private sector Just so, the public purpose doctrine need not be a static barrier to state activity in areas of consuming public importance.'" [Citations omitted.]

The Supreme Court appeared to give substantial weight to the legislature's perception and declaration of public purpose. Therefore, those who might oppose the use of state credit to assist private enterprise to meet objectives deemed by the legislature to be in the public purpose have a choice of either (1) trying to win their case in the legislative arena; or (2) trying to define public purpose more explicitly in the Constitution to preclude such aid.

County anti-pollution bonds. In the 1978 legislative session, a bill was passed to permit the counties to issue revenue bonds for anti-

²⁵Part V, Chapter 39, Hawaii Revised Statutes.

²⁶The tax-exempt status of municipal bonds, the bond issues of state and local governments, is discussed in Chapter 4.

pollution projects,²⁷ similar in approach to the state anti-pollution bonds. The bill was supported by the City and County of Honolulu,²⁸ and one representative of an investment banking firm, noting its involvement as financial adviser to develop a resource recovery facility on Oahu to process and dispose of solid wastes, explained the desirability of the bill in this way:

"...recognizing that the risk of construction and operation of resource facilities is more than would be prudent for a governmental body to undertake without the direct and active participation of private industry, we believe that the most advantageous financing alternative is one which combines the advantages of public financing with the responsibilities of private ownership and operation....

"The proposed legislation would enable a combination of tax-exempt financing and private ownership which would take advantage of lower interest rates as well as federal tax benefits which are available only to the private sector....

"In issuing these bonds, the municipality essentially lends its tax-exemption to a private business to enable it to finance facilities at the lower interest rates prevailing in the tax-exempt market...."²⁹

From all appearances, the county anti-pollution bonds are identical in purpose to the state anti-pollution bonds, and, thus, there is no apparent reason why it would not pass constitutional muster insofar as public purpose is concerned, if the Supreme Court continues to hold to its reasoning in the case of the state anti-pollution bonds.

County economic development bonds. Since 1964, the counties have been authorized to issue industrial development bonds, later renamed economic development bonds.³⁰ The statute authorizes the counties, upon securing a certificate of convenience and necessity from the state Department of Planning and Economic Development, to issue either general obligation or revenue bonds to construct facilities for agricultural, industrial, commercial, or hotel enterprises. The facilities would be leased to private enterprises at rentals adequate

to meet the principal and interest payments on the bonds.

Up to the late 1960's, the industrial development bond market had been expanding at a rapid rate. The issuance of industrial development bonds was particularly widespread in the South. More recently, however, the tax-exempt status of industrial development bonds has come under the increasing scrutiny and control of the Internal Revenue Service, and the expansion of this form of financing has been slowed. Industrial aid financing has been upheld in the courts of some states and struck down in others, on the basis that the bonds did not meet the constitutional requirement of public purpose.³¹

In 1968, the Taxation and Finance Committee reviewed the subject of industrial development bonds and decided not to amend the public purpose clause to accommodate specific purposes:

"...The advisability of specifying particular purposes as public purposes was discussed and rejected. In the particular case of industrial development bonds, it was felt that such a use of public credit would be desirable when it constitutes a public purpose and as such is already provided for with the existing wording."³²

²⁷ Senate Bill 1342-77, H.D. 2, 1978 Regular Session.

²⁸ Letter, Wallace Miyahira, Director and Chief Engineer, Department of Public Works, City and County of Honolulu, to Representative Russell Blair, Chairman, House Committee on Ecology and Environmental Protection, February 3, 1978.

²⁹ Rene' Rofe', White, Weld & Co., Inc., Testimony on House Bill 2354 Relating to Pollution Control Bonds (undated). The House bill was a companion bill to Senate Bill 1342-77, which ultimately was passed by the legislature.

³⁰ Chapter 48, Hawaii Revised Statutes.

³¹ Sue and Wong, *Article VI: Taxation and Finance*, pp. 17-19.

³² State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii of 1968*, Vol. I (Honolulu, 1973), p. 224.

The chairman amplified the Taxation and Finance Committee's position in the Committee of the Whole debates:

"... Our committee had a number of proposals with respect to this section to add a definition of what constitutes public purposes, particularly with respect to authorizing industrial development bonds. We feel that industrial development bonds perhaps should be issued but they should only be issued if they are in fact for a public purpose and if they are in fact for a public purpose, we have no doubt that the courts would hold that they were for a public purpose and we feel that trying to spell any constitutional definition as to what we mean by public purpose would serve no end and in fact might weaken the section."³³

As noted earlier in this chapter's discussion of state anti-pollution bonds, the state Supreme Court took the Taxation and Finance Committee's position to mean that they considered the issuance of industrial development bonds to be for a public purpose but decided against trying to define public purpose for fear of weakening the clause.

To date, no county economic development bonds have been issued, and it is generally believed that no such bonds can be issued unless their constitutionality has been tested.

Special facility bonds for airlines. In 1971, the legislature authorized the state Department of Transportation to issue revenue bonds for the purpose of assisting the airlines to construct special airport facilities.³⁴ Under a special facility lease, the airlines would reimburse the Department of Transportation with rental payments sufficient to meet the principal and interest payments on the revenue bonds issued for the special facility.

There were two basic reasons cited by the legislature for extending state credit to the airlines. The Senate Committee on Transportation reported that:

"Because the airlines do not have title to the property at the airport, they have found it difficult to obtain financing to acquire or

construct the special facility. Therefore, state assistance in financing is required."³⁵

In the House of Representatives, the Committee on Finance reported that:

"If the lessee airlines themselves are required to finance the construction of ... improvements, Honolulu International Airport would be at a competitive disadvantage with other major airports which continue to provide these improvements with public funds raised on a tax exempt basis."³⁶

In April 1972, the Department of Transportation issued \$6.8 million in revenue bonds to finance facilities for Pan American World Airways.³⁷ In June 1977, Western Air Lines was aided through a \$2.3 million special facility bond issue.³⁸

Land reform bonds. In 1967, the legislature passed a landmark act to provide for the conversion of residential leasehold tracts to fee simple ownership.³⁹ The legislature summarized its findings of necessity and public purpose in this way:

"The dispersion of ownership of fee simple residential lots to as large a number of people as possible, the ability of the people to acquire

³³State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii of 1968*, Vol. II (Honolulu, 1972), p. 419.

³⁴Section 261-51 to 261-55, Hawaii Revised Statutes.

³⁵Senate Standing Committee Report No. 182 to Senate Bill 210, 1971 Regular Session.

³⁶House Standing Committee Report No. 864 to Senate Bill 210, 1971 Regular Session.

³⁷Department of Transportation, Official Statement, \$6,800,000 Special Facility Revenue Bonds, Series of 1972, June 1, 1972.

³⁸Department of Transportation, Official Statement, \$2,300,000 Special Facility Revenue Bonds, Series of 1977, April 11, 1977.

³⁹Chapter 516, Hawaii Revised Statutes.

fee simple ownership of residential lots at a fair and reasonable price and the ability of lessees of residential leases to derive full enjoyment from their leaseholds are factors which vitally affect the economy of the State and the public interest, health, welfare, security and happiness.”⁴⁰

Initially, the issuance of revenue bonds was authorized to assist residential lessees in the financing of fee simple ownership. In 1971, the law was amended to authorize the issuance of general obligation bonds.⁴¹

It has been widely recognized that the law cannot be implemented until such time as its constitutionality has been decided by the courts. Beginning in 1975, each annual certificate of indebtedness has carried a statement of the comptroller disagreeing with the reflection of the land reform bonds as part of the authorized but unissued debt of the State:

“...The reason for the disagreement by the Comptroller with such reflection is that Act 215 is in violation of several provisions of the Constitution, among them being Article I, Section 18, prohibiting the taking of private property other than for public use and Article VI, Section 2 prohibiting the appropriation of public money or property or the use of the public credit, except for a public purpose. Act 215, Session Laws of Hawaii 1971, being in violation of the Constitution of the State of Hawaii, the authorization of the issuance of general obligation bonds made by that act is invalid. Thus the general obligation bonds purportedly authorized by said Act 215 should not be reflected in the attached Certificate in any way...”⁴²

Seemingly, the disagreement of the comptroller would establish the basis for a test of the law's constitutionality in the courts. However, no case has been pressed to resolution. In the meanwhile, supporters of the land reform law are cognizant not only of the possible public purpose challenge but of perhaps the more serious challenge of the constitutional prohibition against the taking of private property other than for “public use.” [Article I, Section 18]

Revenue bonds for electrical energy or gas facilities. In 1975, the Senate passed a bill which would have authorized the Department

of Budget and Finance to issue revenue bonds to finance private construction of facilities for “the local furnishing of electrical energy or gas.”⁴³ The bill contained a declaration of purpose to the effect that the health and welfare of the people required that the State make use of opportunities to assist the utility companies in providing electrical energy and gas at the lowest possible cost; that interest on borrowings to finance facilities could be reduced through state issuance of tax-exempt bonds; that the promotion of the health and welfare of the public could be encouraged through state assistance in financing the cost of the facilities of utility companies; and that the issuance of the bonds would be for a public purpose.⁴⁴

The bill also provided that the revenue bonds would not be issued unless the attorney general determined that the bonds were excludable from the constitutional debt limit. The attorney general's opinion was to be based on the Supreme Court's determination with respect to the anti-pollution revenue bonds.

The bill was not passed by the House of Representatives, possibly because the Supreme Court had ruled in the meanwhile that the anti-pollution bonds did not qualify as revenue bonds excludable from the debt limit.

Health facilities revenue bonds. Also in 1975, a bill was introduced to assist private hospitals through state issuance of revenue

⁴⁰Section 1, Act 307, Session Laws of Hawaii 1967.

⁴¹Act 215, Session Laws of Hawaii 1971.

⁴²Certificate of Total Indebtedness of the State of Hawaii as of November 1, 1975. A similar statement of disagreement is attached to the indebtedness certificates for 1976 and 1977.

⁴³Senate Bill No. 649, S.D. 1, 1975 Regular Session.

⁴⁴Senate Standing Committee Report No. 508 to Senate Bill 649, S.D. 1, 1975 Regular Session.

bonds.⁴⁵ The bill would not only have authorized the issuance of bonds to assist hospitals in renovating facilities or constructing new facilities but it would also have authorized using revenue bond proceeds to refinance existing indebtedness of the hospitals. Just as the Supreme Court's decision on the anti-pollution bonds appeared to have stalled the passage of the bill for bonds to assist the utility companies, so it appeared that it had a chilling effect on revenue bonds for hospitals.

State economic development bonds. In 1977, the House passed a bill which was intended to be essentially the state counterpart to the statute on county economic development bonds.⁴⁶ It would have authorized the State to issue general obligation or revenue bonds for agricultural, industrial, commercial, or hotel enterprises. However, the bill did not pass the Senate.

Aid to housing developers. In the 1978 legislative session, the chairperson of the Senate Housing Committee offered a resolution directed to the 1978 constitutional convention. It requested the convention to review the constitutional provisions "in terms of broadening the definition of revenue bonds to include tax exempt housing revenue bonds." The intent would be to make possible the use of state credit by private housing developers. The resolution contended:

"... an appropriately designed tax exempt housing revenue bond program is able to combine the advantages of public financing with the responsibilities and risk of private ownership and operation due to the private sector's ability to take advantage of certain federal tax benefits since interest income is not subject to federal taxation (from the standpoint of the bondholder) and thereby providing a lower interest rate than private financing vehicles of a similar nature"⁴⁷

Issues and alternatives. The basic issue is whether the Constitution should be amended to clearly allow for the issuance of the various special purpose bonds, or from the perspective of those who oppose the use of state credit to assist private enterprise or individuals, whether

the Constitution should be amended to clearly prohibit their issuance. The middle ground would be to take the position of the 1968 convention which decided that the burden should be on the legislature to state the case of public purpose for any of its measures and, if the measures are in fact for a public purpose, the courts would so hold.

Arguments. Those who favor clarifying the Constitution to clearly permit the issuance of special purpose bonds would argue that such issuance is in the public interest, that the use of state credit would bring about lower interest costs and lower costs to consumers, that the industries for which financing assistance measures have been passed or have been proposed are those which affect a broad segment of the public, and that ultimately it would be the people who would benefit from such assistance.

Those who oppose the extension of state credit to private enterprise would argue that the rash of legislative measures enacted and proposed indicates that the floodgates have been opened, that there would be no end to any other industry having a claim on the State's credit, that no case has been made that conventional credit sources are insufficient or unavailable to the various private enterprises, that special purpose financing is special interest legislation, and that the State's credit should be conserved solely for those programs and projects operated by the government.

Non-Delegation of Taxing Powers

What was in 1950 and in 1968 a non-controversial section of the Taxation and Finance article has emerged as an issue.

⁴⁵Senate Bill 576, 1975 Regular Session.

⁴⁶House Bill 8, 1977 Regular Session.

⁴⁷Senate Resolution 413, 1978 Regular Session.

Article VI, Section 1, titled "Taxing Power Inalienable," states: "The power of taxation shall never be surrendered, suspended or contracted away." The issue emerges because the section is seen as a constitutional barrier should the legislature decide to have Hawaii's income tax laws conform automatically to changes and amendments to the federal income tax laws, or to express state income tax liability as a percentage of federal income tax liability.

Section 1 as it stands can reasonably be interpreted as preventing the legislature from delegating its taxing powers to any entity outside of state government, although, by virtue of Article VII, Section 3, the legislature does have the authority to delegate taxing powers to the State's political subdivisions. This interpretation is drawn from the report of the 1968 Taxation and Finance Committee:

"Section 1 relating to the inalienability of taxing power is not amended. The only question raised was the apparent conflict with Section 3 of Article VII which authorizes the legislature to delegating taxing power to political subdivisions. The question was resolved with the determination that Section 1 of Article VI concerns *only relations between the state government and any entity outside of the state government*; since political subdivisions are creatures of the State, a delegation of taxing power to them is not a surrender, suspension, or contraction away of the taxing power by the State . . ."⁴⁸ [Emphasis added.]

A fairly recent case in Minnesota sheds light on the problem faced by advocates of income tax conformance. In *Wallace v. Commissioner of Taxation*, 184 N.W. 2d 588 (1971), the Minnesota Supreme Court invalidated a state income tax statute attempting to incorporate future federal income tax amendments. In dealing with a state constitutional provision similar to Hawaii's provision, the court stated:

"In considering the issue of whether a change in Federal law may alter the force and effect of provisions in a prior state law governing the same subject, it may be said that the principle which controls is that a state legislature may not delegate its legislative power to any outside agency, including the Congress of the United States."

Even though a state constitution may specifically provide authority for the legislature to base the state's income tax laws on federal laws, such a provision could still be challenged, as it was in Nebraska. Article VIII, Section 1B of the Nebraska Constitution states:

"When an income tax is adopted by the Legislature, the Legislature may adopt an income tax law based upon the laws of the United States."

Notwithstanding the provision, its constitutionality was challenged on the basis that "even though there was specific constitutional authority, an adoption of future laws of the United States would still constitute an unconstitutional delegation of legislative authority." However, the Nebraska Supreme Court upheld the validity of the income tax provision in *Anderson v. Tiemann*, 155 N.W. 2d 322 (1967).

In 1971, the then director of taxation of Hawaii sought an opinion from the Department of the Attorney General as to whether the legislature could enact legislation providing for state income tax liability to be based upon a percentage of federal tax liability in view of the non-delegation of taxing powers provision in the Constitution. The Department of the Attorney General concluded that basing the state tax liability upon a percentage of federal tax liability would incorporate the *existing* federal law and not subsequent federal laws, thus ruling out automatic state—federal conformance. The department stated:

"It is our opinion that the legislature may enact legislation basing the state income tax upon a percentage of an individual's federal tax liability. However, any such legislation will be interpreted as incorporating federal law existing at the time of passage of such act and not future federal statutes. A statute automatically incorporating future amendments by Congress would violate the state constitution."⁴⁹

⁴⁸State of Hawaii, *Proceedings of the Constitutional Convention of 1968*, Vol. I, p. 220.

⁴⁹Letter, Alana W. Lau, Deputy Attorney General, to Ralph W. Kondo, Director of Taxation, January 12, 1972.

In the 1978 session, the legislature passed a bill to update the conformance of the Hawaii income tax laws with the federal Internal Revenue Code. The bill also requires the Department of Taxation to submit each year additional conformance amendments, stating:

"It is the intent of the legislature that it shall each year adopt all amendments to the Internal Revenue Code for the calendar year preceding the year in which the legislature meets; provided that the legislature may choose to adopt none of the amendments to the Internal Revenue Code or may provide that certain amendments are limited in their operation."⁵⁰

Although the bill was welcomed by advocates of state-federal income tax conformance, it is still far from the automatic conformance which they are seeking.

Issues and alternatives. Advocates of state-federal income tax conformance are not pushing for a mandatory requirement in the Constitution that there must be such conformance. Rather, they would want to see the non-delegation of taxing powers clause amended in a way that would permit the legislature, if it so decided at some later time, to pass legislation bringing state income tax laws into automatic conformance with federal laws or establishing state income tax liability as a percentage of federal income tax liability. However, this issue of modifying the legislature's inalienable taxing powers could turn on the substantive question as to whether federal taxable income should be used as the basis for Hawaii income taxation.

Arguments.⁵¹ Those who favor automatic state-federal income tax conformance or using federal taxable income as a base would argue that state tax returns, instructions, and regulations would be simplified; the accounting and compliance burden on taxpayers would decrease; fewer state adjustments would be necessary to information on taxpayers' federal income tax returns; the Internal Revenue Code and federal rules, regulations, and court decisions can be utilized and thereby relieve the State of that burden; it would be easier to ex-

change tax information between federal and state auditors.

Those who oppose would contend that the State would be surrendering one of its most sovereign powers; a change in federal tax rates may require a change in the state tax rates to offset an unwanted effect on state tax revenues which would result from the federal tax rate change; that the State would be obligated to accept federal changes in the exemption allowances and deductions; that, by adopting the Internal Revenue Code, the State automatically accepts the social and economic aspects inherent in the Code; and anything that the State might want to do in the income tax field would have to await the action of the United States Congress.

Priority Passage of the General Appropriations and Supplemental Appropriations Bills

The Hawaii Constitution is one of several state constitutions requiring the General Appropriations Bill to be passed before other appropriations bills can be passed. In addition, under the biennial appropriations system, this requirement extends to any supplemental appropriations bill which may be passed in the even-numbered year. The General Appropriations Bill is defined as the bill which authorizes operating expenditures for the ensuing fiscal biennium (or more commonly, the "operating budget"), and the Supplemental Appropriations Bill is the bill amending any appropriation for operating expenditures of the current fiscal biennium.

The exceptions to the requirement for priority passage of the General Appropriations and Supplemental Appropriations Bills are bills

⁵⁰Senate Bill 2200--78, H.D. 1, 1978 Regular Session.

⁵¹Letter, Thomas F. Kimball, Assistant Professor of Business Law, College of Business Administration, University of Hawaii, to Wilbert K. Sakamoto, Office of the Legislative Auditor, March 24, 1977.

recommended by the governor for immediate passage or bills to cover the expenses of the legislature.

This restriction on the legislative process originated with the 1950 Constitution and was modified in 1968 only to accommodate biennial appropriations. In the reasoning of the 1950 Taxation and Finance Committee:

"Prior consideration of the General Appropriations Bill seems to your Committee to provide several distinct advantages—all of which are believed to be in line with good financial procedure. In the first place, it will focus the immediate attention of the legislature on the largest single appropriation. The amount of the General Appropriations Bill tends to determine the total legislative appropriation and to a large degree what will be available for other purposes. Second, the General Appropriations Bill covers the most essential aspects of state spending. It goes without saying that the budget should include all normal operating expenses of the State. It covers each of the several major departments deemed to be essential services. The budget bill in effect provides for the 'bread and butter' items of government expense. Quite obviously, spending for other purposes should be secondary to these necessities. Third, the passage of the General Appropriations Bill in the early period of the legislature is desirable in order to prevent the confusion, which in the past has taken place in Hawaii and takes place in many of the state legislatures, of passing the governor's budget in the dying moments of the legislative session. During this part of the session frequent compromises and changes may be made. Since no complete and accurate knowledge is then available as to the amount that has been authorized outside the budget, if the budget itself has not been adopted balancing revenues against anticipated expenditures is well nigh impossible. Finally, the appropriation bill should receive prior consideration in order that the legislature may be given ample time to intelligently review the action of the governor. Should the governor veto or reduce items after the legislature adjourns, the legislature is without redress. If, however, the budget bill receives early consideration, such changes as may be made by the governor are subject to review by the legislature, and items can be restored under normal procedures. This in effect greatly increases the authority of the legislature in determining the level of the state budget."⁵²

The 1950 Taxation and Finance Committee considered a time limit of 30 days for passage of the General Appropriations Bill, but

it discarded the idea because it feared that, if for some reason the legislature was not able to pass the bill within the specified time, the validity of the budget might be questioned.

The priority passage proposal came under considerable attack in the Committee of the Whole. As one delegate put it:

"As I read this section, it is rather restrictive. It does not give the opportunity to the legislature to pass emergency appropriations. Say that along the Hamakua coast they would have a plague and we have to wait a month for the general appropriation bill to pass, I don't think the legislature could appropriate emergency money to take care of that area. Likewise, if we have another eruption of Mauna Loa and the legislature wants to do something about it, it wouldn't be able to do so until this general appropriation bill is passed.

"... If the Congress itself had a restrictive clause like that they couldn't make emergency appropriations. Now the answer to that as I understand it is that the governor must consent to it. As I read the whole proposal it makes the governor the most powerful individual in the State. It will create him and his commissar of finance dictator. They could, in my judgment, throttle the whole State if they wanted to. I've never seen any provision like that in any constitution in which the governor is given so much power over the finances. Now, historically speaking, finances are always in the hands of the legislature, and that's where it should rest..."⁵³

The 1950 drafters believed that a requirement of priority passage for the operating budget would force early passage of the bill and prevent the legislative logjam characteristic of territorial sessions. However, the objective of preventing a logjam was never realized in the first decade of statehood,⁵⁴ and as Table 3.3 shows, it has not been achieved in the second decade of statehood.

⁵²State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii, 1950*, Vol. I (Honolulu, 1960), p. 193.

⁵³State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii, 1950*, Vol. II (Honolulu, 1961), p.445.

⁵⁴Sue and Wong, *Article VI: Taxation and Finance*, p. 21.

Table 3.3
General and Supplemental Appropriations Bills
Session Day of Final Passage

<i>Year</i>	<i>Session day</i>
1969	66th and final day
1970	70th and final day
1971	55th day of 60-day session
1972	60th and final day
1973	61st and final day
1974	60th and final day
1975	60th and final day
1976	62nd and final day
1977	5th day, Special Session ¹
1978	59th day of 60-day session

¹In 1977, the General Appropriations Bill failed to pass on the 63rd and final day of the regular session.

Sources: House and Senate Journals for the session years 1969 to 1977; Legislative Reference Bureau Status Table for the Year 1978.

The General Appropriations Bill and the Supplemental Appropriations Bill almost always pass on the final day of the session. This is because much of the legislative bargaining revolves around the budget, and the fate of other bills often depends on what happens to specific items in the budget. This is a political reality which constitutional prescription has not been able to change.

Issues and alternatives. The issue is whether the legislative process should continue to be circumscribed by a requirement which evidently has not achieved its objective.

Arguments. Those who would favor deleting the priority requirement for passage of the General Appropriations Bill and Supplemental Appropriations Bill, thus leaving the legislature free to determine the priority of passage of any bill, would argue that the present requirement is unduly restrictive of the legislative process and impinges upon legislative powers; matters concerning the priority of bills are rightfully a prerogative of the legislature; it should be free to act on appropriation measures, including emergency measures, without being dependent on the recommendations of the governor; and details concerning the priority of bills belong in the rules of the legislature, if they are to be specified anywhere at all.

Those who favor retaining the requirement of priority passage would argue that the present provision encourages the legislature to look at the entire financial picture; if miscellaneous appropriation bills were allowed to pass before the budget bills, it would make it more difficult to balance revenues and expenditures; and that the practical effect of the provision is to provide the legislature with constitutional support to resist special interest groups favoring specific appropriation measures.

Chapter 4

STATE AND LOCAL DEBT

The large capital investment authorizations in recent years, the effects of borrowing on debt service requirements, the mushrooming backlog of authorized but unissued bonds, the shadow cast by New York City's financial crisis, public disenchantment over taxes and government spending—all have contributed to renewed concern over the constitutional debt provisions, particularly as they apply to state government. This chapter reviews the arguments of bond vs. cash financing, the origins of constitutional debt restrictions, the current constitutional provisions governing debt, the State's debt structure, the issues of a more rational or effective debt limit formula, the growing pool of unissued debt, the method of authorizing bonds, the State Supreme Court's decision on revenue bonds, and the debt limits and debt positions of the counties.

"Pay-As-You-Go" vs. "Pay-As-You-Use"

There are basically two ways that state and local governments pay for public facilities. One way is to pay cash out of current revenues, and advocates of this method of financing give it a ring of responsibility by calling it "pay-as-you-go." The second method is to borrow the funds to finance the facilities and repay principal plus interest in a series of payments in future years, and its advocates also align themselves with responsibility by labeling the method "pay-as-you-use."

The favoring of one method over the other depends largely on one's personal political and

economic perspective. The "pay-as-you-go" proponents argue that cash financing, ranging from a down payment to full financing from current revenues, encourages responsibility in spending because tax dollars are harder to come by than borrowed dollars; in periods of economic adversity, such as a severe depression, a jurisdiction would not be saddled with unalterable commitments to repay debt; interest payments over long periods are avoided; and future generations should not be burdened with debt.

On the other hand, advocates of borrowing contend that bond financing provides for a more effective means of allocating the costs of public facilities among those who will benefit from the facilities and that, because facilities generally benefit present as well as future taxpayers, all who benefit, or all who use, should share in the costs. Moreover, they argue that, because state and local governments can almost always earn more in interest from their short-term investment than the interest they pay on long-term debt and that because repayments for borrowing will be made in the future with "cheaper" dollars as a result of inflation, it makes good economic sense to borrow.¹

¹Lennox L. Moak, *Administration of Local Government Debt* (Municipal Finance Officers Association, Chicago, 1970), pp. 192–195. In discussing the arguments of cash vs. bond financing, the author uses the term "pay-as-you-acquire" rather than "pay-as-you-go." It is a more revealing term although not as commonly used.

Even the strongest advocates of borrowing would concede, however, that there are limits to borrowing.² There are economic constraints to be considered, such as the size and frequency of bond issues which the bond market will accept, as well as legal constraints, such as the debt restrictions found in many state constitutions.

Origins and Characteristics of Constitutional Debt Restrictions

Constitutional restrictions over state debt date from 1842 when Rhode Island adopted an amendment prohibiting its general assembly from incurring any debt over \$50,000 except with the consent of the people. Beginning in 1817, with New York's construction of the Erie Canal, states began to borrow for public works, particularly for canals and later for railroads. In the South, a number of states also used debt to finance banking facilities, with funds from state bonds being used to finance land banks. The depression of 1837 severely affected the financial position of states, and the most burdened states defaulted on their debt and other states repudiated portions of their debt.

The financial plight of the borrowing states resulted in a growing movement for restrictions over the authority to incur debt. After Rhode Island, New Jersey adopted a debt limit, and other states followed; prior to the Civil War, there were 19 states with constitutional amendments which limited the amount and purpose of state debt. Several southern states adopted debt restriction amendments during the reconstruction period, and all states which subsequently entered the Union have included some provision restricting debt in their constitutions.³

While the state constitutions vary widely in their specific debt provisions, several broad categories of restrictions can be discerned.⁴ In descending order of forcefulness of restriction, these include:

- . The requirement that debt can be incurred only through constitutional amendment. A number of states have a fixed dollar ceiling up to which funds can be borrowed, but the amount is usually so low as to have no relevancy. Thus, constitutional amendment is the real requirement.
- : The requirement that debt can be incurred only after approval in a public referendum.
- . The requirement that the legislature can authorize debt up to some amount related to a percentage of real property valuation or a percentage or factor of state revenues.

In addition, it is common for state constitutions to prescribe the terms for which bonds can be issued, the manner in which they are to be repaid, and to prohibit borrowing for private individuals and associations.

Types of Bonds

Debt for the long-term financing of public facilities and programs is incurred by state and local governments through the issuance of

²For example, a government could not borrow to the extent that its requirements for repayment ultimately consume 100 percent of its revenues, leaving no amounts for other expenditures. As a practical matter, the bond market would have long before judged such a government to be bankrupt and its bonds unsalable.

³A. James Heins, *Constitutional Restrictions Against State Debt* (University of Wisconsin Press, Madison, 1963), pp. 3-9.

⁴Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1976-77*, Vol. II--Revenue and Debt (Washington, D.C., March 1977), pp. 94-96. The state constitutions vary so widely in their details that it is not possible to display each state's debt provisions in a convenient and easily understood table. The Advisory Commission's effort is the latest compilation of the principal aspects of each state's debt provisions, but it covers three pages and is qualified by 30 footnotes.

bonds. The major characteristic which separates the bonds of state and local governments from other bonds, such as corporate bonds or bonds of the United States Government, is that the interest on the bonds is exempt from federal income taxes, usually exempt from state income taxes with respect to the state's own bonds, and, in a few states, exempt also from state income taxes even though the bonds are those of other states. In Hawaii, the interest paid on bonds issued by the State and counties is exempt from the state income tax, but the interest on bonds issued by other government jurisdictions is taxable.⁵

It is the tax-exempt feature of state and local government bonds which makes them uniquely attractive to certain classes of corporate and individual investors. And it is the tax-exempt status of the bonds which enables state and local governments to borrow more cheaply than other entities, more cheaply than even the federal government can borrow. This situation can be interpreted as a national policy of subsidizing borrowing at the state and local levels. Whatever the merits of the policy from a national standpoint, many state and local governments view borrowing through bonds as a bargain and take advantage of the opportunity to issue tax-exempt and, therefore, low-interest bonds.

The types of bonds issued by state and local governments may be categorized by the security supporting the bonds, and they fall into two broad classes:

(1) *General obligation bonds* are bonds for whose payment of principal and interest the issuer has pledged its "full faith and credit." In essence, the issuing jurisdiction pledges its full taxing powers to guarantee payment on the bonds. Thus, in the case of Hawaii's general obligation bonds, the official statement relating to any particular issue would contain the standard pledge: "Under the Constitution and the laws of the State of Hawaii the interest and principal payments of the Bonds shall be a first charge on the general fund of the State of

Hawaii. Under said laws the full faith and credit of the State of Hawaii are pledged to the punctual payment of the Bonds."⁶

(2) *Revenue bonds* are bonds for whose payment of principal and interest the issuer has pledged the revenues of an undertaking, such as an airport, an off-street parking facility, or other revenue-producing enterprises. The bonds are used to finance the specific undertaking. A necessary condition for the marketability of such bonds is that there is a clear demonstration that the undertaking will produce sufficient income to meet all operating expenses as well as interest and principal payments on the bonds. An official statement for the issuance of revenue bonds for Hawaii's airports system would contain this typical pledge of security: "The principal of and interest on the Bond . . . will be equally and ratably payable solely from, and secured solely by a prior and paramount lien on, the receipts of the aviation fuel tax and the revenues of the airports system." There would also be the disclaimer:

"The Bonds do not constitute a general obligation of the State of Hawaii nor [sic] a charge upon the general fund of the State. Neither the full faith and credit of the State of Hawaii nor the full faith and credit of any political subdivision thereof are pledged to the payment or security of the Bonds."⁷

All other things being equal, the general obligation bond is the stronger of the two debt

⁵Commerce Clearing House, *State Tax Review*, November 1, 1977. While state and local government bonds have enjoyed a tax-exempt status since the enactment of the federal income tax in 1913, there have been proposals in Congress to tax such bonds, proposals which are still very much alive but strongly resisted by state and local officials.

⁶State of Hawaii, Official Statement Pertaining to \$75,000,000 General Obligation Bonds of 1977, Series AL, July 15, 1977, p. 1.

⁷State of Hawaii, Official Statement, \$20,000,000 Airports System Revenue Bonds, Series of 1975, July 1, 1975, p. 8.

instruments, and the pledge of security of the full taxing powers of a jurisdiction will usually produce a lower interest rate than the narrower pledge of the revenue bond. Also, among those states with constitutional debt limits, general obligation bonds are usually counted against the debt limit, while revenue bonds are usually excluded.

Thus, a reasonable case can be made that, when governments borrow, their first choice should be the general obligation bond. However, if states have constitutional restrictions which make it difficult or virtually impossible to engage in straightforward borrowing, the likely consequence is that they will borrow through other more expensive means, such as through revenue bond issuance or through the establishment of special authorities to finance and operate facilities.⁸ These considerations appear to have influenced the current debt provisions in Hawaii's constitution.

Hawaii's Debt Provisions

At the time that the 1968 constitutional convention deliberated, state debt was perilously close to the constitutional debt limit. Rather than merely adjusting the then existing formula to accommodate future borrowings, the drafters chose to make sweeping changes to the debt provisions. The changes, drafted by the Taxation and Finance Committee, adopted by the convention, and ultimately ratified by the people, were designed to achieve the following objectives:

(1) To retain limits on state and county indebtedness.

(2) To set limits that are flexible and are related to the ability of each respective unit of government to repay the debt.

(3) To set limits that are sufficiently liberal as to permit adequate financing of future capital improvements but that at the same time provide assurance to investors that their investments in Hawaii municipal securities⁹ are safe.

(4) To encourage the issuance of general obligation bonds rather than revenue bonds in order to make substantial savings in interest charges.

(5) To ensure that the State has a margin of debt issuance to provide for unforeseen contingencies.

(6) To discourage devious and expensive devices used in so many states to circumvent debt ceilings.

(7) To encourage a broad review of debt in terms of the capital needs of the entire community in contrast to the desires of only a segment of the community.

(8) To encourage an annual review of the debt structure of the State and counties.

(9) To remedy technical flaws in the revenue bond provision.¹⁰

When viewed in their entirety, these objectives are seen to aim at (1) a debt limit which is neither too high nor too low; and (2) incentives for the State to utilize its strongest debt instrument, the general obligation bond, for purposes which would otherwise be financed by the weaker and more expensive instrument, the revenue bond.

The state debt limit. As a territory, through provisions in the Organic Act, Hawaii's outstanding debt was limited to 10 percent of the assessed valuation of property, and the total indebtedness in any one year could not exceed

⁸Heins, *Constitutional Restrictions Against State Debt*, pp. 82-90.

⁹"Municipal securities," "municipal bonds," or simply "municipals" are generic terms used to identify the bonds of state as well as local governments.

¹⁰State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii of 1968*, Vol. I, Journal and Documents (Honolulu, 1973), p. 221.

1 percent of the assessed valuation of property. The 1950 Constitution did not fix an annual limit but established \$60 million as the basic debt limit, and provided also that indebtedness beyond \$60 million and up to 15 percent of the assessed valuation of property could be authorized by a two-thirds vote of the legislature.

The 1968 convention swept away the fixed \$60 million limit and the use of the assessed valuation of property as a basis for calculating the additional debt limit. In their place, the 1968 drafters decided on a state debt ceiling equal to three and one-half times the average general fund revenues (minus federal funds and debt reimbursements) of the prior three fiscal years. This is the reasoning of the Taxation and Finance Committee in proposing the change:

"Our present state debt ceiling is 15% of net assessed values of real property—a proviso that is an affront to reason because the State obtains no revenues from real property taxes. Non-reimbursable state general obligation bonds are repaid out of the general funds of the State, so that the amount of general fund revenues is a logical measure of the size of nonreimbursable debt that can be prudently contracted. For this purpose we eliminate from the general fund all federal funds and debt reimbursement receipts, since these monies are not available to cover nonreimbursable debt service charges. The Committee was unanimous in rejecting any fixed dollar limit. The multiple of $3\frac{1}{2}$ times general fund revenues was agreed upon by the Committee after considerable debate. The multiple of $3\frac{1}{2}$ roughly represents the equivalent of raising our present debt ceiling based on real property values from 15% to around 25%. The three-year base period was selected in preference to a shorter base period in order to keep the ceiling from changing too rapidly, particularly in the event of a recession."¹¹

How the formula operates in calculating the present constitutional debt limit is shown in Table 4.1.

While the calculation of the constitutional debt limit appears to be straightforward, two questions might be raised with respect to the formula: (1) Why was a base period of three years chosen for the purpose of calculating the

Table 4.1
Calculation of the
Constitutional Debt Limit
November 1, 1977

Fiscal year	General fund revenues (millions of dollars)
1974-75	\$ 614.9
1975-76	670.8
1976-77	714.5
Three-year total	2,000.2
Annual average	666.7

Debt limit = $3.5 \times \$666.7 = \$2,333.5$ million

Source: Derived from *Certificate of Total Indebtedness of the State of Hawaii as of November 1, 1977*.

average annual revenues? (2) Why was a multiple of three and one-half selected as the factor for calculating the debt limit? Delegate Thomas Hitch, chairman of the Taxation and Finance Committee, addressed the two questions in presenting the new debt limit formula to the 1968 convention:

"The first area of debate in this business was with respect to the length of the base period. Puerto Rico has a two-year base period. New York's Constitution proposed a two-year base period. Pennsylvania has a five-year base period. There are lots of good arguments for a short base period. There are lots of good arguments for a long base period. The primary argument for a short base period is that it is a more up-to-date base period that's more nearly related to the current economic situation of the State. The primary argument for a long base period is to smooth out sizable changes in the debt ceiling as you have sizable changes in general fund revenues from one year to the next, sizably up in the event of a high level of prosperity and very possibly down—and this is what worries the people who wanted a longer base period—very possibly down in the event of a recession. So we simply compromised on a three-year base period and I strongly recommend that to you.

"The final area of debate on this subject is related to the multiple. Should the multiple be two times average general fund revenues of the last three years, or two and a half, or three, or three and a half, or four, or four and a half, or five? Let

¹¹*Ibid.*, p. 222.

me, for background, give you some figures. If we were to take the current debt ceiling of fifteen percent of net assessed real property valuations for tax purposes, we would come up for the spring of 1969, when the legislature will meet again, with an estimated figure of 589 million dollars. If we were to adjust that ceiling to our new proposed formula ceiling that bases the ceiling on general fund revenues, but at the same time take out of the ceiling self-financing general obligation bonds, we would take out of that ceiling 151 million, an estimated—this can't be a tight figure but an estimated—151 million dollars of self-liquidating general obligation bonds. So that putting the old debt ceiling formula related to real property, on to a base that would be comparable to the formula we are proposing with self-liquidating general bonds out of the ceiling, we would have a ceiling of \$438,000,000, taking 151 off of 589. The average general fund revenues as I have been referring to, over the last three years as of the spring of 1969—we're talking about the next legislative session—would be \$220,000,000. So that a multiple of two would give a debt ceiling of \$440,000,000 which is almost identical with what the adjusted present debt ceiling would be. A multiple of two and a half would be the equivalent on an adjusted basis of a real property ceiling of nineteen percent instead of fifteen percent; a multiple of three would be equivalent to a real property ceiling of twenty-three percent instead of fifteen percent; a multiple of three and a half would be equivalent to a real property ceiling of twenty-six percent; and a multiple of four would be the equivalent of a real property ceiling of thirty percent. As I say, the committee debated this subject to which there is no ultimate, absolute, final ordained answer—debated this subject at great length. I must confess that I felt that I was going rather as far up as possible in recommending a multiple of three. The committee decided on a multiple of four by a rather considerable majority, and then decided later to reconsider and ended up with the multiple that is in the committee report of three and a half....¹²

In essence, there was nothing sacred about either the three-year base period or the 3.5 multiple. Both represented compromises arrived at in the Taxation and Finance Committee.

General obligation exclusions from the debt limit. While the 1950 Constitution required that all authorized general obligation debt be counted against the debt limit, the present Constitution permits the exclusion of those general obligation bonds which are issued for self-sustaining undertakings. These undertakings are those which generate sufficient user taxes

or revenues to meet all debt service charges (the annual amount of money necessary to pay the interest and principal on outstanding debt). The intent of the exclusion was to encourage the use of general obligation bonds, rather than revenue bonds, for self-sustaining projects in order to realize savings in interest charges.

In the reasoning of the Taxation and Finance Committee:

"... A self-sustaining activity of the government (such as the Harbor Division) can issue revenue bonds (secured solely by the revenues of the division), but revenue bonds usually sell at about 1% higher interest rate than general obligation bonds—perhaps these days the difference being between 5½% interest and 4½% interest. A 1% interest rate differential on a twenty-year \$10 million bond would cost about \$1 million over the life of the bond. Since the State would in any case undoubtedly stand behind harbor revenue bonds rather than see them in default, the full faith and credit of the State might just as well be pledged in the first place—with sizable interest savings. This could be done today, except that charging these reimbursable general obligation bonds against the state debt limit encourages the legislature to protect its debt margin by issuing revenue bonds which do not count against the debt ceiling."¹³

Such excluded bonds are sometimes referred to as "reimbursable" general obligation bonds, because the special funds supporting the various undertakings are obligated to "reimburse" the general fund for payments of interest and principal.¹⁴ More specifically, the following constitutional provisions are applicable in determining whether general obligation bonds can be excluded from being counted against the debt limit:

¹²State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii of 1968*, Vol. II, Committee of the Whole Debates (Honolulu, 1972), pp. 384–385.

¹³State of Hawaii, *Proceedings of the Constitutional Convention of 1968*, Vol. I, p. 221.

¹⁴The identification of such excluded bonds as "reimbursable" general obligation bonds is an internal state matter, with the term being used to facilitate budgeting, appropriations, and calculating the debt margin. In the bond market, they are issued as straight general obligation bonds.

(1) General obligation bonds *issued* for a public undertaking from which revenues or user taxes (or both) are derived, can be excluded, but only to the extent that the revenues or user taxes are sufficient to meet the debt service charges for the undertaking in the preceding fiscal year, after the costs of operations, maintenance, and repair have been met. If revenue bonds had previously been issued for the undertaking, the revenues or user taxes must also be sufficient to meet the debt service charges for the revenue bonds, before any computation can be made as to the extent general obligation bonds shall be excluded from the debt limit.

(2) General obligation bonds *which have been authorized but which have not yet been issued* for an existing undertaking, which yield revenues or are supported by user taxes (or both), are excludable, but only if in the preceding fiscal year the undertaking was fully self-sustaining in meeting operating, maintenance, and repair costs and debt service charges. If the undertaking was not fully self-sustaining, the authorized but unissued bonds may be excluded if the legislature increases the user charges or user tax rates so that the net revenues or net taxes are sufficient to pay the debt service charges on all general obligation bonds then outstanding and authorized.

Because the test of whether an undertaking or enterprise is self-sustaining is based on its financial status in the previous fiscal year, a general obligation debt for new and unproven types of revenue-producing enterprises is not excludable. Thus, the Taxation and Finance Committee noted that, in the first year at least, bonds which may be issued for such undertakings as an interisland ferry, hovercrafts, or a mass transit system would have to be counted against the debt limit.¹⁵

Revenue bonds. As a class of bonds, revenue bonds, which were excludable from the debt limit under the 1950 Constitution, continue to be excludable under the 1968 Constitution. However, the definition of revenue

bonds was clarified to permit a more flexible pledge of security without affecting their status as bonds exempt from the debt limit.

In permitting their exclusion from the debt limit, the 1950 Constitution defined revenue bonds as indebtedness incurred under revenue bond statutes by a public enterprise or political subdivision or by a public corporation, when the only security for such indebtedness is the *revenues* of the enterprise or corporation. This particular provision was reviewed by the State Supreme Court in *Employees Retirement System v. Ho*, 352 P. 2d (1960). As a territory, Hawaii had issued \$14 million revenue bonds to be repaid from the revenues of the Hawaii Aeronautic Commission and from an aviation fuel tax. The Territory had also issued nearly \$50 million of highway revenue bonds payable from a vehicle fuel tax.

The State Supreme Court held that the Constitution contemplated only two classes of bonds, one class being payable solely from the revenues of a government enterprise, which were not to be included when calculating state debt against the debt limit, and the other class being all other bonds, which were to be included in the debt limit calculations. Since the bonds of the Hawaii Aeronautic Commission were not payable solely from revenues of the enterprise but were also secured by the aviation fuel tax, the bonds had to be included in determining whether the state debt limit had been exceeded, even though the bonds had been issued as revenue bonds. The highway revenue bonds also had to be included since they were not payable solely from revenues but were supported by user fuel taxes. The effect of the decision was that the only revenue bonds which could be excluded when determining whether the debt limit had been exceeded were bonds payable solely from revenues of an enterprise with no taxes of any sort being pledged to secure the bonds.

¹⁵State of Hawaii, *Proceedings of the Constitutional Convention of 1968*, Vol. I, p. 222.

The 1968 Constitution made possible the exclusion from the debt limit of the type of revenue bonds covered by the 1960 Supreme Court decision. Observing that the State Constitution should still provide for the issuance of revenue bonds "since under some circumstances they may still be desirable," the Taxation and Finance Committee, and subsequently the Committee of the Whole, redefined revenue bonds as all bonds payable solely from and secured solely by the revenues, or user taxes, or any combination of both, of a public undertaking, improvement, or system.¹⁶ Thus, the application of user taxes toward the repayment of revenue bonds does not affect their exempt status from the debt limit and has made possible the substantial expansion of revenue bond issuance for the airports system, which is financed by concession revenues, rentals, and other revenues as well as the aviation fuel tax. While the 1968 Constitution did take care of a long-standing problem with respect to revenue bonds, another issue affecting revenue bonds has emerged and is discussed subsequently in this chapter.

Other exclusions from the debt limit. In addition to the exclusions from the debt limit of general obligation bonds for self-sustaining projects and revenue bonds, the Constitution also provides that bonds issued by the State for the counties are excludable, but only for so long as the counties reimburse the State for the payment of principal and interest on the bonds. Also excludable are bonds authorized or issued under special improvement statutes when the properties involved and the assessments on them are the only security, and general obligation bonds authorized or issued for assessable improvements to the extent that reimbursements to the general fund for debt service are made from assessment collections.

The legal debt margin. In order to provide the legislature with information as to the amount available for bond authorizations under the constitutional debt limit, the director of finance is required by section 39-92, Hawaii Revised Statutes, to prepare annually a state

debt statement as of November 1 of each year. Table 4.2 is a condensed version of the certificate filed.

Table 4.2

**Constitutional Debt Margin
of the State of Hawaii
November 1, 1977**

	Millions of dollars
Constitutional debt limit	\$2,333.5
Debt countable against limit	1,961.8
Constitutional debt margin	371.7

Source: Derived from *Certificate of Total Indebtedness of the State of Hawaii as of November 1, 1977*.

Thus, in the 1978 session, the legislature had a constitutional debt margin of \$371.1 million against which it could make additional bond authorizations. The legislature did pass a supplemental appropriations bill which called for \$22.9 million in additional authorizations and another bill cancelling \$2.7 million in prior authorizations, so the debt margin on June 30, 1978 is estimated to be \$351.5 million.¹⁷

In addition to the provisions related to the constitutional debt limit and the calculation of the constitutional debt margin, the present Constitution contains two provisions concerning the method of authorizing debt and the form of bonds which are essentially unchanged from the 1950 Constitution. Before general obligation bonds can be issued, they must be authorized by an extraordinary two-thirds vote of the members to which each house of the legislature is entitled. This provision was retained because "a two-thirds vote . . . provides some assurance to the municipal bond buyer, helps to ensure that debt will be authorized only for sound

¹⁶*Ibid.*, pp. 221, 352.

¹⁷The 1978 legislature also passed H.B. 2430, H.D. 1, which contains an authorization for additional \$54.9 million in general obligation debt, effective July 1, 1978.

projects, and has worked well in the years that it has been a requirement."¹⁸ Also retained from the 1950 Constitution is the provision requiring all general obligation bonds to be in serial form, the first installment of principal to mature not later than five years from the date of the issue, and the last installment not later than thirty-five years from the date of issue.¹⁹

The Structure of State Debt

As between general obligation bond issuance and revenue bond issuance, the debt structure shows remarkable stability in the proportion of debt for which each type of bond is responsible. This is shown in Table 4.3.

Table 4.3
Outstanding Debt
State of Hawaii
General Obligation and Revenue Bonds
Selected Dates

	<u>June 30, 1968</u>	<u>%</u>	<u>November 1, 1977</u>	<u>%</u>
General obligation	\$261,771,200	85.3%	\$1,227,129,000	82.3%
Revenue	45,082,000	14.7	263,142,000	17.7
Total	<u>\$306,853,200</u>	<u>100.0%</u>	<u>1,490,271,000</u>	<u>100.0%</u>

Sources: *Report of the Comptroller, State of Hawaii, for the Fiscal Year Ended June 30, 1968 and Certificate of Total Indebtedness of the State of Hawaii as of November 1, 1977.*

At about the time the 1968 convention met, general obligation bonds were responsible for 85.3 percent of outstanding state debt while revenue bonds accounted for 14.7 percent. Nearly a decade later, on November 1, 1977, the latest date for which official figures are available, the respective percentages for general obligation bonds and revenue bonds were 82.3 percent and 17.7 percent. Nationally, among all of the states, 50 percent of state long-term debt is accounted for by general obligation bonds and 50 percent by bonds of limited obligations, such as revenue bonds.²⁰ Thus,

if one of the objectives of the 1968 debt provisions was to encourage borrowing through general obligation bonds and to discourage debt limit evasion through the expansion of the use of revenue bonds, the situation has not worsened, and, indeed, Hawaii's record of using its strongest debt instrument when it does borrow holds up much better than the average record of the 50 states.

The reason why the proportion of debt commanded by revenue bonds has not been reduced, even though the 1968 Constitution removed the debt limit "penalty" in the use of general obligation bonds for self-sustaining projects, is because of the State's reliance on revenue bonds for the financing of the expansion and improvements to the airports system. There has been substantial general obligation financing for the airports (some \$66 million in general obligation debt were outstanding in 1977), but of far greater importance has been revenue bond financing. As of November 1, 1977, the State had some \$263 million in outstanding revenue bonds, of which nearly 90 percent, or \$234 million, were for the airports system as a result of bond issues since 1969.²¹

As for general obligation bonds, the most important trend has been the significant increase

¹⁸State of Hawaii, *Proceedings of the Constitutional Convention of 1968*, Vol. I, p. 222.

¹⁹By requiring general obligation bonds to take the form of serial bonds, the Constitution in effect prohibits the issuance of "term bonds," where the entire principal matures on one date. No such constitutional restriction applies to revenue bonds. With respect to serial bonds, the 1968 Constitution adds one aspect of flexibility to how repayment of bonds is to be made. The 1950 Constitution required that the principal of bonds mature in equal annual installments, but the 1968 Constitution authorizes the additional option of bonds maturing in equal installments of both principal and interest.

²⁰Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, Vol. II, p. 71.

²¹Certificate of Indebtedness of Total Indebtedness of the State of Hawaii as of November 1, 1977.

Table 4.4
General Obligation Bonds ("G. O." Bonds)
Selected Data

	Nov. 1, 1970	Nov. 1, 1977	% increase
<i>Outstanding</i>	<u>\$394,529,000</u>	<u>\$1,227,129,000</u>	<u>211.0%</u>
Direct "G. O."	288,734,581	990,803,133	243.2
Reimbursable "G. O."	105,794,419	236,325,867	123.4
<i>Authorized but Unissued</i>	<u>\$544,788,427</u>	<u>\$1,098,825,587</u>	<u>101.7%</u>
Direct "G. O."	485,657,917	976,056,836	101.0
Reimbursable "G. O."	59,130,510	122,768,751	107.6

Sources: Derived from *Certificate of Total Indebtedness of the State of Hawaii*, as of November 1, 1970 and November 1, 1977.

in the present decade of outstanding debt, as shown in Table 4.4.

In seven years, outstanding general obligation debt has increased over four times, from the neighborhood of \$400 million to \$1.23 billion. With an additional \$150 million having been issued since November 1, 1977 minus some \$32 million in maturities retired since that date, an estimate of the outstanding debt at the close of fiscal year 1977-78 would be somewhat higher -- about \$1.345 billion. The largest increase has been in what might be called direct general obligation bonds, or bonds for which the general fund is directly responsible for payment. This category has increased nearly five times in the present decade. Reimbursable general obligation bonds, or those bonds for which special funds are responsible for paying into the general fund to service the bonds, have also increased, but nowhere close to the extent that direct general obligation bonds have increased.

Also showing increases are those general obligation bonds which have been authorized but not issued. As accounted for by direct general obligation bonds and reimbursable general obligation bonds, authorized but unissued bonds have doubled in the past seven years but, again, the increase has not been as

significant when compared to the increase in outstanding general obligation debt.

The reason for the increase in outstanding general obligation debt can be seen in Table 4.5, which displays the annual issuance of general obligation bonds from fiscal year 1961-62 to the present fiscal year.

A review of the annual issuance of general obligation bonds shows that the State has been borrowing much more heavily in the decade of the 1970's than it did in the 1960's, and more heavily again in the last several years than in the earlier years of the present decade. In the sixties, the State issued an average of \$37 million in bonds each year while in the seventies annual general obligation issuance has averaged \$159 million.

Not only has the State been entering the bond market more frequently, but its individual issues have been larger. In the sixties, the State issued bonds once or twice a year,²² and its largest issue was a \$39,600,000 issue in 1963

²²The exceptions were fiscal years 1968-69 and 1969-70, when the State floated three bond issues each year.

Table 4.5
General Obligation Bonds
Issued by the State of Hawaii
FY 1961-62 to FY 1977-78

<i>Fiscal year</i>	<i>Amount issued</i>
1961-62	\$ 20,000,000
1962-63	10,000,000
1963-64	54,600,000
1964-65	33,000,000
1965-66	24,000,000
1966-67	20,000,000
1967-68	58,150,000
1968-69	79,500,000
1969-70	33,875,000
1970-71	110,000,000
1971-72	110,000,000
1972-73	190,125,000
1973-74	110,000,000
1974-75	75,000,000
1975-76	275,000,000
1976-77	176,410,000
1977-78	225,000,000

Source: Derived from *Certificate of Total Indebtedness of the State of Hawaii as of November 1, 1977*. For fiscal year 1977-78, the amount issued includes \$150 million issued since November 1, 1977.

to refund other bonds. Ordinarily, state issues to finance capital improvements in the sixties were for \$10 million, \$20 million, \$30 million, or amounts in-between. In recent years, the State has been entering the market about three times a year, and the standard size for a single issue now seems to be \$75 million, the amount of each of the State's last five issues up to June 30, 1978.

In future years, a consultant's study for the state administration has projected general obligation bond issuance for the next five years to be somewhat higher than it has been in recent years. For fiscal years 1978-79 and 1979-80, it projects bond issuance of \$225 million each year; for 1980-81, \$375 million; for 1981-82, \$240 million; and for 1982-83, \$295 million.²³ All told, this would mean additional bond issuance of some \$1.36 billion in the next five

years, an amount close to the State's total outstanding general obligation debt of \$1.345 billion estimated as of June 30, 1978.

Issues and Alternatives

The debt limit formula. If any change is made to the current debt limit formula, it should be preceded by the identification of the specific problem to be resolved. Most critics of the current debt limit formula contend that the present formula allows the debt limit to be set too high. As evidence, they point to what they consider to be the heavy borrowing practices of the State in recent years and the large accumulation of authorized but unissued bonds.

If "too high a debt limit" is indeed the problem, there are fairly simple and straightforward ways of dealing with it without altering the framework of the current constitutional provisions. For example, the debt limit could be decreased by reducing the current multiple of three and one-half times or lengthening the base period of three years against which the multiple is applied, or by doing both. Thus, a multiple of three, instead of three and one-half, applied against the average annual general fund revenues of the last five years, instead of three years, would have the immediate effect of reducing the constitutional debt limit from the present \$2.33 billion to \$1.78 billion. It would be a lost opportunity, however, if the reviewers of the Constitution were to examine the debt limit issue solely from the perspective of the debt limit being set too high.

The more serious defects of the current formula are that: (1) it has little influence over the debt authorization policies of the legislature or the debt management practices of the executive; and (2) related to that condition, it does not force either the legislature or the executive

²³Peat, Marwick, Mitchell & Co., *A Review and Evaluation of the State of Hawaii Debt Program, First of Three Reports* (Honolulu, November 1976), Exhibit III-7.

into a recurring examination of what impact current and future borrowings will have on current and future budgets.

While credit should be given to the 1968 drafters for laying the foundation for a more rational state debt limit based on the general revenues of the State rather than the aggregate real property valuations of the counties, one can, in retrospect, discern an element of reservation as to what they had accomplished, as in these words from the report of the Committee on Taxation and Finance:

"In making its recommendations, the Committee wants it to be clearly understood that a constitutional debt ceiling is not a substitute for good debt policy and effective debt management. It is merely a statement of the upper legal limit under which appropriate borrowing policies may be formulated. The maintenance of a sound financial posture . . . requires that policy-makers give due consideration to a proper balance of cash and bond financing and that, in the future as in the past, an 'administrative' debt ceiling safely below the constitutional debt ceiling be established."²⁴

In effect, the drafters perceived the constitutional debt limit, not as a limit having practical force, but as some kind of "outer" limit under which they hoped a sound "inner" limit would be devised by the administration and the legislature. If there is such an "inner" limit, it has not been enunciated or adopted as a matter of public policy. Therefore, the only agreed-upon and understood restriction on debt is the constitutional debt limit. Yet, no one has seriously argued that Hawaii, within its present tax structure and tax rates, could borrow up to the limit allowed by the Constitution or even up to the additional amount represented by the present \$1 billion-plus in authorized but unissued bonds.

If a debt limit has any rationale, it is to control debt with the specific objective of preventing a jurisdiction from so seriously mismanaging its borrowings that it is forced into insolvency. Whether a jurisdiction can remain solvent when it borrows can only be arrived at by an assessment as to whether it has the ability

to repay from future income the debt that it incurs today. Thus, the review of the debt limit formula and the construction of any alternative debt limit should proceed from two basic questions: (1) What should be the measure of income? and (2) What should be the measure of debt?²⁵

Measures of income. As to the first question, from a general economic perspective, the ability to borrow is limited by the ability to repay. In the case of borrowing by individuals or corporations, lenders look to future income, or assets, or both, for repayment. In the case of general obligation bonds issued by the State, however, it is not practical to think in terms of the State pledging assets to secure debt or of lenders attaching assets of the State. Hence, state general obligation debt must be repaid out of future income, and a debt limit provision, if there is to be one, is properly based on some measure of income.

There are two categories of income measures which might be used for a debt limit provision. One category pertains to the income of state government. The other relates to statewide economic measures which are analogous to national income and economic statistics, such as gross personal income or gross or net state product. While both categories measure in some way the economic health of a jurisdiction, there are several reasons why the income of state government is the better income measure.

First, and perhaps the most important reason, the income of state government is a "hard" measure subject to audit and verification, whereas measures such as gross personal income and gross state product are "softer"

²⁴State of Hawaii, *Proceedings of the Constitutional Convention of 1968*, Vol. I, p. 221.

²⁵Much of the ensuing discussion around the questions of measures of income and measures of debt is drawn from a memorandum from John Haldi to Newton Sue, subject: "Constitutional Debt Limit Provision," dated December 8, 1977.

measures based on numerous statistical estimating techniques, subject to adjustment before becoming final, and not subject to audit by anyone in state government.

Second, the repayment of debt is from the income of state government, and, thus, there is a direct relationship between the two.

Third, state government income is commonly understood and is under continuous review by policy makers in the executive branch and the legislature, whereas economic statistical measures are less commonly used.

Within the category of income of state government, it is logical to focus upon general fund income and to exclude special fund income and income from the federal government. Special fund income is, by definition, earmarked for specific uses, and, in some instances as in the case of the special fund for the airports system, these uses include the repayment of revenue bonds. Receipts from the federal government have come to represent a major augmentation of state funds, but except for general revenue sharing funds, federal funds are earmarked for specific purposes, and the amount of money received from the federal government is beyond the control of state government.

Therefore, the present constitutional income measure based on the state general fund, and excluding receipts which are not derived from the State's revenue-raising powers, is an appropriate income measure, and there is no persuasive case to change it.

The second question as to what should be the measure of debt introduces several alternatives: (1) the total amount of debt *authorized* at any one time, which would include outstanding debt as well as authorized but unissued debt, as provided for in the present Constitution; (2) the total amount of debt *outstanding* at any one time; and (3) debt service, or the annual payments on principal and interest required to service and retire the debt.

The major difference between the first two approaches and the third approach is that the burden of interest payments as well as principal maturities is accounted for by the debt service measure, while only principal is accounted for in viewing debt in its totality. Yet, interest is a very real cost, and is thus a significant component of debt. For example, on \$100 million borrowed at 6 percent and to be retired in annual maturities up to 20 years, the total interest cost would be nearly \$75 million. Theoretically, one could redefine outstanding debt to include total interest payments, and, while this would be a more accurate measure of the State's total debt burden, it does not immediately reveal what the burden would be on each year's budget. For these reasons, there has been renewed interest in constructing a debt limit around what is called the debt service ratio, the annual amount required to pay principal and interest expressed as a percentage of the revenues of the general fund.

The debt service limitation. The precedent for a constitutional debt limit based on debt service has been set by the Commonwealth of Puerto Rico. Up until 1961, Puerto Rico's debt limit was governed by the Puerto Rican Federal Relations Act and, subject to the action of the United States Congress, the limit was expressed as an amount equal to 10 percent of the assessed valuation of property. In July 1961, the commonwealth was given the authority by Congress to establish its own debt limit in the form of an amendment to its constitution.²⁶

The constitutional formula adopted by Puerto Rico sets no maximum on the total amount of debt itself but establishes a limit to the amount of money which can be applied to service the debt. It provides that the maximum annual debt service in any future year for all bonds outstanding cannot exceed 15 percent of the average of the last two years' annual revenues. Only revenues raised by common-

²⁶Puerto Rico, *A New and Realistic Concept of Debt Control*, August 1962, p. 3.

wealth legislation can be included in computing the limit. Thus, federal funds are excluded. At the time of the adoption of the constitutional amendment, commonwealth debt service was about 7½ percent of treasury revenues, and Puerto Rico officials believed that “a limitation of 15 percent of the average of the last two years’ revenues should permit sufficient borrowing to provide necessary capital improvements and at the same time...be well within the limits of the Commonwealth’s capacity to repay debt.”²⁷

Puerto Rico’s constitutional debt limit reads:

“...The power of the Commonwealth of Puerto Rico to contract and to authorize the contracting of debts shall be exercised as determined by the Legislative Assembly, but no direct obligations of the Commonwealth for money borrowed directly by the Commonwealth evidenced by bonds or notes for the payment of which the full faith, credit and taxing power of the Commonwealth shall be pledged shall be issued by the Commonwealth if the total of (i) the amount of principal of and interest of such bonds and notes, together with the amount of principal of and interest on all such bonds theretofore issued by the Commonwealth and then outstanding, payable in any fiscal year, and (ii) any amounts paid by the Commonwealth in the fiscal year next preceding the then current fiscal year for principal or interest on account of any outstanding obligations evidenced by bonds or notes guaranteed by the Commonwealth, shall exceed 15% of the average of the total amount of the annual revenues raised under the provisions of Commonwealth legislation and covered into the Treasury of Puerto Rico in the two fiscal years next preceding the then current fiscal year...” [Article VI, Section 2]

In 1967, New York’s constitutional convention proposed an amendment similar to Puerto Rico’s:

“No debt shall be contracted by or in behalf of the State unless authorized for capital construction by law enacted by two regular sessions of succeeding terms of the legislature, and unless the amount of debt service on such debt together with the total amount of all other debt service as hereinafter defined, for any fiscal year, shall not exceed 12 per cent of the average of the total amount of tax revenues and other revenues received by the state in its general fund in the two

preceding years.” [Proposed Article X, Section 11a]

The amendment was lost when New York voters rejected the product of the constitutional convention under the all-or-nothing procedure for ratification. As far as can be determined, the proposed debt amendment was not the reason for rejection. There were many other proposed amendments, the most controversial of which was an amendment related to aid to parochial schools.

Hawaii’s debt service experience is displayed in Table 4.6.

Table 4.6
Hawaii’s Debt Service on General Obligation Bond
As a Percent of the General Fund
1968–1977

<i>Year</i>	<i>General fund¹</i> <i>(in million \$)</i>	<i>Debt</i> <i>service</i> <i>on GO debt²</i> <i>(in million \$)</i>	<i>% of</i> <i>general</i> <i>fund</i>
1968	\$253.2	\$12.1	4.8
1969	299.7	15.6	5.2
1970	353.9	17.4	4.9
1971	390.1	22.7	5.8
1972	402.8	29.9	7.4
1973	452.2	35.7	7.9
1974	529.1	47.4	9.0
1975	614.9	56.3	9.2
1976	670.8	71.2	10.6
1977	714.5	85.5	12.0

¹Excludes federal funds and debt service reimbursement funds as defined in the State Constitution.

²Excludes debt service on reimbursable general obligation bonds excludable under Article VI, Section 3, of the Constitution.

Source: Finance Division, Department of Budget and Finance.

²⁷*Ibid.*, pp. 11–15.

As is revealed by the table, debt service has been trending increasingly higher, not only in absolute amounts but in the percentage which it commands of the general fund. In the past ten years, debt service has increased more than seven times—a function of outstanding debt (for which the general fund is responsible) likewise increasing by almost the same ratio. Also pertinent is the increasing percentage of the general fund which is required for debt service, nearly tripling from 4.8 percent to 12.0 percent in ten years.

It should be noted also that the maximum debt service at any point in time is not usually revealed by the debt service required in the current year. Under Hawaii's practice of issuing bonds in 3- to 20-year maturities, the maximum debt service would be in the third year from the year of bond issuance, when the first principal payments are due, not in the intervening period when only interest payments are made. It was for similar reasons that both the Puerto Rico and New York formulas specified a limitation based on *maximum* debt service (in whatever year that might be) rather than debt service in the immediate or next fiscal year.

If an alternative debt limit were to be formulated for Hawaii based on the debt service ratio, and taking into account maximum debt service and flattening out general fund fluctuations by requiring the calculation of average annual revenues from a base period of two or more years, the current percentage of maximum debt service to general fund revenues would be higher than is shown for the last fiscal year in Table 4.6. What that percentage might be as a constitutional limit depends on whether one's view is that debt service already imposes too heavy a burden on the budget or whether the percentage should be set at a level at least sufficient to accommodate the projected issuance of an additional \$1.36 billion in general obligation bonds over the next five years. One suggested approach is to limit debt service charges so that such charges in relation to general fund revenues in the future will be no higher than they are now.²⁸

Arguments. In the 1968 convention, the alternative of a debt limit centering on the concept of the debt service ratio was discussed by the Taxation and Finance Committee, but not to the point of the Committee either favoring the idea or rejecting it. It was first broached to the committee by Andrew Ing, then State Director of Finance, who favored abolishment of the debt limit, but if such a proposal were not politically acceptable, his second choice was a debt limit based on debt service being not more than 15 percent of the average annual general fund revenues calculated from a two-year base, similar to the formula adopted by Puerto Rico and proposed by New York.²⁹

Subsequently, Senator John J. Hulten, then President of the Senate, presented the case before the committee for a constitutional limit based on debt service. Noting that the committee was considering proposals to limit total debt as a multiple of tax revenues, he stated that "a simpler and more direct relationship than [the] ratio of total debt to tax revenues would be a relationship between *debt service* and the revenue base," outlining the following reasons as to why the debt service ratio was to be preferred:

"1. When we speak of total debt, be it outstanding debt or authorized debt, we speak only of our commitment to repay principal. As of July 1, 1968, the State had outstanding debt consisting of over \$250 million in general obligation bonds. This is a sum equivalent to our total principal repayment requirements. But in addition to principal, we also have a requirement to pay about \$85 million in interest over the next 20 years. It would appear that any meaningful assessment of our debt position should take into consideration not only principal but also our interest obligations.

"2. Debt service, or the amount required to pay principal *and* interest, is a more accurate measurement of our repayment commitments than total debt. A limitation on debt service would

²⁸Letter, Dr. Thomas K. Hitch to Rep. Jack K. Suwa, August 10, 1976.

²⁹State of Hawaii, 1968 Constitution Convention, Taxation and Finance Committee, *Minutes*, July 25, 1968.

set no maximum on the total amount of debt itself but would limit the amount of money which can be pledged to service the debt. In essence, we would simply be saying that the State could not spend more than some established percentage of its revenues for debt service in any particular year.

"3. We need to think of debt not as some mystical sum to be repaid sometime in the future. Our orientation should be that if we borrow, it would have a specific effect, in terms of debt service charges, on the budget for a particular year. And it is particularly important to measure not only the debt service requirements for the next year, but for the year in which the maximum debt service will be required." 30

In the committee's discussion of the debt service proposal, the only argument raised against it was that a jurisdiction, if it found itself restricted by the annual debt service limit, might be tempted to lower its annual debt service requirements by issuing bonds with longer maturities and stretching out the payments "even beyond the life of the facility being financed." In response, Senator Hulten did not see it as a problem:

"... in the first place, your investors are going to look askance at that. There is a limit to which you can extend these bonds. They are certainly not going to be interested in bonds that are alive when the facilities are long gone, so I don't think there is a problem of attenuation. It has been well established in the market as to the terms of these bonds. Another thing, if you want to go from a 20-year bond to a 30-year bond, it does give you some flexibility if you are pressing your debt ceiling and if you have a legitimate, necessary project. Secondly, you can take advantage of lower interest rates because if interest rates go down you can finance more and this will encourage you to finance more. I think it gives you the flexibility. If you felt that this was a problem, one thing you may do to get around this is, even though it will take away some flexibility, to put a statement in the constitution to limit the term of any general obligation bond to thirty years. I don't think there is a problem but this is one way you could check it." 31

Another possible argument against a debt limit based solely on debt service is that it would not control the amount of bonds which the legislature could authorize, and the result could be further expansion of the already large pool of authorized but unissued bonds. However,

there is an alternative way to deal with the accumulation of authorized but unissued bonds without necessarily having to place a limit on authorizations. The alternative is discussed in the following section.

The growing pool of authorized but unissued debt. The large and increasing amount of authorized but unissued debt, which has been running over \$1 billion for the past three years, represents a large number of capital improvement projects yet to be completed, including a substantial number yet to be initiated. Based on past experience, a reasonable prediction is that many of the projects for which bond financing was authorized will never be implemented. Table 4.7 shows how the authorized but unissued debt has increased in the present decade:

Table 4.7
Authorized But Unissued General Obligation Debt
As of November 1, 1970-77

1970	\$ 544,788,427
1971	786,654,326
1972	832,306,326
1973	688,145,217
1974	927,360,574
1975	1,058,157,514
1976	1,050,281,818
1977	1,098,825,587

Source: *Certificate of Total Indebtedness of the State of Hawaii*, November 1, 1970 - 1977.

At around the time of the 1968 convention, authorized but unissued bonds amounted to about \$239 million. With the more generous debt limit provided by the 1968 Constitution, authorized but unissued debt rapidly increased

³⁰John J. Hulten, President of the Senate, Testimony to the Committee on Taxation and Finance, 1968 Constitutional Convention, August 2, 1968.

³¹State of Hawaii, 1968 Constitutional Convention, Taxation and Finance Committee, *Minutes*, August 2, 1968.

to \$545 million in 1970, and it has since more than doubled. As Table 4.7 shows, the trend is for unissued debt to increase each year, the only exception being 1973, when the General Appropriations Bill was not passed by a two-thirds majority of both houses (thus invalidating the accompanying bond authorization), and, in 1976, when from November 1 of the prior year the State made a small dent in the authorized but unissued backlog by selling an unprecedented \$226 million in general obligation bonds. The trend can be reversed only if the State issues bonds in amounts larger than the amounts of new bond authorizations by the legislature, or if another more effective system is applied toward the periodic cancellation of unissued debt.

How old some of the bond authorizations are is shown by Table 4.8, which displays the specific legislative authorizations and the purposes and amounts for which the bonds were authorized.

As of November 1, 1977, about one third of the authorized but unissued debt related to authorizations made before 1975. The condition of a growing pool of unissued debt is the result of several factors.

First, there is no effective system for the review of appropriations for capital improvements to determine whether those appropriations which have no expenditures or encumbrances can be cancelled or lapsed. In addition, large appropriation balances for projects which have been implemented can remain on the books as a result of having only relatively small encumbrances against them. And as one study found: "Encumbering small amounts against an appropriation (for perhaps, a planning study) is often done deliberately to preserve appropriations about to lapse."³²

Second, the period during which the appropriations for capital improvements are effective run far longer than for other appropriations. Generally, appropriations which remain unexpended and unencumbered at the close of

Table 4.8

Authorized But Unissued
General Obligation Debt
By Legislative Acts
As of November 1, 1977

Act 97, 1970, state parks	\$ 913,000
Act 110, 1970, lands for houselots	4,403,084
Act 187, 1970, public improvements	1,000,000
Act 68, 1971, capital investment	81,420,604
Act 215, 1971, housing	5,000,000
Act 68, 1972, Sand Island park	1,000,000
Act 146, 1972, university projects	5,837,478
Act 176, 1972, public improvements	19,523,269
Act 197, 1972, North Kohala development	950,000
Act 83, 1973, Molokai development	4,600,000
Act 105, 1974, bikeways	50,000
Act 218, 1974, public improvements	218,970,232
Act 3, 1975, Hamilton Library	1,357,000
Act 195, 1975, public improvements	267,301,927
Act 197, 1975, Judiciary facilities	167,000
Act 28, 1976, law school facilities	838,000
Act 226, 1976, capital improvements	204,420,824
Act 2, 1977, industrial loan companies	20,000,000
*Act 9, 1977, public improvements	43,935,000
*Act 10, 1977, public improvements	212,639,000
*Act 11, 1977, Judiciary facilities	21,619,000
*Act 13, 1977, public improvements	28,362,000
Subtotal authorized but unissued	\$1,144,307,418
Less excess bond allocation over appropriation to be reallocated to above acts	45,481,831
Total authorized but unissued	\$1,098,825,587

*Enacted in Special Session, 1977.

Source: *Certificate of Total Indebtedness of the State of Hawaii as of November 1, 1977.*

any fiscal year are lapsed. In the case of capital improvements, however, appropriations made for a particular fiscal year are not lapsed at the end of the year. The practice of special treatment for capital appropriations has varied. In the sixties, some legislative acts gave capital improvement appropriations indefinite life. Beginning in 1968, most capital improvement appropriations have been governed by provisions for lapsing. The effective period of the appropriations has generally ranged from two to five years, the more recent practice being four years

³²Peat, Marwick, Mitchell & Co., *Review and Evaluation of the State of Hawaii Debt Program, Final Report* (Honolulu, May 1977), p. 53.

—the year for which the appropriations are made, plus three additional years. The legislative acts originally providing for the appropriations can also be amended to extend even further the effective period of the appropriations.³³

Third, appropriations are made for capital improvement projects which are not implemented in the fiscal year for which the appropriations are requested. This is a phenomenon known as “front loading,” requesting and making appropriations in the first and second years even though the projects are not likely to be implemented then. As long ago as 1968, one study found that no real planning and programming of capital improvements can occur because the budget includes far more projects than can reasonably be expected to be undertaken in any fiscal year.³⁴ It is a continuing condition. Appropriations for legislative “pork barrel” projects are not the sole cause of this condition. The executive branch requests many capital project appropriations for a particular year or biennium even though there is little likelihood that all of the appropriations will be expended or encumbered. This can be seen in Table 4.9, which reflects the implementation performance for one single act providing for capital improvement appropriations.

Table 4.9
Status of Act 195, SLH 1975
General Obligation Bond Appropriations
As of June 30, 1977
(In millions of \$)

Amount requested by the executive	\$266 ^a
Amount appropriated	325 ^b
Expenditures	43 ^b
Encumbrances	34 ^b

^aState of Hawaii, *The Multi-year Program and Financial Plan and Executive Budget for the Period 1975–1981* (Budget Period: 1975–1977), Vol. I, p. 133.

^bDepartment of Accounting and General Services, *Summary Statement of Bond-Loan-Fund Appropriations, Allotments, and Expenditures as of June 30, 1977*, p. III.

Act 195, SLH 1975, is the General Appropriations Act of 1975, which made appropriations, including capital investment appropriations, for the fiscal biennium July 1, 1975 to June 30, 1977. As can be seen from Table 4.9, even if the amount requested by the executive is used as a base rather than the larger amount appropriated by the legislature to accommodate its own projects, the amounts expended and encumbered in the fiscal biennium comprise only a fraction of the total amount requested in the executive budget. In the case of Act 195, at the end of two years, the amount of expenditures and encumbrances was 28 percent of the executive budget request.

Fourth, it is not in the political interest of either the executive or the legislature to lapse capital improvement appropriations. From the standpoint of the executive, the large number of projects represented by the pool of authorized but unissued debt has significant implications regarding executive vs. legislative power. Combined with the discretionary authority accorded to the governor to determine which projects are to be implemented, the vast pool of projects on the books provides the administration with the opportunity to pick and choose.³⁵ Effective authority over the development of the capital improvements program thus passes from the legislature to the executive. From the standpoint of individual legislators, capital improvement appropriations for projects in their district are held out to constituents as evidence of their legislative performance, and it is thus not easy for them to support their cancellation.

³³The original 1972 appropriation (and accompanying general obligation bond authorization) for North Kohala development called for the authorization to lapse on June 30, 1973. In 1973, the lapsing date was extended to June 30, 1974, and in 1974 it was extended to June 30, 1979.

³⁴State of Hawaii, Legislative Auditor, *Capital Improvements Planning Process* (Honolulu, June 1968), p. 34.

³⁵State of Hawaii, Legislative Auditor, *Fiscal Authority and Relationships of the Branches of State Government*, Testimony before the House Finance Committee, December 6, 1973.

All this has several consequences, one of which is that it is virtually impossible to fix accountability for the capital improvements program. The legislature blames the executive for not implementing the projects, and the executive blames the legislature for authorizing too many. In addition, if each capital improvements budget is, in effect, a "wish list," rather than a program to be definitely executed within the time frame indicated by the budget, there can be little public confidence in either the capital budgeting or appropriations process. Finally, and perhaps more ominously, the growing authorized but unissued debt can hardly escape the attention of the bond market. As early as 1972, *Moody's*, the major bond-rating service, alerted the market to the size of the State's authorized but unissued debt.³⁶ A concern of investors would be that, without any further legislative authorization, there could be issued vast additional amounts of Hawaii bonds, with the effect of diluting the security behind existing bonds. The concern might not be justified, but it is one which is a natural consequence of the growing size of the State's authorized but unissued debt.

Constitutional lapsing. One alternative to the present non-system is to include in the Constitution provisions for the periodic lapsing of authorized but unissued debt. One approach to the *existing* authorized but unissued debt would be the cancellation of any portions of appropriations from all prior legislative acts which have not been expended or encumbered as of a certain future date, e.g., one year from the date of ratification of the proposal, with the corresponding bond authorizations to be reduced accordingly. An approach to *future* debt authorizations would be to specify a definite period, e.g., two years if the biennial appropriations system is retained, during which the appropriations are to be effective and after which any portions of the appropriations not expended or encumbered would lapse and their bond authorizations would be reduced accordingly.³⁷

Such constitutional approaches to resolve the problem would likely have the following

effects. As to past authorizations, executive agencies would be forced to review every capital project and determine which projects are still "alive," which projects can be safely implemented before their appropriations lapse, which projects would require reauthorizations by the legislature, and which projects are, in fact, "dead" and can be cancelled. As to future authorizations, executive agencies would have to program the development of their projects and their appropriation requests more carefully, or they would risk provoking the inquiry or incurring the displeasure of the legislature in requesting reauthorizations.

In the 1968 convention, the Taxation and Finance Committee considered the problem of authorized but unissued bonds, and the chairman stated the case for constitutional treatment of the problem:

"There should be an automatic lapsing provision in the Constitution. There are some real advantages to this provision due to the fact that the governor has not chosen to veto capital improvement bond authorizations and the legislature has not chosen to restrict itself. For example, we have \$5½ million of authorized general obligation bonds from 1960 for low income housing. In terms of costs, the figures that were calculated in 1960 are so antiquated that if this authorization were to be reactivated tomorrow, it would have to be updated in every respect. Therefore, there should be in the constitution a provision that would automatically lapse authorized but unissued bonds after a specified period of time, unless there is a firm contract to begin a project. As has been testified, the City and County of Honolulu automatically lapse these authorizations that are not activated by the end of the fiscal year."³⁸

³⁶*Moody's Bond Survey*, Vol. 64, No. 4, January 24, 1972, p. 1235.

³⁷Executive agencies have sometimes argued that capital appropriations need to be continued in order to secure matching federal funds. If this is, in fact, the case, an exception to lapsing might be made to accommodate federal funding requirements.

³⁸State of Hawaii, 1968 Constitutional Convention, Taxation and Finance Committee, *Minutes*, August 13, 1978. While their specific provisions vary, all of the charters of the four counties now provide for some form of lapsing of capital appropriations.

However, the proposal died when a subcommittee appointed by the chairman to deal with the issue could not reach agreement.

Arguments. Proponents of some form of constitutional lapsing of authorized but unissued debt would argue that the accumulation of over \$1 billion in unissued debt, with no end in sight, reflects the disinclination of both the legislature and the executive branch to deal with the problem and that, therefore, it is a proper issue for constitutional remedy. The cancellation of existing authorized but unissued debt and a provision for future lapsing would contribute to more rational development of the capital improvements program, more careful programming and budgeting of capital appropriations, and restoration of confidence in legislative appropriations.

Those who oppose constitutional provisions would argue that, while it may take a long time to get capital projects off the ground, the time is often necessary for all aspects of implementation to fall into place. If there is constitutional lapsing, agencies would find it necessary to seek reauthorizations, thus placing an additional burden on the legislative process. Moreover, forcing appropriations to be expended or encumbered within a specified time frame would remove the flexibility of deferring projects if conditions in the construction industry or in the bond market indicate that implementation should be undertaken at a later time.

Method of authorizing state debt. The present Constitution requires the authorization by a two-thirds vote of the members to which each house of the legislature is entitled before bonds can be issued. The two-thirds requirement generally applies to the issuance of long-term general obligation bonds. Exceptions to the two-thirds requirement, with a majority being sufficient for their authorization, are bonds to meet appropriations in anticipation of the collection of revenues or to meet casual deficits or failures of revenue, if required to be paid in one year; bonds to sup-

press insurrection, to repel invasion, to defend the State in war, or to meet emergencies caused by disaster or act of God; and revenue bonds.

The two-thirds requirement has its origins in the 1950 Constitution. It was retained in the 1968 Constitution for the reasons stated by the chairman of the Taxation and Finance Committee:

"When you incur indebtedness for 20 or 25 years, this commits not only the present generation to financial obligations, but also the next generation. A majority vote would be sufficient for short-term indebtedness; however, a major commitment that will be a drain on the resources of the state for an extended period of time should take more than a simple majority."³⁹

There was also the consideration that a two-thirds vote of both houses of the legislature would provide "some assurance to the municipal bond investor" and would help to "eliminate the passage of unsound projects."⁴⁰

Alternatives to the current requirement for authorizing bonds flow in opposite directions. One approach would be to make authorization more stringent and difficult, such as approval by a vote of the people. The second approach would be to relax the two-thirds requirement and have bonds authorized by a majority of the legislature.

Referendum.⁴¹ Proposals to have bond issues authorized by a referendum of the people, a procedure long in force in a number of states and many local governments, have been introduced in the legislature from time to time. Referendum proposals were also introduced in the 1968 convention, but none made any

³⁹*Ibid.*

⁴⁰State of Hawaii, *Proceedings of the Constitutional Convention of 1968*, Vol. II, p. 383.

⁴¹The 1978 Constitutional Convention Study on Article II, Suffrage and Elections, includes a general discussion of the referendum.

headway. The referendum issue did not come up for any substantial discussion in the Taxation and Finance Committee, possibly because members were persuaded by the view that, when straightforward borrowing is made too restrictive, the experience elsewhere is that governments will evade the restriction and use more costly means to finance their requirements.

The evidence is that bond authorizations are frequently turned down through the referendum process. Table 4.10 displays the aggregate results in the United States of state and local bond issue elections. In certain years, more bonds are defeated than are approved, and while more recent data is lacking, it would appear that, given the increasing concern of taxpayers over government spending generally, bond issues will continue to face significant opposition whenever they are brought before the people.

Table 4.10
State and Bond Issue Elections
In the United States
(Billions of \$)

	<i>Amt approved</i>	<i>%</i>	<i>Amt defeated</i>	<i>%</i>
1970	\$5.4	63%	\$ 3.2	37%
1971	3.1	34	5.9	66
1972	7.9	64	4.4	36
1973	6.3	52	5.8	48
1974	8.0	62	4.9	38
1975	3.4	29	11.6	71

Source: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1976-77 Edition*, Vol. II, p. 74.

Relaxing the two-thirds requirement. Other critics of the current constitutional requirement for bonds to be authorized by a two-thirds vote of each house of the legislature would relax the requirement, on the basis that it should be treated like any other legislation, with a majority being sufficient for passage.

In practice, the two-thirds requirement, given the substantial presence in each house of the majority party, has not proven to be a substantial barrier for the passage of bond authorizations, but it can at times be troublesome for supporters of passage.

The bond authorization is usually included in the General Appropriations Bill in the odd-numbered year or in the Supplemental Appropriations Bill in the even-numbered year. With both bills being omnibus measures covering many appropriations for operating expenditures as well as capital expenditures, members of the legislature may have cause to vote against the bills for reasons other than the bond authorization. This seems to have been the case in 1973, when the General Appropriations Bill was passed by a majority in each house but failed to attain a two-thirds majority. Thus, the bond authorization portion of the bill was invalidated.

Arguments. Supporters of the referendum for the authorization of bond issues would argue that, because of the long-lasting impact and effects of borrowing, the voters should reserve to themselves the burden of debt which they are willing to assume. They would point out also that the referendum requirement is common in other states and could serve to generate interest in government programs. Another argument would be that, if proposed bond issues need to be approved through the referendum process, the administration and the legislature would be more selective in proposing projects to be financed by bonds and government spending would be held down.

Opponents of the referendum for debt would argue that it runs counter to a basic tenet of representative government that public officials are elected to study all of the facts and issues and to make decisions on behalf of the people. They would argue also that the referendum process is cumbersome and that the time it takes to authorize bond issues might mean that the government would not be able to take advantage of favorable bond market conditions. Another argument would be that the

referendum might restrict straightforward borrowing, but it would then invite circumvention of the referendum requirement, as other jurisdictions have managed to do, by using various nonguaranteed borrowing methods at higher costs to the public.

As to the alternative of relaxing the two-thirds vote requirement and providing for the authorization of bonds by a majority vote of the legislature, proponents would argue that the requirement produces an effect opposite from what the constitutional drafters intended. Rather than bringing about more soundly conceived capital improvement authorizations, the two-thirds rule simply means that more legislators need to be accommodated with respect to their special projects, and the result is larger capital budgets and, correspondingly, larger bond authorizations.

Opponents of relaxing the two-thirds requirement would argue that, as important a matter as the authorization of debt should require an extraordinary majority, because the effects of debt are to be felt by taxpayers long after the legislature makes the authorization. Those who belong to or are sympathetic to the minority party would argue that the two-thirds requirement on bond authorizations strengthens the role of the minority in the legislature.

Revenue bonds. A 1976 Supreme Court decision, 56 H. 566, 545 P. 2d 1175, raises the issue as to whether revenue bonds need to be redefined.

In 1973, the legislature enacted Act 161, which authorized the State to issue revenue bonds to finance anti-pollution projects. Under the act, the Department of Budget and Finance could enter into a project agreement and lend the proceeds from the revenue bonds to a private company for the purpose of acquiring, constructing, improving, or equipping an anti-pollution project, and the company would be obligated to pay the principal and interest on the bonds. The act was passed in response to the concern that, with the increase of anti-

pollution requirements, private companies, such as the utility companies, needed to be assisted with less expensive financing than could be provided through conventional sources.

As discussed in Chapter 3, the Court found no problem with the act satisfying a "public purpose." However, the Court found that the anti-pollution bonds did not qualify as revenue bonds as defined in the Constitution and, therefore, the bonds would have to be charged against the debt limit. In reviewing the constitutional provisions for revenue bonds, the Court's opinion was that the law authorizing the bonds must obligate the issuer of the bonds to (1) impose rates and charges for the use and services of the undertaking sufficient to pay for the costs of its operations and to pay the principal and interest on revenue bonds and deposit such revenues in a special fund; and (2) have sufficient proprietary control, for a period of time, over the undertaking, because such control is necessary to provide the required security, in the form of revenues, to make the required payments. The Court held that, since the anti-pollution bond act did not meet the two requirements, the revenue bonds would have to be included in the debt countable against the constitutional debt ceiling. Since it was legislative intent that the act would not be implemented if the revenue bonds had to be counted, no anti-pollution revenue bonds have been issued.

Conceivably, other revenue bond laws, such as the anti-pollution revenue bonds authorized to be issued by the counties,⁴² the special facility revenue bonds for the airlines, economic development bonds for the counties and other bonds proposed but not yet enacted, such as revenue bonds to assist housing developers, revenue bonds for private hospital construction, and state economic development bonds,

⁴²S.B. No. 1342-77, H.D. 2, was passed in the 1978 session of the legislature but had not been signed into law by the governor at the time of the writing of this report.

could be affected by the Supreme Court's decision. Thus, supporters of these types of revenue bonds would want to see the Constitution amended in a way that will allow for their issuance as revenue bonds and for their exclusion from the debt limit.

Arguments. Those who favor redefining revenue bonds to clearly include bonds to assist the private sector would argue that it is in the interest of the State to secure financing for those enterprises which would otherwise have to be financed conventionally, because, ultimately, lower interest costs mean lower costs to consumers. Those who oppose would argue that constitutional redefinition would, in effect, open the floodgates, and that public credit should be conserved by using it only for those enterprises which are owned and operated by the government.

County debt limits. The 1968 Constitution made two changes to county debt limits. It provided for a higher debt ceiling by changing the 1950 limitation of 10 percent of real property valuation to 15 percent. It also provided the counties with greater flexibility in bond issuance by removing the 1950 restriction that limited annual bond issuance to a limit of 2 percent of property valuation. The 1968 Constitution retained the 1950 provision of considering county debt as being the debt outstanding rather than the debt authorized, as in the case of the State. For the purpose of calculating the debt limit of each county, it also retained as a base the total of the assessed values for tax rate purposes of real property in each county, "since the counties obtain the bulk of their revenue from real property taxes."⁴³

There has been little attention to county debt limits as an issue. This is because all of the counties appear to have ample legal debt margins as shown in Table 4.11, and there are no pressures to increase the counties' legal borrowing capacities.

Table 4.11
Legal Debt Margin of the Counties
June 30, 1977

Honolulu:

1977 property valuation	\$7,805,949,576
Debt limit	1,170,892,436
Funded debt	157,288,790
Debt margin	1,013,603,646

Maui:

1977 property valuation	\$ 920,361,980
Debt limit	138,054,297
Funded debt	20,622,420
Debt margin	117,431,877

Hawaii:

1977 property valuation	\$ 916,666,000
Debt limit	137,500,000
Funded debt	35,884,000
Debt margin	101,616,000

Kauai:

1977 property valuation	\$ 412,706,395
Debt limit	61,905,959
Funded debt	15,677,935
Debt margin	46,228,024

Sources: *Finance Director's Annual Report for the Fiscal Year Ended June 30, 1977*, for each respective county.

No debt of the counties is anywhere close to the constitutional debt limit. While the counties can legally borrow up to 15 percent of assessed valuation, the debt of Honolulu and Maui amounts to 2 percent of net assessed valuation; Hawaii, 3.9 percent; and Kauai, 3.8 percent. There are several reasons why the debt margin has been ample, not only as of June 30, 1977, but for the past decade. First, the 1968 Constitution changed the percentage of real property valuation from 10 percent to

⁴³State of Hawaii, *Proceedings of the Constitutional Convention of 1968*, Vol. I, p. 222.

15 percent. Second, the real property valuation base of each county has soared in the last ten years. Compared to 1967 valuations, the 1977 valuations for Honolulu are 2.7 times higher; Maui, 4.85 times; Hawaii, 3.96 times; and Kauai, 4.12 times. Third, as can be discerned in Table 4.12, the counties have borrowed infrequently and in relatively modest amounts.

Table 4.12
General Obligation Bonds Issued by the Counties¹
1968-1977

<i>Honolulu:</i>		<i>Hawaii:</i>	
1968	\$ 16,645,000	1970	\$10,000,000
1971	30,000,000	1972	8,325,000
1972	35,000,000	1974	10,000,000
1976	35,000,000	1976	7,000,000
1977	20,000,000	1977	500,000
Total	\$136,645,000	Total	\$35,825,000

<i>Maui:</i>		<i>Kauai:</i>	
1968	\$ 2,800,000	1970	\$ 2,000,000
1971	14,000,000	1972	5,000,000
		1973	5,000,000
		1977	5,000,000
Total	\$16,800,000	Total	\$17,000,000

¹Excludes reimbursable general obligation bonds issued for the water supply departments of Honolulu, Maui, and Kauai.

Sources: *Finance Director's Annual Financial Report for Fiscal Year Ended June 30, 1977*, for each respective county.

Given the present debt position of the counties and even allowing for an acceleration of borrowing for needs not now foreseen, there is the belief that the current debt ceiling formula is too generous and too unrealistic.⁴⁴ If the present 15 percent formula is retained, Table 4.13 shows what the estimated annual constitutional debt limit would be for each of the counties through 1985.

By 1985, under the present constitutional debt limit formula, the limit for Honolulu

Table 4.13
Projected Debt Limits of the Counties
(In million \$)

	<i>Honolulu</i>	<i>Maui</i>	<i>Hawaii</i>	<i>Kauai</i>
1978-79	1,346.5	164.6	156.3	70.4
1979-80	1,481.2	181.0	171.9	77.4
1980-81	1,629.3	199.1	189.1	85.2
1981-82	1,792.2	219.1	208.0	93.7
1982-83	1,971.4	241.0	228.9	103.1
1983-84	2,168.6	265.1	251.7	113.4
1984-85	2,385.4	291.6	276.9	124.7

Source: Derived from Department of Taxation, *Real Property Net Assessed Valuations for Each County, 1977-1985*, January 1978.

would be 1.8 times what it was in 1977; for Maui, 2.5 times higher; for Hawaii, 2.0 times higher; and for Kauai, 2.7 times higher. The more than adequate debt margins today and the projection of substantially higher debt limits over the near term have led some to advocate that county debt limits should be lowered, virtually the only issue with respect to county debt limits receiving any comment.

Arguments. Those who support lowering the debt limit of the counties would argue that the counties already have adequate debt margins, that the present debt limit formula has no influence over county debt policies because it has been set too high, and that the debt limit would not serve as a restraint on indiscriminate borrowing practices should any county embark on such a course. Those who oppose lowering the debt limit would argue that the constitutional limit is only an upper limit under which the counties have managed to set their own debt issuance levels, that the ample legal debt margins enable the counties to display their debt positions to the bond market from a favorable perspective, and that a large margin is necessary against the contingency of needs not now foreseen.

⁴⁴The Tax Foundation of Hawaii advocates the lowering of the county debt limit to 10 percent of the real property assessed valuation for tax rate purposes.

Chapter 5

COUNTY TAXING POWERS

Over the years, the counties have accumulated a long list of grievances against the State. Each of the counties probably has its own set of grievances, but the more common complaints have included the continuing county assumption of debt for facilities taken over by the State; the proliferation of types of real property exemptions and increases in exemption levels which the counties view as seriously eroding their real property tax base; the uncertainties of state grants-in-aid; the real property assessment practices of the State; and the establishment of a state motor vehicle weight tax. Efforts to secure remedy from the legislature have failed, and, thus, the counties believe that their situation can be corrected only through constitutional provisions granting the counties greater taxing powers and financial authority.

The issue of taxing powers for the counties was discussed in the 1950 convention; it was reviewed in 1968; it surfaces in practically every legislative session; and it is likely to emerge again as an issue in the 1978 convention. This chapter reviews the considerations of the 1950 and 1968 conventions, the issue of residual taxing power for the counties, and, as now supported by the Hawaii State Association of Counties, the issue of exclusive county control over the real property tax and the issue of authority for the counties to levy a general excise tax.¹

The 1950 Framework for State—County Fiscal Relations

The federal system divides powers between a sovereign central government and the several sovereign states, but no such division is inherent in the relationship between the state and local governments. Local units of government are creatures of the state and have only such powers as the state confers upon them. This is the prevailing pattern of state—local relations, and it was the framework under which the current constitutional provisions were established.

Counties have no taxing powers under the current Constitution. Rather, county taxing powers are clearly dependent on the legislature, as shown by the following constitutional provisions:

Political subdivisions are creatures of the legislature and exercise those powers granted to them under general laws. [Article VII, Section 1]

The taxing power is reserved to the State except so much as may be delegated by

¹The focus of this chapter is on issues. For an overview of the revenue system of the counties, see Legislative Reference Bureau, *Hawaii Constitutional Convention Studies, Article VII: Local Government* (Honolulu, 1978).

the legislature to the political subdivisions.
[Article VII, Section 3]

These provisions have their origins in the 1950 Constitution. The Committee on Local Government presented the following reasons for not making any constitutional grant of taxing powers to the counties:

"Your Committee recognizes that complete home rule would grant broad powers of taxation to the local units of government. Applied to the situation which exists in Hawaii, the Committee found it impractical to advocate such broad local tax power. The facts show that much of the wealth is produced on islands other than Oahu; that much of the taxes paid in Oahu could be attributed to the other islands; and that many business concerns have property located on several islands. On the basis of those findings the committee felt that it would be inequitable to base the power of taxation of the political subdivisions on the present status of property and earnings. Moreover, any attempt in the Constitution to apportion property and earnings for taxation purposes between the several political subdivisions would make for further confusion and injustice because of the great interdependence of these political subdivisions. The Committee also felt that a wealthy county owed an obligation to the state to aid the development of a poorer county. These considerations constrained the Committee to leave the entire taxing power to the state."²

There was no expression in the Committee of the Whole for a constitutional grant of taxing powers to the counties. The only opposition to the provision reserving taxing power to the State came from those who felt that the provision in the local government article was redundant, since the proposed Taxation and Finance article already declared that the power of taxation resided in the State.³

1968 Rejection of County Taxing Powers

The 1968 constitutional convention left unchanged the original provisions governing state-local fiscal relations. The Taxation and Finance Committee reported that it had voted "overwhelmingly" to retain full taxing power to the legislature, subject to the right of the

legislature to delegate taxing power to the counties. The committee stated:

"... Some of the reasons for this decision were: efficiency, integrated statewide tax policy, simplicity and uniformity of taxation. Concern was expressed about the effect of substantial disparities between the counties' tax bases on their relative abilities to raise tax revenues and also the possibility of proliferation of local taxes such as has occurred in some states which have granted broad taxing powers to political subdivisions."⁴

The 1968 Committee on Local Government also took up the issue of county taxing and concluded that taxing powers should not be granted to the counties for the following reasons:

"1. Additional taxing powers are not needed unless major functional powers are granted.

"2. Taxes should not be levied to meet local conditions without regard to the State as a whole.

"3. As the neighbor island counties lack an economic base of sufficient size to create a new tax base, continued dependence upon state financial aid would be required—or at least expected.

"4. The economic base of the State is well defined and only the state legislature can effectively tap that base through taxation.

"5. Low-yield nuisance taxes would prevail with high administrative costs.

"6. Apportioning taxes among the counties according to wealth produced would cause many taxpayers compliance problems and greatly increase administration costs.

"7. The counties already possess taxing powers in two major areas: property taxation and highway-user taxation.

²State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii, 1950*, Vol. I, Journal and Documents (Honolulu, 1960), p. 229.

³State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii, 1950*, Vol. II, Committee of the Whole Debates (Honolulu, 1961), p. 539.

⁴State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii of 1968*, Vol. I, Journal and Documents (Honolulu, 1973), p. 220.

"8. There are no major sources of tax revenue left open to the counties.

"9. Past experience indicates the counties will continue a preference for seeking state aid rather than levy local taxes.

"10. As the counties perform relatively minor functions of government in terms of total governmental responsibilities, the legislature should control the taxing power.

"11. The advantages of uniform taxation would be lost.

"12. The present system of taxation is more economical and more efficient."⁵

Residual taxing powers. In rejecting a constitutional grant of taxing powers to the counties, the 1968 delegates rejected the proposal of the Hawaii State Association of Counties calling for a constitutional amendment to read: "Each political subdivision shall have all powers of government, including the power to tax, not denied by this Constitution or by general law."⁶

As the proposal was explained to the Taxation and Finance Committee, "the counties would be allowed to tax in all areas without restriction until such time as the legislature decides to preempt a particular field of taxation." Councilman George Koga, representing the Honolulu City Council and the Hawaii State Association of Counties, explained why the counties were supporting the proposal:

"... Adoption of this concept does not mean that there will be an increase in taxes, unless new functions are assumed or existing functions broadened. This would happen even if this concept is not adopted. As an example, the only balancing tax the City and County of Honolulu has at the present time is the real property tax. If we should want to broaden our functions or assume a new function, the only area we can look to for revenue is the real property tax. Some of the legislators and a large segment of the population feel that perhaps real property is being taxed about as high as it should be, but under the present system we would have no alternative, if we want to assume a new function, but to raise the property tax. If given residual powers as proposed, we could look possibly to other sources that we think should pay some of the costs of

carrying on some of the new functions. This we would be able to do within each respective county without going to the legislature. To me, this is the heart of home rule. If you permit the counties to perform their functions with the broadest possible flexibility, the needs of the people within each county are best fulfilled."⁷

At the time of the writing of this report, it is not known whether the counties will resurrect their 1968 proposal for "residual taxing powers," but it would appear from the resolutions that they have adopted that their more immediate concerns are control over the real property tax program and constitutional authority to levy a general excise tax.

The Real Property Tax

Restrictions. Since colonial times, the property tax has been the most important source of tax revenues for local governments. However, the power of local governments to levy property taxes is subject to constitutional or statutory restrictions, or both, in most states. As recently as 1976, a survey showed that 21 states had some form of constitutional restriction over the real property tax, and many other states had some form of statutory controls.⁸

State restrictions on the real property tax can be grouped into five categories:

Rate limits are the most common type of control on the local real property tax, usually expressed as the maximum number of mills per dollar of assessed valuation which can be applied against assessed valuation without a vote of the electorate.

⁵*Ibid.*, p. 231.

⁶*Ibid.*, p. 230.

⁷State of Hawaii, Committee on Taxation and Finance, 1968 Constitutional Convention, *Minutes*, August 2, 1968.

⁸Advisory Commission on Intergovernmental Relations, *State Limitations on Local Taxes and Expenditures* (Washington, D.C., February 1977), pp. 54-65.

Levy limits establish the maximum revenues that can be raised through the property tax, usually expressed as an allowed annual percentage increase. If the assessed valuation of a jurisdiction increases, the property tax rate may have to be reduced to conform to the controlled levy.

Full disclosure laws represent a newer form of control that relies not on explicit tax or spending limits but on forcing public discussion before proposed tax and expenditure decisions become final. Under a full disclosure procedure, a property tax rate is established that will yield revenues equal to the previous year's, and, in order to increase the amount, the local governing board must advertise its intent to set a higher rate and hold public hearings before its governing board can vote on a higher rate.

Expenditure or total revenue limits are ceilings on the amount local jurisdictions can either appropriate or spend during a year. Inasmuch as real property tax revenues usually constitute the main source of revenues for local governments, overall expenditure or appropriation limits indirectly restrict the real property tax.

Assessment ratio rules require assessments to be limited by some fraction or percentage of full market value.⁹

The Advisory Commission on Intergovernmental Relations, the organization which has probably done the most work in the real property tax field, particularly from the perspective of state-local relations, continues to believe in the authority of local governments to determine local tax and expenditure policies. However, the commission now concedes that, when local governments are compensated by a different tax source or by a state revenue sharing program, the state can enact limits to achieve its fiscal objectives, but that local political authority should not be impaired any more than is necessary to achieve legitimate state goals. The commission does support full disclosure procedures, and it recommends

that "all local governments adopt, or be required to adopt, a full disclosure policy, which requires in advance of public hearings, the preparation and dissemination of any analysis of revenue changes attributed to rate revisions as well as those which result from property assessment reevaluations or other non-legislative actions." The commission sees such disclosure as being the desirable middle ground between complete local fiscal discretion and tight state controls.¹⁰

Hawaii's real property tax system. There are no constitutional restrictions on the real property tax. In two constitutional conventions, the only substantial discussion of the real property tax occurred in the 1950 convention, when the Taxation and Finance Committee initially proposed to abolish the home exemption in order to achieve "spreading the burden of property taxes on all property" The proposal was subsequently withdrawn after a vote to table it in the Committee of the Whole was accepted by the Taxation and Finance chairman as an expression of the convention that it did not want home exemptions discontinued.¹¹ Such state controls as exist over the real property tax are entirely statutory.¹²

Hawaii has been the only state with a completely centralized administration of the real property tax. Administration has been centralized since the real property tax was introduced in the days of the Hawaiian monarchy, and it has remained so through territorial years and since statehood. Real property tax revenues are used exclusively for county support, but the county governments are responsible only for the determination of the

⁹*Ibid.*, pp. 12-14.

¹⁰*Ibid.*, pp. 6-7.

¹¹State of Hawaii, *Proceedings of the Constitutional Convention, 1950*, Vol. I, pp. 427-436.

¹²Chapter 246, Hawaii Revised Statutes.

basic tax rates and for the expenditure of tax revenues. The legislature has not granted to the counties any powers over exemptions or assessments. The state administration is entirely responsible for administering the tax, including the functions of assessment, assessment notification, billing, collection, tax map maintenance, research, technical support, and the hearing of appeals.¹³

While the real property tax remains the most important revenue source for the counties, its actual relationship to total revenues can be seen in Table 5.1, which compares real property tax revenues with total operating revenues for each county.

Table 5.1
Real Property Tax Revenues of the Counties
Compared with Total Operating Revenues
Fiscal Year 1976

	Total operating revenues	Real property revenues	% of total
Honolulu	\$249,256,003	\$117,249,133	47%
Hawaii	35,260,525	18,781,089	53
Maui	33,951,377	11,896,154	35
Kauai	14,607,427	5,982,956	41
All counties	\$333,075,332	\$153,909,332	46%

Source: Derived from Tax Foundation of Hawaii, *Government in Hawaii, 1977*, pp. 31-32. Certain exclusions are noted in the source document.

Table 5.1 shows that real property tax revenues of the four counties, unlike some local jurisdictions elsewhere in the United States, do not occupy an overwhelmingly dominant position. Only Hawaii county has over half of its total operating revenues accounted for by real property tax revenues. The lowest county is Maui, with 35 percent of its total operating revenues being comprised of real property tax revenues, with the average of the four counties being 46 percent.

One recent survey of the 50 states and the District of Columbia assigned each

of the jurisdictions to one of three categories: (1) greatest dependence on the property tax; (2) moderate dependence on the property tax; and (3) least dependence on the property tax. Hawaii was one of 15 jurisdictions assigned to the "least dependence" category.¹⁴

The impetus for county control. The counties had long sought control of the administration of the real property tax, but their efforts to obtain control through the legislature have been unsuccessful. However, two related events in 1975 contributed to creating a climate which gave renewed impetus to efforts by the counties to control the real property tax, through the legislature if possible, and through the constitutional convention if necessary.

In 1975, net assessed valuation of real property went up sharply, 23.1 percent statewide over the previous year. Some communities saw their residential real property valuations increase drastically, and the result was taxpayer outrage, particularly among homeowners. An unprecedented 6186 real property tax appeals were filed on Oahu alone.¹⁵ Shortly before the appeals deadline, the legislative auditor submitted an audit report on the State Department of Taxation.¹⁶ The auditor's basic finding was that there were widespread inequities in the State's assessments of real property, resulting from the unsystematic and non-rational basis on which parcels were selected for reappraisal; the use of faulty assessment techniques; inadequate policies and guidelines

¹³Legislative Auditor, State of Hawaii, *An Analysis of the Decentralization of Real Property Taxation*, p. 3.

¹⁴Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, Vol. II (Washington, D.C., March 1977), p. 124.

¹⁵Department of Taxation, State of Hawaii, *Annual Report, 1975-76*, pp. 15, 26.

¹⁶Legislative Auditor, State of Hawaii, *Financial Audit of the Department of Taxation* (Honolulu, August 1975).

on assessments; and tedious, manual assessment procedures.¹⁷

The Senate in the 1976 session studied the question of decentralization of real property tax administration on the basis of an analysis its Committee on Ways and Means requested from the legislative auditor as to the possible effects if real property administration were to be assumed by the counties. The legislative auditor's findings were the following:

"Effects of Decentralization on Administrative Costs

Decentralization may have little effect on the real property tax administration costs borne by the city and county of Honolulu; however, it may far more than double administrative costs borne by each of the neighbor island counties.

Assessed Inequities

Decentralization will have no clearly predictable effect upon inequities between parcels and between neighborhoods within a county. State-wide, intercounty equity and uniformity in assessment would no longer be an attainable possibility nor a recognized objective under a decentralized system of real property taxation.

Tax Relief

Statewide tax relief measures, enacted under a centralized system of real property taxation, can have unequal impacts upon the tax bases and revenues of the various counties. However, the potential for affecting an equitable distribution of the tax burden is far greater under a centralized system. Individual county tax relief measures can involve counties in competitive situations which can erode their tax bases.

Accountability

Decentralization would solve accountability problems only to the extent that the counties would actually control the real property tax.

Land use and Economic Control

Decentralization would result in a net loss in the power to execute land use and economic policy with this State.¹⁸

In the 1978 legislative session, the Senate Committee on Intergovernmental Relations reported out a bill which would have transferred

all of the powers, functions, personnel, and equipment relating to real property taxation to the several counties.¹⁹ However, the bill did not advance further in the legislative process, thus leaving the issue pretty much as it was in the past few years.

Meanwhile, two other legislative actions served to intensify county efforts to control the real property tax. In the 1976 session, the legislature increased the home exemption from \$8,000 to \$12,000.²⁰ In the 1977 session, the legislature passed a law limiting assessments to 60 percent of fair market value, rather than 70 percent as had been the case under the practices of the state Department of Taxation, and requiring "full disclosure" procedures, patterned after a Florida law, before tax rates could be changed from those of the previous year.²¹

These two enactments caused an immediate shortfall in real property revenues, as can be seen in Table 5.2. Only Kauai showed an increase in revenues.

Thus, rather than relief in the direction of assuming greater control over their financial affairs, the counties saw in the more recent action of the legislature further erosion of their tax base, as well as infringement on the setting of tax rates. Therefore, the counties appeared more than ever determined to secure through constitutional amendment what they have not been able to obtain through legislative action.

¹⁷Legislative Auditor, State of Hawaii, An Overview by the Legislative Auditor of the Financial Audit of the Department of Taxation, September 8, 1975, pp. 2-4.

¹⁸Legislative Auditor, An Analysis of the Decentralization of the Real Property Tax, pp. 15-16.

¹⁹Senate Bill 1732-78, S.D. 1, 1978 Regular Session.

²⁰Act 6, Session Laws of Hawaii 1976.

²¹Act 139, Session Laws of Hawaii 1977.

Table 5.2
Real Property Tax Collections
FY 1977 v. FY 1976
(In thousands of \$)

	FY 1977	FY 1976	% change 1976- 1977
Oahu	\$114,326	\$117,124	[2.4]
Maui	11,726	11,896	[1.4]
Hawaii	16,943	18,781	[9.8]
Kauai	6,208	5,983	3.8
State	<u>\$149,203</u>	<u>\$153,784</u>	[3.0]

Source: Department of Taxation, *Annual Report 1976-1977*, p. 26.

Issue and alternatives. The issue revolves around substance and means: first, whether the counties should be given control over all aspects of real property tax administration and, second, whether the Constitution is the proper place to assign such control.

Arguments. Those who favor assumption of control by the counties over real property tax administration would argue that it is legitimate for the counties to seek redress through the Constitution where all efforts to secure remedy through the legislative process have failed and that as basic a matter as division of functions between the counties and the State should be a matter for the Constitution to determine. As to the substance of the issue, they would argue that the State has done a poor job in assessments; that the county governments would be more willing than the State to give assessment administration the attention and resources to ensure equitable assessments; that statewide uniformity in assessments is not necessarily urgent in a geographical setting of noncontiguous island counties; that, with respect to exemptions, the counties could tailor tax relief to meet their own particular social needs while being able to control their revenue needs; and that the result of complete county control would be to assign control to

a single level of government, thus enhancing accountability to the public.

Those who oppose decentralization of real property tax administration would argue, first of all, that the entire question over the real property tax is statutory and that, since the counties are creatures of the legislature, the Constitution is no place for a resolution of the issue. As to the substance of the issue, opponents would argue that statewide equity in assessments is important to prevent competitive, and potentially ruinous, underassessments to lure industries and businesses from one county to another; that inequities within a county are just as likely to arise from county administration as with state administration; that, at a lower level of government, assessments would be more political; that, with respect to exemptions and other tax relief measures, these should be tailored to statewide social objectives; and that accountability to the public can be enhanced, not necessarily by assigning all of the real property tax to one level of government, but by assuring that assessments, exemptions, and appeals procedures of the State are fair and the setting of tax rates by the counties are reasonable and decided upon only after full disclosure to the public.

Authority for the Counties to Levy an Excise Tax

In addition to the movement for control of the real property tax, the counties have also announced their determination to secure constitutional authority to levy a general excise tax.²² The excise tax, now the exclusive preserve of the State, is sometimes referred to as the "sales tax," but it is not quite the same as sales taxes imposed in other states or local jurisdictions.

²²Hawaii State Association of Counties, Resolution, Proposals to Amend the Constitution Relating to Local Government, December 8, 1977.

Hawaii's general excise tax has been categorized as the "broadest-based multiple rate, multiple stage sales tax now imposed anywhere in the United States." A specific study on Hawaii's general excise tax identifies these distinguishing characteristics:

"No other single sales tax provides such a high proportion... of total state revenues as does this tax. In many other respects the general excise tax also defies comparison with the retail sales tax used elsewhere in the nation: It is levied on the seller instead of the buyer. It has few exemptions rather than many. It taxes services on the same basis as transfers of tangible personal property. And it is an explicit tax on business sales as well as on purchases made by the household sector."²³

The pervasiveness of the general excise tax makes it the State's biggest money-maker. In fiscal year 1977-78, the estimate was that the State will realize \$371 million in revenues from the general excise tax, or fully half of the estimated \$702 million in state tax revenues.²⁴ No other state tax, including the individual income tax, comes close to producing the yield of the general excise tax.

It is not surprising, then, that the counties should look at the general excise tax as a potential source of revenues. First, it would take the pressure off the real property tax, particularly on residential property, where, if experience elsewhere is a reliable indicator and the 1975 protests are a prelude, a tax revolt would be more likely to originate. Second, it is a relatively stable and reliable source of revenue, with the characteristic of moving as the economy moves but without the volatile nature of assessments on real property. Third, whatever the regressiveness of the general excise tax, and a strong case can be made that it is regressive, the manner of collection is less likely to cause the same uproar as sharply increased real property tax bills.

The estimated potential yield of the excise tax to the counties for the next five years, if either a 1 percent or 2 percent "piggyback" tax were authorized for the counties, is shown in Table 5.2.

Table 5.2
Estimated Excise Tax Revenues
Based on a 1 Percent and 2 percent Levy
FY 1979 to FY 1983
(in millions of \$)

Fiscal year	Estimated excise tax base ¹	1% levy	2% levy
1979	\$ 9,527.1	\$ 95.3	190.5%
1980	10,543.9	105.4	210.9
1981	11,681.8	116.8	233.6
1982	12,955.5	129.6	259.1
1983	14,382.7	143.8	287.7

¹Source: Derived from State of Hawaii, *The Multi-Year Program and Financial Plan and Executive Budget, 1976*, p. 118. Base includes only those items taxable at the 4 percent rate (retail goods and services).

The significant yield of the general excise tax can be appreciated by comparing it with the yield of the real property tax. The amount to be raised from taxes on all real property classes statewide was estimated to be \$154.2 million in Fiscal Year 1977-78; whereas, a 1 percent general excise tax would have produced over \$86 million in the same year, and, as shown in Table 5.2, over \$93 million in the next year. The \$86 million which a 1 percent general excise tax would have yielded for the counties in FY 1977-78 would have surpassed the \$61 million in estimated revenues from taxes on all improved residential property by some \$25 million.²⁵

The power of the general excise tax to generate revenues has led the chairman of the House Committee on Finance to pose the issue in this manner:

²³Arthur D. Little, Inc., *Hawaii's General Excise Tax: Prospects, Problems, and Prescriptions*, November 1968, p. 1.

²⁴State of Hawaii, *The Supplemental Executive Budget*, December 1977, p. 55.

²⁵Data pertaining to real property tax revenues from Department of Taxation, State of Hawaii, *Real Property Taxation and Tax Rates for the Fiscal Year 1977-78*, August 1977, p. 1. Data pertaining to the excise tax derived from State of Hawaii, *The Multi-year Program and Financial Plan and Executive Budget, 1976*, p. 118.

"...I would suggest that those who support giving the counties excise taxing powers should look at the matter, not merely from the standpoint of generating more revenues but from the possibility of partial or complete replacement of the real property tax.

"I do not think that the taxpayers would accept a large levy simply for the sake of generating more revenues. That is why I think the alternative of replacing the real property tax, particularly the real property tax on homeowners, should be carefully analyzed in any proposal for increased county taxing powers.

"The appeal to the counties of the general excise tax as a potentially big money-maker should be balanced against the interests of taxpayers. We need to answer the question: Would an increase in the general excise tax to generate more revenues for the counties be fair to taxpayers?"²⁶

While the general excise tax has been denied to the counties, it is, in the form of a sales tax, common to local jurisdictions elsewhere in the United States. As of July 1, 1976, there were 26 states with local governments authorized to impose a sales tax of some type.²⁷

Issues and alternatives. Like the issue of the real property tax, the issue of the general excise tax is both substantive and procedural; first, whether the counties should be given the authority to impose a general excise tax and, second, whether the Constitution is the proper place for the grant of such authority.

Arguments. With respect to the question as to whether the Constitution itself should grant to the counties the authority to impose a general excise tax, supporters would argue the failure of the legislature to satisfy county revenue needs leaves the Constitution as their only and final resort. As to the merits of the counties obtaining authority to levy an excise tax, they would argue that, aside from the real property tax, the counties have no other significant tax sources for general purposes; that the authority to levy an excise tax does not mean that it would automatically be used, but it would be a hedge against constraints on the real property tax or against revenue needs not now foreseen; that the excise tax is a preferred

alternative to continuing increases in the real property tax; that state assistance, in the form of grants-in-aid, has been an undependable source of support; and that, without a new and reliable revenue source, financial independence for the counties would not be possible, and true home rule would be rendered meaningless.

Those who oppose a grant of authority to the counties to impose a general excise tax would argue, from a procedural standpoint, that, unless there is a fundamental change in the constitutional framework for state-county relations, the Constitution should not be used as a basis for the specification of taxes. They would argue that grants of tax authority to political subdivisions, in Hawaii and elsewhere, have traditionally been a matter for the legislature to decide and should remain so. As to the substantive issue of county imposition of an excise tax, they would argue that, far from placing a greater burden on the general excise tax, the legislature has made efforts to liberalize the tax by removing its most undesirable pyramiding effects and that liberalizing the tax should be the direction in which government policy should go; that no case has been proven that the counties actually need new revenues; that, in any event, there should be a sorting-out of state and county functions before any changes are made to revenue sources; that the public will not accept new taxes simply to give the counties more revenues; and that any change in the state-county revenue system should be accomplished on a comprehensive basis after analysis of the revenue needs of each; and that the granting of excise tax authority to the counties would be a piecemeal change which does not consider the potential additional burden that it would impose on taxpayers.

²⁶Representative Jack K. Suwa, Excise Taxation for County Operations (Panel Discussion, Hawaii State Association of Counties, December 7, 1977), pp. 4-5.

²⁷Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, pp. 188-189.

Chapter 6

GOVERNMENTAL AUDITING

In the past decade, two trends have dominated the development of governmental auditing at the state and local levels. One trend is the continuing shift of post-audit responsibilities from the executive branch to the legislature. The second trend is the expansion of auditing beyond its traditional financial focus to encompass examinations of management performance, agency operations, and program effectiveness.

Hawaii's Constitution was a early leader in assigning the post-audit function to an official responsible to the legislature, or to a "Legislative Auditor," as the position has come to be called. When the constitutional convention met in 1950, there were only four states with auditors responsible to the legislature.¹ By the time the 1968 convention met, there were 29 states with legislative post-audits.² The latest count is that there are 39 states with post-audit responsibilities located in the legislative branch.³

As to the trend in the conduct of "performance audits," a generic term used to cover those audits which are not strictly financial but include tests for efficiency of operations and effectiveness of programs, a 1971 review found nine states with performance auditing programs and identified Michigan, New York, California, and Hawaii as being the "most advanced."⁴ Since 1971, a number of other states have reported the establishment of performance auditing programs, usually at the initiative of the legislature, and the trend in that direction now appears to be pronounced.

This chapter reviews the generally accepted principles related to post-auditing, the considerations of the 1950 and 1968 constitutional conventions, and the issues raised by the emergence of charter government in all counties and the practice of the executive branch auditing its own agencies.

Some Principles of Governmental Auditing

There is a growing body of literature dealing with post-auditing, particularly as practiced by government. While practitioners of governmental auditing may differ as to the exact scope and content of the post-audit function, there is substantial agreement as to the desirable organizational arrangements for the post-audit and its applications.

The pre-audit and post-audit. In auditing, the post-audit function should be separated from the pre-audit function.

¹Legislative Reference Bureau, *Manual on State Constitutional Provisions* (University of Hawaii, 1950), p. 275.

²Newton N.S. Sue and Thomas W. Wong, *Hawaii Constitutional Convention Studies, Article VI: Taxation and Finance* (University of Hawaii, 1968), p. 93.

³The Council of State Governments, *The Book of the States, 1976-1977*, Vol. XXI (Lexington, Kentucky, 1976) pp. 130-135.

⁴Massachusetts, Legislative Research Council, *Report Relative to Legislative Post Audit*, February 17, 1971, p. 36.

There are two basic categories of auditing, the pre-audit and the post-audit. Pre-audits are examinations made before financial transactions take place. The purpose of the pre-audit is to ensure that a proposed expenditure is not in violation of law or regulation and that sufficient funds are available to cover the proposed expenditure.

The function of the pre-audit is probably of greater importance in government than in private business because of the numerous, detailed and technical restrictions placed upon the use of government funds and upon the amounts that may be used for designated purposes. In practice, pre-auditing is usually conducted as a normal part of accounting routine. Pre-auditing is a control function designed to prevent funds appropriated for one purpose from being used for some other purpose, and it can have the force of forestalling expenditures of questionable propriety.

The pre-audit is considered a function of the executive branch. It is appropriately an executive function, because the pre-audit enables managers in the executive branch to exercise control over the use of funds by subordinate officials. If an external group, such as auditors responsible directly to the legislature, were responsible for pre-auditing, the external auditors would become the effective managers in the executive branch, and such a condition would be contrary to the system of separation of powers.

The post-audit is an after-the-fact examination. It is conducted to ensure that revenues are collected and expenditures are made in compliance with law, that public resources are being conserved through the efficient and effective administration of public programs, and that internal controls exist which safeguard public funds from loss, waste, extravagance, and fraud.

It is not within the purview of the post-audit to control, direct, or interfere with the operations of the government agency being audited. The accepted parameters of post-

auditing are to limit the function to examining, reporting, and recommending.

Since the post-audit is a check on the administrative branch, it should not be performed by persons or agents of that branch. As one public administration specialist puts it, "The objectivity of post-auditing could not be trusted if it were carried out by representatives of the same branch that authorized the expenditures in the first place." It follows that it is illogical to put the same agency or officials in charge of both pre-auditing and post-auditing, because an office approving an expenditure in the pre-audit is not likely to question it in the post-audit. Worse, "such a combination of functions is apt to put temptation in the way of any weak character who functions in both roles." Some years ago, Illinois separated the responsibilities of pre-auditing and post-auditing, but only after an official responsible for both functions was found to have embezzled millions of dollars from the state.⁵

Legislative responsibility for the post-audit.

The responsibility for the post-audit should be assigned to the legislative body or to an official responsible to that body.

The objectivity of the post-audit rests on its conduct as an *independent* examination. Because it is designed as a check on the executive branch, the function should be located outside that branch. Its appropriate assignment is to the legislative branch.

The post-audit is implied in the powers of the legislature to appropriate money to administrative departments and agencies to carry on the programs of government. Where the form of government is characterized by separation of powers, authority commensurate with full responsibility for all administrative operations may be accorded the executive as long as the legislative body utilizes post-auditing to bring

⁵Felix A. Nigro, *Modern Public Administration* (Harper & Row, New York, 1970), pp. 397-398.

it to complete accountability for its performance.

Moreover, there is increased recognition that, in support of its policy-making responsibility, it is the legislature which needs impartial information concerning government operations and programs. The assignment of the post-audit function to the legislative body or to an official responsible to that body provides for independence from the executive branch and enables the function to be responsive to legislative needs.⁶ Because self-auditing is generally condemned, there are precious few who would still propose that post-auditing responsibilities can be assumed by agencies or agents of the executive branch.⁷

Objectivity and independence of the post-audit. *The organizational arrangements for the post-audit function should protect its independence and promote its objectivity.*

Post-audits are worth very little if they are not objective. What is desired from post-auditing is the *truth* about a program or agency, or at least as much of the truth as can be humanly perceived. Objectivity will hardly come about if those who are in the business of auditing are subject to the pressures of either an agency's supporters or its detractors.

The prerequisite to objectivity is independence, the condition which allows auditors to report the facts as they see them. Without arrangements and relationships deliberately designed to protect its independence, the legislative auditing arm would be vulnerable to influence from powerful interests, both within and outside the legislature.

One leading theoretician of government auditing states the necessity for independence in this way:

"... The state auditor may serve the legislature or he may stand alone; what he absolutely cannot do is to be a servant of the executive, except in minor incidentals. To do so would be to become an internal auditor and thus to accept a drastic

lowering of his constitutional standing. No state auditor, or at any rate no chief state auditor, can afford to be without independence; he needs it as a judge needs it, in order to be impartial and fearless in criticism."⁸

The principle of independence of the post-audit function in a legislative setting does not mean that the audit agency should not be under the umbrella of responsibility to the legislature. Neither does it mean that the audit agency should not be responsive to legislative requests to audit certain programs or agencies. But beyond satisfying immediate legislative interests, the audit agency should have at least that measure of independence which permits it to select freely which programs or agencies are to be audited, and, in the conduct and reporting of audits, independence means at least being insulated from the retaliatory pressures which might originate from within the legislature, from the executive branch, or from forces outside of government.

Newer dimension of the post-audit. *The post-audit should review the financial activities of government as well as the efficiency of government operations and the effectiveness of public programs.*

The traditional type of governmental post-audit addressed itself primarily to the accuracy of the financial statements and the adequacy of financial records and internal control systems of agencies. The newer dimensions of the post-audit encompass: (1) the examination of operations to determine the extent of management efficiency in its utilization of public resources; and (2) the examina-

⁶Jesse Burkhead, *Government Budgeting* (John Wiley and Son, New York, 1961), pp. 362-363.

⁷The state auditor of Washington says that the independence of the post-audit can be secured by electing the auditor and developing the function as a "fourth power" of government: Robert V. Graham, "Is Auditing a Fourth Power? Yes, *State Government*, Autumn, 1970, pp. 258-259, 266-270.

⁸E. L. Normanton, *The Accountability and Audit of Governments* (Frederick A. Praeger, New York, 1966), p. 298.

tion of government programs to determine the extent to which the programs are accomplishing the results expected of them.

The more modern concept of the post-audit is that systematic examinations should be conducted not only to determine the propriety of expenditures but also to ascertain how efficiently and effectively government funds are spent. It recognizes that funds may be expended legally but unwisely, and that government must be held to greater accountability for the efficient management of its operations and the effectiveness of its programs.

The Congress of Supreme Audit Institutions, an international organization comprised of national auditors, has recommended that a full or complete concept for the auditing of government programs or agencies should include recognition of the following elements:

"Fiscal accountability, which should include fiscal integrity, full disclosure and compliance with applicable laws and regulations.

"Managerial accountability, which should be concerned with efficiency and economy in the use of public funds, property, personnel and other resources.

"Program accountability, which should be concerned with whether government programs and activities are achieving the objectives established for them with due regard to both costs and results."⁹

Similarly, the U.S. General Accounting Office, the auditing arm of Congress, has recommended as guidelines for state auditing acts and constitutional amendments that auditing be defined to recognize the following components:

"*Financial and compliance*--determines whether financial operations are properly conducted, whether the financial reports of an audited entity are presented fairly, and whether the entity has complied with applicable laws and regulations.

"*Economy and efficiency*--determines whether the entity is managing or utilizing its resources (personnel, property, space, and so forth) in an economical and efficient manner and the causes of any inefficiencies or uneconomical practices,

including inadequacies in management information systems, administrative procedures, or organizational structures.

"*Program results*--determines whether the desired results or benefits are being achieved, whether the objectives established by the Legislature or other authorizing body are being met, and whether the agency has considered alternatives which might yield desired results at lower costs."¹⁰

Formal post-audit reports. *Audit reports should be formal, written reports and a matter of public record.*

The result of post-audit examinations should be formalized in written reports which should be submitted to the legislative body and to the officials responsible for taking action on the audit recommendations. In addition, audit reports should be a matter of public record for the basic reason that the public has a right to know how well public officials are discharging their responsibility in the conduct of governmental operations. Against the general tendency that "no regime will permit its weaknesses to be publicized if they are the rule rather than the exception," public audit reports assure that no public agency will be shielded from public view and scrutiny.¹¹

Formalized audit reports and public disclosure serve to safeguard the integrity of the post-audit itself. As previously stated, the accepted parameters of the post-audit limit the function to examining, recommending, and reporting. Policy-making and the exercise of management and control functions are beyond the scope of those engaged in the post-audit. Formal public reports serve to bring the post-

⁹VIIth International Congress of Supreme Audit Institutions, *Recommendations on Management or Operational Auditing Approved* (Montreal, September 1971).

¹⁰Comptroller General of the United States, *Suggested State Auditing Acts and Constitutional Amendments*, 1974, p. 7.

¹¹Normanton, *The Accountability and Audit of Governments*, p. 158.

audit function under public accountability, just as the post-audit itself seeks to bring the programs and operations of government under accountability.

The value of publicity and formal reporting in connection with the conduct of post-audits has been summed up in this way:

"In a society in which *informed* criticism is increasingly rare, the few prime sources of impartial reporting and comment based upon inside information are therefore of especial value. The list is a short one, and high upon it must figure the published reports of state audit. These are checked and double-checked for accuracy and are issued by officials who enjoy statutory protection against the pressures to which the citizen is exposed through authority, hierarchy and association. State audit is not a participant in the decisions of power, and it examines their consequences without involvement."¹²

Hawaii's Constitutional Provisions for Post-Auditing

In establishing the auditor as a constitutional office, the 1950 drafters evidently believed, as the National Municipal League's Model State Constitution was later to point out, that the post-audit function is of "such importance as to justify constitutional prescription for appointment."¹³

The 1950 convention believed that it was breaking new ground in establishing the office. The drafters observed that they were creating one of the more important positions in the field of financial management, and they expected that the auditor would serve as a force in eliminating waste and inefficiency in government operations, provide the legislature with an effective check against usurpation of powers by the executive, and ensure that public funds have been expended in accordance with legislative intent.¹⁴

Several considerations guided the constitutional formulation of the office:

First, the auditor should be responsible

to the legislature. The 1950 Committee on Taxation and Finance believed that "inasmuch as [the legislature] determines what moneys are to be spent . . . and is vested with the responsibility for determining state policy, it should be the [branch] to which accounting is made." In fixing legislative responsibility, the committee rejected the idea of popular election of the auditor, on the basis that "it throws the Auditor directly into politics and the usual result has been the selection of a strong politician rather than a qualified auditor." It also rejected the alternative of having the auditor appointed by the governor (as was the procedure in territorial government), because "it is never good practice to have the accounts audited by the agency responsible for the spending."

Second, the auditor "must maintain—to be effective—a degree of independence." The delegates believed that the auditor should be free from the "undue pressure" which might be exerted by any one legislature. It was felt that the auditor's position should be stabilized and that he should be in a reasonably secure position to offer suggestions and criticisms to the legislature.

Third, as part of the responsibility of conducting post-audits, the auditor should also serve "at all times as the 'watchdog' of public spending." Outside the regular audits, the auditor should provide the legislature with "such information as it may need. . . ." "It should also be the responsibility of an auditor to submit recommendations covering means and methods for improving financial management. His work can never be completely divorced from either

¹²*Ibid.*, p. 159.

¹³National Municipal League, *Model State Constitution*, 6th Ed. (New York, 1963), p. 12.

¹⁴State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii, 1950*, Vol. I (Honolulu, 1960), pp. 463–464.

budget-making, expenditure controls, or financial planning.”¹⁵

With the foregoing considerations, the 1950 drafters structured a constitutional office for the post-audit, of which the main elements are the following:

- . The auditor is appointed by the legislature for a term of eight years and thereafter until a successor is appointed.
- . The auditor can be removed by the legislature for cause, but only by a two-thirds vote of the members in joint session.
- . The post-audit function and jurisdiction in auditing the accounts of the State and political subdivisions are vested in the auditor.
- . Outside of the regular audits the auditor is empowered to conduct, the legislature may direct the conduct of other investigations and the making of additional reports.
- . The auditor is to report his findings and recommendations to the legislature and to the governor.

In retrospect, and in what now appears to have been a stroke of farsightedness, the drafters of 1950 had translated into constitutional provisions virtually all of the contemporary post-auditing principles: clear separation of the post-audit function from the executive branch; assignment of the function to an official of the legislative branch; safeguarding the independence of the auditor through tenure and the requirement for an extraordinary majority for removal; and formal public reports of audit findings and recommendations.

In only one respect did the 1950 provisions not completely translate the currently accepted principles of post-auditing. The constitutional language did not completely articulate the newer dimensions of post-auditing, although it is evident that the original drafters had fore-

seen that the post-audit function would encompass duties beyond those required by the traditional financial post-audit. It remained for the 1968 convention to recognize the newer dimensions of auditing.

1968 Constitutional Review

The Office of the Legislative Auditor was not activated until 1965, when the legislature appointed an auditor in accordance with the constitutional provisions. Between that time and the time the 1968 convention met, the legislative auditor had proceeded to develop and execute an audit program which included three kinds of audits: (1) *financial audits* which attest to the accuracy of the financial statements of the agencies, examine the adequacy of internal control systems, and determine the legality of expenditures; (2) *operations audits* which examine managerial efficiency, the manner in which agencies are organized and how well resources are acquired and utilized; and (3) *program audits* which assess whether the programs of government are attaining the results expected of them.¹⁶

The 1968 Taxation and Finance Committee took note of the newer dimensions of auditing, and, for a time, considered clarifying the provisions of the Constitution. However, it decided against making a change, believing that, in the changing environment of governmental auditing, it should not be necessary, from the standpoint of the Constitution, to identify the specific kinds of audits which the auditor is empowered to conduct.

In its report, the Committee on Taxation and Finance said:

¹⁵State of Hawaii, *Proceedings of the Constitutional Convention of Hawaii, 1950*, Vol. I, pp. 197-198.

¹⁶Legislative Auditor, *Manual of Guides of the Office of the Legislative Auditor*, September 27, 1967, p. A-1.

"Your Committee has heard and considered suggestions that clarifying language be included to define the post-audit function more clearly. It has determined that the current provisions are sufficient to encompass the on-going audit activities of the auditor, including financial, program and performance audits, and that it is not necessary to enumerate the specific sub-categories of audit which the auditor is empowered to conduct."¹⁷

With that expression of constitutional intent, the 1968 convention left intact the original provisions of the 1950 Constitution.

Post-Auditing and the Emergence of Charter Government

The constitutional provisions for the post-audit assign to the legislative auditor audit jurisdiction over state agencies as well as political subdivisions. With charter government, the jurisdiction over the counties may need to be reviewed in the context of the charter provisions of the various counties.

With the emergence of charter government among the neighbor island counties, along with the charter of the City and County of Honolulu, all of the counties now have charter provisions which require the periodic conduct of post-audits under the responsibility of the respective legislative bodies of each county.

Rather than duplicate the audits conducted for the various county councils, the legislative auditor, at various times, has assisted the counties in reviewing audit specifications, proposals, workpapers, and preliminary reports. For example, under a long-standing agreement with the legislative auditor of the County of Hawaii, the state legislative auditor has "furnished technical assistance to the County's Legislative Auditor in the planning and preparation for the audit, in the administration of the audit contract and in the review of the preliminary and final drafts of the audit report. This arrangement prevents duplicating the post-audit functions of the two offices and allows [the state legislative auditor] to use the report

to inform the Governor and the State Legislature on the financial condition and general operations of the County of Hawaii."¹⁷

If there is a movement to provide the counties with greater "home rule," and other parts of the Constitution are amended to bring about greater home rule, it may be appropriate for the constitutional reviewers to examine the post-audit provisions in the context of whatever actions may be taken with respect to county powers. If greater home rule is given to the counties, one possible alternative consistent with such action would be to amend the provisions to delete the legislative auditor's automatic jurisdiction over the counties but to retain the legislature's prerogative of directing the auditor to conduct special investigations.

Executive Auditing

While the Constitution assigns the post-audit function to the legislative auditor, audits are also conducted by the executive branch. This has led some to question whether audits, conducted by internal auditors in the executive branch or by certified public accountants under contract to agencies of the executive branch, are consistent with the intent of the Constitution or whether such audits are tantamount to self-auditing.

In the 1978 session of the legislature, the House of Representatives adopted a resolution directed to the 1978 constitutional convention and requesting a solution to the particular issue, among other issues, of "[t]he conduct of post-audits and whether all post-audits, including those conducted by executive agencies or by firms under contract to the executive branch should be covered or consolidated under constitutional provisions."¹⁸

¹⁷Legislative Auditor, An Overview by the Legislative Auditor of the Financial Audit of the County of Hawaii, 1976-77, January 1968, p. 1.

¹⁸House Resolution 595, H.D. 1, 1978 Regular Session.

The problem of executive auditing has apparently bothered the legislature for some time. It received earlier attention, particularly with respect to audits conducted, by or under contract to, the Department of Accounting and General Services. In 1975, a joint Senate-House report recommended that "the department of accounting and general services . . . refocus its attention from the conduct of routine audits to monitoring the internal control and accounting systems of agencies and to assist the agencies in correcting their systems, and, if necessary, to establish new systems. The appropriation made for AGS 104¹⁹ is intended for the department of accounting and general services to monitor and improve the internal control and accounting systems of the various agencies, rather than the conduct of post audits, except in those specific situations where audits are required as a condition for receiving or maintaining federal grants or where a specific audit is required by statute."²⁰

The practice of executive auditing, at least with respect to the Department of Accounting and General Services, has a statutory basis. The general provisions governing the department were part of the Reorganization Act of 1959, the basic act which reorganized territorial government and established state government. Among the duties assigned is one that "[t]he department shall preaudit and conduct after-the-fact audits of the financial accounts of all state departments to determine the legality of expenditures and the accuracy of accounts. . . ."²¹

There appears to be only one reasonable explanation as to why such an anomalous provision, which appears to fly in the face of the Constitution, should have been written into law. In 1959, no agreement could be reached with respect to the appointment of a legislative auditor and, indeed, it would be some years later—in 1965—that the position would be filled and the office established.

On its face, it would appear that the assignment of the pre-audit function, together with the conduct of "after-the-fact" audit to

one agency, and one which functions as the accounting agency for the State, would be contrary to the basic auditing principle that the pre-audit and the post-audit should never be exercised by the same agency. In this connection, the federal government, in requiring audits to be conducted of revenue sharing funds, has explicitly stated that such audits must be "independent," and that "no auditor shall be considered to be independent if such person . . . maintains the official accounting records being audited or reports to the person who does maintain such records."²²

Some legislators have complained that executive audits are considered to be the preserve of the executive branch. Executive audit reports are not routinely distributed to the legislature or to the news media and public. And the question arises as to whether such audits can be completely objective, whether they are conducted by executive agency personnel or by certified public accountant firms. In the case of the latter, by the standards of the auditing profession, the firms are required to maintain "independence," but the scope of any examination and the particular areas to be covered are matters for the executive agency to decide.

Issues and Alternatives

The issue of audit jurisdiction over the counties is contingent upon what changes might be made with respect to county powers.

¹⁹"AGS 104" is the appropriations program code for the internal post-audit program of the Department of Accounting and General Services.

²⁰Conference Committee Report No. 28 on S.B. 535, 1975 Regular Session.

²¹Section 26-6, Hawaii Revised Statutes.

²²Department of the Treasury, *Audit Guides and Standards for Revenue Sharing and Antirecession Fiscal Assistance Recipients* (Washington, D.C., December 1977), p. 11-1.

However, the issue of executive auditing can stand by itself, and, as raised by the House of Representatives, it goes to the question whether such audits should be consolidated under the constitutional provisions which assign the post-audit function to the legislative auditor.

Arguments. Those who favor consolidating all post-audits under the existing constitutional provisions would contend that auditing by the executive branch of itself, regardless of whether the audits are conducted by executive agency personnel or by CPA firms under contract to the executive branch, is self-auditing and, by all principles of auditing, indefensible; that, if audits are to be contracted to CPA firms, they could just as well be contracted by the official charged by the Constitution with the post-audit function; and that hundreds of thousands of

dollars are expended on executive audits and reports each year, with little opportunity for legislative or news media review or public notice of their findings.

Those who oppose consolidating all post-audits under the existing constitutional provisions would argue that audits conducted by the executive branch are designed to assist the executive agencies in improving their various financial systems; that, when such audits originate from within the executive branch, they are likely to be more responsive to the specific needs of agencies than if they were to be conducted by external auditors; and that, in many cases, objectivity is safeguarded by contracting the audits to certified public accountants, who are required by their professional standards to remain independent.

ARTICLE VI

TAXATION AND FINANCE

TAXING POWER INALIENABLE

Section 1. The power of taxation shall never be surrendered, suspended or contracted away.

APPROPRIATIONS FOR
PRIVATE PURPOSES PROHIBITED

Section 2. No tax shall be levied or appropriation of public money or property made, nor shall the public credit be used, directly or indirectly, except for a public purpose. No grant shall be made in violation of Section 3 of Article I of this constitution. [Sec. 6, ren Const Con 1968 and election Nov 5, 1968]

BONDS; DEBT LIMITATIONS

Section 3. For the purposes of this section, the term "bonds" shall include bonds, notes and other instruments of indebtedness; the term "general obligation bonds" means all bonds for the payment of the principal and interest of which the full faith and credit of the State or a political subdivision are pledged; and the term "revenue bonds" means all bonds payable solely from and secured solely by the revenues, or user taxes, or any combination of both, of a public undertaking, improvement or system.

All bonds issued by or on behalf of the State or a political subdivision must be authorized by the legislature, and bonds of a political subdivision must also be authorized by its governing body.

Bonds may be issued by the State when authorized by a two-thirds vote of the members

to which each house of the legislature is entitled, provided that such bonds at the time of authorization would not cause the total of state indebtedness to exceed a sum equal to three and one-half times the average of the general fund revenues of the State in the three fiscal years immediately preceding the session of the legislature authorizing such issuance. For the purpose of this paragraph, general fund revenues of the State shall not include monies received as grants from the federal government and receipts in reimbursement of any indebtedness that is excluded in computing the total indebtedness of the State.

By majority vote of the members to which each house of the legislature is entitled and without regard to any debt limit, there may be issued by or on behalf of the State: bonds to meet appropriations for any fiscal period in anticipation of the collection of revenues for such period or to meet casual deficits or failures of revenue, if required to be paid within one year; bonds to suppress insurrection, to repel invasion, to defend the State in war or to meet emergencies caused by disaster or act of God; and revenue bonds.

A sum equal to fifteen percent of the total of the assessed values for tax rate purposes of real property in any political subdivision, as determined by the last tax assessment rolls pursuant to law, is established as the limit of the funded debt of such political subdivision that is outstanding and unpaid at any time.

Bonds to meet appropriations for any fiscal period in anticipation of the collection of revenues for such period or to meet casual deficits or failures of revenue, if required to be paid within one year, may be issued by any

political subdivision under authorization of law and of its governing body without regard to any debt limit.

All general obligation bonds for a term exceeding one year shall be in serial form maturing in substantially equal installments of principal, or maturing in substantially equal installment of both principal and interest, the first installment of principal to mature not later than five years from the date of the issue of such series, and the last installment not later than thirty-five years from the date of such issue. The interest and principal payments of general obligation bonds shall be a first charge on the general fund of the State or political subdivision, as the case may be.

In determining the total indebtedness of the State or funded debt of any political subdivision, the following shall be excluded:

(a) Bonds that have matured, or that mature in the then current fiscal year, or that have been irrevocably called for redemption and the redemption date has occurred or will occur in the then fiscal year, and for the full payment of which monies have been irrevocably set aside.

(b) Revenue bonds, authorized or issued, if the issuer thereof is obligated by law to impose rates and charges for the use and services of the public undertaking, improvement or system, or to impose a user tax, or to impose a combination of rates and charges and user tax, as the case may be, sufficient to pay the cost of operation, maintenance and repair of the public undertaking, improvement or system and the required payments of the principal of and interest on all revenue bonds issued for the public undertaking, improvement or system, and if the issuer is obligated to deposit such revenues or tax or a combination of both into a special fund and to apply the same to such payments in the amount necessary therefor. For the purposes of this section a user tax shall mean a tax on goods or services or on the consumption thereof, the receipts of which are substantially derived from the consumption, use or sale of goods and

services in the utilization of the functions or services furnished by the public undertaking, improvement or system.

(c) Bonds authorized or issued under special improvement statutes when the only security for such bonds is the properties benefited or improved or the assessments thereon.

(d) General obligation bonds authorized or issued for assessable improvements, but only to the extent that reimbursements to the general fund for the principal and interest on such bonds are in fact made from assessment collections available therefor.

(e) General obligation bonds issued for a public undertaking, improvement or system from which revenues, user taxes, or a combination of both may be derived for the payment of all or part of the principal and interest as reimbursement to the general fund, but only to the extent that reimbursements to the general fund are in fact made from the net revenue, net user tax receipts, or combination of both, as determined for the immediately preceding fiscal year. For the purposes of this section, net revenue or net user tax receipts shall be the revenue or receipts remaining after the costs of operation, maintenance and repair of such public undertaking, improvement or system and the required payments of the principal of and interest on all revenue bonds issued therefor have been made.

(f) General obligation bonds of the State, authorized but unissued, for an existing public undertaking, improvement or system that produces revenues, or user tax receipts, or a combination of both, but only if in the fiscal year immediately preceding the authorization, the public undertaking, improvement or system produced a net revenue, net user taxes or a combination of both, that was sufficient to pay into the general fund the full amount of the principal and interest then due for all general obligation bonds then outstanding for such public undertaking, improvement or system.

(g) General obligation bonds of the State, authorized but unissued, for an existing public undertaking, improvement or system that has not been self-sustaining as determined for the immediately preceding fiscal year, and that produces revenues, or user tax receipts, or a combination of both, but only if the rates or charges for the use and services of the undertaking have been, or the rate of such user tax has been, increased by law or by the issuing body as authorized by law, in an amount that is determined will produce sufficient net revenue or net user taxes, or any combination thereof, for reimbursement to the general fund for the payment of principal and interest on all general obligation bonds then outstanding and authorized for such public undertaking, improvement or system.

(h) General obligation bonds issued by the State for any political subdivision, whether issued before or after the effective date of this section, but only for as long as reimbursement by the political subdivision to the State for the payment of principal and interest on such bonds is required by law; provided that in the case of bonds authorized or issued after the effective date of this amendment, the consent of the governing body of the political subdivision has first been obtained; and provided further that during the period that such bonds are excluded from total indebtedness of the State, the principal amount then outstanding shall be included within the funded debt of such political subdivision.

Determinations of the exclusions from the total indebtedness of the State or funded debt of any political subdivision provided for in this section shall be made annually and certified by law or as prescribed by law. For the purposes of this section, amounts received from on-street parking may be considered and treated as revenues of a parking undertaking.

Nothing in this section shall prevent the refunding of any bond at any time. [Am Const Con 1968 and election Nov 5, 1968]

THE BUDGET

Section 4. Within such time prior to the opening of each regular session in an odd-numbered year as may be prescribed by law, the governor shall submit to the legislature a budget setting forth a complete plan of proposed expenditures and anticipated receipts of the State for the ensuing fiscal biennium, together with such other information as the legislature may require. The budget shall be submitted in a form prescribed by law. The governor shall also, upon the opening of each such session, submit bills to provide for such proposed expenditures and for any recommended additional revenues or borrowings by which the proposed expenditures are to be met. Such bills shall be introduced in the legislature upon the opening of each such session. [Am Const Con 1968 and election Nov 5, 1968]

LEGISLATIVE APPROPRIATIONS; PROCEDURES

Section 5. In each regular session in an odd-numbered year, the legislature shall transmit to the governor an appropriation bill or bills providing for the anticipated total expenditures of the State for the ensuing fiscal biennium. In such session, no appropriation bill, except bills recommended by the governor for immediate passage, or to cover the expenses of the legislature, shall be passed on final reading until the bill authorizing operating expenditures for the ensuing fiscal biennium, to be known as the general appropriations bill, shall have been transmitted to the governor.

In each regular session in an even-numbered year, at such time as may be prescribed by law, the governor may submit to the legislature a bill to amend any appropriation for operating expenditures of the current fiscal biennium, to be known as the supplemental appropriations bill, and bills to amend any appropriations for capital expenditures of the current fiscal

biennium, and at the same time he shall submit a bill or bills to provide for any added revenues or borrowings that such amendments may require. In each regular session in an even-numbered year, bills may be introduced in the legislature to amend any appropriation act or bond authorization act of the current fiscal biennium or prior fiscal periods. In any such session in which the legislature submits to the governor a supplemental appropriations bill, no other appropriation bill, except bills recommended by the governor for immediate passage, or to cover the expenses of the legislature, shall be passed on final reading until such supplemental appropriations bill shall have been transmitted to the governor. [Am Const Con 1968 and election Nov 5, 1968; am L 1972, S B No 1947-72 and election Nov 7, 1972]

EXPENDITURE CONTROLS

Section 6. Provision for the control of the rate of expenditures of appropriated state monies, and for the reduction of such expenditures under prescribed conditions, shall

be made by law. [Sec. 7, ren Const Con 1968 and election Nov 5, 1968]

AUDITOR

Section 7. The legislature, by a majority vote of each house in joint session, shall appoint an auditor who shall serve for a period of eight years and thereafter until a successor shall have been appointed. The legislature, by a two-thirds vote of the members in joint session, may remove the auditor from office at any time for cause. It shall be the duty of the auditor to conduct post-audits of all transactions and of all accounts kept by or for all departments, offices and agencies of the State and its political subdivisions, to certify to the accuracy of all financial statements issued by the respective accounting officers and to report his findings and recommendations to the governor and to the legislature at such times as shall be prescribed by law. He shall also make such additional reports and conduct such other investigations as may be directed by the legislature. [Sec. 8, ren Const Con 1968 and election Nov 5, 1968]

GLOSSARY OF TERMS

Administrative debt limitation or ceiling

A self-imposed debt limitation which is below the legal debt ceiling

Amortization

Gradual reduction, redemption, or liquidation of the balance of an account according to a specified schedule of times and amounts, such as in the extinguishment of a debt

Annual budget

A budget applicable to a single fiscal year

Appropriated receipts

Receipts that are identified with and dedicated to a specific purpose and are not available for further appropriation; they are considered appropriated when received for such purposes

Appropriation

An authorization granted by a legislative body to make expenditures and to incur obligations for specific purposes. An appropriation is usually limited in amount and as to the time when it may be expended.

Assessed values for tax rate purposes

The valuation set by government on real estate as a basis for levying taxes

Assessment of real property

The process of making the official valuation of real property for purposes of taxation

Authority

A governmental unit or public agency created to perform a single function or a restricted group of related activities. Usually such units are financed from service charges, fees, and tolls, but in some instances they also have taxing powers. An authority may be completely independent of other governmental units, or in some cases it may be partially dependent upon other governments for its creating, its financing, or the exercise of certain powers.

Authority bonds

Bonds payable from the revenues of a specific authority (q.v.). Since such authorities usually have no revenue other than charges for services, their bonds are ordinarily revenue bonds (q.v.).

Biennial appropriations

Authorizations granted by a legislative body to make expenditures and to incur obligations for a fiscal period of two years

Biennial budget

A budget applicable to a fiscal period of two years

Bond

A written promise to pay a specified sum of money, called the face value or principal amount, at a specified date in the future, called the maturity date, together with periodic interest at a specified rate. (The difference between a note and a bond is that the latter runs for a longer period of time and requires greater legal formality.)

Bond fund

A fund used to account for the proceeds of bond issues

Bonds authorized and unissued

Bonds which have been legally authorized but not issued and which can be issued and sold without further authorization

Bonds issued and outstanding

Bonds issued of which the principal has not yet been paid

Budget

A plan of financial operation embodying an estimate of proposed expenditures for a given period and the proposed means of financing them. (The term "budget" is used in two senses in practice. Sometimes it designates the financial plan presented to the appropriating body for adoption and sometimes the plan finally approved by that body. It is usually necessary to specify whether the budget under consideration is preliminary and tentative or whether it has been approved by the appropriating body.)

Capital improvement program

A plan for capital expenditures to be incurred each year over a fixed period of years to meet capital needs arising from the long-term work program or otherwise. It sets forth each project or other contemplated expenditure in which the government is to have a part and specifies the full resources estimated to be available to finance the projected expenditures.

Capital investment costs

Costs associated with capital improvements, including the acquisition and development of land, the design and construction of new facilities, and the making of renovations or additions to existing facilities

Debt limit

The maximum amount of debt which a governmental unit may incur under constitutional, statutory, or charter requirements

Debt margin

The difference between the legal debt limit of a government unit and the existing debt chargeable against the limit

Debt service charges

The annual amount of money necessary to pay the interest and principal on outstanding debt

Debt service ratio

The annual amount required to pay the principal and interest of general obligation bonds, expressed as a percentage of the revenues of the general fund

Debt service reimbursements to the general fund

Moneys assigned to the general fund from other funds for the payment of principal and interest on outstanding bonds

Earmarking of revenues

The automatic channeling of revenues to finance a particular government program

Encumbrances

Obligations in the form of purchase orders, contracts, or similar commitments which are chargeable to an appropriation and for which a part of the appropriation is reserved. They cease to be encumbrances when paid.

Established undertaking

A governmental undertaking which has an experience in producing revenues or deriving user taxes in the fiscal year preceding the authorization of bonds for that undertaking

First charge on general revenues

The commitment of the state or political subdivision to give the highest precedence in making interest and principal payments on issued and outstanding general obligation bonds

Fiscal year

A 12-month period of time to which the annual budget applies

Fiscal period

Any period at the end of which a govern-

mental unit determines its financial position and the results of its operations

Full faith and credit

A pledge of the general taxing power for the payment of debt obligations. Bonds carrying such pledges are usually referred to as general obligation bonds or full faith and credit bonds.

Funded debt

Debt which is chargeable against the constitutional debt limit

General appropriations bill

The bill which authorizes expenditures for the ensuing fiscal biennium

General fund

Fund consisting of all revenues not earmarked for specific purposes which are available for general use in financing government operations and services

General fund revenues

Revenues other than those revenues earmarked for specific purposes

General obligation bonds

Bonds secured by an unconditional pledge of the issuing government to pay them

Industrial development bonds, industrial aid bonds, industrial aid financing, economic development bonds

Bonds issued by governmental units, the proceeds of which are used to construct facilities for private industrial concerns. Lease payments are used to service the bonds. Such bonds may be in the form of general obligation bonds or revenue bonds.

Municipal securities, municipal bonds

The tax-exempt bonds of state as well as local governments

Operations audit

The operations audit examines the efficiency of a program or agency

Pay-as-you-go

The financial policy of a governmental unit which finances all of its capital outlays from current revenues rather than by borrowing. A governmental unit which pays for some improvements from current revenues and others by borrowing is said to be on a partial or modified pay-as-you-go basis.

Pay-as-you-use

A term used to describe the financial policy of a governmental unit which borrows the funds to finance facilities

Performance audits

A term used to cover those audits which are not strictly financial but include tests for efficiency of operations and effectiveness of programs

Post-audit

An audit made after the transactions to be audited have taken place

Pre-audit

An examination for the purpose of determining the propriety of proposed financial transactions

Program audit

An audit to assess whether the programs are attaining the results expected of them

Real property tax administration

As it relates to Hawaii, the functions of assessment, assessment notification, billing, collection, tax map maintenance, research, technical support, and the hearing of appeals

Refunding bonds

Bonds issued to pay, call, and redeem all or any part of outstanding bonds

Reimbursable general obligation bonds

General obligation bonds issued for a public undertaking, improvement or system in which payment of principal and interest is reimbursed to the general fund from assessment collections, revenues, or user taxes

Restrictions on appropriations

Any portion of the appropriation that is purposefully withheld by the executive from expenditure

Revenue bonds

Bonds secured solely from the revenues of an undertaking

Self-sustaining

Fully self-sustaining: An undertaking, improvement, or system which produces revenues or derives user taxes sufficient to meet all of the cost of operation, maintenance, and repair and all of the debt service requirements (q.v.) of bonds issued for that undertaking, improvement, or system

Partially self-sustaining: An undertaking which produces revenues or derives user taxes sufficient to meet *all* of the cost of operation, maintenance, and repair and *part* of the debt service requirements (q.v.) of bonds issued for that undertaking, improvement, or system

Serial bonds

Bonds the principal of which is repaid in periodic installments over the life of the issue

Special assessment

A compulsory levy made by a government against certain properties to defray part or all of the cost of a specific improvement or service

Special fund

Any fund which must be devoted to some special use in accordance with specific regulations and restrictions; it accounts for revenues

from specific taxes or other earmarked revenue sources which by law are designated to finance particular functions or activities of government

Special purpose bonds

Bonds issued by government to assist private enterprises and individuals to finance capital projects

Supplementary appropriations bill

The bill, submitted in an even-numbered year, to amend any appropriation for operating expenditures of the current fiscal biennium

Term bonds

Bonds the entire principal of which matures on one date

User charges and fees, user revenues

Fees and charges levied by the government for specific uses of government property, facilities, or services in order to recover, wholly or partially, the costs incurred by government in providing for such specific uses or services

User taxes

Compulsory charges levied by a governmental unit upon an item or commodity for the purpose of financing specific types of facilities or services (e.g., the fuel tax used to finance highways)