An Issue Brief From:

Policy Matters Ohio

The Third Frontier Revisited:
Constitutional and Fiscal Implications of State Issue 1

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On November 8, 2005, Ohioans will be asked to vote on State Issue 1, a proposed amendment to the state constitution. Issue 1 is being placed on the ballot because it was passed as a joint resolution by the Ohio General Assembly.[1] The amendment combines three distinct programs. One of the programs is a revised version of the Third Frontier bond issue that was defeated at the polls in November 2003. This part of the amendment permits the state to issue up to $500 million in general obligation bonds to support research and product commercialization. The other two components of the amendment authorize the issuance of general obligation bonds for local public infrastructure projects ($1.35 billion) and for private site development ($150 million). In 2003, Policy Matters Ohio released a report that explained the legal and fiscal implications of the proposed Third Frontier amendment.[2] The purpose of this brief is to update the main findings of the earlier report in light of revisions to the language of the amendment and new estimates of its fiscal impact. The update will focus on the Third Frontier component of Issue 1. Policy Matters Ohio does not take a position on the issue.

Executive Summary

- The amendment permits the state, state universities, and local governments to become stockholders in private companies and to share in any resulting financial gains, overturning constitutional prohibitions that have been in place for over 150 years.

- The issuance of general obligation bonds to provide direct aid to industry is a departure from the historical use of public sector bonding authority. In the past, general obligation bonds have not been used to finance research and development activities, except for state-financed projects to promote the use of Ohio coal.

- The General Assembly has improved the amendment as compared to the 2003 version by requiring implementing legislation to include the accountability of state funding, ensuring that all of Ohio's regions receive benefits, and providing for access to the program by economically and socially disadvantaged individuals and businesses.

- Debt service for $500 million in state obligations for the Third Frontier portion of State Issue 1, as estimated by the Ohio Office of Budget and Management, will be $687 million over 17 years. Interest payments of $187 million comprise over one-fourth of this total.

- The amendment requires the General Assembly to restrict or limit the use of eminent domain to take property for ultimate use by private businesses.

[1] Amended Substitute House Joint Resolution No. 2, 126th General Assembly.
[2] *Exploring the Third Frontier: Constitutional and Fiscal Implications of Issue 1*, Policy Matters Ohio, October 2003.

- Debt service for state obligations issued for the Third Frontier and site development programs are not counted in the five percent constitutional debt limit. Although the state is unlikely to default on its debt, the state's commitment to make debt service payments may come at the expense of social services, education, and other discretionary programs during a financial crisis.

- State universities, local governments, and designated local economic development agencies will be permitted to issue bonds subject to authorizing legislation by the General Assembly. The General Assembly will determine what types of bonds may be issued (revenue or general obligation), in what amounts, and for which specific purposes.

- Although public attention has focused on the amount of the state bond issuance, a much closer relationship between the public and private sectors will be the enduring legacy of the amendment.

- Policy Matters Ohio recommends that if the amendment is passed, the implementing legislation should ensure the accountability of public funds used for Third Frontier projects by all levels of government, universities and other non-profits, and the private sector.

Overview

In the Third Frontier section of the amendment, the provisions giving the public sector the authority to issue bonds and redefining the manner in which government can interact with the private sector are nearly identical to the text used in 2003. New provisions of the amendment are related to the use of eminent domain, program oversight, and the distribution of Third Frontier program benefits. These new provisions are discussed below in the section titled "Accountability and Program Benefits."

As in 2003, the amendment makes support for research and product commercialization a public purpose under the Ohio Constitution, and permits the state, state universities, and local governments to use bonds and other sources of revenue to make grants, loans, loan guarantees, advances, direct investments, and in-kind contributions using personnel and property. The amendment permits the public sector to become a stockholder in a private company and to take an interest in any kind of private property, including patents, copyrights, royalties and licenses. Although much of the public attention has focused on the amount of the bond issuance, a closer relationship between public and private interests in economic development policy will be the enduring legacy of the amendment.

Direct public investment in the private sector

State Issue 1 will allow the public sector to become an investor in the private sector and to share in any resulting financial gains for purposes that fall within the Third Frontier or site development programs. The amendment specifies that these two purposes, whether financed through bonds or some other source of revenue, are not subject to Sections 4 and

6 of Article VIII of Ohio Constitution which prohibit public aid to private, for-profit businesses (see below).[3] The text elaborates on the wide range of methods that the public sector can utilize to accomplish its goals:

> Implementation of the research and development purposes includes supporting any and all related matters and activities, including…financial rights and matters such as royalties, licensing, and *other financial gain or sharing* resulting from research and development purposes.[4] [emphasis added.]
>
> The exercise of these powers by the state and state agencies, including state-supported and state-assisted institutions of higher education, and local public entities and agencies, may be jointly or in coordination with each other, with researchers or research organizations and institutions, with private institutions of higher education, with individuals, or *with private sector entities*. *State and local public participation may be in such manner as the entity or agency determines*, including by any one or a combination of grants, loans, including loans to lenders or the purchase of loans, subsidies, contributions, advances, or guarantees, or by *direct investments of or payment or reimbursement from available moneys*…either alone or jointly, in collaborative or cooperative ventures, with other public agencies and *private sector entities* including not for profit entities.[5] [emphasis added.]

To date, only the state's coal research and development program, which is established under a distinct constitutional provision, allows the state to share in any financial gains resulting from state financial assistance, and this provision only allows for grants, loans, and loan guarantees, not direct investments.[6] Giving the public sector the authority to make direct investments permits the state and local governments to become stockholders in private companies, overturning constitutional prohibitions that have been in place since 1852.[7] These prohibitions were the result of the state's disastrous experiences in the 1830s and 1840s in helping private companies to finance canals, turnpikes, and railroads.[8] They not only prohibited direct investment, but also prevented the state and local governments from giving aid of any kind directly to private, for-profit industry.

This arms-length relationship between the public and private sectors changed in the 1960s with the adoption of a constitutional amendment that allowed the state, political subdivisions, and designated non-profit agencies to use revenue bonds to make or

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[3] Am. Sub. H.J.R. No. 2, As Adopted by the Senate, division (E), lines 227-234.
[4] *Id*., division (D)(2), lines 153-161.
[5] *Id*., division (D)(2), lines 169-186.
[6] Section 15, Article VIII, Ohio Constitution.
[7] Sections 4 and 6 of Article VIII, Ohio Constitution. Note that the Bureau of Workers' Compensation and the state pension funds are not subject to these restrictions on investment because they do not manage "state" funds, but funds that are held in trust for injured workers or for retirees.
[8] David M. Gold. "Public Aid to Private Enterprise under the Ohio Constitution: Sections 4, 6, and 13 of Article VIII in Historical Perspective." University of Toledo Law Review, vol. 16, pp. 405-464.

guarantee loans to businesses for property and equipment.[9] Revenue bonds are not repaid with general tax revenue but from some other source, such as usage or regulatory fees, or income derived from a specific project. Currently, the state uses profits from its monopoly on the distribution of spirituous liquor to support its revenue bonds for economic development. Two existing Third Frontier programs are supported through liquor profits – the R&D Investment Loan Fund and the Innovation Ohio Loan Fund.

Since the 1960s, the state has become more aggressive in its interpretation of what kinds of economic development activities the constitution allows. The Department of Development's Edison Program, which was started in the 1980s, provides grants to support university-industry research partnerships and technical assistance programs to manufacturing. The Third Frontier Action program makes grants to venture and seed capital firms without becoming a stockholder or requiring a financial return from the recipient of financial assistance. In addition, the recently created Ohio Venture Capital Authority backs private investors' loans to venture capital firms with tax credits.

General Obligation Bonds and Debt Service

Once the amendment is approved, the General Assembly can pass implementing legislation to permit the state to issue general obligation bonds to support Third Frontier programs. General obligation bonds are repaid with general tax revenue and are backed by the state's pledge of its "full faith and credit." The state is obligated by contract to pay bondholders the full amount they are owed, regardless of the state's fiscal condition. Currently, the state constitution does not allow the issuance of general obligation bonds to provide aid to industry, except for research projects to promote the use of Ohio coal.

The constitution prohibits the state from issuing additional general obligation bonds if the state's debt service level for any future year exceeds 5% of expected revenues from the General Revenue Fund and net lottery profits.[10] The General Assembly may waive this prohibition with a three-fifths vote of each house. The amendment would exempt the Third Frontier and site development components of Issue 1 from this requirement, which is intended to protect the state's credit rating. Tom Johnson, Director of the Office of Budget and Management (OBM), stated in testimony before the Senate Finance and Financial Institutions Committee that the rationale for excluding the programs from the 5% calculation is that, "These programs will leverage additional federal and private dollars and it is important that these investments move forward without delay."[11] He added that "OBM has reviewed this proposal with the rating agencies and they have indicated that the increase in debt service from these programs, absent other changes in the State's financial position, would not adversely impact the State's credit rating."

[9] Section 13, Article VIII, Ohio Constitution.
[10] Section 17, Article VIII, Ohio Constitution.
[11] Tom Johnson, Director, Office of Budget and Management. "Testimony on S.J.R. 2, Proposed Constitutional Amendment Article VIII Section 2p," before the Senate Finance and Financial Institutions Committee, May 11, 2005.

In its most recent calculation of the state's debt service level, OBM projected it would reach 4.24% in FY 2007.[12] It is important to note that the amendment sets ceilings on state bond issuances but does not require the state to issue bonds. The General Assembly has the option of authorizing bond issuances at a level lower than that permitted in the proposed amendment. Also, the implementing legislation may be structured to give OBM the discretion to issue a lower amount than authorized, depending on the state's fiscal condition. There is little risk that the state will default on its general obligation debt service, absent a total economic meltdown. The state can always cut other programs to make room for debt payments. The risk of general obligation debt is that debt service will crowd out discretionary programs in difficult financial times.

Some of the bond payments for the Third Frontier and site development programs likely will be subject to federal income tax because a large share of the proceeds will benefit private industry. Therefore, the state will pay a somewhat higher rate of interest than otherwise would be the case for tax-exempt general obligation bonds. The Office of Budget and Management estimates that the difference in interest rates will be approximately one-half of one percent. Bonds issued by universities and local governments would be subject to the same tax treatment. The amendment lets the General Assembly determine in implementing legislation whether to allow universities and local governments to issue revenue bonds or general obligation bonds (or both) for the same purposes as the state.

The amendment prescribes annual caps on the amount of bonds that may be issued, in addition to the overall program limits. For the Third Frontier, $100 million may be issued in each of the first three years, and $50 million per year for four years thereafter. Site development bond issuances are also expected to follow a seven-year schedule. Public infrastructure issuances are expected to follow a ten-year schedule. The state does not expect to issue public infrastructure debt until state fiscal year 2008 because there is still room to issue approximately $240 million in debt under an existing constitutional section during state fiscal years 2006 and 2007.[13] This delay has not been lost on State Issue 1's critics, who have alleged that the public infrastructure ballot issue is not needed now and is merely being used as a vehicle to garner public support for the Third Frontier and site development components.[14] The Ohio Supreme Court ruled against a legal challenge to Issue 1 that sought to remove it from the ballot on the grounds that it violated the constitution's mandate that amendments be submitted separately to the voters.[15] The court found that the combination of the three programs in a single amendment was permissible because the three programs are all germane to the topic of job creation in Ohio.[16]

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[12] "Constitution Article VIII, Section 17. Determination and Certification by Governor's Designee." Office of Budget and Management." October 6, 2005. The debt service figure is recalculated for each new issuance. The 4.24% figure is a calculation of "highest future debt service" based on FY 2006 estimated revenues and debt service and the estimated debt service amount in FY 2007.

[13] Executive Budget for FYs 2006 and 2007. Table B-7, Summary of State Debt as of 6-30-04 and FY 2006 and 2007 Estimated Issuance Amounts, p. B-5.

[14] David Zanotti, "Issue 1 would rob Ohio taxpayers," *The Plain Dealer*, October 7, 2005.

[15] Section 1, Article XVI requires that amendments be submitted separately to the voters.

[16] *State ex rel. Willke et al. v. Taft,* ___ Ohio St.3d ___, 2005-Ohio-5503.

Table 1 shows the total amount of principal and interest that OBM estimates would be paid over the life of the programs. The estimates are based on a 5.75% interest rate and a 20-year term for the tax-exempt public infrastructure component, and 6.25% interest rate and a 10-year term for the other two components.[17] This scenario assumes that all of the Third Frontier and site development bonds will be taxable, which may or may not be the case depending on the implementing legislation. Recent state general obligation bond issuances have been in the range of 4.75% to 5.0% for bonds with 20-year terms. On the other hand, current interest rates on long-term capital markets are at historic lows, a situation that may not continue if central banks around the world tighten interest rates to keep inflation in check.[18]

Table 1. Total Projected Debt Service Amounts on Issue 1 Components (millions of $)

Component*	Principal	Interest	P&I Total**	Interest Amount Share of Total
Infrastructure Renewal	1,350	956	2,306	41.5%
Third Frontier	500	187	687	27.2%
Site Development	150	56	206	27.9%
Total	2,000	1,200	3,200	37.5%

*Note: Estimates assume one level payment each year and 20-year terms for infrastructure renewal bonds and 10-year terms for Third Frontier and Site Development bonds.
** The cumulative P&I Total is rounded by OBM.
Source: Payment amounts, OBM; Interest payment share, Policy Matters Ohio.

A detailed cost-benefit analysis of the Third Frontier bond issuance is beyond the scope of this paper. There are many different rationales for economic development programs, and it is not always the case that programs should be expected to pay for themselves in terms of their fiscal benefits for the state, even in the long run. Some programs aim their benefits at economically distressed regions or groups, for example, with the goal of generating employment or economic activity where private investment is lacking. In order to "break even" for the state from a fiscal standpoint, the $500 million in bonds issued for the Third Frontier would have to generate $687 million in additional state tax revenues over a 17-year period. This figure includes $187 million in interest payments, which will comprise more than one out of every four dollars of debt service over the life of the program.

Accountability and Program Benefits

The amendment contains new provisions that were not present in 2003. In response to the U.S. Supreme Court's controversial holding in *Kelo v. New London*, the amendment requires the implementing legislation to restrict or limit the use of eminent domain to take

[17] Information on OBM estimates was provided by Kurt Kaufman, Debt Manager for the State of Ohio, Office of Budget and Management.
[18] Greg Ip, Sebastian Moffett, and John E. Hilsenrath, "Era of Low Rates Around the Globe May Soon Be Over. Banks from Japan to Europe Ponder Tightening with Fed; Signs of Inflation Pop Up," *The Wall Street Journal*, October 13, 2005, p. A1.

property for ultimate use by the private sector.[19] Other requirements include "ensuring the accountability of all state funding" authorized by the amendment, as well as:

> provision for the implementation of the development purposes…to benefit people and businesses otherwise qualified for receipt of funding for the development purposes referred to in division (A) of this section, including economically disadvantaged businesses and individuals in all areas of this state, including the use to the extent practicable of Ohio products, materials, services and labor.[20]

The reference to accountability of all state funding in the text of the amendment is a significant improvement over the version of the amendment presented to the electorate in 2003. It is up to the legislature to give these provisions teeth, however. Even though the amendment only refers to state funding, the legislature also should take steps to ensure the accountability of public funds used by all levels of government, universities, non-profits, and private entities involved in research and product commercialization. In addition to accountability of public funds after they have been spent, it is also important to ensure that the selection process for investments and grants is competitive, transparent, and insulated from political pressures.

Additional understandings were reached between both political parties in the legislature and the Taft Administration that are not included in the text of the amendment but provide more detail for the implementing legislation. These understandings include:

- increasing the size of the Third Frontier Commission, the body that approves grants under the program, and ensuring representation from all areas of the state;
- requiring Third Frontier program awards to the private sector to go to Ohio businesses and providing for the repayment of benefits if the recipient does not stay in Ohio for at least three years after the grant period;
- specifying that research and development projects are subject to prevailing wage requirements;
- requiring the Department of Development to adopt a version of the Department of Administrative Services' Encouraging Diversity, Growth, and Equity (EDGE) program to assist socially and economically disadvantaged businesses.[21]

The concern about regional representation is a response to the fact that Third Frontier awards have been concentrated overwhelmingly in the Cleveland, Columbus, and Cincinnati metropolitan areas. The concern about social and economic inclusion is a

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[19] Kelo et al. *v*. City of New London et al.. U.S. Supreme Court. No. 04—108. Argued February 22, 2005–Decided June 23, 2005.

[20] Am. Sub. H.J.R. No. 2, As Adopted by the Senate, Division (F), lines 244-258.

[21] "Taft wins House backing for bond package; Senate endorsement expected Wednesday," *Gongwer News Service*, Ohio Report, Vol. 74, Rept. No 151, August 2, 2005. "Amended House Joint Resolution 2: Agreement in Principle," document provided by Senate Minority Caucus.

response to a pattern of making awards to large research institutions and high technology firms. According to an article in the Cleveland *Plain Dealer*, firms and institutions that received the approximately $325 million of Third Frontier grants disbursed as of August, 2005, report creating 1,562 jobs.[22] Job creation numbers for economic development programs are notoriously difficult to evaluate, especially when they are self-reported. If this report is taken at face value then these jobs come at an average cost of $208,000 each.

Conclusion

Ohio voters must carefully consider the implications of the amendment. It is always a serious matter to contemplate amending the constitution. The amendment is about more than just a state bond issuance and its fiscal implications. The Third Frontier also would change the constitution to permit a closer relationship between the public and private sectors in economic development. Given the state's economic climate and the perception that the state is falling behind the rest of the nation, Ohioans may be ready to support this policy approach. As an investor, the public sector could share in any gains that result from its investments, and may be better able to ensure that companies' actions conform to the public interest. Companies or ideas that have been unable to attract the attention of existing research and development funding sources or the venture capital industry may receive funding for products that otherwise would have been overlooked.

On the other hand, such broad-based empowerment of governmental authority comes with risks that must be weighed against the potential for positive outcomes. One of these risks is that general obligation debt will cause the public sector to make long-term financial commitments it cannot modify during a financial crisis. These commitments may come at the expense of social services, education, and other discretionary programs. Another risk is that public purpose become indistinguishable from private gain, and public funds are wasted in dubious schemes that do not produce any economic benefits for the state.

These negative possibilities are not inevitable outcomes of the amendment. The General Assembly modified the amendment since it was last on the ballot in 2003 in a manner that reflects a heightened concern with accountability and equity in the distribution of benefits. Properly addressing these concerns requires establishing a process for awarding Third Frontier financial assistance that is competitive, transparent, and insulated from political pressures. Economic development assistance should be given with clear, verifiable goals that allow the public to accurately track recipients' progress. Approval of State Issue 1 would mark a watershed in Ohio's economic development efforts. Whether the expanded authority of the public sector is used successfully will depend on the vigilance of the legislature and the appropriate state agencies in defining and tracking the public interest in economic development policy.

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[22] Becky Gaylord, "High tech, highways reach out for money: state bond proposal has its share of critics," *The Plain Dealer*, August 15, 2005, pp. A1, A4.

Policy Matters Ohio is a non-profit research institute dedicated to bridging the gap between research and policy in Ohio. Policy Matters seeks to broaden debate about economic policy by providing quantitative and qualitative analysis of issues important to ohio's working people. Other areas of inquiry for Policy Matters include work, wages, and benefits; education; basic needs; privatization, and tax policy. Generous funding has been provided by the George Gund Foundation, the St. Ann Foundation, the Nord Family Foundation, the Joyce Foundation, the Cleveland Foundation, Greater Cleveland Community Shares and other sources.

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