Executive Summary

On November 4th, Ohio voters will decide whether to amend the state constitution to broaden the ability of the state, state universities, and local governments to provide support for "research and the resulting product innovation, development, and commercialization…"[1] The amendment does not define these terms, but, taken at face value, they encompass activities that extend from basic scientific research to product testing and prototype development. A "yes" vote will allow the legislature to authorize the state to issue up to $500 million in bonds over the next decade to support these purposes. The amendment is supported by the Taft Administration as part of its "Third Frontier" economic development program.

This white paper from Policy Matters Ohio explains the legal and fiscal implications of the proposed amendment. The paper summarizes the proposed amendment, explains how bond proceeds might be used, examines trends in the state's debt service levels, and explores how the amendment will change the state constitution. Policy Matters does not take a stance for or against passage of Issue 1.

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 – Issue 1 involves many complex financial and legal issues. Some of the most important issues include the following:

- The amendment makes support for research and product commercialization a public purpose under the Ohio Constitution, and permits the public sector to use bonds and other sources of revenue to make grants, loans, loan guarantees, advances, direct investments, or in-kind contributions using personnel or property.

- Once the amendment is approved, the General Assembly can pass implementing legislation to permit the state to issue general obligation bonds. 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 financial condition. Currently, the state, but not local governments, can issue such bonds to finance research that increases the use of Ohio coal. Otherwise, the Ohio Constitution only permits the state to take on debt to finance direct aid to the private sector by using "revenue" bonds. Revenue bonds use non-tax receipts, such as the state's profits from its liquor monopoly, to repay bondholders.

- The principal rationale offered by the Taft Administration for the bond issuance is that the funds are needed for programs that finance operating expenses associated with research and product development. These expenses include wages and supplies needed to run a business or a research laboratory.

- State universities and local governments will be permitted to issue such bonds as well, subject to authorizing legislation by the General Assembly. The General

[1] Am. S.J.R. 1, lines 32-33.

Assembly will have the task of deciding what types of bonds may be issued (revenue or general obligation), in what amounts, and for which specific purposes.

- For decades, economic development programs have focused on financing facilities and equipment. The amendment clarifies the public sector's constitutional authority to support business' operating expenses, and to finance projects designed to create or acquire intellectual property. Although some state programs support these activities, current constitutional sections are not explicit, so the state has relied on Attorney Generals' opinions that have not been tested in court.

- Bond payments likely will be subject to federal income tax because some 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 general obligation bonds. The Ohio Office of Budget and Management estimates that the state would pay $190 million in interest over a twenty-year period if it were to issue $50 million in bonds each year for ten years at a 6.5% interest rate.

- In recent years the state has made grants to venture and seed capital firms without becoming a stockholder or requiring a financial return from firms' investments. The amendment creates an exception to constitutional provisions that prohibit the public sector from becoming a stockholder in a private business.

The approval of State Issue 1 will open a new era in Ohio's economic development policy. Both state and local governments will be empowered to devote more resources to research and product commercialization efforts and to engage in partnerships with the private sector that are far closer than those that exist today. 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 would be better able to ensure that companies' actions conform to the public interest. 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 purposes become indistinguishable from private gain, and public funds are wasted in dubious schemes that produce no economic returns for the state.

Certainly, these negative results are not inevitable outcomes of the amendment. Safeguards could be put in place to manage these situations properly. Nonetheless, the proposed amendment removes long-standing constitutional barriers that prevent the public sector from becoming a stockholder in private businesses. This is not a step to be taken lightly. If the amendment is approved, state and local governments must shoulder the responsibility of ensuring that the implementation of programs to support research, venture capital, and product development achieve their intended results.