

A REPORT FROM

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EXPLORING THE THIRD FRONTIER:
CONSTITUTIONAL AND FISCAL
IMPLICATIONS
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POLICY MATTERS OHIO, the publisher of this report, is a nonprofit, nonpartisan research institute, dedicated to bridging the gap between research and policy in Ohio. Policy Matters seeks to broaden the debate about economic policy in Ohio by providing quantitative and qualitative analysis of important issues facing the state. Other areas of inquiry for Policy Matters have included unemployment compensation, workforce policy, wages, education, housing and economic development. Funding for the institute comes from the George Gund Foundation, the St. Ann Foundation, the Cleveland Foundation, the Nord Family Foundation and other sources.

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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.

I. INTRODUCTION

On November 4, 2003, Ohio voters will decide whether to amend the state constitution to broadly expand the state's authority to issue debt. A “yes” vote will allow the General Assembly to authorize the state to issue up to \$500 million in general obligation bonds. If further authorizing legislation is passed, state institutions of higher education and political subdivisions would be able to issue bonds as well. The amendment will take effect immediately if approved. It is the capstone of Governor Taft’s Third Frontier Initiative, which includes a number of existing programs intended to stimulate high-tech economic development.

The programs listed below are the major official components of the Third Frontier. They are administered by the Third Frontier Commission, an inter-departmental board comprised of the Director of the Department of Development, the Governor’s Science and Technology Advisor, and the Chancellor of the Board of Regents.² The Commission is advised by the sixteen-member Third Frontier Advisory Board. By law, the membership of the board must include two legislators, nine business representatives, and five university representatives.³ Although the Commission and the Board must conduct their business in public under Ohio law, they are not required to take testimony or otherwise receive public input.

Third Frontier Action Fund

This program uses General Revenue Fund (GRF) resources to (1) make grants to support investment in start-up companies, and (2) to private companies, universities, and other organizations to partner together and advance the commercialization of new technologies and the Ohio fuel cell industry.⁴

Biomedical Research and Technology Transfer Fund

The BRTTF makes grants for biomedical research using funding from the settlement agreement of the multi-state lawsuit against tobacco companies.

Wright Brothers Capital Fund

This program is funded out of the state’s higher education bond issuances. Support is limited to capital assets at universities. Most of the funding is used to support Wright Centers of Innovation, which are collaborative efforts between universities and industry in specific technology areas. The remainder is used for smaller scale capital improvements that do not involve a Wright Center.

Innovation Ohio Loan Fund

² The Commission was established by the most recent capital budget bill (H.B. 675 of the 124th General Assembly). The Commission assumed the duties of the Biomedical Research and Technology Transfer Commission, which was abolished by the bill, and also assumed oversight duties over Department of Development programs associated with the Third Frontier.

³ R.C. 184.03.

⁴ See Part III for an explanation of the GRF.

This initiative is supported by economic development revenue bonds for which debt service payments are made out of state liquor profits. This program will make loans to existing Ohio firms for research and development.

Recently, the Taft Administration announced the creation of a Third Frontier Internship Program that is designed to place college students at private businesses. The program is funded with \$11.4 million in federal Workforce Investment Act resources during the current budget biennium.

The state maintains many other science and technology programs that are not officially part of the Third Frontier. For example, the Edison program funds non-profit organizations that foster industry-driven research at Ohio universities and research institutions and provide technical assistance to small manufacturers. The program also supports business incubators. The R&D Loan Fund Program provides loans to assist with the cost of equipment and facilities used in R&D. The state also provides many tax credits and tax exemptions in order to stimulate research and development (R&D) and investment in high-tech Ohio firms.⁵

Although much of the debate about Issue 1 will focus on the amount of the bond issue and its resulting debt service levels, Issue 1 is also an amendment to the state's constitution. The state bond issuance is only one of the amendment's provisions. Other provisions in the amendment provide a broad-based framework for how the state should relate to the private sector and foster economic development. The amendment reflects a desire for the public sector to take an active role in promoting the kind of "high-technology" economic development that has occurred in California's Silicon Valley, the Research Triangle in North Carolina, and, more recently, Austin, Texas.

Ohio's citizens should use this opportunity to engage in a wide-ranging discussion about the role of the public sector in the economy in the 21st century. Important questions need to be asked, many of which are beyond the scope of this paper. Do we want the state to be a source of venture capital? What are consequences for universities when they operate *de facto* industrial policies? How should we judge the success of the Third Frontier? What controls are in place to make sure that money is well spent? Regardless of the outcome of the election, such questions should be asked now and in the years to come.

The purpose of this report is to explain the legal and fiscal implications of Issue 1. A separate report issued by Policy Matters Ohio will review some of the projects supported

⁵ By way of example, an Ohio corporation might be eligible for any of the following: (1) the Technology Investment Tax Credit, which is intended to stimulate investment in technology-intensive Ohio-based companies (R.C. 122.15 to 122.154; 5733.35); a credit for a portion of the corporation's research expenses (R.C. 5733.351); a credit for loan repayments under the R&D Loan Fund Program (R.C. 5733.352); and credits for losses incurred on loans made under the Ohio Venture Capital Program (R.C. 5744.49).

through the Third Frontier Action Fund, which is the longest-running Third Frontier program. Policy Matters Ohio takes no position on Issue 1.

This introduction is Part I. Part II of the report explains how some of the bond proceeds might be used. Part III provides background information on general obligation bonds and trends in the state's debt service levels. Part IV provides historical background on the constitutional sections that define the public sector's authority to undertake certain types of economic development activities. Part V is the conclusion.

SUMMARY OF THE PROPOSED AMENDMENT

The proposed amendment would permit state agencies, including state institutions of higher education, and local public entities and agencies, to support the implementation of “science and technology based research and development purposes” (referred to in the amendment as “development purposes”). These public sector organizations may work in collaboration with each other and with the private sector. “Development purposes” include research and the resulting product innovation. The public sector may implement development purposes by “supporting any and all related matters and activities, including:

- Attracting researchers and research teams by endowing research chairs or otherwise;
- Activities to develop and commercialize products and processes;
- Intellectual property matters such as copyrights and patents;
- Property interests, including time sharing arrangements; and
- Financial rights and matters such as profit sharing, royalties, licensing, joint ventures, stock ownership, and other financial gain or sharing resulting from development purposes.”⁶

The amendment permits the public sector to use any form of financial participation: grants, loans (including loans to lenders or the purchase of loans), subsidies, contributions, advances, guarantees, direct investments, reimbursements, and providing in-kind staffing or material support. State and local public agencies may pay the costs of capital formation,⁷ direct operating costs, the costs of research and facilities, and support for public and private institutions of higher education, research organizations or institutions, and private sector entities.

The state is limited to issuing debt in an aggregate principal amount of \$500 million, no more than \$50 million of which may be issued in any fiscal year, except for the first fiscal year, during which \$100 million may be issued. Bond proceeds may not be used for coal research. State universities and local governments may also issue bonds, subject to authorizing legislation. The amendment also permits the state and local governments to use revenue from other sources for development purposes. The state bond issuance is exempt from certain other constitutional sections, including the state’s 5% debt service limit and the requirement that authorizing legislation provide a specific source of tax revenue sufficient to pay the interest and principal on the bonds.⁸ Actions taken pursuant to the amendment are not subject to constitutional prohibitions against public sector aid to private, for-profit organizations.⁹

⁶ Am. S.J.R. 1 of the 125th G.A., lines 39-47.

⁷ The precise meaning of “capital formation” is not clear, but presumably it refers to providing resources to seed and venture capital funds or helping companies raise capital in other ways.

⁸ Section 17, Article VIII, and Section 11, Article XII, Oh. Const.

⁹ Sections 4 and 6, Article VIII, Oh. Const.

II. WHAT MIGHT THE BOND ISSUANCE BE USED FOR?

Aside from coal research and development, state and local economic development activities that involve direct aid to private, for-profit businesses take place under the authority of Section 13, Article VIII of the Ohio Constitution, which was approved by the voters in 1965.¹⁰ Section 13 was passed to permit the state to issue revenue bonds for facility and equipment loans to industry. Beginning in the 1980s, public sector economic development practices expanded to include activities that probably were not intended or even anticipated by Section 13's proponents or by the electorate nearly forty years ago. These activities include direct grants to private industry, state and university support for venture and seed capital funds, and funding for private research and development activities, including support for operating expenses.¹¹ These new activities reflect government's desire to respond to the changing needs of the private sector. They also reflect a perception that competitive advantage in the new "knowledge economy" is created by intellectual capital and intangible assets as much as by physical facilities and equipment.

Frank Samuel, the Governor's Science and Technology Advisor, highlighted the need for governmental support of intellectual capital and research capacity in an August 2003 interview.¹² Samuel stressed that the objective of the proposed bond issuance in Issue 1 is to increase funding available to support operating expenses for technology-based economic development, and to make such funding available on a predictable basis. The Biomedical Research and Technology Trust Fund supports operating expenses for bioscience research, and the Third Frontier Action Fund uses GRF for operating expenses, but Samuel argued that more operating expense funding is needed for the Third Frontier. Because the major general-purpose Third Frontier program relies on appropriations from the state's capital budget, it is restricted to financing capital assets. Samuel argued that if the state were in better financial shape, the General Assembly could simply appropriate money from the GRF. But the state does not have other funds available, so the bonds are needed, he said. Samuel indicated that the Third Frontier Commission would seek the advice of the Third Frontier Advisory Board on how the money should be spent, but he expected that funds would be used to increase funding for existing programs, as well as to begin new ones.

¹⁰ The term "direct aid" is meant to include situations in which: public funds are loaned or granted to a business, either directly or through an intermediary organization; public funds are used to help a business gain access to funding on a more favorable basis than market conditions would otherwise allow; and when property or services are provided to a business at less than fair market value. This term is not meant to include general government services that may be essential for economic development, such as education or infrastructure construction, but are generally considered to be traditional functions of government.

¹¹ "Operating expenses" are all selling and general & administrative expenses. Expenditures for these items include wages, maintenance, office supplies. A "capital asset" is a long-term asset that is not purchased or sold in the normal course of business. Generally, it includes fixed assets, e.g., land, buildings, furniture, equipment, fixtures and furniture. "Capitalized costs" are business expenses that are written off or deducted over a period of time through depreciation or amortization schedules. Ventureline Accounting Glossary, www.ventureline.com.

¹² Interview with Frank Samuel, Governor's Science and Technology Advisor, 8-12-03.

One of the programs that is likely to be expanded if the amendment passes is the Eminent Scholars program administered by the Ohio Board of Regents. The program provides matching grants to universities to help them recruit leading scientists, who, it is hoped, will increase the amount and quality of external research grant funds flowing to Ohio universities.¹³ The program was started under Governor Celeste in the 1980s, but was discontinued under Governor Voinovich. Funding was restored during the FY 2000-01 budget biennium.¹⁴ Although not technically part of the Third Frontier, the proposal to recruit world-class scientists figures prominently in two major science and technology reports that provide a blueprint for the Third Frontier. In the Battelle Memorial Institute's report Innovation – The Future of Ohio's Economy, which was prepared for the Department of Development, a key recommendation is the establishment of "Centers of Innovation" that "[a]re expected to become both world-class research and development centers and places where new products are designed and developed in cooperation with Ohio's current and emerging industries."¹⁵ The report stresses that top-notch researchers are essential ingredients for the centers, and recommends that the centers

[c]ould be partially supported with \$500 million in a voter-approved bond issue for the operational costs of applied research and technology commercialization, and \$500 million for the capital funds (\$50 million a year over 10 years from the state's capital budget).¹⁶

Likewise, the Ohio Business Roundtable's report, World Class Ohio, contains the following recommendation for the bond issuance:

Use one-third of the fund to attract and support entrepreneurial scholars, world-class researchers with a track record of translating research and creating new companies and who are focused on the specific technologies areas identified in this prospectus.¹⁷

The Roundtable report recommends that two-thirds of the bond issuance be used for "commercialization engine programs" around the state.¹⁸ This concept is not well defined, but it appears to involve the state assisting local efforts to address perceived barriers to new company formation and technology commercialization, such as lack of seed and venture capital or insufficient technology transfer from universities. Since the state is already engaged in these activities, the major purpose of the bond issuance from the Roundtable's point of view seems to be the creation of more resources.

¹³ The program includes separate match components for operating funds and capital funds. In the FY 2003-2004 capital budget (H.B. 675, 124th G.A.), the program received an appropriation of \$2 million. In the FY 2003-2004 operating budget (H.B. 675, 125th G.A.) the program received an appropriation of \$1,462,500.

¹⁴ H.B. 215, 123rd General Assembly.

¹⁵ Battelle Memorial Institute, Technology Partnership Practice. Innovation – The Future of Ohio's Economy. An Ohio Technology-Based Economic Development Strategy. Prepared for the Ohio Department of Development. May, 2002. Cleveland, Ohio., p. xxi.

¹⁶ *Id.*, p. 101. See also p. 97, final paragraph.

¹⁷ Ohio Business Roundtable. World Class Ohio: A Prospectus for Achieving Success in the Third Frontier. June 2003, p. 6.

¹⁸ *Id.*

The membership of the Ohio Business Roundtable is well represented on the Third Frontier Advisory Board, so it is likely that these recommendations will carry some weight. In fact, some of the individuals who served on the task forces that wrote the Roundtable's report are members of the Advisory Board, including the Board's Chairperson, Mark Collar of Procter & Gamble. In total, five of the business members of the Board are from companies that belong to the Ohio Business Roundtable.¹⁹ In the end, however, there is no certainty as to which programs will receive bond proceeds, or whether any new programs will be started. As Frank Samuel indicated during the interview discussed above, these questions cannot be answered definitively until the General Assembly passes implementing legislation.

What type of business activities will receive public sector support?

One of the issues that implementing legislation must address is that it is unclear what types of business activities are meant to be encompassed in the meaning of the term "development purposes." This term is defined to "[i]nclude, without limitation, research and resulting product innovation, development, and commercialization..."²⁰ Since these terms are not otherwise defined in the amendment, we must look to their ordinary meanings. The term "research" has been defined for tax and accounting purposes in both state and federal law, and also in the field of economics.²¹ Although these definitions vary, in all of these contexts, the term implies a search for new knowledge or understanding. The concept has a definite boundary -- it does not include mere tinkering or making minor or cosmetic changes to a product or device.

It is much more difficult to interpret the terms "product innovation, development, and commercialization" because they are open-ended. The term "commercialization" in particular, is extremely vague. Just as the term "commerce" in Section 13 became a catch-all phrase that eventually led to the use of revenue bonds for projects to build rental housing units and commercial office buildings (items that were probably not intended at the time of Section 13's adoption), it is possible that the term "commercialization" will authorize activities that are far removed from actual research projects.²² This possibility is all the more real because the amendment specifically indicates that the "Implementation of development purposes includes supporting any and all related matters and activities..."²³ Does this mean that the state can support marketing studies, or a

¹⁹ These companies are American Electric Power, LEXIS/NEXIS, Owens Corning, Procter & Gamble, and PolyOne.

²⁰ See lines 31-33 of Am. S.J.R. 1, 125th G.A.

²¹ For example, for purposes of the technology investment tax credit program, "research and development" means designing, creating or formulating new or enhanced products, equipment, or processes, and conducting scientific or technological inquiry and experimentation in the physical sciences with the goal of increasing scientific knowledge that may reveal the bases for new or enhanced products, equipment, or processes." R.C. 122.15(G).

²² See Bd. of Cty. Commrs. of Lake Cty. v. Zupancic (1991), 62 Ohio St.3d 297, and Cty. of Stark v. Ferguson (1981), 2 Ohio App.3d 72.

²³ See lines 39-40 of Am. S.J.R. 1, 125th G.A., and the list of activities that follows. The list includes "activities to develop and commercialize products and processes," but this phrase does not help to further define the concept of commercialization.

marketing campaign for a new product? And when is a product considered to be fully commercialized and no longer eligible for public support – after the first sale, or when it has achieved widespread market acceptance? Obviously, it is not possible to predict all of the scenarios that might arise, but the scope of activities that may be permitted by this term is unclear.

PART III. BONDS AND DEBT SERVICE

General obligation bonds

General obligation bonds are backed by the full faith and credit of the state. Specific constitutional amendments spell out the purposes for which bond proceeds may be used and, with the exception of educational facilities, specify a limit on the total permitted amount of obligations.²⁴ They are typically issued to raise revenue for capital expenditures. The debt service for most general obligation bonds is paid out of the state's General Revenue Fund (GRF), which, as the name suggests, is the main repository for receipts from major sources of taxation such as the individual income tax, corporate franchise tax, and sales tax. The GRF serves as the major source of state funding for discretionary programs. The state has GRF-backed bond issuances outstanding for K-12 and higher education facilities, parks and natural resources, coal research and development (see below), local government infrastructure improvements, and conservation.²⁵ The state also issues general obligation bonds for highway capital improvements that are backed by the motor vehicle fuel tax and other highway user receipts. Ohio currently has the second highest debt rating from the three national bond-rating agencies.²⁶

To reassure potential investors that the state will honor its commitments, constitutional sections authorizing general obligation bonds permit the state to promise to make payments without legislative appropriations. In other words, debt service payments take precedence over discretionary program spending. There is the possibility that during a fiscal crisis excessive debt service will crowd out discretionary program expenditures, or cause bond-rating agencies to downgrade the state's debt, making it more expensive for the state to borrow money.

Lease-rental bonds

A second type of bond that may depend on GRF funds to meet debt service requirements is known as a "lease-rental bond." This type of bond is used to construct state buildings such as offices or prisons, and for certain capital facilities (e.g., mental health or recreational facilities). Lease-rental bonds are not backed by the full faith and credit of the state, but are nonetheless relevant for calculating the state's debt service ratio (the ratio of debt service payments to total GRF expenditures).

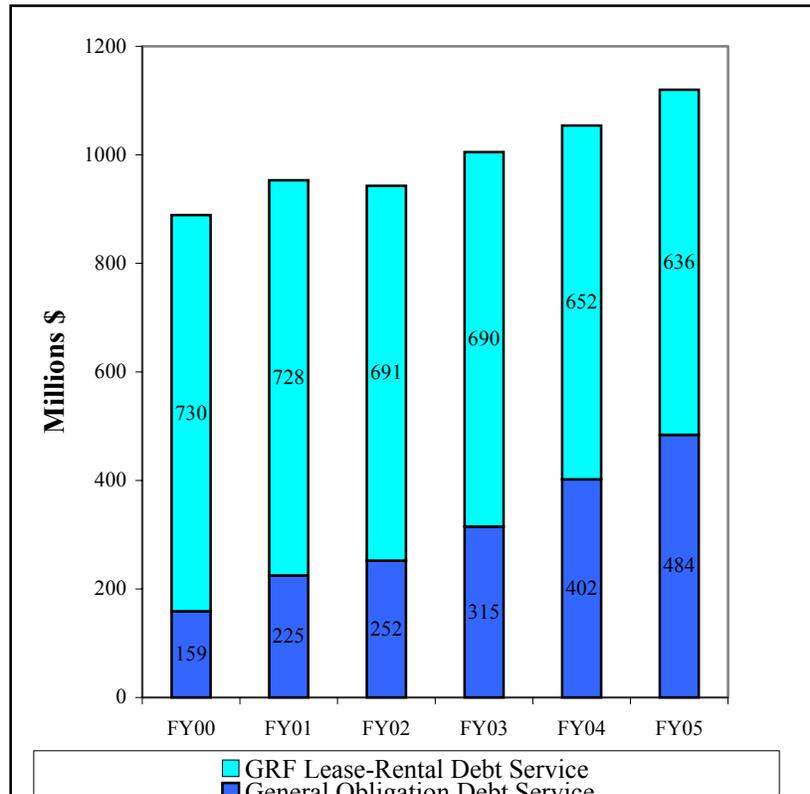
²⁴ Section 2n of Article 8 authorizes bond issuances for education.

²⁵ FY04/05 Executive Budget, p. B18-B20.

²⁶ "Ohio's credit status holds steady among bond raters," *The Columbus Dispatch*, July 11, 2003, p. B4.

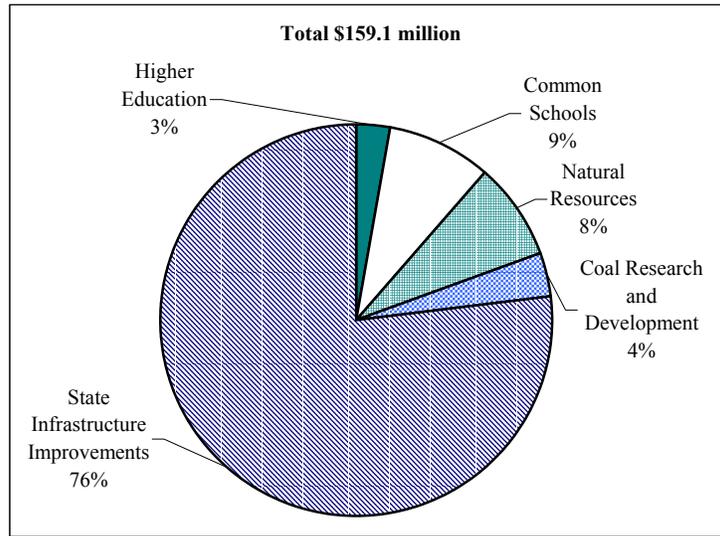
Because of a constitutional amendment passed in 1999, the state finances educational facilities (both K-12 and Higher Education) with general obligation debt, rather than lease-rental bonds, as formerly had been the case. For this reason, the amount of debt service on lease-rental bonds has declined, even though the debt service on these types of obligations is still larger than the amount needed for general obligation bonds. As shown in Figure 1, the total amount of GRF appropriations for debt service has grown from approximately \$889 million in FY 2000 to \$1.113 billion in FY 2005, driven by a substantial increase in general obligation debt. These statistics are not adjusted for inflation. Debt service appropriations for general obligation bonds have grown from approximately \$159 million to slightly over \$483 million during that same period. The figures for FY 2005 include the \$7.36 million appropriation for a projected \$50 million Third Frontier bond issuance that would take place in FY 2004. Figures 2 and 3 display changes in the composition of state general obligation debt over the FY 2000-2005 time period.

Figure 1. GRF Appropriations for Debt Service, FY00-05



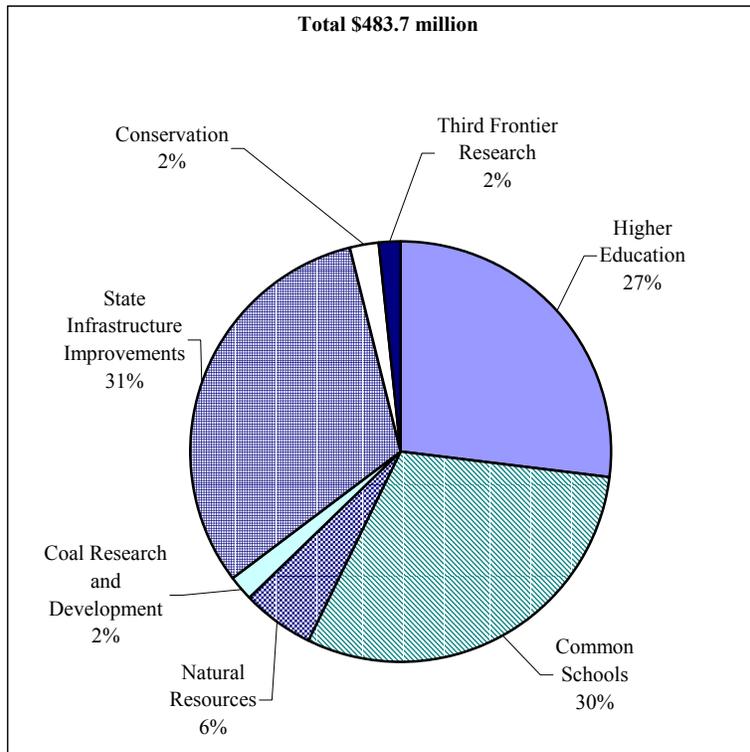
Source: Office of Budget and Management

Figure 2. Appropriations for General Obligation Debt Service, FY 2000



Source: Office of Budget and Management

Figure 3. Appropriations for General Obligation Debt Service, FY 2005



Source: Office of Budget and Management

Debt service created by Issue 1

Because the General Assembly must enact implementing legislation if Issue 1 passes, the precise amount of debt that would be issued is unknown. Nonetheless, the state operating budget for FY 2004-05, as enacted by Am. Sub. H.B. 95 of the 125th General Assembly, contains an appropriation of \$7.36 million for debt service on the proposed Third Frontier bond issuance. According to the Office of Budget and Management, this estimate is based on debt service for one year on the issuance of a total of \$50 million with a 10-year maturity, paying a taxable fixed-rate 7% interest, and a small cushion because of uncertainty about the amount of the issuance.²⁷ More recently, OBM issued another estimate based on bonds with a ten-year maturity and a taxable 6.5% interest.²⁸ In this scenario, interest payments would total \$190 million over twenty years on the \$500 million principal amount. The amount of debt service would peak at \$69 million in the tenth year after the first bond issuance, when the first year's issuances are retired and the final \$50 million is issued. Of course, interest rates cannot be predicted in advance. If the interest rate were 6%, interest payments would total \$170 million over twenty years; at 7.5%, they would be \$220 million.²⁹

The amendment specifies that the bonds are free from state taxation. In general, obligations issued by state and local governments are not subject to federal income taxes, but this may not be the case with Third Frontier bonds. The Third Frontier bonds are likely to be subject to federal income tax if more than 10% of the proceeds are transferred to the private sector.³⁰ Consequently, the state will have to pay a higher rate of interest on Third Frontier bonds than on other general obligation bonds.

The 5% debt service limit

Section 17, Article VIII of the Ohio Constitution prohibits the state from issuing additional obligations if the state's debt service level for any future year exceeds 5% of expected revenues from the GRF and net lottery proceeds. The General Assembly may waive this provision by a three-fifths vote of each house. The amendment proposed in Issue 1 would exempt the state's bond issuance from this calculation. In FY 2004, the state's expected debt service ratio is 4.26%. For FY 2005, if Third Frontier bonds are issued according to the scenario described above, the state's debt service ratio will be

²⁷ Personal communication from Kurt Kaufman, Debt Manager for the State of Ohio, OBM, to Policy Matters Ohio, July 17, 2003. The estimate assumes two payments of principal and interest each year.

²⁸ "Taft kicks off 'Third Frontier' campaign at OSU with nearly \$2 million already banked". Gongwer News Service Ohio Report, September 24th, 2003.

²⁹ Calculations by Policy Matters Ohio using the assumption that \$50 million in principal amount is issued each year over a ten-year period, with a fixed interest rate and two principal and interest payments each year.

³⁰ Bonds issued by a state or local government are considered taxable "private activity bonds" if they meet a private business use test, private security or payment test, or a private loan financing test. See 26 U.S.C. § 141 and also the *Internal Revenue Bulletin 2003-23 (June 9, 2003)*, p. 1004, "Notice of Proposed Rulemaking and Notice of Public Hearing, Obligations of States and Political Subdivisions, REG-113007-99."

4.38%.³¹ The long-term development of the state's debt ratio is difficult to estimate because it depends on many factors, including how much additional debt will be issued for other programs, and future interest rate movements. Nonetheless, substantial increases in debt will be difficult to sustain if the recent increase in the sales tax is allowed to expire as planned, and no alternative revenues are found.

\$50 million in budgetary perspective

In addition to considering the additional debt service that would be created by a Third Frontier bond issuance, it is useful to put the amount of the bond proceeds in perspective. In terms of the overall state appropriations, additional revenue of \$50 million each year that could be obtained through Third Frontier bond issuances is not a large amount. The Office of Budget and Management estimates that in FY 2005, GRF revenues from all sources will be slightly over \$24.9 billion.³² The state would actually receive slightly less than \$50 million from a bond issuance because of the transactional costs involved, such as underwriter's fees.³³ On the other hand, \$50 million would be a significant boost to many important state programs. Table 1 below lists some of the programs that are under the direction of the Department of Development (ODOD) and the Ohio Board of Regents (OBOR), the two major state departments involved in the Third Frontier. These programs are by no means the largest items in each agency's budget. For example, the State Share of Instruction in the Regents' budget, which is the basic method of providing operating support at state institutions of higher education, receives an annual appropriation level of over \$1.5 billion in the current budget biennium.³⁴ Nonetheless, the programs listed below are related to education, training, and workforce development, and are complementary to the goals of the Third Frontier.³⁵

³¹ Policy Matters Ohio calculation based on estimated total GRF revenues from all sources provided by OBM in *State of Ohio, Budget Highlights for Fiscal Years 2004 and 2005*, Table 1, p. 27. The calculation used \$637.9 million to estimate net lottery proceeds. This is the minimum amount specified in law for the Ohio Lottery Commission to transfer to the Lottery Profits Education Fund. Debt service levels were estimated using the general obligation and lease-rental appropriation amounts provided by OBM for Figures 1-3 above.

³² *State of Ohio Budget Highlights, Fiscal Years 2004 and 2005*, Table 1, p. 27.

³³ The actual amount of expenses for a bond issuance of \$50 million par value would be \$170,500 if the face value of each bond is \$5,000, but would rise to \$412,500 if the face value of each bond is \$1,000. These estimates are based on the fees charged from an Ohio Public Facilities Commission general obligation bond issuance. Most of the fees from underwriters and the various bond counsel are charged on a "per bond" basis. The total amounts also include \$100,000 in state expenses related to printing, mailing, travel, and rating agencies. Source: Policy Matters Ohio analysis of information provided by OBM.

³⁴ Am. Sub. H.B. 95, 125th G.A., Section 89, ALI GRF 235-501.

³⁵ Proponents of the Third Frontier have acknowledged that Ohio's education and training systems are a weak point in the state's economic development strategy. One of the four strategies suggested in the report by the Battelle Memorial Institute is to "Develop, retain, and expand the state's workforce to ensure a sufficient intellectual, entrepreneurial, and technical talent base." Battelle Memorial Institute, *op. cit.*, Table 18, "Ohio's Technology-Based Economic Development Strategies and Actions," pp. 88-89.

Table 1. Appropriation Amounts, Selected State-funded Adult Education and Training Programs³⁶		
Program	Description	FY 2005 Appropriation (millions)
Access Challenge (OBOR)	Subsidizes tuition restraint at designated campuses	\$ 67.6
Investment in Training Grants (ODOD)	Reimbursement of employer training expenses	\$ 12.2
Jobs Challenge (OBOR)	Provides grants to campuses to support partnerships with employers to train workers	\$ 9.3
Ohio Instructional Grants (OBOR)	Provides grants for tuition expenses to full-time college students based on financial need	\$ 115.3

Issuance of bonds by universities and local governments

Most of the public attention that the amendment has received has focused on the issuance of general obligation bonds by the state. The amendment also provides for the issuance of obligations by state institutions of higher education and by “local public agencies” and “local public entities.”³⁷ In general, universities and local governments that derive their authority from statute, such as counties and townships, will have to wait for authorizing legislation from the General Assembly. In the event that the General Assembly does not pass legislation providing for municipal bond issuances, municipalities may be able to issue bonds without specific state approval because of their “home rule” powers under the Ohio Constitution. Otherwise, the Ohio Constitution gives the General Assembly the authority to regulate the ability of municipalities to levy taxes and incur debts.³⁸ In its legislation, the General Assembly will have the task of deciding what types of bonds (general obligation or revenue) may be issued by universities and local governments, in what amounts, and for which specific purposes.

Uses of other revenue sources

Public sector organizations are not restricted to using bond proceeds in order to implement research and product commercialization. For example, one of the provisions of the amendment reads as follows:

³⁶ Amounts are rounded. Program descriptions are drawn from the 2003 LSC Redbooks for the Department of Development and Board of Regents. Appropriation amounts for FY 2005 are found in Am. Sub. H.B. 95 of the 125th General Assembly, Section 38 “DEV Department of Development” and Section 89, “BOR Board of Regents.”

³⁷ The meaning of the term “public entities” is unclear.

³⁸ Section 13, Article XVIII.

Those obligations and the obligations of local public entities or agencies issued for the development purposes referred to in this section, provisions for the payment of debt service on them, the purposes and uses to which and the manner in which the proceeds of those obligations *or money from other sources* are to be or may be applied, and other implementation of the development purposes as referred to in this section, are not subject to Sections 4 and 6 or Article VIII of the Ohio Constitution.³⁹ [emphasis added]

The amendment makes no specification as to what these other sources of revenue must be. Other references also make it clear that the amendment contemplates other sources of revenue.⁴⁰

IV. A BRIEF HISTORY OF STATE AID TO INDUSTRY IN OHIO

Ohio currently has only one constitutional section that authorizes general obligation bonds for direct aid to private, for-profit firms – Section 15 of Article 8. This section, adopted in 1985, permits the state to make grants, loans, and guarantees “[f]or research and development of coal technology that will encourage the use of Ohio coal, to any individual, association, or corporation doing business in this state, or to any educational or scientific institution in this state...” No more than \$100 million in principal amount of bonds may be outstanding at any one time. As of June, 2002, the state had issued coal research and development bonds with a total of \$137 million in principal since the amendment was adopted, of which \$49.2 million remained outstanding.⁴¹ Additional bonds in the amount of \$15 million are expected to be issued over the FY 2004-05 biennium.⁴² The General Assembly has appropriated \$16.4 million from the GRF to meet coal research debt service obligations over the FY 2004-05 biennium.⁴³

Before adoption of Section 15, general obligation bonds to directly aid private firms had not been issued in Ohio since the 19th century. Before the Civil War, Ohio and many other states became directly involved in financing canals, turnpikes, and railroads, thereby greatly increasing the state’s debts. Many of these ventures were failures.⁴⁴ In

³⁹ Lines 143-151, Am. S.J.R. 1, 125th G.A..

⁴⁰ See the following references in Am. S.J.R. 1: line 48, “State and local public moneys, *including* the proceeds of bonds, notes, and other obligations...”; lines 65-66, “[p]ayment or reimbursement from *available moneys*”; and, lines 72-77, “In addition to state level monetary participation as referred to in division (B) of this section *or otherwise...*” [emphasis added.] The provisions that reference bond issuances are permissive, not mandatory. It does not seem logical to suggest that the intent of the amendment is that the public sector must either issue bonds or take no action whatsoever to implement development purposes.

⁴¹ Executive Budget for FYs 2004 and 2005. OBM. Summary table for general obligation bonds, p. B-17.

⁴² *Id.*, Table B-7, p. B-25.

⁴³ Section 13, Air Quality Development Authority, AM. SUB. H.B. 95, 125th General Assembly.

⁴⁴ 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. See pp. 408-413 for a review of state and local economic development activities that led to the reforms of the Constitutional Convention of 1851. Gold’s article is the most comprehensive treatment of the evolution of the case law surrounding these three sections of the Constitution.

response, the Constitution of 1851 prohibited the state from taking on debt for these types of “internal improvements” (Sec. 6, Art. XII) and by prohibiting the state from assuming debts of political subdivisions or corporations (Sec. 5, Article VIII). Other sections of the Constitution of 1851 prohibited the state and political subdivisions from becoming a joint owner or stockholder in any private enterprise, and from giving or loaning credit to or for a private enterprise (Secs. 4 and 6, Art. VIII). In the early 20th century, the constitution was amended to permit the state to contract debts for internal improvement with specific constitutional approval. As a safeguard, an amendment was adopted that prevented the state or political subdivisions from incurring any bonded indebtedness unless implementing legislation provided a specific source of revenue to pay the debt and retire the bonds (Sec. 11, Art. XII).

Sections 4 and 6 of Article VIII, enacted in 1851, were intended to prohibit the state and political subdivisions from becoming entangled with private enterprise. Section 4, which pertains to the state, reads as follows:

The credit of the state shall not, in any manner, be given or loaned to, or in aid of, any individual [,] association or corporation whatever; nor shall the state ever hereafter become a joint owner, or stockholder, in any company or association in this state, or elsewhere, formed for any purpose whatever.

Section 6 contains similar language pertaining to political subdivisions. Sections 4 and 6 were the main barriers preventing public aid for private enterprise. Generally, Ohio courts were strict in their interpretations of Sections 4 and 6. Until passage of Section 13 of Article VIII, the state could provide financial assistance to other public entities or to a non-profit organization for a public purpose, but not to a private, for-profit entity, regardless of whether a public purpose was involved.⁴⁵ “Cases construing Section 6 of Article VIII have found that it forbids the union of public and private capital or credit in any enterprise whatsoever,” the Supreme Court noted in a recent decision, adding that “It does not matter that the public may, directly or indirectly, benefit from the enterprise.”⁴⁶

Section 13, Article VIII authorizes direct aid to industry and revenue bonds

By the 1960s, other states’ industrial recruitment efforts led Ohio’s manufacturers to transfer plants to the South and West. The triggering event for the campaign to adopt Section 13 was the Ohio Supreme Court’s holding in Saxbe v. Brand (1964) that the state, acting through the Development Financing Commission, could not use revenue bonds to make loans to private, for-profit corporations.⁴⁷ After the Saxbe decision, Governor James Rhodes led the effort to adopt Section 13, Article VIII of the Ohio Constitution, which the voters approved in 1965.⁴⁸ The campaign to win voter approval for Section 13 focused on the need for an industrial loan program that would not require

⁴⁵ O.A.G. 85-011, citing State ex rel. Saxbe v. Brand (1964), 176 Ohio St. 44.

⁴⁶ C.I.V.I.C. Group v. Warren (2000), 88 Ohio St.3d 37, p. 40. Rehearing denied, 88 Ohio St.3d 1489.

⁴⁷ See note 7. Gold, *op. cit.*, p. 448.

⁴⁸ *Id.*

the use of tax revenue.⁴⁹ Section 13 authorizes the state, its agencies, and designated nonprofits to issue revenue bonds, make loans and loan guarantees, and lend aid and credit to the private sector for economic development without being subject to the constitutional limitations of Sections 4 and 6. It was amended in 1974 to permit financing of pollution control and solid waste disposal equipment.⁵⁰ The section also extends the same authority to political subdivisions, and to non-profit corporations that are designated as agencies of a political subdivision.

The purpose of the aid must be for acquisition, construction, enlargement, improvement, or equipment of “property, structures, equipment, and facilities within the State of Ohio for industry, commerce, distribution, or research...” Public entities are not limited to the role of financiers. They can acquire, improve, and dispose of property directly if they wish.

Section 13 permits corporations to loan or contribute funds to public authorities but does not otherwise address the issue of public-private joint ventures and public sector stockholding.

To ensure that public entities were restricted to using revenue bonds, Section 13 provides that “[m]oneys raised by taxation shall not be obligated or pledged for the payment of bonds or other obligations issued or guarantees made pursuant to laws enacted under this section.” The section does not define tax revenue. Whether a specific revenue source is derived from taxation is decided by courts by looking at all of the circumstances involved in the collection and disbursement of a particular type of revenue. For example, the Supreme Court upheld the authority of a state agency to issue revenue bonds repaid with fees that were assessed in order to create a fund to pay the costs of cleanup and repair for leaking petroleum storage tanks.⁵¹ The Court was persuaded that the assessments were fees for a specific service, rather than taxes, because the fees were assessed only against the owners of tanks, were used only for specific purposes, and were never placed in the GRF. Moreover, tank owners were not charged an assessment if funds available to the agency exceeded a certain amount.

Soon after the enactment of Sec. 13, Article VIII, the legislature reenacted the industrial revenue bond program. The original implementing legislation also permitted political subdivisions to establish Community Improvement Corporations (CIC’s) to serve as non-profit economic development agencies that could issue revenue bonds in their own right.⁵²

⁴⁹ The Cleveland Plain Dealer cited state officials as saying that “No taxpayers’ money would be required to operate the program...” (“Issue No. 4 Aimed at Financing Industry,” Cleveland Plain Dealer, April 27, 1965, p. 3.) See also D. Gold, *op. cit.*, p. 453.

⁵⁰ Am. S.J.R. 22 of the 110th General Assembly, approved by the voters November 5, 1974.

⁵¹ State ex rel. Petroleum Underground Storage Tank Release Compensation Board v. Withrow (1991), 62 Ohio St.3d 111.

⁵² CIC’s are established according to procedures outlined in R.C. Chapter 1724. R.C. Chapter 165. governs the issuance of revenue bonds by the state and by CIC’s for which debt service is paid by income that results from a project financed with bond proceeds.

State loan programs under R.C. Chapter 166.

Currently, the state mainly uses liquor profits to fund debt service resulting from issuance of revenue bonds for economic development purposes. Proceeds from the sale of the bonds repaid with liquor profits are placed in the Facilities Establishment Fund, a special account that the Department of Development uses to make loans or loan guarantees (often referred to as “166 loans” because of their authorizing legislation in R.C. Chapter 166. of the Revised Code).

Over time, the General Assembly has increased the number of programs that receive funding using bond proceeds backed by liquor profits.⁵³ Some of these programs, such as 166 loans, are structured as “revolving loan funds,” in which the proceeds from loan repayments are recycled and used to finance additional loans, to retire existing debt before maturity, or to support new debt issuances. If they are managed skillfully, such revolving loan funds can become a long-term source of economic development funding. Spending authorized by Sec. 13, Art. VIII remains subject to the constitutional requirement that the General Assembly appropriate specific amounts for each program. Loans made by programs authorized by Chapter 166 (Facilities Establishment Fund Program, Innovation Ohio Loan Program, R&D Loan Fund Program) Program require Controlling Board approval.⁵⁴

What are liquor profits?

In Ohio, the state has a monopoly on the distribution of spirituous liquor. The Division of Liquor Control sets wholesale and retail prices for liquor. Liquor profits are gross profits that remain after paying the expenses of the Division of Liquor Control.⁵⁵ The Office of Budget and Management (OBM) determines the amount of liquor profits monthly, and transfers the determined amount to the GRF. The law does not require OBM to authorize a transfer. For this reason, liquor profits are not considered tax revenue.⁵⁶ A separate “gallonage tax” is imposed on liquor sales and placed in the GRF.

Outstanding principal and debt service on R.C. Chapter 166. bonds

As of June 30, 2003, there were \$246.19 million in principal amount of state loans and loan guarantees outstanding under R.C. Chapter 166. In addition, port authorities and other non-profits, acting as regional economic development agencies with state assistance, had issued an additional \$27.03 million principal amount of 166 loans, and

⁵³ The following programs receive appropriations from the Facilities Establishment Fund Group in the FY04-05 budget biennium: Innovation Ohio Loan Fund, Research and Development Loan Program, Facilities Establishment Fund, Rural Industrial Park Loan Program, Urban Redevelopment Loan Program, Family Farm Loan Guarantee, Capital Access Loan Program.

⁵⁴ R.C. sections 166.07, 166.16, 166.21.

⁵⁵ R.C. 4301.10(B)(4).

⁵⁶ The Supreme Court has held that liquor profits are not tax revenue and may be for debt service. Duerck v. Donehey (1981), 67 Ohio St.2d 216.

one guarantee of nearly \$2 million.⁵⁷ To support these obligations, the current state operating budget provides for debt service payments of over \$23 million this fiscal year, and for slightly over \$29 million in FY 2005.⁵⁸

The projected increase in debt service payments results from legislation to create two major revenue bond programs, the Innovation Ohio Loan Fund and the R&D Investment Fund. The latter program is structured as a loan program to help finance facilities and equipment for R&D projects. The two programs received combined total appropriations of over \$210 million for the current budget biennium.⁵⁹ The state issued the first Innovation Ohio bonds in summer of 2003. In anticipation of these increased demands, the General Assembly increased the annual limit on the amount of liquor profits that may be used for Chapter 166 loans from \$25 million to \$45 million.⁶⁰ At present, liquor profits seem adequate to cover the increased debt service, leaving approximately \$100 million remaining to transfer to the GRF.⁶¹

Given the available excess profits, the Taft Administration could have chosen to amend Section 13 to permit revenue bonds to be issued for operating funds for research and product commercialization, rather than seeking a general obligation bond issuance. There could be several reasons why it did not. Projected liquor profits may not be adequate to provide debt service for the entire \$500 million Issue 1 state bond request, especially if additional bonds are needed for existing programs. Also, revenue bonds require higher interest payments because they are not secured by the state's full faith and credit. Nonetheless, it does seem that the amount of available liquor profits could support an additional debt increase to provide part of the requested \$500 million amount.

Using other forms of aid or tax revenue as a source of aid under Section 13

Section 13 is silent as to use of grants as a form of aid, and on the use of tax revenue when state obligations or guarantees are not at issue. Moreover, the phrase "property, structures, equipment, and facilities," leads to an inference that the purpose of assistance is to finance capital assets, and not to support operating expenses.

In an interview given many years after the adoption of the amendment, Fred Neuenschwander, who was Director of Development under the first Rhodes Administration, stated that Section 13 was not meant to authorize making grants or using

⁵⁷ *Innovation Ohio Program. Preliminary Official Statement, Series 2003A Taxable Development Assistance Bonds.* 7-10-03, p. 13.

⁵⁸ The appropriation is in the Department of Commerce budget. Am. Sub. H.B. 95, Section 29, ALI LCF 800-633 "Economic Development Debt Service." Smaller amounts are allocated to pay the debt service on bonds issued for brownfield revitalization.

⁵⁹ Section 38, H.B. 95, 125th G.A., and Section 3, H.B. 1, 125th G.A.

⁶⁰ R.C. 166.11 as amended by H.B. 1, 125th General Assembly. Within the last year, the General Assembly has twice increased the limit on the principal amount of loans that may be issued under R.C. Chapter 166, first from \$500 million to \$700 million in December, 2002 (H.B. 675 of the 124th General Assembly), and then to \$800 million in June, 2003 (H.B. 1, 125th G.A.). H.B. 1 also increased the principal amount of bonds that may be issued from \$300 million to \$500 million.

⁶¹ Actual liquor profit transfers into the GRF (after bond service payments and other expenses) were \$115 million in FY 2003. OBM estimates that the transfer amount will decline to \$97 million in FY 2005. State of Ohio Budget Highlights, Fiscal Years 2004 and 2005. OBM, Table 1, p. 27.

tax revenue for financial assistance. Furthermore, aid was intended to finance capital assets only.⁶² Unfortunately, Section 13 was not explicit on these points. As a consequence of the section's silences and ambiguities, over time, a number of activities have been undertaken under the authority of Section 13 that probably were not intended by its promoters.

The evolution of permissible actions under Section 13, Article VIII

Table 2 above compares the state's authority under existing Section 13 to proposed Section 2p. From a legal standpoint, omissions and ambiguities in Section 13's text have set the stage for the Attorney General to give a series of opinions favorable to the expansion of public sector economic development activities. Although the Attorney General's opinions are based on case law concerning Article 13, some of the specific points of law discussed in the opinions have not been tested in court.

⁶² Telephone interview by D. Gold with Fred Neuenschwander, April 18, 1984, cited in Gold, *op. cit.*, pp. 453, 456, and 457.

Table 2. Summary Comparison of Section 13 and Proposed Section 2p		
Form of Aid	Section 13	Proposed Section 2p
Loan	Permitted by text	Permitted by text
Loan guarantees	Permitted by text if no tax revenue used	Permitted by text without restrictions as to revenue source
Grants	Term is not mentioned in text; AG opinions interpret section to permit grants for tangible and intangible assets	Permitted by text
Stock Ownership	Term is not mentioned in text; AG opinion permits grants to venture capital firms if the state does not receive any financial return	Text mentioned “direct investments” and “joint, collaborative, or cooperative ventures” with the private sector ⁶³
Joint Ownership	Term is not mentioned in text; The Ohio Supreme Court held that a joint venture the complies with Section 13 is permissible ⁶⁴	
Purpose Of Aid	Section 13	Proposed Section 2p
Tangible assets	Text permits certain kinds of support for “property, structures, equipment and facilities within the State of Ohio for industry, commerce, distribution, and research”	Text permits payment for “costs of research and facilities” and support for public and private institutions of higher education, research organizations, and private sector entities
Intangible assets	Term is not mentioned in text; AG interprets “property” to include intangible assets	Text permits support for “intellectual property matters such as copyrights and patents”
Working capital (operating costs)	Term is not mentioned in text; AG interprets case law construing the terms “property” and “commerce” to include working capital	Text permits payment for “direct operating costs,” “attracting researchers and research teams,” and “activities to develop and commercialize products and processes”

⁶³ See lines 61-71 of Am. S.J.R. 1.

⁶⁴ Ryan v. Gahanna (1984), 9 Ohio St.3d 126, concerned a city that used municipal bonds to finance the construction of an industrial park, and subsequently permitted tenants at the park to lease the property at favorable rates. The Ohio Supreme Court held that the action was invalid because the city pledged its tax revenue to repay the bonds. The Court held that leasing the property at favorable rates constituted a “joint venture” between the city and private corporations, and noted that the project would have been valid if the city had not pledged its tax revenue to repay the bonds. Favorable lease terms would seem to be a lending of aid, and not a joint venture, however. The court did not consider whether the lease created a merger public and private property as in Eichenberger v. Neff (1974), 42 Ohio App.2d 69.

Revenue Sources	Section 13	Proposed Section 2p
Tax revenue as a source of aid	Prohibits the use of tax revenue to make guarantees	Does not limit public sector support to a specific revenue source; explicitly permits the state to issue general obligation bonds; permits local governments to issue bonds and does not require the use of revenue bonds
Tax revenue as a source of bond repayments	Prohibits the use of tax revenue to pay for bonds or other obligations (requires the use of revenue bonds serviced by non-tax revenue, e.g., liquor profits)	

Section 13 and the authority to make grants

In the 1970s, the Department of Development began to use an additional industrial recruitment tool – “industrial inducement grants.” These grants used GRF funds that in some cases were given directly to private, for-profit corporations, and in other cases were passed through public entities or non-profit corporations before being given to private, for-profit corporations. The program, now known as the Business Development Grant program, is reauthorized in the uncodified (temporary law) sections of successive biennial budget bills. The program has been appropriated \$8.9 million per year over the current budget cycle.⁶⁵

The industrial inducement grant program raised constitutional issues not only regarding the use of grants as a form of aid, but also as to the permissibility of using tax revenue as the source of assistance. The Department received a favorable opinion from the Attorney General about this program in 1985.⁶⁶ The specific grants at issue in the opinion included expenditures for the acquisition of real property, site improvements, and a water treatment plant. The opinion concluded that the grants were within the authority of Section 13 because they were given to finance “property, structures, equipment and facilities within the state for industry and commerce.”⁶⁷ The opinion went on to state that Section 13’s prohibition against using tax revenues when borrowing or making guarantees “[d]oes not purport to preclude the expenditure of *current tax revenues* for the purpose of *making loans* or *otherwise lending the aid or credit of the state* for the purposes authorized in § 13” [emphasis added].⁶⁸

Grants for intangible property and ownership interests under Section 13

In 1994, ODOD began to make grants using GRF moneys to the National Center for Industrial Competitiveness, a Dayton non-profit organization that was funded primarily by the federal government. Funding has since been discontinued. NCIC’s purpose was

⁶⁵ Sections 38 and 38.04, Am. Sub. H.B. 95, As Reported by the Committee of Conference.

⁶⁶ O.A.G. 85-011.

⁶⁷ *Id.*, p. 2-44.

⁶⁸ *Id.*

to promote “defense conversion” in the wake of the cold war by using loans, guarantees, and direct investments to help defense contractors to diversify and to assist in the formation new high-tech businesses. The NCIC situation was different from the Business Development Grant program in that NCIC conducted business like a financial firm and sought to use its revenues to fund additional assistance. The ODOD asked the Attorney General whether this arrangement violated the stockholding prohibition in Section 4, Article VIII. In addition, the NCIC sought to take an interest in intellectual property that resulted from research, which raised the issue of whether intangible property was encompassed within the meaning of the term “property” in Section 13, Article VIII.

In a 1998 opinion on ODOD’s funding of the NCIC, the Attorney General stated that intellectual property was encompassed within the meaning of the term “property” as used in Section 13, Article VIII, reasoning that in the absence of a limiting definition, or specific qualifying language, the word should be given its common meaning “that can encompass everything that is owned.”⁶⁹ Therefore, acquisition of such property using state funds was permissible as long as its use fell within the prescribed purposes of Section 13, Article VIII (industry, commerce, distribution, or research). The opinion stated that the NCIC’s practice of making loans and taking equity interests was not a violation of Article 4’s prohibition against stockholding provisions because the NCIC did not share its financial returns with the state, and was not acting as an agent of the state. Moreover, the opinion went on to mention that Section 13, Article VIII contained specific language exempting actions taken under its authority from the stockholder prohibitions of Section 4 and 6, or any other prohibition in Article VIII:

Under the plain language of Ohio Const. art. VIII, § 13, action taken pursuant to that provision is not subject to the requirements, limitations, or prohibitions of any other section of Article VIII. The stockholding prohibitions with which you are concerned appear in Ohio Const. art. VIII, § 4, and, thus, are rendered inapplicable to situations governed by Ohio Const. art. VIII, § 13.⁷⁰

It is not certain that a court would agree with this last point. The “plain language” of the clause of Section 13 referred to in the quotation above uses the terms “[b]onds, obligations, loans, guarantees and the lending of aid and credit...” but never uses the terms “stockholder” or “joint owner” as found in Section 4. To date, state agencies have not used this implied authority to invest directly in private firms. Instead, the Department of Development provides grant funding to private seed and venture capital companies through the Technology Action Fund (now the Third Frontier Action Fund). These companies invest the funds but do not share any financial returns with the state. This program also gives grants to private companies, universities, and other organizations to partner together and advance the commercialization of new technology and the Ohio fuel cell industry.

⁶⁹ O.A.G. 98-034, pp. 26-27.

⁷⁰ *Id.*, p. 22.

Support for operating expenses under Section 13

In 2000, the ODOD received an opinion from the Attorney General regarding a “capital access program” that was in the planning stages.⁷¹ Under the program, the ODOD would place funds into a reserve account that would guarantee a portion of a bank’s losses on loans to small business borrowers. The loans were ultimately to be used for “working capital” (i.e., operating expenditures). The issue of loan guarantees was a familiar one, and, in keeping with earlier opinions and case law, the Attorney General advised that the ODOD could guarantee the loans under the authority of Section 13 as long as tax revenues were not used. The issue of whether working capital was a permitted purpose of guarantees under Section 13 had not been previously considered by the Attorney General.⁷² The ODOD provided the following definition of working capital to the Attorney General:

Working capital is used to fund current operations and may include, but is not limited to, payroll and payroll taxes, trade payables, accrued liabilities, inventory, computer software and hardware, rolling stock, small tools and short term equipment purchases.⁷³

The opinion reviewed relevant case law, noting that courts had permitted expenditures under Section 13 “[f]or a wide variety of property, including intangible property, and to authorize the support of a wide variety of enterprises, including commercial services and retail operations.”⁷⁴ The opinion concluded that providing working capital was a permitted use of funds under Section 13. Unfortunately, the opinion did not separately consider various kinds of operating expenses. Most importantly, the issue of whether payments for employee wages or payments for personal service contracts may be considered “property” as that term is used in Section 13 deserves specific, careful consideration. From the standpoint of the small business borrower who hires an employee, the employee’s services result from a contract, but the employer does not have the legal rights to possess or dispose of the employee’s services (key elements of property). If an employee’s services are not “property” as that term is used in Section 13, then it is difficult to see how payments for such services are authorized by Section 13. Clearly, personal services do not fit under Section 13’s other authorized expenditures -- “structures, equipment, and facilities” -- as those terms are commonly understood.

From the perspective of public support for R&D programs, this opinion might be reconciled with Section 13 by viewing an R&D project as an attempt to create intangible property, such as a patentable product or process. Certain operating expenses will be incurred in the course of the project, just as they would for a building (e.g., architectural design). Nonetheless, not every R&D project results in a patent, or even in intellectual

⁷¹ O.A.G. 2000-13.

⁷² Gold, *op. cit.*, pp. 455-57, notes that the Ohio Thomas Edison program, which provides GRF-funded grants for industrial research projects that are carried out at universities and permits the state to share in any resulting financial gains, also raises similar constitutional issues to the NCIC and Capital Access Program. The Third Frontier Action Fund’s grants to firms for R&D projects would seem to raise the same concerns.

⁷³ O.A.G. 2000-013, p. 13, from *Black’s Law Dictionary* 1605 (6th ed. 1990).

⁷⁴ *Id.*, pp. 17-18.

property. State support for general operating expenses that are not tied to any specific R&D project remains difficult to reconcile Section 13.

Nonetheless, the opinion reinforced the expansive interpretation of the term “property” as used in Section 13. The General Assembly passed enabling legislation for the Capital Access Program in 2001. In the current budget, the program will receive a \$3 million appropriation each fiscal year from the Facilities Establishment Fund.⁷⁵

In the nearly 40 years since Saxbe v. Brand, Ohio’s economic development policies have evolved from a situation in which the state was prohibited from providing assistance to a private, for-profit firm for any purpose, to a situation in which the state provides funding for venture capital investments, gives grants directly to firms for physical infrastructure and for operating expenses in R&D projects, and provides loans and loan guarantees through various programs authorized under R.C. Chapter 166. This expansion of activities has been permitted by Attorney General opinions that have not been tested in court.

The major prohibition in Section 13 that is still left standing is the prohibition on the use of tax revenue to pay for bonds. If Issue 1 is approved, this would seem to be the clearest constitutional change to Section 13. With respect to Section 4, the amendment would remove prohibition against the public sector becoming a stockholder. Otherwise, the proposed amendment provides explicit authorization for many of the economic development activities discussed above so that, to a certain extent, the ambiguities or omissions of Section 13 will no longer be at issue when the state assists activities related to research and product commercialization. For these activities, it would be clear that the state may provide funds for operating expenses, give grants, and invest directly in firms.

⁷⁵ Section 38, Am. Sub. H.B. No. 95, 125th General Assembly, As Reported by the Committee of Conference.

V. CONCLUSION

Ohio's citizens are being asked to vote on an amendment to the state's constitution that authorizes the state to issue up to \$500 million in general obligation bonds. The state will back these bonds with its full faith and credit. By law, the state must meet debt service payments for this type of bond regardless of its financial condition. The bond issuance would provide additional funding for Governor Taft's Third Frontier project, which includes existing programs that support research and development, product commercialization, and high-technology start-up companies. Supporters' principal rationale for the bond issuance is that the funds are needed to support day-to-day expenses of running a business or research laboratory, and to recruit world class researchers to Ohio.

The Ohio General Assembly must pass implementing legislation for the bonds to be issued. Assuming the state will issue bonds worth \$50 million each year for ten years at an interest rate of 6.5%, OBM has calculated that debt service payments will total \$190 million over a twenty-year period. Interest payments on Third Frontier bonds probably will be subject to federal income tax if more than 10% of the proceeds are used for private business purposes. They will be free from state taxes at all times, however.

Most of the public's attention has focused on the authorization for a state bond issuance, but this is not the only significant provision in the amendment. The amendment also permits the public sector to use other revenue sources for research and product commercialization. Long after the state's general obligation bonds have been retired, the other provisions of the amendment will remain in force. The enduring objective of the amendment is to make public support for research and product innovation, development, and commercialization a public purpose under the Ohio Constitution. To pursue this purpose, the public sector can assist businesses in nearly any manner it chooses, including grants, loans, guarantees, direct investment, or in-kind staffing or material support.

The amendment also gives local governments and state institutions of higher education authority to issue bonds and to participate generally in supporting research and product development. The precise details of this authority will have to be worked out by the General Assembly in implementing legislation. The General Assembly could allow local governments to issue general obligation bonds to support research purposes.

Direct public aid to the private sector currently takes place under Section 13, Article VIII of the Ohio Constitution. This amendment was passed in 1965 to allow state and local governments to make loans to private companies for facilities and equipment. Section 13 permitted the public sector to issue revenue bonds that would be repaid with revenue sources other than taxes. Over time, the state diversified its economic development programs. Certain state programs now use grants, instead of loans, and finance operating costs and intellectual property, not just capital assets. In recent years, the state has given grants to venture capital firms without expecting any financial return. The state's authority to use these expanded powers largely rests on Attorney General opinions that

have interpreted points on which Section 13, Article VIII of the Ohio Constitution is silent, or unclear. The amendment would clarify the authority of the public sector to undertake these forms of support when dealing with research and product commercialization activities.

The proposed amendment authorizes a clear departure from current practice, however, by exempting public support for research and product commercialization from prohibitions in Sections 4 and 6 of Article VIII of the Ohio Constitution that prevent the public sector from becoming a stockholder in private businesses. These prohibitions have been in the state constitution since 1851. They were enacted to avoid repeating the state's and local governments' disastrous experiences in trying to support railroads and canals with public funds in the early 19th century. It is not possible to predict whether the General Assembly would choose to make use of this power in the implementing legislation, but the authority is there to be used in the future.

The economy has changed greatly in the last 150 years. With the appropriate safeguards, the experiences of one era need not be repeated in another. Ohio's citizens should use the amendment as an opportunity to debate the public sector's role in the economy generally and to think about how the public sector can help or hinder economic growth and diversification. The amendment gives the public sector more leeway to develop a closer partnership with the private sector in pursuing research and technology commercialization. This would be the amendment's enduring legacy.

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