CHAPTER 11

GOVERNMENT SPENDING: SMOKE & MIRRORS

Paul H. Brewbaker

PAUL H. BREWBAKER
Economist
Bank of Hawaii

LOWELL L. KALAPA
President
Tax Foundation of Hawaii

Randall W. Roth

RANDALL W. ROTH
Professor of Law
William S. Richardson
School of Law
University of Hawaii

Marcia Y. Sakai

MARCIA Y. SAKAI
Assistant Professor
Business Administration
and Economics Division
University of Hawaii at Hilo

"How much does our state government spend each year?"

You have asked a simple question and you probably expect a simple answer. Instead, we will tell you about the Hawaii State Legislature's increasing use of practices that obscure the level of state spending and thereby make it impossible to give you a simple answer.

We begin by emphasizing the importance of a straightforward budget process. It allows bureaucrats to keep track of government finances and helps politicians understand what they can and cannot afford. Equally important, it promotes accountability by providing voters with the basic information to evaluate the job being done by their political leaders. Practices that make it difficult to understand the budget process should be followed only when there is a good reason.

The practices that we are about to detail obscure the budget process without providing a benefit. Because of them, voters are likely to think (1) the level of state spending is lower than it really is, (2) there is no surplus at a time when that may not be true, and (3) taxation has been no higher than necessary to fund current policy initiatives.

Special (and revolving) funds. Most government receipts go into what's called the general fund. This supports schools, health care and sanitation, public safety, welfare and other day-to-day operations of government. But a growing amount gets put into separate accounts, referred to as special and revolving funds.

The size of the general fund is important. The two most important reasons for our purposes relate to provisions of the Hawaii State Constitution. The first places a "spending ceiling" on the amount of general funds that can be appropriated in any year. The second sometimes mandates a rebate when there is a substantial surplus of general funds. We'll tell you more about these constitutional provisions later.

Special funds usually are financed by revenues from a specific source and earmarked for a specific purpose. One example is the highway special fund financed by fuel taxes, vehicle-weight taxes, and registration fees, and used only to build and maintain roads. Another example is the airports special fund obtained from landing fees, concessionaire lease payments and aviation fuel taxes, and used only for airport-related needs. Revolving funds are similar to special funds, but typically are established with an initial lump-sum allocation or with a series of installments. These amounts are then made available to particular programs which are expected to replenish the fund. An example is the $120 million loan that provided a kick-start to the State's affordable housing program. To keep our explanation reasonably simple, we will treat revolving funds as a type of special fund (since the effect for our purposes is the same).

Special-fund balances do not revert to the general fund each fiscal year but are carried forward to be used in future years. Because special funds traditionally involve activities that generate their own revenue, they are left on their own to operate with less frequent legislative review.

The usual reasons for using special funds are to target a tax so that a specific project (such as road repairs) is paid for by the direct beneficiaries (such as users of the repaired roads) and to insulate certain basic functions from economic or political influences.

The spending ceiling. In an attempt to keep government expenditures in line with taxpayers' ability to pay taxes, the Hawaii State Constitution puts a limit on increases in expenditures from the general fund. The "ceiling" is based on a fixed formula. There is, however, considerable flexibility. The legislature can exceed the spending ceiling by putting a public spotlight on this phase of the budget process and approving any such action by a two-thirds vote, rather than the usual majority. That's the proper mechanism for exceeding the ceiling.

The loophole. The legislature, to avoid this public spotlight and tougher voting requirement, has exploited a loophole. By simply reclassifying an arbitrary amount of general funds to special-fund status, the level of general-fund appropriations drops "magically" (as professional illusionists like to say), typically to an amount comfortably below the constitutionally mandated spending ceiling. Has spending been reduced? Of course not. Has the spending ceiling been exceeded? Technically no. Do smoke and mirrors hide reality from the taxpayers?

Before answering this last question, we will share a quote from the Hawaii State Tax Review Commission. Using the gentle language one expects from an eclectic, nonpartisan body, the commission put it this way: "Special funds that merely set aside general fund revenues for general fund expenditures cannot be justified; they restrict budget flexibility, create inefficiencies, and lessen accountability. The purpose for such funds may be laudable and worthwhile, but the use of this type of special fund is not. Desired programs and services can be given priority under the normal budget process without resorting to this type of financing." This is a nice way of telling legislators that their hand has been caught in the cookie jar. If they want more cookies they should ask for them properly.

The commission's concerns led to a visit by the legislative auditor. Among other things, this government watchdog recommended that the 1992 legislature stop using 22 of the many special and revolving funds then in use. Unfortunately, the recommendations were deferred just as they had been the year before.

Another consequence of reclassifying general funds is that only general funds are counted in applying the mandatory rebate provision. By pumping money into special funds, the legislature avoids being forced to rebate taxes to taxpayers.

Lawmakers are understandably reluctant to give back money that was politically difficult to raise. Tucking that money away in a special fund increases the chances that their constituents won't expect its return or demand that it be used in a particular way. In this fashion, the legislature during the late 1980's and early 1990's was able to create the illusion that taxes were producing just enough revenue to run the state, rather than generating a surplus.

Another questionable practice. The legislature uses another back-alley to avoid the public spotlight—going over the constitutional spending ceiling without declaring how much in aggregate the ceiling is being exceeded. This occurs because additional, and by themselves small, spending bills come to the floor for approval *after* the legislature has voted to exceed the spending ceiling. This follows the letter but not the spirit of the constitution. Once totaled, the many "small" appropriations during the 1989-1991 fiscal biennium exceeded the spending ceiling by $500 million! That doesn't take into account the even larger amount that was diverted into special and revolving funds!

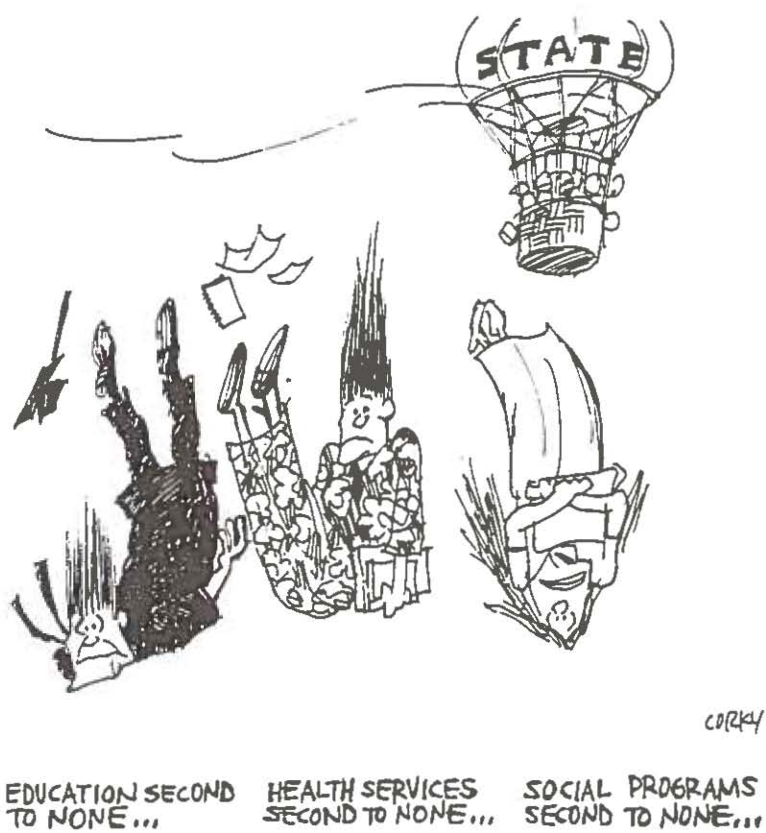
Are we advocating a tax cut? Not necessarily. We're mostly interested in open and honest accounting. If our elected representatives want to exceed the constitutional spending ceiling properly (under a public spotlight and by a two-thirds vote) and within the spirit of that provision (by making clear the extent to which the ceiling is being exceeded), they can do so. In some situations, it may be highly desirable that they go through the ceiling. But it should not be done in ways calculated to mislead.

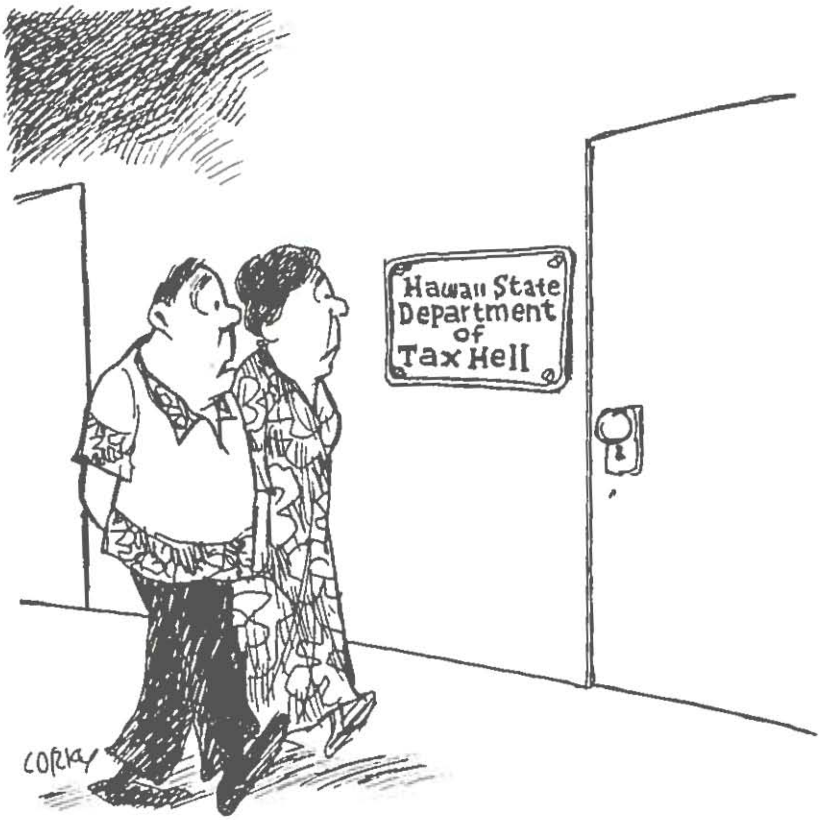
Special funds have become a New Age pork barrel for a variety of otherwise laudable initiatives that for some reason can't seem to stand normal budget scrutiny. Some are one-shot deals, designed to hide fat as an alternative to tax-rebate liposuction. Others commit the State to general fund revenue diversions lasting five, seven or even ten years.

General funds diverted into special funds during good times are generally not returned during the bad. The wrong programs get cut first when money is tight. Basic public services are likely to suffer most.

And there is the problem of raised expectations. People quickly grow to rely on the public services made possible by special funds and excess spending. What will happen when revenues fall or don't keep up with spending demands? Perhaps the "piggy bank" of special funds can be tapped. But if that money runs out, will the illusion vanish into a call for tax increases to avoid the pain of eliminating services?

Primary issue is honesty. According to many in the legislature, the spending ceiling "gets in the way." After all, if the money is there (and it certainly was in the late 1980s and early 1990s) why not use available loopholes to fund worthwhile special programs as they come along? The simple answer is that government should be honest with the people it governs.





"AFTER A WHILE, WE GET INURED TO THINGS..."