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STATE TREASURER OF OHIO

Ohio Constitutional Modernization Commission
Committee on Finance, Taxation, and Economic Development

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Introduction

Chairman Cole and members of the Finance, Taxation & Economic Committee – good morning. Thank you for the opportunity to appear before you on behalf of Treasurer Josh Mandel to provide some thoughts regarding certain aspects of Article VIII of the Ohio Constitution. I will be providing an overview of the modern function and mechanics of the Sinking Fund Commission, the modern mechanism for funding debt and other obligations in the state, as well as potentially obsolete sections of Article VIII.

I would like to start my remarks by using history as a guide. First, I will give you a brief history of the sinking fund. Second, I will explain the history of the legal mechanisms for issuing state debt. Third, and finally, I will look back on the suggested changes to Article VIII, as presented by the 1970's Constitutional Revision Commission.

History

The adoption in 1851 of Article VIII of the Ohio Constitution included the creation of the sinking fund, and called for the commissioners to manage it. What you may not know, is that prior to 1851 there existed a state debt-issuing predecessor, in the form of the Ohio Canal Commission. It was the Ohio Canal Commission's books, records and funds that the Sinking Fund Commission took over in 1851, in addition to other issuance authority provided in the 1851 Constitution.

The Ohio Canal Commission, by way of reference and comparison, was created by Governor Morrow in 1825, issued debt via stocks, instead of the bonds, or fixed income securities, used today, and was responsible for the financing of the Erie Canal and the Miami Canal. By 1832 the canals were open to traffic, creating development opportunities for the State of Ohio to broaden its economic base from just agricultural to transportation services and eventually, industrial. Even though the canals were functioning by 1832, the Ohio Canal Commission was already defunct. The canal commissioners were to use a sinking fund, into which they would set aside money to pay back the stockholders who had invested in the canals. However, due to the state's poor fiscal condition and inefficient tax collection, there was never enough money collected to make a single interest or principal payment in the years spanning 1825 through 1845.

By 1846, the state was able to reform the taxation system and stabilize its finances. A couple of years later, new laws providing for the efficient collection of taxes, provisions for annual sinking fund payments as well as provisions that payments were to be made strictly from the established sinking fund, helped the state to refinance its canal debt and make its first principal payment.

With that history in mind, we arrive in 1851, the adoption of Article VIII of the Ohio Constitution and the legal mechanisms for issuing state debt. As you are aware, Section 1 of Article VIII states the express prohibition of debt exceeding $750,000, and Section 2 has authorized additional debt to this section for specific purposes. All debts are specified as to being paid only from the sinking fund. With a better understanding of debt issuance in the State prior to 1851, the conservative approach to debt, i.e. the express limitation of $750,000 and the restrictions on where from debt must be paid, is a logical response to a challenging financial history. In fact, Ohio's conservative approach to debt continues to reap rewards today, as evidenced by the state's high credit ratings.

At this time I would draw your attention to the exhibits included in your packet. Exhibit one explains in a chart form the debt authorizations provided in Article VIII. The authorizations are listed chronologically, as adopted, beginning with the first non-repealed division (b), in 1947. Division (a) related to compensation for WWI veterans and has since been repealed.

By looking only at the first three columns, "Maximum Par Amount", "Maximum Outstanding", and "Annual Maximum", the chart demonstrates how the mechanisms for authorizing new debt issuance have changed over the years. At first, the authorization provides for a "Maximum Par Amount," then an "Annual Maximum" criterion is added. Later, there is the addition of the "Maximum Par Outstanding" criterion. Later still, the "Maximum Par Amount" is removed, and only the "Maximum *Outstanding"* par and "Annual Maximum" is employed. You'll note on the chart that some sections do not provide legal mechanisms related to the limitation of debt whatsoever. In all cases, however, debt authorization is given for a specific purpose, be it veterans compensation, highways, or public infrastructure. It is not until 1999 when Section 17 was enacted to place a general 5% limitation on all debt payable by the state treasury.

The concept behind the general debt limitation provided for in Section 17 brings me to the 1970s Constitutional Revision Commission and its recommendations. The 1970's commission did a lot of work on Article VIII, and even though their recommendations related to Article VIII were not ultimately adopted, they are still relevant today and provide a baseline for evaluating potentially obsolete sections of the Constitution. A moment ago, I mentioned the relevance of Section 17 of Article VIII. One of the recommendations of the 1970's commission was to implement a formulaic mechanism to funding debt in the state, based on percentage of revenues in the state's general revenue fund, over a period of time. In concept this is what Section 17 accomplishes, however Section 17 today is utilized as additional debt authorization, rather than the only authorization, which would have been the 1970's commission's recommendation.

Another one of the 1970's commission's recommendations was to allow the state to borrow on a short-term basis to meet appropriations, where monies are borrowed and repaid within the same fiscal year. Currently, this is not possible in the state, as the Constitution limits borrowing for only the specific purposes shown in exhibit one.

The 1970's commission also recommended passing to the General Assembly the authority to prescribe the methods and procedures for issuing, refunding, retiring and repaying state debt, and imposing certain duties upon the Treasurer of State relating to that authority.

Additionally, the 1970's commission recommended that the authority of the state to issue under Section 2i of Article VIII be retained. As I will explain in more detail later, this section authorizes several purposes under which to this day, the Treasurer issues non-general obligation debt for capital facilities improvements.

Finally, and importantly, the 1970's commission recommended that a provision be included to assure the continued validity of all obligations issued under Article VIII prior to any amendments and that such debt be included for the purposes of the proposed general debt limitation.

With that historical perspective, we can now delve more deeply into the specifics of the modern function of the Sinking Fund Commission, the modern mechanisms for funding debt and other obligations in the state, and consider possible obsolete sections of Article VIII.

The Modern Function and Mechanics of the Sinking Fund Commission

As you are aware, the Constitution lays the groundwork of the legal mechanics of issuing debt. Since its inception in 1851, the Commissioners of the Sinking Fund took on the task of interpreting the legal authorization and implementing it, creating legal obligations, selling them, and ensuring the repayment of those obligations with interest to investors. This implementation of the legal authority could be considered the financial or applied mechanics of debt, and for any governmental issuer the financial mechanics of debt issuance include two categories of activities: selling the obligations, or debt issuance, and the repayment of debt, or debt administration. The Sinking Fund Commission, since 2001, has not been an issuer of debt for the State. However, the Sinking Fund Commission continues to act in a debt administration capacity for the state.

Even though the Commissioners of the Sinking Fund, which include the five statewide elected officials, have not met since March of 2008, the debt administration activities of the Sinking Fund Commission have continued. These activities include overseeing the timely payment of principal and interest, or debt service, in coordination with the Office of Budget and Management, the production of the semi-annual report, the annual independent audit of certain information contained within that report, reporting additional information to the reporting section of the Office of Budget and Management for its compilation of the State's Comprehensive Annual Financial Report, and the payment of administrative expenses related to the issuance of debt and post-issuance compliance.

The Sinking Fund Commission's activities are performed by the staff of the Debt Management department of the Treasurer's office. However, the Sinking Fund Commission is treated as a component unit of state government, and has been appropriated State tax dollars for the performance of its duties. These appropriations include separate line item in the Treasurer's budget for certain administrative elements as well as a separate program for expenses specific to the payment of debt service and the remaining administrative expenses for each purpose authorizing general obligation bond issuance under the Constitution.

Mechanics of Funding Debt and Other Obligations

While the Sinking Fund Commission no longer issues debt, as you know, there are other issuers of debt in the state. The Treasurer's office and the Ohio Public Facilities Commission are the two issuers that implement the authority outlined in Section 2, taking over those issuance responsibilities from the Sinking Fund Commission. You may also have heard of other issuers in the state, such as the Ohio Water Development Authority (OWDA), the Ohio Housing Finance Authority (OHFA) or the Ohio Higher Educational Facility Commission (OHEFC), but only the Treasurer of State and the Ohio Public Facilities Commission can issue obligations payable from the state treasury. The other issuers mentioned issue obligations backed, or paid by, other dedicated revenues, and even though they cannot issue obligations payable from the state treasury, they are authorized to issue obligations through the legal mechanics established in Article VIII, Sections 13, 14 and 16.

The eligible governmental entity, whether previously the Commissioners of the Sinking Fund, or currently the Ohio Public Facilities Commission, the Treasurer of State or other instrumentality, corporation or political subdivision of the state, is authorized by the Constitution to issue debt either with a security pledge of the state's full faith, credit and taxing power, (i.e., general obligation), or without it. Obligations without the general obligation pledge have included revenue bonds, such as those issued by OWDA or OHFA, or for economic development purposes, as authorized under Section 13 of Article VIII. Technically, the bonds issued under Section 2i for Mental Health, Parks and Recreation and State Facilities, to name a few, would be considered non-general obligation, or revenue bonds, as described in the Constitution.

The Constitution explicitly delegates lawmaking and debt authorization to the General Assembly in some cases. In all cases the implementing provisions of the Ohio Revised Code offer more specifics on how debt must be issued. For example, the Revised Code provisions require that the governmental entity issue securities, in a public or private sale depending on the authorizing legislation, as opposed to borrowing directly from a bank. It is the Revised Code that delves more deeply into the specific mechanics of debt issuance and security, such as providing the ability for the Treasurer to issue bonds secured by the biennial appropriation of lease rental payments by state agencies borrowing for specific, General Assembly-approved capital improvement purposes.

To issue the lease-appropriation bonds I just mentioned, the mechanics of funding debt are both legal and financial for the state. The legal analysis includes first referencing the section of the Ohio Constitution for authorization, in this case, Article VIII, Section 2i. Second, as the Constitution does not dictate a specific debt limitation, reference is made to the Ohio Revised Code, Chapter 154. Third, as Chapter 154 does not dictate a specific limitation on the amount of debt, reference is made to the current capital budget to determine General Assembly authorized amounts of debt.

The financial analysis begins with a coordinated effort among the issuer, state agencies and the General Assembly. As state debt payable from the state treasury is managed by the Office of Budget and Management (OBM) on a cash-flow basis, OBM is continuously surveying the capital needs of the state and its agencies, and plans for new debt issuance on an on-going basis. State agencies report to OBM when capital cash reserves for approved projects are estimated to be depleted, and the Debt Management section of OBM coordinates the State's Bond Sale

Calendar, to ensure that the agency's funding needs are met on a timely basis. This cash-flow nature of the state's borrowing practices benefits the state by providing budgetary forecasting as well as helping to ensure that the state does not borrow too much or too often.

The state is concerned about borrowing too much or too often for another reason, other than budgetary. There are also federal tax rules that apply, as the state does much of its borrowing on a tax-exempt basis. Borrowing on a tax-exempt basis means that the state can issue debt at lower interest rates, and therefore pay less in total interest costs over time. The ability to issue tax-exempt bonds comes with a set of specific rules for eligible governmental issuers to follow, to prevent them from issuing too much or too often, or essentially taking advantage of a tax incentive that the federal government views as a subsidy to the eligible issuers. Thus, in addition to the state law analysis, and the financial or budgetary analysis, there is also a federal law analysis that must be undertaken, should tax-exempt bonds be issued, in order to meet the preliminary requirements of issuing debt.

With a better understanding of the practical application of the Sinking Fund Commission's duties in today's environment, as well as an understanding of how debt is issued in the state today, we can now move to discuss more specifically whether any provisions of Article VIII can be considered obsolete.

Article VIII and Potential Obsolete Provisions

At this time I would draw your attention back to the two exhibits included in your packet. Exhibit two is a chart showing the maturities and coupons still outstanding, according to authorized constitutional purpose. These maturities and coupons represent debt issued by the Commissioners of the Sinking Fund.

Of the 18 amendments to Section 2, all purposes, with the exception of three, either have coupons or maturities outstanding, or under which the state is issuing bonds currently. The three exceptions are: 1) Section 2a, which was repealed in 1953; 2) Section 2j, which was for Vietnam Veterans Compensation, and has no further issuance authority or bonds outstanding; and 3) Section 2k, which reached its maximum issuance authority for Public Infrastructure bonds. Some of these amendments, on their face, seem to be low-hanging fruit, obviously obsolete. However, the outstanding coupons or maturities make the removal of these amendments more challenging. For this reason, it would be important to include a recommendation, similar to that of the 1970's commission, to maintain the existing obligations validity, even if no further authorization to issue for that purpose exists.

Sections 3 through 6 of Article VIII prohibit additional debt, prohibit the ability of the state to become a joint owner or stockholder, prohibit the state from assuming the debt of its political subdivisions, and prohibit political subdivisions from becoming joint owners or stockholders, respectively. The 1970's commission recommended keeping these sections.

Now we arrive at Sections 7 through 11 of Article VIII, those pertaining to the creation of the sinking fund. The 1970's commission also considered these sections as potentially obsolete and attempted to remove all references to the sinking fund. As mentioned earlier, the Sinking Fund Commission does act under these provisions to this day, in some respects. I'll address the current application of each separately:

- Section 7 creates the sinking fund. A sinking fund per se is not used today for the payment of principal and interest on bonds; or at least not in the manner originally intended by the language in this section.
- Section 8 creates the Board of Commissioners of the Sinking Fund.
- Section 9 requires a biennial report of the commissioners to the General Assembly containing the status of the sinking fund, which as just mentioned is no longer used. Therefore, the commissioners do not give this biennial report currently.
- Section 10 requires the use of the sinking fund for the payment of interest and principal when due.
- Section 11 requires the Commissioners of the Sinking Fund to put forth a semiannual report of the Board's proceedings to the Governor and the General Assembly. This has taken the form of document that reports all current authorization of general obligation bond issuance, interest and principal payments paid in the prior period, and payments coming due in the following period. While this report is prepared by the staff of the Treasurer's Debt Management Department, each commissioner is asked to review and approve the report.

As you have probably gleaned, the Treasurer's office effectively manages all modern functions of the commission, so with thoughtful consideration of outstanding debt previously issued by the commissioners, the Board of the Commissioners of the Sinking Fund, and the related provisions, may be viable candidates for removal from the Constitution, as long as this Constitutional Modernization Commission understands the ramifications of this removal – namely, the need to preserve certain rights related to previously issued bonds, and the need to create a new financial or applied mechanism for the payment or oversight of debt administration, such as authorizing the General Assembly to impose those duties related to debt administration upon the Treasurer of State.

Summary

In closing, the topic of Article VIII and obsolete provisions is complex. The topic of state debt and municipal finance is complex and often times changing. This testimony has attempted to summarize the modern function of the Commissioners of the Sinking Fund and the issuance of other state debt, as well as consider potentially obsolete sections. There is a lot more to cover, and we would like to offer our time and resources to this committee as you continue to deepen your understanding of the material. At this time I would be happy to answer any questions. Thank you for the opportunity to present to you today.