

Constitutional Limitations on Indebtedness: The Case of California

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INTRODUCTION

* In the heady days following successful completion of the Erie Canal, U.S. states and cities issued unprecedented amounts of debt to finance railroads, turnpikes, and canals (Williamson 1964; Davis and Cull 1992). Dutch and British investors eagerly bought up the American state and local bonds underwritten by Baring Brothers, Huth and Company, and other leading investment houses. Unfortunately, many of the projects funded by these bond issues got underway just as the Depression of 1837 began, and anticipated revenues failed to materialize. Corruption and speculation also took a toll. Nine states and several cities ultimately defaulted on the bonds they had issued.¹ The states eventually resumed payment on these bonds and made at least partial restitution, but it was decades before the confidence of foreign investors was fully restored. For most defaulting states, regaining credit-worthiness required the unpopular expedient of instituting excise and property taxes to raise the necessary revenue (McGrane 1935).

Sobered by these defaults and the undesirable consequences they engendered, the citizens of these and most other states subsequently wrote into their constitutions limitations on the issuance of full faith and credit debt. What is meant by “full faith and credit” is the unconditional promise of the state to levy whatever taxes are necessary to meet interest and principal payments. Bonds bearing the full faith and credit pledge are

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¹The defaulting states were Maryland, Illinois, Indiana, Michigan, Mississippi, Louisiana, Arkansas, Florida, and Pennsylvania (McGrane 1935).

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referred to as either general obligation bonds or as “guaranteed” debt. Such debt may in the first instance be funded by designated fees, taxes, or lease revenue (in which case it is called “self-liquidating”), but it is considered guaranteed if the state pledges in the indenture that it will step in with tax revenue if these sources are insufficient.

Most state constitutions have certain idiosyncratic features in their provisions regarding bonded indebtedness, but limitations on general obligation bonds are of four basic types. As shown in Table 1, the most common limitation is the requirement of referendum approval, stipulated in the constitutions of California and 19 other states. Although some states require a referendum to approve any general obligation bond issues, what most constitutions (including California’s) actually specify is that voter approval is required to issue guaranteed debt in excess of some small sum, generally ranging from \$50,000 to \$2 million, that can be applied to short-term, “casual” deficits. As a practical matter, such provisions preclude state authorities from issuing any long-term guaranteed debt until the referendum approval condition is satisfied.² The entries in Table 1 indicate that the constitution of California and those of 11 other states also specify that guaranteed debt be approved by a supermajority of the legislature. In California the requirement is two-thirds of the members of both houses, but the required supermajorities vary from 60 percent to three-fourths of the membership.

Fifteen other state constitutions forbid guaranteed debt to exceed a revenue-based ceiling, the most common being fixed percentages of general revenue or of total assessed property valuation. Nine prohibit the issue of guaranteed debt entirely. As in the case of almost all states in the referendum approval category, the states that prohibit guaranteed long-term debt do

²South Carolina’s constitution contains a referendum approval requirement in addition to its revenue-based limit. Prior to 1975 Louisiana’s Constitution ostensibly prohibited long-term guaranteed debt. According to Ratchford (1941) and Heins (1963), however, in both cases major loopholes effectively negated these provisions, and they are thus not indicated as present in Table 1.

Table 1. State Constitutional Limitations on Guaranteed Long-Term Debt, FY 1990

State	Referendum Approval	Super-majority	Prohibition	Revenue-based	No Limitation
Alabama			X		
Alaska	X				
Arizona			X		
Arkansas	X				
California	X	X			
Colorado			X		
Connecticut					X
Delaware		X			
Florida	X				
Georgia				X	
Hawaii				X	
Idaho	X				
Illinois	X	X			
Indiana			X		
Iowa	X				
Kansas	X				
Kentucky	X				
Louisiana		X			
Maine	X	X			
Maryland					X
Massachusetts		X			
Michigan	X	X			
Minnesota		X			
Mississippi				X	
Missouri	X				
Montana		X			
Nebraska			X		
Nevada				X	
New Hampshire					X
New Jersey	X				
New Mexico	X			X	
New York	X				

Table 1. Continued

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State	Referendum Approval	Super- majority	Prohibition	Revenue- based	No Limitation
North Carolina	X			X	
North Dakota			X		
Ohio			X		
Oklahoma	X				
Oregon				X	
Pennsylvania	X			X	
Rhode Island	X				
South Carolina				X	
South Dakota		X		X	
Tennessee					X
Texas			X		
Utah				X	
Vermont					X
Virginia		X		X	
Washington		X		X	
West Virginia			X		
Wisconsin				X	
Wyoming	X			X	

permit borrowing small sums to cover “casual” deficits, and allow for full faith and credit debt to be issued for “extraordinary purposes” such as repelling invasions or suppressing insurrections. Only five states currently have no constitutional limitations on general obligation bonds, which means that their issue is authorized in the manner of ordinary legislation.

Presumably, constitutional provisions impose constraints on policy-makers because they are difficult to enact and thus difficult to overturn. Certainly this is the article of faith to which backers of the federal Balanced Budget Amendment subscribe. But is this actually the case when it comes to state constitutional debt limitations? Are they effective in holding down debt?

According to Kiewiet and Szakaly (1995), states whose constitutions either prohibit them from issuing guaranteed debt, or, like California, that

require referendum approval to issue it, carry substantially less guaranteed debt than other states. Revenue-based limitations and legislative supermajority requirements, in contrast, are not effective in limiting the issuance of general obligation bonds.

Interestingly, Kiewiet and Szakaly's findings indicate that referendum requirements are as effective in limiting the issuance of guaranteed debt as outright prohibitions against doing so. The reason why prohibitions do not entirely prohibit is because approval for general obligation bond issues can be gotten in the form of an amendment to the constitution! It is thus probably more accurate to view debt issuance prohibitions as equivalent to the requirements for adopting constitutional amendments, which in most states consist of obtaining both referendum and legislative supermajority approval. Given that it does not appear to pose much of an obstacle, the imposition of a legislative supermajority requirement on top of a referendum approval requirement would appear to be superfluous.³ In general, then, Kiewiet and Szakaly's findings support Moak's (1982) contention that "The history of public debt in the United States at all levels tends to show that the electorate is financially more conservative than are its representatives in government" (p. 114).

THE LIMITS OF CONSTITUTIONAL LIMITATION

Although effective in limiting full faith and credit debt, state constitutional debt limitations are readily and routinely circumvented (Ratchford 1941; Heins 1963; Bunch 1991; Nice 1991). The most widely recognized means by which public authorities sidestep these strictures is to issue bonds that are not backed by the taxing power of the state, but rather by a nontax flow of revenue. Because the taxpayers of the state are not directly liable in the case of default on such bonds, the courts have ruled that constitutional limitations on debt do not apply. Debt of this nature is referred to as either revenue bonds or as "nonguaranteed" debt.

³The California Constitution forbids amending the constitution in order to approve general obligation bond issues. This seems moot at best, in that the requirements for obtaining approval for a bond issue are identical to the requirements for amending the constitution. One can only speculate as to what the courts would do if an amendment to the state constitution authorizing a bond issue were in fact approved.

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Lacking the full faith and credit pledge associated with general obligation bonds, nonguaranteed revenue bonds generally pay higher rates of interest (Forbes, Fischer, and Peterson 1981). Nonetheless, there remain several reasons why a public entity might still prefer to issue revenue bonds, particular when there is a bona fide flow of revenue to back them, e.g., utility bills, tolls, or user fees. In many cases, however, nonguaranteed debt is issued for projects that generate little or no revenue, for the sole purpose of circumventing constitutional limitations on guaranteed debt. Most notably, public authorities issue nonguaranteed “lease-payment” bonds to build facilities, such as prisons, schools, hospitals, and office buildings, that traditionally are funded through general obligation bonds. The authorities then lease the facilities to other state and local government agencies, who pay the rent out of the ongoing appropriations they receive (Bennett and DiLorenzo 1982). Certificates of participation are another form of nonguaranteed debt that is nevertheless financed out of general tax revenue.

A second major reason why state constitutional debt limitations do not constrain debt financing is because of devolution—the displacement of long-term debt issuance from the state level of government to the local level. To be sure, it may not be practical for most local governments to undertake large-scale capital projects, but in most cases anything that can be financed by a state government can be done by either local governments or by special districts as well. Moreover, state governments have broad authority to mandate that local governments provide particular services and facilities that may necessitate debt financing to be put into place (Glendening and Reeves 1984). Several previous studies report strong evidence of devolution (Heins 1963; Nice 1991; Kiewiet and Szakaly 1995).

Although proponents of constitutional debt limitations tend to characterize both circumvention and devolution as subterfuge, there is nothing in these debt “end-runs” that are illegal, conspiratorial, or even disingenuous in nature. These complaints are thus similar to those concerning the existence of loopholes in the federal tax code. On the other hand, one need not have a phobia about debt financing to have some serious concerns about these phenomena. First, shifting from guaranteed debt to nonguaranteed debt (or from debt issued at the state level to the local level) results in significantly higher borrowing costs. In addition to the higher interest rates that must be paid, issuing nonguaranteed debt entails higher administrative, legal, and insurance costs, and typically requires bond “upsizing” to cover reserve fund requirements and carrying charges during

project construction. According to Nicol's (1995) calculations, debt service costs on lease-payment bonds are approximately 20 percent higher than for general obligation bonds.

The issuance of large amounts of nonguaranteed state debt or local debt can drive up interest rates on state guaranteed debt as well. This is because only citizens of the state in which state and local bonds are issued can claim the interest they yield to be exempt from state and local taxes. Issuers of all types of municipal bonds (guaranteed or nonguaranteed, state or local) must thus sell to the same pool of in-state investors. As Bahl and Duncombe (1993) put it, all debt issued by public authorities, be it guaranteed or nonguaranteed, state or local, "ultimately is a claim on the resource base of the state" (p. 32).

It is also naive to believe that the taxpayers of a state are insulated from the consequences of default just because a bond is nonguaranteed, or because it was issued by a single city or county. According to Jones (1984), the Washington Public Power Supply System (WPPSS) default of 1983 drove up the state of Washington's cost of credit by a full percentage point. The negative impact of the recent Orange County bankruptcy fiasco upon California bonds in general has also been widely documented.⁴

A final problem arises from the fact that state governments rarely issue nonguaranteed debt directly, but instead establish authorities, boards, agencies, special districts, and commissions to do so. O'Brien (1989) posits that because they shift debt issuance away from elected officials to others who are far less accountable, constitutional limitations on guaranteed debt may actually *increase* total state debt. Others worry more generally about a loss of accountability, but this need not be the case; several states, including California, require legislative approval of revenue bond issues or place other statutory limitations upon them.

Rather, the problem that inevitably arises from the delegation of debt-issuing authority to large numbers of separate agencies is the diffusion of

⁴In general, the distinction between guaranteed and nonguaranteed debt is blurred by the fact that actions which are possible from a legal standpoint are unthinkable from a practical standpoint. For instance, the state could legally close down a department or agency that is making lease payments to another state entity (in California the lessor is usually the Public Works Board), thus eliminating its budget and necessarily producing a default. The reaction of the credit markets to such a move, however, would be swift and terrible. In all likelihood the state would be unable to borrow any money for any reason until the situation were rectified.

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responsibility and the fragmentation of decision making. Policymakers never directly confront trade-offs among the myriad competing demands for long-term debt financing, and fail to set priorities. In a major report issued by the National Conference of State Legislatures, Yondorf and Puls (1987) identify the failure to prioritize capital projects as one of the major weaknesses in the financial operations of state governments.

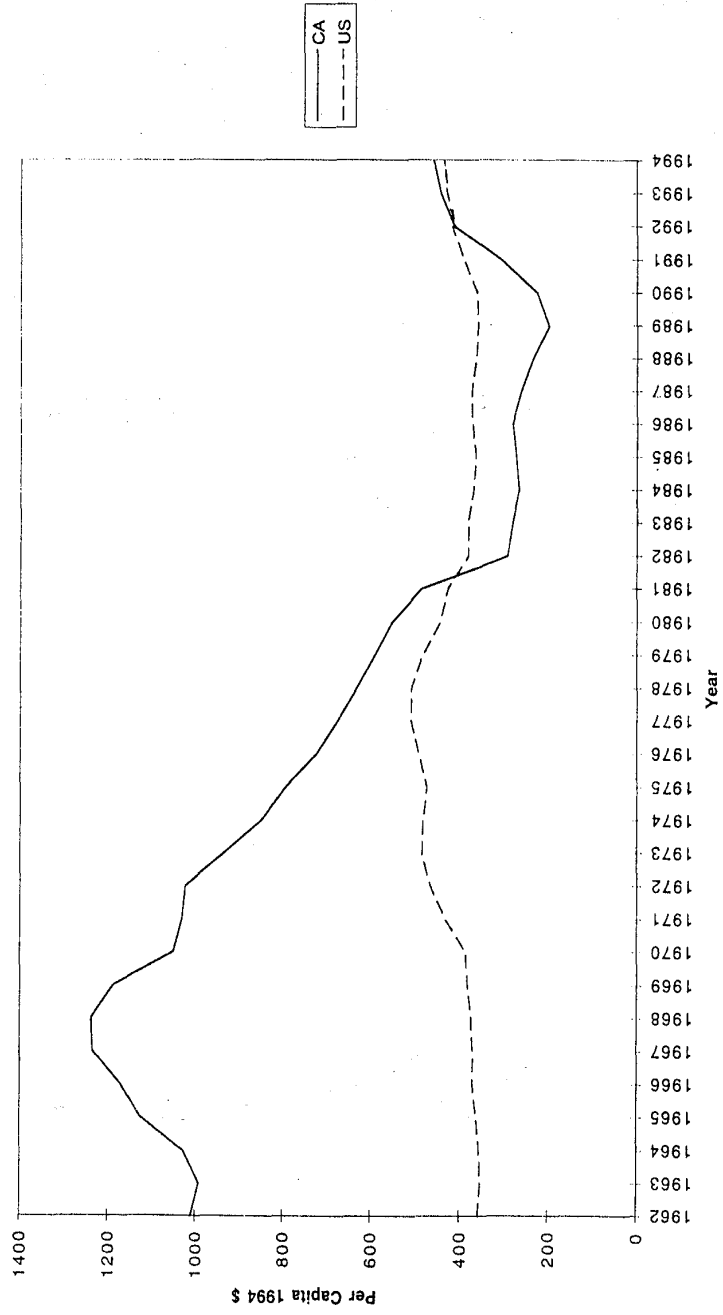
THE CASE OF CALIFORNIA

The discussion so far has been based upon the collective experience of state and local governments in general. We turn now to the record of long-term bond issuance by the state of California. Figures 1, 2, and 3 compare the total amounts of outstanding state guaranteed debt, nonguaranteed debt, and total long-term local debt from FY1962 through FY1992. In each case the figures reported are in constant (1994) dollars per capita.

Turning first to Figure 1, we see that by the late 1960s guaranteed debt in California exceeded \$1,200 per capita in today's dollars, which was three times greater than the national average. From then on, however, it fell rapidly, and by the end of the 1980s it was substantially lower than the national average. This decline owes to continued rapid population growth as well as to a relatively slow rate of new general obligation bond issues. The sharp increase in per capita guaranteed debt levels that have occurred since then results from the decision of the Department of the Treasury (under then-Secretary Kathleen Brown) to expedite sale of the \$11 billion of general obligation bonds the voters had approved over the past several years but that had not been issued. Very little guaranteed debt has been approved in the 1990s, which implies that per capita guaranteed debt levels are likely to begin declining again in the near future.

Given that referendum requirements do constrain guaranteed debt levels while other constitutional limitations do not, the fact that the state of

Figure 1. State Full Faith and Credit Debt: FY 1962-94



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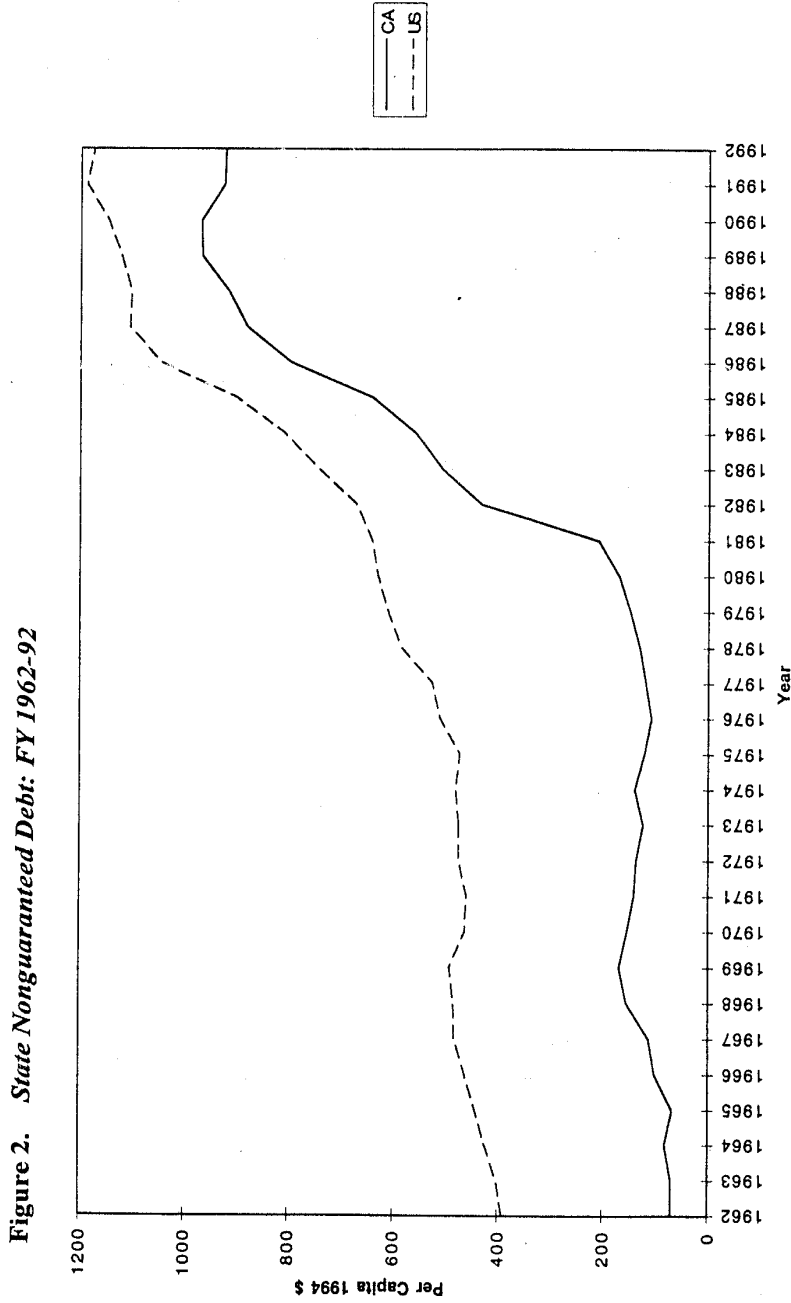
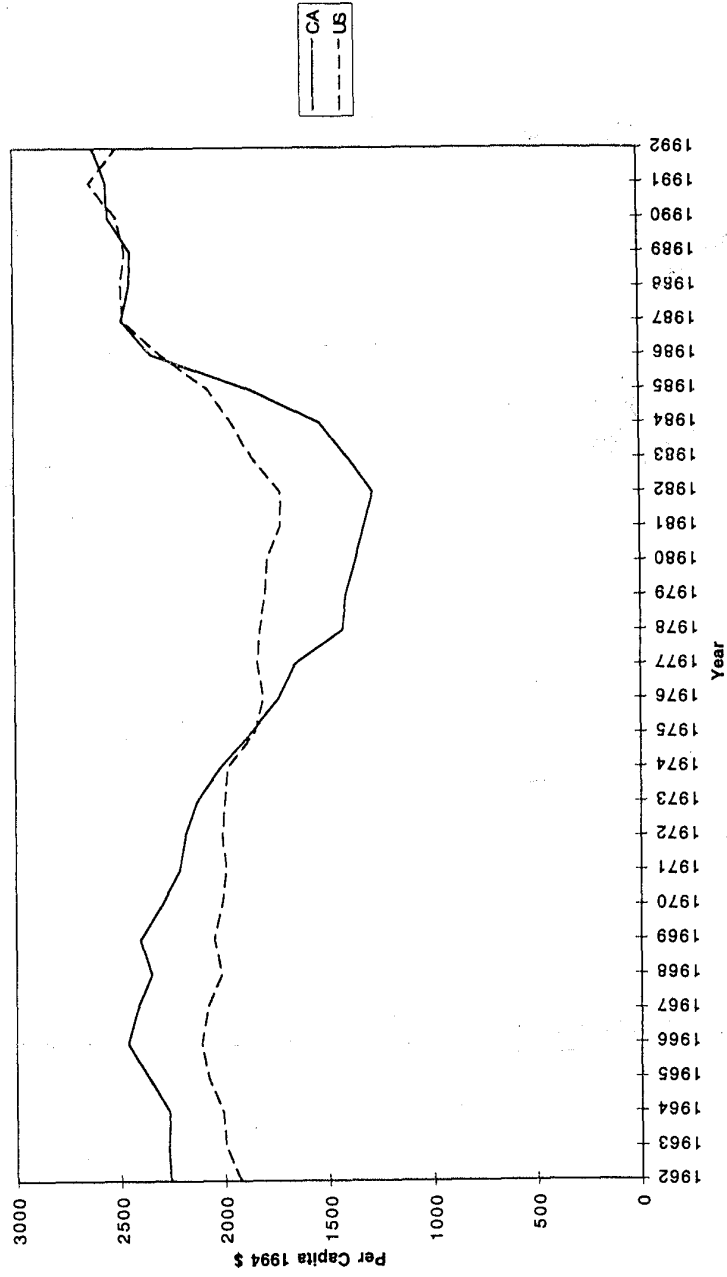


Figure 2. State Nonguaranteed Debt: FY 1962-92

Figure 3. Local Long-Term Debt; FY 1962-92



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California has managed to issue the volume of general obligation bonds that it has is fairly remarkable. In fact, in the many other states that also have referendum requirements, only in Rhode Island and New Jersey have voters consistently been as willing to take on guaranteed debt (Kiewiet and Szakaly 1995).

In contrast to the guaranteed debt series portrayed in Figure 1, the data on nonguaranteed state debt in California closely track the national average. Nonguaranteed debt levels increased rapidly in California in the 1980s, just as they did in the rest of the country. As many authorities on municipal bonds have noted, this surge largely reflects the proliferation of “public debt for private purposes,” or what is referred to in California as “conduit” revenue bonds (Forbes, Fischer, and Peterson 1981; Leonard 1986; Zimmerman 1991). In this form of debt financing, the proceeds of the issue are made available to a private party for activities that are judged to be in the public interest.

The original manifestation of private-purpose debt was the industrial revenue bond. In the mid-1970s, however, state and local governments began issuing such debt for housing developments, mortgage loans, shopping malls, fast food franchises, student loans, and sports stadiums. Ironically, this type of debt financing, which had been creeping upward in volume during the 1960s, accelerated rapidly after Congress ostensibly acted to curtail it (Leonard 1986). Congress ultimately reacted to the burgeoning loss of tax revenue resulting from the proliferation of private-purpose debt by imposing statewide volume caps in the 1986 Tax Reform Act (Kenyon and Zimmerman 1991). The impact of this legislation is evident in Figure 2, which shows the state nonguaranteed debt series flattening out, in California as well as in the country as a whole, in the years following 1986.

Figure 3, which reports real per capita level of long-term debt carried by local governments, also indicates that the experience of California generally tracks that of the country as a whole. In the first half of the series local governments in California carried somewhat more debt than average, and in the FY1977-86 period somewhat less than average, but the differences were never large.

THE PROBLEM OF PUBLIC-LEASE BONDS

There is nothing in the aggregate debt series, then, that is particularly alarming. By the late 1970s the state had managed to substantially reduce

the relatively high level of per capita general obligation debt it had amassed in the 1960s and now carries a level of per capita guaranteed debt that is very close to the national average. Nonguaranteed debt has remained at a level that is significantly lower than average, and levels of local debt often lower (and never much higher) than average.

It is when state nonguaranteed debt is decomposed into its constituent parts, however, that a worrisome pattern of circumvention emerges. These data are reported in Table 2 and Figure 4. As the data in Table 2 indicate, much of the nonguaranteed debt issued at the state level in California during the past decade has been in the form of enterprise revenue and conduit revenue bonds—in both cases debt that is backed by a well-defined stream of nontax revenue, and therefore no real cause of concern. What is a matter for concern is the nearly \$6 billion in public-lease revenue bonds that are currently outstanding. As indicated earlier, the “lease” payments that back such debt comes primarily from general state tax revenue. As noted by the California Debt Advisory Commission (1990), bond-rating agencies typically include lease-revenue bonds and certificates of participation (along with general obligation bonds) in calculating total state tax-supported debt.

If no additional lease-payment bonds are issued, debt service on those already issued will soon exceed \$500 million (Hill 1995). Moreover, all indications are that resort to this type of debt-financing will only continue to increase in the future. The governor’s budget for fiscal year 1996 calls for the authorization of \$3.3 billion in new lease-payment bonds, primarily for new jails and prisons. According to projections made by the state Department of Finance (1995), in the next decade the state will issue nearly as much in public-lease revenue bonds (\$8.7 billion) as in general obligation bonds (\$11.6 billion). Presumably, the decision to go with lease-payment financing instead of issuing general obligation bonds is based at least in part upon concern that the voters would balk at approving such a large bond issue. After approving 42 of 43 state bond issues in the 1980s, California voters have rejected almost every proposed issue since then, including two for correctional facilities that appeared on the November 1990 ballot.

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Table 2. Major Issuers of Long-Term Debt on Behalf of the State of California, 1985-94

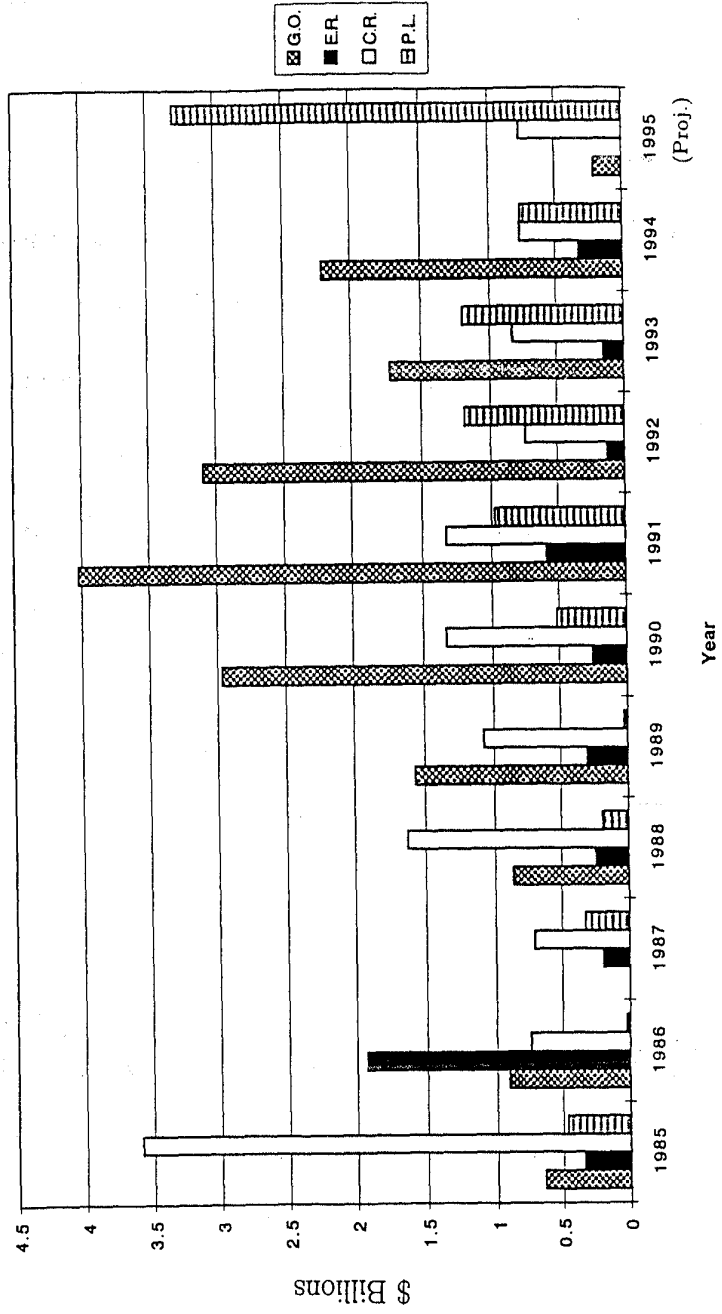
Issuer	General Obligation Bonds	Enterprise Revenue Bonds	Conduit Revenue Bonds	Public Lease Revenue Bonds	Certificates of Participation
State	17,971	340	0	0	0
Regents (UC)	0	1,569	0	95	211
Trustees (CSU)	0	206	9	22	0
Alt. Energy	0	0	149	0	0
Water	0	1,106	0	240	0
Educational	0	0	854	0	0
Health	0	861	4,206	0	2
Housing	0	0	2,786	0	0
Pollution	0	0	3,686	0	0
Public Works	0	105	0	4,388	0
L.A.	0	0	0	952	0
Veteran Affairs	0	0	988	0	0
Schools	0	0	0	77	0
Fairs	0	1	0	0	126
Other	0	12	7	7	0
Total	17,971	4,200	12,685	5,781	339

*amounts are in \$millions

As indicated earlier, lease-payment bonds are a particularly costly way for the state to borrow money. The burgeoning use of lease-payment bonds also threatens to produce levels of tax-supported debt that investors will deem excessive. This will have deleterious consequences for bond ratings, and will necessarily drive up borrowing costs even further.

Even more important, the use of public-lease bonds to circumvent constitutional requirements for issuing general obligation bonds is a mechanism by which policymakers can escape from the demanding and uncomfortable task of prioritizing projects and making trade-offs among

Figure 4. Net New Debt Issues by the State of California; 1985-1995



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competing demands. This is symptomatic of a larger problem. The state government has established a large number of boards, commissions, and authorities that issue bonds. Although individual boards and authorities prioritize capital outlays within their own domains, there is currently no mechanism for making trade-offs in capital projects across policy domains. The Legislative Analyst's Office has repeatedly called for reform of the way in which the state government makes capital outlay decisions. In a report issued in the halcyon days of a booming state economy and low debt-service costs, the answer to the question, "What is most wrong with the State's Current Process?" was the lack of a multi-year capital outlay plan that prioritized the many competing demands for long-term borrowing (Vasché 1987, 24). This call for reform was repeated again in this year's analysis of the governor's budget:

If the state is to address its capital outlay investments in a context of limited fiscal resources, the current piecemeal approach to capital outlay decision-making needs to be addressed. The Legislature could make significant strides toward changing this approach and maximizing the state's expenditures for capital outlay by initiating a comprehensive and proactive legislative process for the review and financing of capital programs (Legislative Analyst's Office 1995, I-17).

RECOMMENDATIONS

The people of California are not being well served by the debt limitations that are currently specified in the state constitution. To be sure, the referendum and legislative supermajority approval requirements for issuing general obligation bonds have served the purpose of preventing the state from issuing excessive levels of guaranteed debt. However, this has only led the state to issue more costly debt instruments, most notably lease-payment bonds and certificates of participation, to carry out policies that voters or their representatives presumably support, e.g., more prisons in which to put more criminals. There remains a strong argument that taxpayers ultimately need some constitutional safeguard against excessive debt, and as far as we can tell the requirement of referendum approval is the most reliable. What is necessary, then, is to extend the scope of the referendum approval requirement to cover lease-payment bonds and related methods of debt financing.

Even more significant a problem is the lack of prioritizing that is inherent in the currently fragmented system for issuing bonds. The requirement of referendum approval for general obligation bonds does not enhance and most likely detracts from the ability of state policymakers to set priorities and to make trade-offs among competing demands for scarce fiscal resources.

The major goal of constitutional reform in this area, then, should be to establish an institutional framework for setting capital outlay priorities, to provide the governor and legislature with incentives to adhere to that framework, but to retain the ultimate safeguard of the referendum approval mechanism. Fortunately, such provisions do not need to be invented *de novo*, as they are already present in the constitutions of several states. Adopting these provisions, which are as follows, would lead to significant improvements in the way in which the state of California issues and finances long-term debt:

Recommendation 1:

The governor shall annually submit to the legislature a comprehensive, unified, multi-year capital budget that proposes capital projects for the upcoming fiscal year and establishes a priority order for all such projects across all agencies and departments of the state government. The legislature shall use this budget proposal to adopt an annual Capital Outlay Budget. As the proceeds of bond issues become available, projects shall be undertaken in the priority order established in the Capital Outlay Budget.

This is similar to the chief recommendation made in the report, alluded to earlier, issued by the National Conference on State Legislatures (Yondorf and Puls 1987). Although specific provisions differ widely, over a dozen states currently require their executives to propose and their legislatures to approve capital budgets.

Recommendation 2:

a) Long-term bonds may be issued by the state of California and by its agencies without approval by the voters for capital projects specifically itemized and prioritized in the capital budget, provided that such bonds at the time of issuance would not cause the total amount of principal and interest payable in the current or any future fiscal year, whichever is higher, on such bonds and on all outstanding debt, to exceed a sum equal to 12

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percent of the average of the general fund revenues of the state in the three fiscal years immediately preceding such issuance.

b) Any bond issue by or on behalf of the state may exceed the debt limit if it has been approved by a two-thirds vote of all the members elected to each house of the legislature and if, at a general election or primary, it has been submitted to the people and shall have received a majority of all votes cast for and against it at such election. For any issue that would cause the total amount of principal and interest payable in the current or any future fiscal year, whichever is higher, on such bonds and on all outstanding debt, to exceed a sum equal to 18 percent of the average of the general fund revenues of the state in the three fiscal years immediately preceding such issuance, such issue shall have received two-thirds of all votes cast for and against it in a general election or primary.

Part (a) of this recommendation resembles provisions of the constitution of Pennsylvania that was ratified in 1968. The intent here is to allow state policymakers maximal flexibility in setting capital outlay priorities, but retains the requirement that they obtain voter approval for bond issues when debt levels approach a relatively high level. The ceiling recommended here is debt service payments amounting to four percent of general revenue, calculated on a three-year rolling average basis (this type of formula is stipulated in Hawaii's Constitution). Bond-rating agencies tend to regard five percent of general revenue as the threshold at which debt service payments become a matter of serious concern, so this is a little lower than that.

The second part of the recommendation simply increases the requirement of voter approval for new debt issues to a two-thirds supermajority when debt levels rise above an average of six percent of general revenue. This does not make it impossible to issue debt in excess of the six-percent ceiling, but the case for doing so obviously must be quite compelling if the two-thirds referendum approval requirement is to be met.

Recommendation 3:

In calculating the amount of principal and interest payable on all debt, issued and outstanding, totals shall include all general obligation bonds and all other debt financed from lease rentals or other charges payable directly or indirectly from state revenue.

This provision is also drawn from a similar provision in the constitution of Pennsylvania. It stipulates that the debt ceilings specified previously apply

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to lease-payment bonds, certificates of participation, and other forms of debt, which, although technically nonguaranteed, is not supported by a nontax flow of revenue. Would such a measure make it impossible to circumvent constitutional debt limitations? Probably not, but it would remove a major incentive for issuing higher cost, nonguaranteed debt instead of guaranteed debt. The record of Pennsylvania is also encouraging in this regard, in that it is one of the handfuls of states that was carrying less nonguaranteed state debt per capita in 1990 than in 1960.

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