

Approved March 21, 1986
Date

MINUTES OF THE Senate COMMITTEE ON Assessment and Taxation

The meeting was called to order by Senator Fred A. Kerr at
Chairperson

11:00 a.m./~~p.m.~~ on Tuesday, March 18, 1986 in room 519-S of the Capitol.

All members were present ~~except~~:

Committee staff present:

Tom Severn, Research Department
Melinda Hanson, Research Department
Don Hayward, Revisor's Office
LaVonne Mumert, Secretary to the Committee

Conferees appearing before the committee:

Representative Jim Braden
Senator Frank Gaines
Dr. H. Edward Flentje
Jim Maag, Kansas Bankers Association
Ben Craig, Kansas Bankers Association
Belden Daniels, Consultant for the Kansas Economic Development Commission
Robert A. Anderson, Kansas Independent Oil and Gas Association

S.C.R. 1635 - Constitutional amendment; repeal of section relating to
internal improvements

Representative Jim Braden testified in support of the resolution. He stated that the Legislative Economic Development Commission voted 10-0 to support S.C.R. 1635. He said that a number of recommendations in the Redwood report cannot be carried out unless the prohibition is repealed. Answering questions from Senator Allen, Representative Braden noted that there is a greatly increased concern about the state's economic development and that this favorable climate for change may not be present in another year.

Senator Frank Gaines spoke in favor of the resolution. He mentioned a federal study projecting adverse demographic trends for Kansas. He advised that Dr. Redwood has stated that the whole key for success in Kansas is a willingness to change. Senator Gaines said the repeal is needed in order for Kansas to compete and to have greater flexibility. Senator Montgomery asked about the cash basis law. Senator Gaines replied that the resolution does not affect that law. Senator Frey observed that local units of government have the ability to engage in internal improvements, and Senator Gaines agreed but noted that this is very limited.

Dr. H. Edward Flentje testified in favor of S.C.R. 1635 (Attachment 1). He said that he is testifying on his own behalf but is a faculty member of Wichita State University and is the coordinator for the Kansas Public Agenda Commission. He described the history of the internal improvements prohibition. He concludes that the prohibition has forced local units of government to initiate economic development and to be responsible for public infrastructure development. He thinks this situation has deterred statewide economic growth. Dr. Flentje said that the term "internal improvements" is archaic. Responding to questions from Senator Allen, Dr. Flentje said that S.C.R. 1635 is not a debt provision and that the state constitution contains a debt provision. He stated that the prohibition stands in the way of state initiative and he feels that things will change more rapidly in the future.

Jim Maag introduced Ben Craig.

Ben Craig spoke in favor of the resolution (Attachment 2). He advised that the 18-member Kansas Bankers Association Task Force on Economic Development has unanimously endorsed the repeal of the prohibition. He stressed that "these are not normal times" and the economic conditions existing in Kansas

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

CONTINUATION SHEET

MINUTES OF THE Senate COMMITTEE ON Assessment and Taxation,
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are not cyclical. He feels that unless changes are made, Kansas' economy will continue to be significantly below the national economy.

Senator Mulich moved that the minutes of the March 17, 1986 meeting be approved. Senator Thiessen seconded the motion, and the motion carried.

The meeting was recessed until 2:30 p.m.

Belden Daniels urged that S.C.R. 1635 be passed. He stressed that the conclusions of the Redwood report are that the issues facing Kansas are not cyclical but that there is a fundamental structural change in agriculture, the oil and gas industry and the aviation industry. Mr. Daniels stated that Kansas is a part of a global economy where all factors are at risk. He said that if Kansas does not take decisive action, it will experience a continued decline. He pointed out that economic growth or decline is "what happens to you", while economic development is a clear choice. Mr. Daniels said bold new initiatives are clearly called for. He emphasized the importance of a partnership between the public and private sector, with the state being the source of leadership. He stated that the primary impact of these changes will not be in the urban areas, but will be in the non-metropolitan areas of the state. He referred to the nine initiatives (Attachment 3) which address all 34 of the Redwood recommendations. Mr. Daniels said that the first three initiatives are seriously crippled if the internal improvements prohibition is not addressed by this legislative session. He pointed out the absence of risk capital in Kansas and said the Kansas Development Credit Corporation is no longer sufficient. Mr. Daniels advised that the banking industry will provide \$10 million for a venture capital fund, which needs a \$10 million match from the state. Mr. Daniels said that, under the current constitutional ban, the state can grant funds but cannot invest them. He talked about a state agency, such as KPERS, having the ability to make investments, while the state itself is prohibited from doing so. Mr. Daniels described how he had changed from his former opinion that a constitutional amendment should be drafted to address only the nine initiatives rather than proposing an outright removal of the ban. He said his impressions of the private sector and the universities, plus the element of constant change, reversed his opinion on the matter.

Senator Hayden asked what Mr. Daniels referred to with regard to restructuring the oil and gas industry. Mr. Daniels replied that he was speaking about more efficiency, ways of lowering costs, tertiary recovery, etc. Answering a question from Chairman Kerr, Mr. Daniels said that one of the good reasons for the change is because surrounding states are participating in this type of development. Senator Frey asked about the high-risk capital system. Mr. Daniels stressed that no change is being proposed that would affect KPERS. He explained how an individual risk may be high, but pooling the risk spreads the gains and/or losses. In response to Senator Karr's question about the amount of budgets that must be used to finance debt, Mr. Daniels said that the internal improvements prohibition and the debt limitation are separate. He added that the Supreme Court has undermined debt limitations. There was discussion about clearly defining debt limitations in conjunction with removing the internal improvements prohibition.

Robert A. Anderson spoke in opposition to the resolution. He discussed concerns about the state competing with private industry. Mr. Anderson gave examples of instances where the internal improvements provision has been used to stop various state activities. He said that while he opposes a complete removal of the ban, he is supportive of amending the prohibition to allow specific exemptions.

Belden Daniels answered further questions. Senator Hayden asked Mr. Daniels his opinion on a provision that any project must have a two-thirds vote of the Legislature. Mr. Daniels answered that he feels that if there is

CONTINUATION SHEET

MINUTES OF THE Senate COMMITTEE ON Assessment and Taxation,
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to be a restraint, that type of provision is the most desirable. Responding to questions from Senator Allen, Mr. Daniels said that the first two initiatives, and especially the first one, are designed to benefit smaller communities "outside the golden triangle". Mr. Daniels observed that he expects the Legislature to be faced with infrastructure issues which have been heretofore addressed by the federal government. He noted that most rural areas are not structured to handle such matters.

Dr. H. Edward Flentje responded to further questioning by Committee members. He said that he recommends both repealing the internal improvements prohibition and addressing the debt limitation provision. Senator Frey voiced concerns that the rural areas of the state would not benefit by the proposed initiatives. Dr. Flentje noted that cities such as Overland Park and Wichita are already "in the economic development business" and are very professional. He said their efforts will continue no matter what action the state takes. He feels that smaller cities should have priority to benefit from the initiatives. Dr. Flentje suggested that these cities could be prioritized by statute. He emphasized that people with expertise in this field will be needed to carry out the programs.

Chairman Kerr announced that the hearing on S.C.R. 1635 will continue on Friday, March 21. Committee members were provided with a Background Paper from the Institute for Public Policy and Business Research (Attachment 4) and a report to the Subcommittee on Finance from H. Edward Flentje (Attachment 5).

Meeting adjourned.

ASSESSMENT AND TAXATION

OBSERVERS
(PLEASE PRINT)

DATE	NAME	ADDRESS	REPRESENTING
3/18/86			
11:00	DANA FERRELL	Topoka	Budget
	Carol Hedges	Topoka	Gov. Office
	Diane Duffy	" "	" "
	Steve Jack	"	"
	CHARLES BELT	WICHITA	WICH. COFC
	Mary Ellen Carter	Wichita	Ks. Assoc. for Small Business
	RON GACHES	WICHITA	BMAC
	Tom Whitaker	Topoka	Ks. Motor Carriers Assn
	Jim M. Briden	Topoka	Observer
	Robert C. Anderson	Osborne	Mid Cont. Oil Co.
	RON CALBERT	NEWTON	United Transportation Union
	Leroy Jones	Overland Park	B.L.E.
	JEAN BARBEE	TOPEKA	KANSAS CONSULTING ENGINEERS
	PAVO GRANT	"	KCCI
	David Letman	"	"
	Mark James	"	Senate
	Ben Craig	Overland Park	KBA
	Jim Miller	Topoka	KBA
	Emery E. Hager	"	KBA
	M. Hanna	"	Cap. Journal
2:30	Richard Jahnke	Rt 11 Leonardville	FARM BUREAU
	William Holter	Leonardville	myself
	Steve Jack	Topoka	Governor's Office
	Diane Duffy	"	"
	Carol Hedges	"	"
	Margaret Beane	Lawrence	LWUK
	M. Hanna	Topeka	K. Soc. J. 1
	Jim Turner	Topoka	KLSI
	Robert C. Anderson	Osborne	Mid Cont. Oil Co.
	RON CALBERT	NEWTON	U.T.U.

**Statement to
Committee on Assessment and Taxation
Kansas Senate**

by
H. Edward Flentje
March 18, 1986

Mr. Chairman, members of the Committee, I thank you for the invitation to testify today on the internal improvements prohibition in the Kansas Constitution. As most of you are aware, I am currently conducting a study of capital finance and infrastructure for the Special Commission on a Public Agenda for Kansas. My comments today are based on preliminary findings and conclusions from that study. The views expressed and recommendations made, however, are strictly my own and do not represent the Special Commission or its committees.

Let me begin by stating my recommendation that you initiate the steps necessary to eliminate the internal improvements prohibition from the Kansas Constitution. This prohibition is a nineteenth century idea which has deterred state initiative in Kansas for most of the twentieth century. Kansas electors should be given the opportunity to abandon this idea in order that state government may prepare for growth in the twenty-first century.

Let me explain the logic of this recommendation by first reviewing briefly how this constitutional provision came into being and then assessing its impact on development in Kansas.

Our state constitution was written by the Wyandotte Convention in less than four weeks, 20 working days to be exact. As you might imagine, we borrowed heavily from other states. Our internal improvements provision was lifted with little change from Wisconsin -- a state whose constitution was adopted in 1848. Debate and action on this provision took our convention delegates only a few minutes by my estimate.

My point here is simply this: The constitutional language under consideration here was molded not by careful consideration at the Wyandotte Convention but by national fervor over state debt defaults and debt repudiations resulting from excessive debt financing of internal improvements by state governments in the 1820-40 period. The roots of this debt fiasco are tangled but may be found in financial vacuum left by Andrew Jackson's curtailment of federal aid for internal improvements and his derailment of the U.S. bank which was a stable source of financing such improvements. Encouraged by early successes in state financing of internal improvements, such as New York's underwriting of the Erie Canal, state governments moved into this vacuum often with grandiose plans for road, canals, and financing, piled up monumental debts in a few short years, and then crashed in the depression of 1837. Nine states defaulted on their debts; four repudiated all or part of their debts; and others secured

downward adjustments in debt payments. Many states raised taxes to meet their obligations, and debt service became the major component of state expenditures in a number of states. From this point in time on limitations on state debt or on state participation in internal improvements or both were written into every state constitution.

So much for the early history, what has been the impact of this provision on development in Kansas? My own conclusions are that the internal improvements prohibition has 1) required that the initiative for economic development in Kansas be with local government rather than state government; 2) forced the bulk of responsibility for developing public infrastructure essential to growth upon local government; and 3) deterred economic growth in Kansas by blocking for several years major state initiatives, such as, state highways, state financing of water resource development, and state assistance in rail service, among others.

First, concerning economic development, the internal improvements prohibition has created an ironic situation in which local governments in Kansas have been authorized by the state to do what the state is precluded from doing. This pattern was established early in statehood as local communities took the initiative with state authority to aid railroad development and provide incentives to a variety of private endeavors. Today, state law provides local governments with an array of tools to aid private enterprise, for example, in acquiring land and capital -- two essential ingredients for economic development. State government, however, continues to be constrained from taking any substantial initiative of direct assistance to industry and has become at best a weak economic development partner with local government. This constitutional constraint will become an even more serious handicap as economic competition grows nationally and internationally and as major development projects require closer cooperation between government and business. While other states are experimenting with a host of industrial incentives, Kansas competes with a shackle on one foot.

One more point concerning economic development: Freeing the state to become an active partner in economic development is particularly important outside the major metropolitan areas in my judgment. The urban centers, for example, Wichita, Overland Park, and Lenexa, which have developed a capacity to promote economic growth and have economic conditions on their side, can survive, possibly even prevail, economically without state initiative. The second-level cities, the Winfields, Coffeyvilles, Great Bends, Concordias, Colbys, and others like them, are struggling economically against long-term, adverse trends and are in particular need of a strengthened state capacity for economic development.

Second, the internal improvements prohibition has made state government less than an equal partner in developing public infrastructure essential for economic growth. For nearly 60 years, that is, until the internal improvements prohibition was first amended in 1920, state government was precluded from aiding in the construction of Kansas roads. For nearly 100 years the state could

not assist in providing flood protection, water supply, or sewers. As a result early in statehood the initiative for public infrastructure fell to local communities and mostly remains there yet today.

This local focus in infrastructure has retarded the development of projects which are regional in nature, that is, beyond the scope of one local jurisdiction but not of compelling statewide significance. For example, since 1972 laws have been on the books authorizing revenue bond financing of resort facilities at state parks, but no projects have moved forward. In 1974, state lawmakers authorized a southeast Kansas road to be financed by tolls and if necessary through the state highway and state freeway funds; but no road appeared. Actually, four years passed before the Kansas Supreme Court cleared the project from constitutional objections. In 1978 Governor Bennett proposed the development of a recreational corridor on the Arkansas River from Hutchinson to Wichita, but protests from local landowners stalled the project in the legislature. In these projects as well as many others, the state constitution has been a drag on state government's ability to move forward on public improvements of regional importance.

Third, the process of amending the internal improvements prohibition has slowed state government's ability to respond when compelling need arises and has thereby deterred economic growth. While documenting the precise economic losses incurred would be difficult, the awkward, time-consuming steps needed for Kansas to build state highways or to finance regional water supply illustrate the problem. In road-building, for example, Kansas trailed most states in planning and constructing state highways. Our first amendment to the internal improvements provision in 1920 must in retrospect be described as ill-conceived and short-sighted; it limited state participation to financial aid for county roads and wrote a rigid funding formula into the constitution. Another eight years were required to generate the political support for a more carefully drafted amendment which authorized a state system of highways and taxes to fund them. Kansas achieved in 1928 what most states had in place a decade earlier and a few had in place more than two decades earlier.

In the case of water, Kansas had suffered through 90 years of too much or too little water when the 1951 floods devastated property and caused loss of life throughout much of the state. This natural disaster helped bring about the realization that state government should have a stake in water. After seven more years of planning, persuading, and politicking, water resource development became the second major exemption to the internal improvements prohibition. Fifteen years after the constitutional amendment, state officials signed the first agreement making a long-term financial commitment with the federal government in return for regional water supplies. One hundred eleven years had passed before Kansas made its first financial commitment to water development.

In sum, the internal improvements provision of the Kansas Constitution was originally intended to prohibit state government from

direct involvement in economic development projects, and this intent has largely been fulfilled. If Kansas is to change this situation and take the initiative in stimulating economic growth, the archaic internal improvements language should be stricken from our constitution.

March 18, 1986

TO: Senate Committee on Assessment and Taxation

FROM: Ben Craig, Chairman of the Kansas Bankers Association Task Force on Economic Development

RE: SCR 1635, Repeal of Internal Improvements Prohibition

Thank you, Mr. Chairman and Members of the Committee, for this opportunity to present our support for the passage of SCR 1635.

The support of the Kansas Bankers Association was not quickly nor easily developed. It is also safe to say that support would not be forthcoming during economic conditions other than these. But our current economic condition is not merely cyclical, and unless bold and prompt action occurs from both the private and public sector, our economy will continue to be significantly below the national level, and vastly below the expectations of present and future generations of Kansans!

KBA President Deryl Schuster appointed a new blue-ribbon Task Force on Economic Development immediately following our convention last May. A roster of the Task Force is included in this testimony, and it includes bankers from the largest to the smallest, from both rural and urban communities, and from all parts of Kansas from east to west borders. We have met frequently, have solicited the advice of many experts, have worked hard, and have arrived at certain inescapable conclusions. And the main conclusion is that the public sector and the private sector, in partnership, will have to initiate bold, creative projects if Kansas is to take her necessary place in the economic mainstream.

In order for these Public-Private joint initiatives to occur, the Internal Improvements prohibition will have to be repealed. Most bold projects, which add to our economic base will not be possible without repeal. The Task Force dealt long and hard with this most difficult issue. We met with Gov. Carlin, university economists, Consultant Belden Daniels and others for many hours trying to come to grips with this issue-----because it is an issue of risk. We became convinced, however, and respectfully urge the Senate Committee to concur, that this risk is necessary to stop the decline in our Kansas economy, and commence the long, hard job of building and rebuilding over the long term.

The private sector is placing a great deal of confidence in the State Legislature when one urges repeal of this provision. Some states, in some times, have greatly abused their future generations through these means. But we believe this confidence is well-placed, that if we are all truly aware of the risk, then that risk becomes more manageable. There are certainly some projects that the state should not initiate, and there is a limit as to how many projects the state can safely accommodate. But on this issue, we urge the Legislature and the people of Kansas not to expect that the worst possible case will happen, precisely because we are all so aware of possible problems.

There has been considerable interest in a proposal for a major Venture Capital Corporation that the KBA has presented to the Kansas Legislature through the Legislative Commission of Kansas Economic Development. A copy of our communication to that Commission is attached. This could be one example of the use of "internal improvements".

Mr. Chairman, Members of the Committee, thank you for allowing us to share the efforts and conclusions of the KBA Task Force on Economic Development regarding SCR 1635.

KBA TASK FORCE ON ECONOMIC DEVELOPMENT

1985-1986

Ben Craig, Chairman	Metcalf State Bank	Overland Park
James Bartels	Farmers State Bank & Trust	Hays
Frank J. Becker	First National Bank	El Dorado
Gary L. Donley	Citizens Bank & Trust	Abilene
Franklin D. Gaines	First National Bank	Fredonia
R. E. King	First National Bank	Winfield
Howard K. Loomis	The Peoples Bank	Pratt
James O. Myers	Admire Bank & Trust	Emporia
Patrick W. Michaelis	Council Grove National Bank	Council Grove
Richard D. Powers	Garden National Bank	Garden City
Robert J. Spacheck	Pilsen State Bank	Lincolnville
John J. Sullivan, Jr.	MidAmerican Bank & Trust	Shawnee Mission
William Thompson	City State Bank	Fort Scott
Kurt Watson	Fourth National Bank & Trust	Wichita
Deryl K. Schuster, KBA President	First National Bank	Liberal
Richard D. Nichols, KBA President-elect	Home State Bank & Trust Co.	McPherson
C. N. Hoffman, KBA Treasurer	National Bank of America	Salina
Don C. Steffes, KBA Chairman	McPherson Bank & Trust	McPherson

March 13, 1986

TO: Legislative Commission on Kansas Economic Development

FROM: Harold Stones, Kansas Bankers Association

RE: Confirmation of oral testimony presented March 7, 1986

The KBA Board of Directors has tentatively approved the recommendation of the KBA Task Force on Economic Development. The approval is considered "tentative" because the decision was reached by mail, and it will be final when formally approved at a regular Board meeting.

Private discussions with some members of the Commission lead me to believe some clarification may be helpful. That is the purpose of this Memorandum.

The KBA Task Force has recommended we ask the Kansas Legislature to consider issuing an "Incentive Challenge" to the Kansas Bankers Association. If such challenge would include an appropriation for \$10 million to be used in equity for the funding of a Venture Capital Corporation, technically referred to as a Small Business Investment Company (SBIC), then the KBA would accept the challenge and attempt to raise more than \$10 million for the same purpose, and for the same SBIC.

There is already a vehicle in place, but it will have to be funded. Twenty years ago the Kansas Development Credit Corporation was funded by equity stock of around \$400,000 from various corporations, and a line of credit arrangement of some \$5 million from 400 Kansas banks. Years later, an offshoot called Kansas Venture Capital, Inc., was founded, but is not well funded. The KBA would recommend these two organizations merge into one Small Business Investment Corporation, and invest their current funds in the new SBIC. We will encourage the 400 banks with lines of credit to the KDCC to convert that credit into equity capital in the new SBIC, and we will work with the remaining 225 banks to encourage them to contribute at least 1% of their capital and surplus as equity in the SBIC. We will also work to solicit other types of business organizations to support the equity funding.

If such funding is forthcoming, the SBIC can apply to the Small Business Administration to leverage that part of the private \$10+ million which is used or committed on a three-to-one basis. There is a \$35 million limit to matching funds, so we would be looking at an SBIC with a \$50 million potential to attract new jobs for Kansans. (\$10mm State; \$10mm+ KBA; \$30mm SBA).

I am told by the Wichita and Kansas City SBA officials that some \$69 million in SBIC funding has occurred nation-wide this year, and that \$181 million is left unappropriated, and is available through the end of their fiscal year, which is September 30, 1986. They informed me that this is the last year such public funding will be available, and, absent unexpected Congressional action, all SBIC funding after October 1, 1986, will have to come from "privatized" SBA markets which will carry more expensive terms. This was unexpected news, and places an even greater urgency for action now. I would urge Commission staff to confirm this by calling Mr. Clayton Hunter or Howard Teeter of the Wichita SBA Office, Harold Nossman of the Kansas City office, or Leonard Fagan, Area Financial Analyst in the Washington D. C. office (202/653-6473).

(over, please)

I recommended to the Commission, and will elaborate here, the inclusion of an Investment Tax Credit both on the investment of equity into a Venture Capital Corporation, and on the future income of such equity. **Some members of the Commission erroneously believed that this Investment Tax Credit was the origination and invention of the KBA.** I would not apologize if this were the case, but it happens that it is not. Members need to recall that the "Redwood Study", on page 14 elaborates in Taxation Recommendation Number 4 that such Investment Tax Credit is needed to encourage high-risk investment in venture capital corporations.

Later, Belden Daniels confirmed that one of the nine initiatives being prepared for the Legislature includes such an Investment Tax Credit at the rate of 30%. Also, legislation is apparently being prepared to exempt future income from such high-risk investment corporations. We believe such tax treatment is necessary to provide the incentive to make high risk investments, and we hope there will be many smaller local SBIC's developed, in addition to the larger, state-wide one we propose. If they are to develop, such tax credit is essential. Again, these are part of the nine major legislative initiatives being prepared for legislative consideration. The KBA Task Force endorsed all nine of them, and will testify in their behalf. We assumed, rightly or wrongly, that the Legislature would not want to discriminate against the banking industry, or any other industry by legislating them out of any of the proposed initiatives.

So we are in favor of the Investment Tax Credit of 30% on investment in an SBIC, and we do urge inclusion of that provision in the Legislature's Incentive Challenge Package to us.

What if the Legislature does not see fit to issue such challenge? We will do our best to make progress without it, but the road will be much more difficult, and results much more meager. The Legislature's incentives would make raising the \$10 much more "do-able" and such a strong message would raise the industry's enthusiasm level where it needs to be to voluntarily invest that large amount of capital. Also, the Legislature's non-involvement means the loss of an original \$10 million equity which could be used over and over again.

We are pleased to suggest such a plan for bold action and the formation of the most significant "public-private partnership" in recent history. We truly believe the people of Kansas will be very positively served through such an arrangement. We look forward to hearing the Kansas Legislature's response to this suggestion.

March 7, 1986

KANSAS ECONOMIC DEVELOPMENT INITIATIVES

The nine economic development initiatives listed below are under consideration by the Legislative Commission on Economic Development. These nine initiatives address all 34 recommendations contained in the 1986 Redwood/Krider Interim Report. Each initiative will be precisely targeted for Kansas and is drawn from the very best models in other states.

INITIATIVE

DESCRIPTION

1. Create a Statewide Risk Capital System

This initiative will create a truly statewide, rural/urban system of technical support and available capital for new, existing and innovative businesses. The establishment of a statewide risk capital system will:

- a. Expand the capability of existing Small Business Development Centers to provide managerial counseling.
- b. Expand the capacity of the existing Certified Development Companies for financial packaging.
- c. Increase available risk capital through a restructuring of the existing Kansas Development Credit Corporation in a secondary market in KPERS.

This system will make private capital available to sound local small businesses in any part of the state in 1986.

2. Enact a Targeted Venture Capital Tax Credit Act

The state's extreme shortage of high risk and venture capital was described in the 1986 Interim Kansas Economic Development Study as "the main economic development problem for Kansas." Until one was established this year, there were no formal Kansas venture capital partnerships. As a result, there is a serious lack of financing for new innovative businesses and the expansion of solid established businesses that are applying research to develop new and innovative products. This initiative is intended to stimulate the formation of venture capital partnerships by establishing a tax credit against Kansas tax liability for persons or entities that invest in venture capital firms which in turn invest in Kansas companies.

3. Establish a Kansas Technology Enterprise Corporation (KTEC)

This initiative is intended to address two problems:

- a. The relative lack of interaction between private enterprise and educational institutions in areas of innovation and applied research.
- b. The lack of seed-capital financing for the development and commercialization of new products or processes.

The Corporation would foster innovation by:

- a. Engaging in seed capital financing for the development and implementation of innovations.
- b. Awarding applied research matching grants to educational institutions and businesses to more innovation toward commercial application.
- c. Providing managerial assistance and technical referral services to small, new and emerging companies.

The Corporation is intended to absorb and expand the activities of the existing Advanced Technology Commission. It is a powerful institution which brings Kansas universities, the private sector and state government into a creative partnership to finance research and development in the states basic industries and to support the birth and expansion of innovative new Kansas firms.

The establishment of such a Corporation can improve the pace at which industries innovate and grow, thereby increasing the number of available jobs and stimulating the economy.

4. Repeal the Internal Improvements Prohibition

The Constitutional prohibition against the use of state funds for internal improvements stems from excessive debts incurred by several states by funding the construction of canals, roads and railroads during the early 1800's. Following the national financial crisis of 1837, a few states defaulted on their loans for internal improvements. The Kansas provision reflects the desire of the 1859 Wyandotte Convention to avoid a similar situation in Kansas.

5. Allow local governments the option to provide property tax abatements for the location or expansion of industry.

Tax burdens sometimes become deterrents to locations in Kansas. These burdens prohibit the creation of employment and the increase in personal income for a community if they restrain the company from locating.

An option that can be available to cities or counties is the abatement or exemption of property taxes. This option is intended to allow industry to concentrate their money in the equipment and land purchases necessary for expansion or relocation. Twenty-four states currently offer constitutional or statutory provisions which allow companies this incentive.

Local governments will be allowed the option to grant these abatements if they feel that the proposed expansion will provide economic benefits to their community.

6. Restructure the Kansas Department of Economic Development

This initiative will more clearly define the mission of KDED and fund additional activities. The proposals being considered by the Commission are:

- a. Existing Industry - Expand and focus the responsibilities of the existing small business division and increase the number of field offices from two to five.
- b. Industrial Recruitment - Substantially increase the funding for targeted industrial recruitment and advertising, open an office in Europe and expand the Kansas presence in Japan.
- c. Trade Development - Establish a new division focused solely on interstate and international trade, including all of the state's agricultural marketing functions.
- d. Community Development - Expand the activities of the Community Development division in assisting Kansas communities.

These changes, if funded adequately, will substantially improve the state's leadership role in economic development.

7. Establish a Legislative Economic Development Committee

The proposal to establish a permanent committee(s) on economic development is intended to address two key problems:

- a. Economic development legislation is handled by multiple committees in each house. This results in less visibility for economic development issues and fragments the policy making process.
- b. The appointment of temporary ad hoc or interim committees on economic development lacks the continuity needed to address the state's economic and employment needs.

A permanent committee devoted exclusively to economic development policy is badly needed.

8. Establish Kansas, Inc., a forum for strategic economic planning

Kansas lacks an entity to provide ongoing short and long term strategic economic analysis and planning. Its establishment would give Kansas the capability to analyze the economic impact of gaining or losing a major industry, the potential benefits of a particular economic policy and to identify opportunities and strategies for economic growth. The mission and organization of "Kansas, Inc." will be based on the best models in other states.

9. Create four Interim Task Forces

Four areas need special analysis during the 1986 interim: agricultural research, funding for state universities, the state's capital markets, and the state's tax structure.

Institute for Public Policy and Business Research

Background Paper

Recommendation #27. Review the constitutional prohibition on internal improvements to determine if it should be modified or repealed.

Also relates to recommendations #13, 14, 15, 16, 18, 28, 29, and 32.

Introduction

Several recommendations contained in the Kansas Economic Development Study may not be workable in Kansas as their implementation would violate the Internal Improvements Prohibition of the Kansas Constitution.

Article 11, Section 9 states that

"The state shall never be a party in carrying on any work of internal improvement except that: (1) it may adopt, construct, reconstruct and maintain a state system of highways, but no general property tax shall ever be laid nor general obligation bonds issued by the state for such highways; (2) it may be a party to flood control works and works for the conservation or development of water resources; (3) it may, whenever any work of internal improvement not authorized by (1) or (2) is once authorized by a separate bill passed by the affirmative vote of not less than two-thirds of all members then elected (or appointed) and qualified to each house, expend or distribute funds received from the federal government therefore and may participate with the federal government therein by contributing any state funds appropriated in accordance with the law for such purpose in any amount not exceeding the amount received from the federal government for such improve-

ment, but no general property tax shall ever be laid nor general obligation bonds be issued by the state therefor; and (4) it may expend funds received from the federal government for any public purpose in accordance with the federal law authorizing the same."

Historic and Current Rationale for the Constitutional Prohibition

The state legislative department determines what governmental functions the state shall undertake. In doing so, they may exercise such powers as are not prohibited by the federal constitution or by the state constitution. Acts of internal improvement are not prohibited by the federal constitution. Therefore, in order to preclude the Kansas legislature from acts of internal improvement, a state constitutional prohibition was necessary.

The rationale for such a prohibition stems from the financial crisis many states were experiencing around 1837. In State ex rel. Coleman v. Kelly, 71 Kan. 811 (1905), the Kansas Supreme Court quoted from a Michigan case that traced the events leading to the prohibitive sentiment:

"The War of 1812 demonstrated the great need for a better system of intercommunication between the various portions of the country. The condition of the highways, both land and water, was such that troops and provisions could be moved but slowly and at great expense. This was also true of the products of the country. Succeeding the war of 1812, the state of New York entered upon the construction of the Erie Canal. Its construction was doubtless of great benefit to the agricultural and commercial interests of the

state, and especially to the city of New York. Other states were prompted to follow the lead of New York, and projected the digging of canals, the improvement of waterways, and the construction of railroads. Nearly all the state constitutions adopted between 1830 and 1850 either gave the legislature permission, or made it mandatory, to 'encourage internal improvements within the state.' Many enterprises of this character were entered upon which were ill-advised. So many of them were undertaken, many of the states incurred obligations they were unable to meet. The rate of interest in these new countries was much higher than capital commanded in Europe. Money from there after 1830 was furnished almost without limit, to be invested in the various projects devised by the several states. The state debts increased from \$13,000,000 in 1830 to \$100,000,000 in 1838. After the financial crisis of 1837 came, foreign capitalists who sought to draw out this money were unable to do so. An effort to collect these obligations proved abortive. Upon one pretext or another, many of the states repudiated their debts made for internal improvements. The states most disastrously affected were Maryland, Pennsylvania, Indiana, Illinois, Louisiana, Mississippi, and our own state [Michigan]." Id. at 831-32.

With these events in mind, the Kansas Supreme Court, in State ex rel. Coleman v. Kelly, 71 Kan. 811 (1905), set out the basic rationale for the prohibition:

"This constitutional provision is a limitation placed by the people in their paramount law upon the power of the legislature, preventing it from diverting the energies of the state from public and governmental functions into private and business enterprises. No circumstances can arise which will justify its violation by any governmental department." 71 Kan. at 829.

Constitutionality of Economic Development Recommenda-

tions

Eight of the thirty-four recommendations contained in the study are likely to be challenged as unconstitutional under the internal improvements prohibition if they are put into effect. These are the finance recommendations, numbers 13, 14, 15, 16, and 18, recommendations for state support of incubators, numbers 28 and 29, and state CDBGs, number 32.

The first issue to address in determining constitutionality is whether the establishment of the recommendation in question would constitute a work of internal improvement. Here, the courts have distinguished unconstitutional internal improvements from constitutional public improvements. Article 11, Section 6 of the Kansas Constitution allows the state to contract public debts for the purpose of making public improvements:

"For the purpose of defraying extraordinary expenses and making public improvements, the state may contract public debts; but such debts shall never, in the aggregate, exceed one million dollars, except as hereinafter provided. Every such debt shall be authorized by law for some purpose specified therein, and the vote of a majority of all the members elected to each house, to be taken by the yeas and nays, shall be necessary to the passage of such law; and tax sufficient to pay the annual interest of such debt, and the principal and interest; and such appropriation shall not be repealed nor the taxes postponed or diminished, until the interest and principal of such debt shall have been wholly paid."

In State ex rel. Boynton v. State Highway Commission, 138 Kan. 913, 919, the court discussed the difference between internal and public improvements:

"It is clear the framers of our constitution used the term 'public improvements' in section 5 [now section 6] as meaning something entirely distinct from what was meant by 'internal improvements' used in section 8 [now section 9], for the one was permitted, the other prohibited. Although not as full as they might be, the debates in the constitutional convention disclosed this: The term 'public improvements,' used in section 5, meant public buildings which the state should need in carrying on its functions, such as the state house, state penal, educational and eleemosynary institutions (Wyandotte Constitutional Convention, p. 327), while the term 'internal improvements,' used in section 8, applied to turnpikes, canals and the like. (Wyandotte Constitutional Convention, p. 329; State v. Kelly, 71 Kan. 811)" (p. 919)

In Leavenworth County v. Miller, 7 Kan. 479, 493, Chief Justice Valentine discussed this subject and quoted from an Alabama case:

"The state, as a state, is absolutely prohibited from engaging in any works of internal improvement. We will concede that this prohibition does not extend to the building of a statehouse, penitentiary, state university, and such other public improvements as are used exclusively by and for the state, as a sovereign corporation; but it does extend to every other species of public improvement. It certainly extends to the construction of every species of public improvement which is used, or may be used, by the public generally--by any and every private individual who may choose to use it--such as public roads, bridges, etc. Wetumpka v. Winter, 29 Ala. 660.

If it is determined that a proposal would constitute an internal improvement, then the next issue

becomes whether the state is a party to the work of internal improvement. In discussions on this point Kansas courts have allowed state expenditures on internal improvements as long as the outlays are for inspection, supervision, or regulation and do not involve direct expenditures by the state in carrying on the work of internal improvement. In State ex rel. Hopkins v. Raub, 106 Kan. 196, the court discussed the State's role in highway construction before the internal improvements prohibition was amended to allow for a state-constructed system of highways:

"The fact that state funds are expended for inspection and regulation does not make the state a party to the business or the work carried on. In the building of roads and bridges the state neither buys nor furnishes any material, and does not directly invest any money in that work. The state highway commission is performing a very important work in an educational and regulatory way and in coordinating the efforts of the communities and municipalities of the state to build and maintain trunk and lateral highways throughout the state, but important as the work is, it does not furnish a basis for the complaint that the state itself is engaged in carrying on a work of internal improvement." 106 Kan. at 202.

Attorney General Opinion No. 84-102 generalizes the Raub decision:

"The decision of State ex rel. v. Raub, 106 Kan. 196 (1920), indicates that the state must have more than a supervisory role over a project to invoke the provisions of the section. The state must itself be engaged in

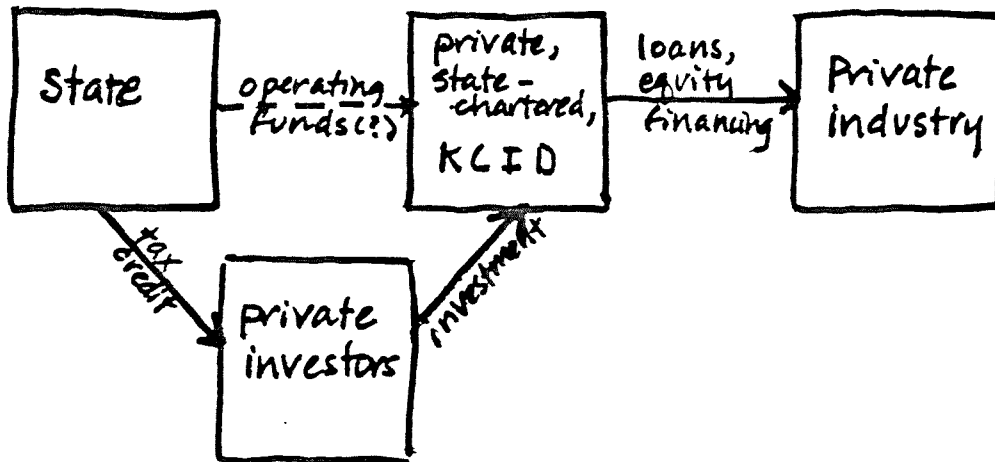
carrying on the work; it must expend state moneys in a role more substantial than that of a coordinator, supervisor or regulator. Accordingly, where the expenditure of funds occurs at the county or city level (which entities are not bound by the limits of Article 11, Section 9), with the state's role confined to that of inspector or coordinator, the section's provisions are never triggered."

Kansas courts have not yet ruled directly on the types of improvements specified in the recommendations. In this memorandum we examine each of the eight recommendations that are likely to be questioned for constitutionality with respect to the internal improvements prohibition.

#13. Establish a Kansas Corporation for Innovation Development (KCID).

The flow chart in figure one pictorializes the financing arrangements contemplated in recommendation 13. The KCID is a private, state-chartered organization. The states involvement with the KCID is limited to organizational concerns and may include some initial funding for start-up of operations. A tax credit will provide an incentive for private investment in the KCID. The KCID will provide loans or equity financing to businesses and SBICs.

Figure 1.



The KCID would be an internal improvement, as opposed to a public improvement, since it is not "to be used exclusively by and for the state." (State ex rel. Boynton v. State Highway Commission, 38 Kan. 913, 919.) Kansas courts have stated that the internal improvements prohibition was designed to avoid involving the state "in a purely private business enterprise," (State v. Kelly, 71 Kan. 811) and that "economic distress is not justification for ignoring the Constitution itself" (State v. Atherton, 139 Kan. 197).

However, internal improvements are not unconstitutional per se. For unconstitutionality it must be shown that the state is a party to the work of internal improvement. Article 11, Section 9, only prohibits the state as a state from engaging in works of internal improvements (Leavenworth County v. Miller, 7 Kan. 479 (1871)). In State ex rel. Tomasic v. Kansas City, Kansas Port Authority, 230 Kan. 404 (1981), the court

said that "the state may authorize public or private corporations or individuals to construct internal improvements." In State ex rel. Hopkins v. Raub, 106 Kan. 196 (1920), the court said, "The fact that state funds are expended for inspection and regulation does not make the state a party to the business or the work carried on." The KCID should survive a constitutional challenge, even though the purpose of the organization is directed specifically towards internal improvements, as long as state funds are not expended for other than the inspection or the regulation of the CID. Unfortunately, the wording of the recommendation is ambiguous on this point.

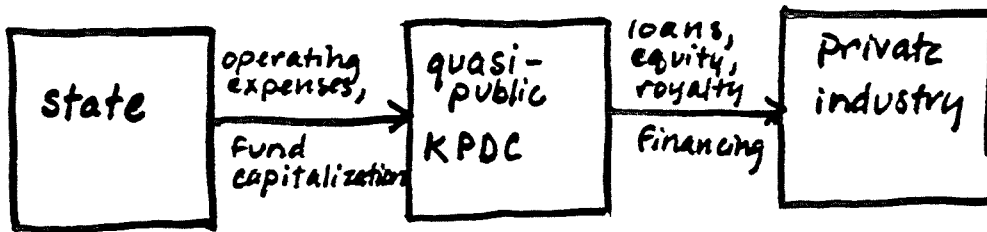
The recommendation calls for a tax credit to provide private investment, but the final sentence states that "further leveraging of state funds would occur if the KCID required that all its investments be matched with funds from the private sector." There is no other reference to state funding in this recommendation. Readers are confused as to whether public as well as private funding is contemplated, or whether this is a reference to state revenues foregone by the tax credit. In light of the express statements calling for state funding under other recommendations, we should not leave it to be implied in this instance. This important point should be clarified in the final draft since

constitutionality of the KCID may be determined by the existence of state funding.

#14. Establish a Kansas Product Development Corporation.

The flow chart in figure two depicts the funding arrangements called for in this recommendation. The KPDC is a quasi-public institution. The state would temporarily finance the KPDC's operating expenses and fund capitalization. The KPDC will provide loans, equity financing, or financing through royalty agreements, to entrepreneurs with viable ideas.

Figure Z.



If the KPDC, a quasi-public institution, acts as an arm or agency of the state, then the flow of funds that is relevant to the internal improvements prohibition is not from the state to the KPDC (as it was from the state to the KCID), rather, it is from the KPDC to the entrepreneurs.

The funding of private enterprise called for in this recommendation would constitute an internal, as opposed to a public, improvement. (State ex rel. Boynton v. State Highway Commission, 138 Kan. 913; State v. Kelly, 71 Kan. 811).

As to whether the direct state funding of private enterprise (the entrepreneurs) would make the state a party to an internal improvement, a negative inference can be drawn from State ex rel. Hopkins v. Raub, where the court found that the state may regulate and coordinate local highway projects since "[the state] does not directly invest any money in that work" (106 Kan. 196, at 202). The KPDC would make the state a party to works of internal improvement by making direct investments in private business enterprise.

It is possible that the structure of the KPDC's investment could make a difference in the constitutionality argument. Other states' case law seems to indicate that internal improvement investments in the form of loans may be constitutionally permissible. (In Wisconsin: State v. Nusbaum, 208 N.W.2nd 635; In re Advisory Opinion, 158 N.W.2nd 416.) This may be because the state does not owe money, rather someone owes the state money. Equity financing and royalty agreements are more constitutionally suspect than loans since there is no legal guarantee for a certain

return on (or of) the state's money and these arrangements must therefore be viewed as unconditional outlays of state funds, more like outright purchases of internal improvements. While most product development companies structure their investments as royalty agreements, perhaps the KPDC could avoid unconstitutionality if it restricted the form of its investments to loan financing.

#15. Establish a state fund to match federal Small Business Innovation Research grants to Kansas small business.

The flow chart set out in figure three shows the funding arrangement called for by recommendation #15. The federal SBIR program makes grants to small firms. The state would match these grants.

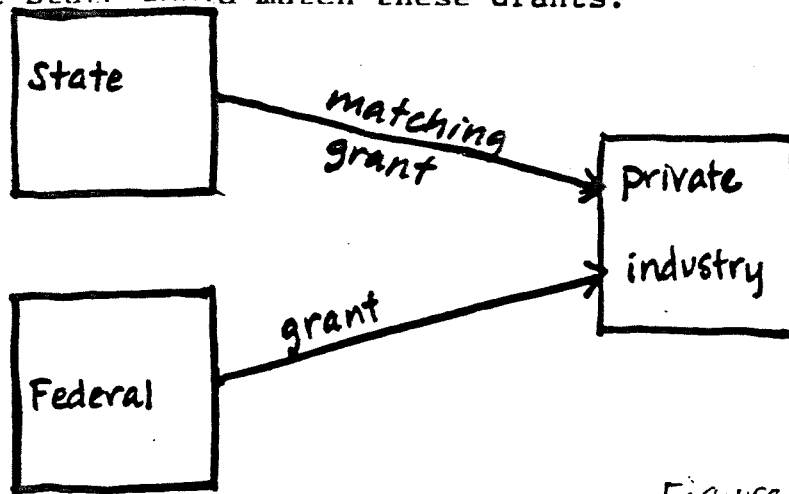


Figure 3

Following the analysis set out in #14 above, the constitution would prohibit direct state funding of private enterprise called for by an SBIR matching grant program. However, Subsection (3) of Article 11,

Section 9 is an exception to the internal improvements prohibition which does allow the state to make expenditures to match federal funds:

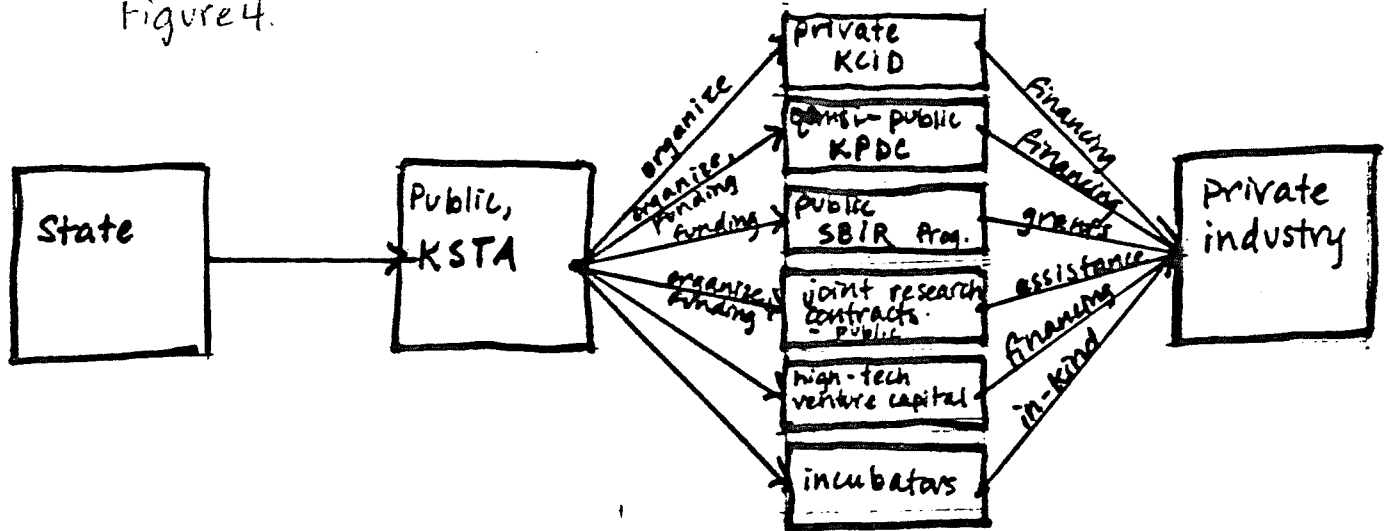
"(3) [The state] may . . . expend or distribute funds received from the federal government [for internal improvements] and may participate with the federal government therein by contributing any state funds appropriated in accordance with the law for such purpose in any amount not exceeding the amount received from the federal government for such improvement, . . ."

Unfortunately, the SBIR matching grant program would not qualify as an exception to the internal improvements prohibition under this subsection. The exception contemplates state distribution of federal funds and this does not occur under the federal SBIR program. Under the federal program, funds are distributed directly from the federal government to the SBIR grant recipient. The state has no part in distribution of the federal funds. Also, the contribution of state funds must be made "in accordance with the law for such purpose." "The law" referred to is the federal law governing state matching of federal program funds. (See Attorney General Opinion 83-61 where the state matches Federal loan guarantees for railroad rehabilitation.) The federal SBIR legislation contains no provisions for state matching grants. The State SBIR matching grant program would therefore be in violation of the internal improvements prohibition.

#16. Establish a Kansas Science and Technology Authority.

The flow chart in figure 4 shows the relationships created by the Kansas Science and Technology Authority. The Authority would be a public organization in charge of operating several different economic development programs.

Figure 4.



The organizational and managerial function of the Kansas Science and Technology Authority would not violate the constitution. The Authority would be analogous to the State Highway Commission situation in State ex rel. Hopkins v. Raub, 106 Kan. 196 (1920), where the court said: "The fact that state funds are expended for inspection and regulation does not make the state a party to the business or the work carried on.

However, for some programs, the Science and Technology Authority does more than coordinate, supervise,

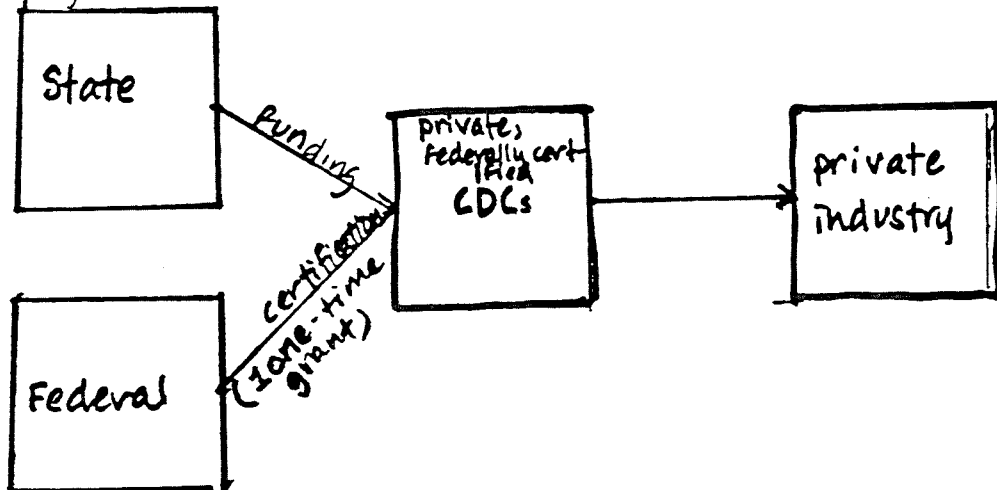
or regulate. In some cases the Authority channels state funds to the program. The Authorities involvement with each of these programs must be distinguished on the basis of its constitutionality. The organization by the Authority of a Kansas Corporation of Innovation Development would be constitutional, only so long as the Authority does not pass state funds to the KCID. (See discussion on recommendation #13, above.) The solicitation and facilitation of joint research contracts and grants between state universities, businesses and government would be constitutional based on State v. Raub supra since the Authority would only be spending money to coordinate the work to be carried on.

It may be constitutional for the Authority to pass state funds to the Kansas Product Development Corporation since the KPDL is a quasi-public and not a private industry. However, the further channeling of those state funds from the KPDC to private industry would still be unconstitutional (see #14 above) making grants of state money through the Kansas SBIR Program would be unconstitutional (see #15 above). The constitutionality of managing a high tech venture capital fund, and constructing and operating incubators would depend on the degree of the Authority's involvement with those operations and this has not been specified at this time.

#18. Provide temporary state funding for Certified Development Companies.

The flow-chart in figure 5 maps the relationships between the federal government, the state government and private industry which would be created by state funding of CDCs.

Figure 5.



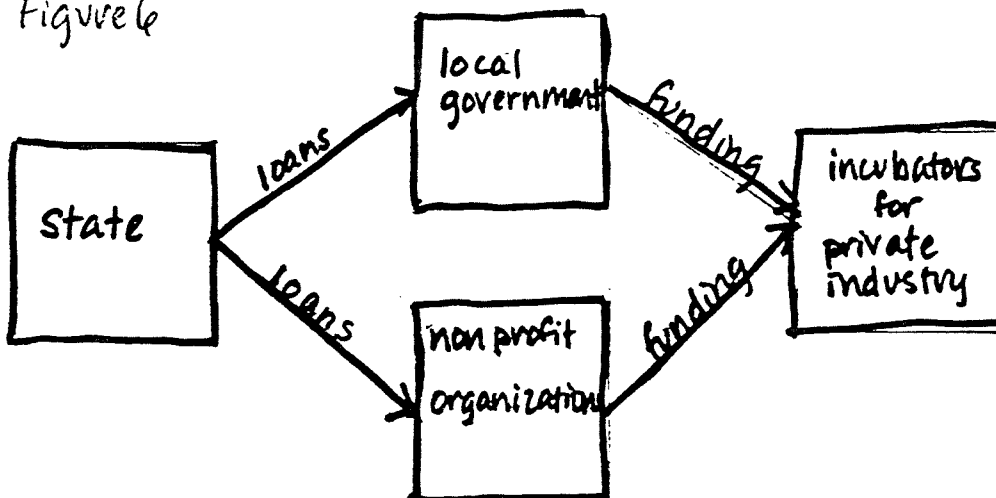
The CDCs would be characterized as internal improvements because they are not institutions "which the state should need in carrying on its functions." (State ex rel. Boynton v. State Highway Commission, 138 Kan. 913.) The direct funding called for in this recommendation would make the state a party to the work of internal improvement. However, the fact that the state has already provided some funding to CDCs by awarding onetime grants of \$40,000 to two Kansas CDCs is evidence that the current arrangement does not violate the internal improvements prohibition. If direct funding of the CDCs is not in violation of the prohibition

then the reason is that the funding is "appropriated in accordance with the law for such purpose in [an] amount not exceeding the amount received from the federal government for such improvement". Article 11, Section 9, Subsection 3. Increased funding for CDCs would be constitutional as long as the net amount of funding does not exceed direct funding received from the federal government.

#28. Provide low or no-interest matching loans to local governments and nonprofit organizations to facilitate the establishment of incubators.

The flow chart in figure 6 depicts the flow of funds contemplated under recommendation #28.

Figure 6



The incubators proposed in this recommendation are physical structures which would clearly be classified as internal improvements since they are not "public buildings which the state should need in carrying on

its functions." (State ex rel. Boynton v. State Highway Commission, 138 Kan. 913). Under this arrangement the local communities would be doing the contracting for the internal improvement and the state would not be a party to that contract. Arguably, the state is therefore not a party to an act of internal improvement. In State ex rel. Tomasic v. Kansas City, Kansas Port Authority, the court agreed that the state may authorize public or private corporations to construct internal improvements (230 Kan. 404 (1981)). But that case is distinguishable since the state only authorized the Port Authorities and did not provide them any financial assistance. In our case there is the issue of state funding of the local community with directions that the funding be used for economic development. "[W]here the expenditure of funds occurs at the county or city level (which entities are not bound by the limits of Article 11, Section 9), with the state's role confined to that of inspector or coordinator, the section's provisions are never triggered." (Attorney General Opinion 84-102) (our emphasis). This state funding also calls to mind the general principle of law that one cannot do through another what one is forbidden to do oneself.

It is possible, however, that since the state funding contemplated under this recommendation is in

the form of a loan, it would not constitute a direct state investment and the state would therefore not be a party to the internal improvement. (See analysis of recommendation #14 above.)

#29. A general loan pool for infrastructure development should be available for use by communities to promote economic development.

The flow chart in figure 7 sets out the funding arrangements for recommendation #29.

Figure 7



The types of infrastructure specified in recommendation #29--"roads, sewers, water lines and other improvements"--would be internal improvements. (State ex rel. Boynton v. State Highway Commission, 138 Kan. 913.) As in #28 above, the tough question is whether the state is a party to the internal improvement. An analysis of this section for constitutionality would be identical to the analysis of recommendation #28 above.

#32. A state community development block grant program should be established and targeted to economic development.

The flow chart in figure 8 shows the flow of funds called for by recommendation #32.

Figure 8.



The grants called for under this recommendation are to be used by the local communities for infrastructure improvements (roads, sewers, water lines etc.), incubators and industrial parks. These constructions would be internal improvements. (State ex rel. Boynton v. State Highway Commission, 138 Kan. 913). The determination of whether the state is a party to these works of internal improvement would follow the analysis set out under #28 and #29 above. The local community would actually be contracting for the internal improvement. However, the state is funding these improvements by grants to the local community with instructions that the grants be targeted to the improvements. Again, this seems to violate the general principle of law that one cannot do through another that which one is forbidden to do oneself.

One difference between the analysis of recommendation #32 and recommendations #28 and #29 is that since #32 calls for a state grant and not a state loan, it

loans from other forms of financing. (See recommenda-
tion #14 above.)

Shirley Klenda Sicilian,
Research Economist
Institute for Public Policy
and Business Research



March 7, 1986

TO: Subcommittee on Finance
FROM: H. Edward Flentje
SUBJECT: Study of Capital Finance and Public Infrastructure

As a progress report on the study of capital finance and public infrastructure I am submitting documents within the following outline:

- I. Review of Existing Policy
 - A. "Capital Finance Policy in Kansas"
 - B. "Policy Chronology of Capital Finance in Kansas"
 - C. "Outstanding Public Debt in Kansas, 1861-1984"
- II. Basis for Evaluating Existing Policy
 - A. "Criteria for Assessing Capital Planning and Budgeting"
 - B. "Capital Expenditure Trends in Kansas" (to be provided at meeting)
- III. Policy Choices in Capital Finance and Infrastructure

Attachment 5
Senate Tax Comm. - 3/18/86

H. Edward Flentje

Dated 3/7/86

Capital Finance Policy in Kansas

The principal means by which Kansas finances capital improvements and public infrastructure may be summarized as follows:

1. "Pay as we go." The historic admonition of Governor John St. John (1881) that Kansas should avoid debts and "pay as we go" captures a dominant strain of capital finance in Kansas. The severe debt limitations and ban on "internal improvements" in the Kansas Constitution reflect this philosophy. Under a pure pay as we go policy state government would finance capital improvements from current general revenues available to the state. While there are important exceptions, Kansas has followed this policy for extended periods of state history particularly during the first 60 years of statehood. Present day examples of pay as we go include paying from general revenue funds for the purchase of water storage in federal reservoirs, for capital improvements at state correctional institutions, and for major maintenance projects at state universities.
2. Delegate debt financing of capital improvements to local government. Given the severe constitutional limitations on capital finance and a strict pay as we go philosophy, state government has delegated to local government that which the state

was precluded from doing directly. Beginning early in statehood, lawmakers focused state attention somewhat narrowly on the facility requirements of state institutions and delegated responsibility, as well as liberal debt financing authority, for the bulk of public infrastructure -- roads, water supply, and sanitation -- to local governments. Today, state statutes grant hundreds of authorizations for debt financing to local units and require minimal supervision of local debt issuance. As a result, local governments in Kansas are estimated to spend nine dollars on infrastructure for every dollar spent by state government.

3. Pay as we go with special purpose capital improvement funds.

Kansas survived with a strict pay as we go philosophy as long as the state faced no major demands for capital improvements. When new capital projects competed with budgetary requests for the on-going operation of state government, capital improvements could be more easily deferred and often were. To protect capital improvement requests from the annual competition for current revenues under a strict pay as we go philosophy, special purpose capital improvement funds have been authorized, the most prominent being the road and highway fund. In 1928 Kansas electors adopted a constitutional amendment which authorized special taxes on motor vehicles and motor fuels and dedicated these revenues to road and highway purposes. This change made roads and highways state government's major contribution to public infrastructure in Kansas. Since 1928, two other special purpose capital improvement funds supported by state levies on property have been authorized,

the Educational Building Fund for Regent's institutions (1941) and the State Institutions Building Fund for state institutions (1953) for the mentally ill or retarded, handicapped, and children. In sum, these capital improvement funds constitute a revision of a strict pay as we go policy. Capital improvements continue to be funded from a current revenues, that is, on a pay as we go basis, but these revenues are set aside, dedicated to capital improvement purposes, and thereby protected from competition with other state purposes.

4. Authorize state agencies to finance capital improvements with bonded debt backed by anticipated revenues. The state constitution severely limited state government's ability to finance capital improvements through the issuance of debt. The constitutional concept of debt was that debt backed by the taxing power of the state, historically meaning debt backed by state's power to tax property. As a result for the first 70 years of statehood less than \$1 million in capital improvements were underwritten through state debt. Kansas lawmakers first sought to escape state debt limits in the early 1930s when the federal government offered to loan the state funds for road building purposes. The State Highway Commission was authorized to borrow federal funds and enter into long term obligations with the federal government for their repayment from revenues anticipated to be received into the highway fund. The Kansas Supreme Court sanctioned this legislative action and ruled that the debt incurred was not state debt as envisioned in the constitution, in

other words, debt backed by the property tax. Within another 20 years revenue debt was similarly authorized for the construction of student dormitories on campuses of Regent's institutions (1949) and for the building of armories throughout the state (1953). Today, the state has incurred revenue debt to construct highways, higher education facilities (including housing, sewerage treatment, student unions, stadiums, recreation complexes, clinical facilities, field houses, libraries, parking, and classroom buildings), fish hatcheries, and office buildings. Statutes authorize revenue debt financing for certain other state facilities, such as resorts at state parks, but this authority has not been exercised. Kansas state government has over \$300 million in revenue debt currently outstanding and spends roughly \$25 million each year to service this debt.

5. Create independent authorities to undertake capital improvements through debt financing. In 1953 the Kansas legislature created the Kansas Turnpike Authority as "a body politic and corporate" and authorized the Authority to issue revenue debt for the purpose of constructing turnpike facilities within Kansas. After the Kansas Supreme Court cleared the Authority from constitutional objections in 1954, the Authority issued \$160 million in revenue bonds to finance construction of a 236 mile toll road from Kansas City by Topeka and Wichita to the Oklahoma border. Repayment of this debt was secured solely from tolls and income from the turnpike. In 1957 the Authority financed the construction of the 18th Street Expressway through an additional \$19.5 million in

revenue bonds which were secured by toll revenues from the expressway and the State Highway Fund. Kansas lawmakers have authorized other toll roads under the auspices of the Authority to be constructed through debt financing secured by toll revenues and by the State Highway Fund and the State Freeway Fund, but no further road projects have been undertaken.

6. Rely on federal assistance to underwrite capital improvements for state purposes. Kansas has historically sought to maximize federal assistance available for capital improvements. Literally at the dawn of statehood federal grants of land and land proceeds were committed to the construction of facilities at state institutions. In the twentieth century federal assistance to roads and highways began in the 1920s and continues at a high level today. The construction of federal water projects in Kansas began in earnest in the 1940s, and since 1958 the State of Kansas has committed to participating in the construction of nine federal reservoirs, incurring a state obligation to repay a minimum of \$25 million up to a maximum of \$70 million. New federal water projects are now on hold. A substantial portion of federal general revenue sharing available to Kansas was dedicated to capital construction at state universities during the 1970s, but this program is now gone. In 1984 the state lawmakers agreed to act as conduit for \$18 million in federal loans to rehabilitate Kyle Railways and conditionally guaranteed to repay 50 percent of any defaults on the loans. With a few important exceptions federal assistance available to undertake capital improvements for state purposes is on the decline.

H. Edward Flentje
Dated 3/7/86

Policy Chronology on Capital Finance in Kansas

- 1859 Wyandotte Convention adopts state constitution with strict limits on state debt and prohibition on state participation in internal improvements.
- 1871 Kansas Supreme Court rules that while state government is prohibited from participating in internal improvements, the state may delegate to local units of government the authority to undertake internal improvements.
- 1920 Voters adopt constitutional amendment exempting state aid for the construction of county roads and highways from the internal improvements prohibition and limiting the form of such aid.
- 1928 Voters adopt constitutional amendment exempting the construction, reconstruction, and maintenance of a state system of highways from the internal improvements prohibition, and authorizing special taxes on motor vehicles and fuels for road and highway purposes.
- 1933 Lawmakers authorize Kansas Highway Commission to borrow federal funds in order to undertake expanded highway improvements; in 1934 the Kansas Supreme Court rules this borrowing is not subject to constitutional limitations on state debt.
- 1941 Lawmakers authorize Educational Building Fund supported with a levy on property dedicated to construction, reconstruction, equipment and repair of building and grounds of Regents institutions (authorization based on constitutional amendment adopted in 1918).
- 1949 Kansas Supreme Court rules debt financing of college dormitories does not violate debt limitations and is not prohibited by internal improvements provision in state constitution.
- 1952 Voters adopt constitutional amendment authorizing State Institutions Building Fund; levy enacted in 1953 and dedicated to construction, reconstruction, equipment and repair of building and grounds of State institutions for mentally ill and retarded, handicapped, and juveniles.
- 1953 Lawmakers create Kansas Turnpike Authority and authorize debt financing of Kansas turnpike.
- 1953 Kansas Supreme Court rules debt financing of armories throughout the state does not violate debt limitations in state constitution.
- 1958 Voters adopt constitutional amendment exempting flood control works and works for the conservation or development of water resources from internal improvements prohibition.
- 1985 Lawmakers authorize Secretary of Administration to finance certain fixtures and equipment of state agencies through certificates of participation.

DRAFT
3/7/86

TABLE 1
Outstanding Public Debt in Kansas
1861 to 1984

Year	<u>Total Debt (in thousands)</u>		<u>Debt per capita</u>	
	State	Local	State	Local
1861	\$ 181	N.A.	\$ 1.30	N.A.
1872	1,342	\$ 10,749	3.68	\$ 29.48
1880	1,066	13,999	1.07	14.05
1890	800	36,492	.56	25.57
1900	692	32,399	.47	22.03
1913	529	47,417	.31	28.04
1920	0	72,097	.00	40.75
1930	24,500	137,464	13.02	73.08
1940	14,000(est.)	100,276	7.77	55.68
1950	5,500	110,617	2.87	58.06
1960	202,331	534,546	92.87	245.36
1970	223,600	938,300	99.42	417.19
1980	438,100	2,838,500	185.32	1,200.72
1984	356,100	5,204,100	145.35	2,124.12

Sources: James Ernest Boyle, The Financial History of Kansas; Summary History of Kansas Finance, 1861-1937; Kenneth E. Beasley, State Supervision of Municipal Debt in Kansas; and U.S. Census.

H. Edward Flentje
Dated 3/7/86

Criteria for Assessing Capital Planning and Budgeting

A. The planning process should:

1. provide a consistent time frame for capital improvement plans
2. assess the impact of social and economic change on demand for facilities
3. inventory current assets/facilities
4. conduct on-going assessment of the condition of existing assets/facilities, for example:
 - how are facilities valued?
 - how are facilities depreciated?
5. provide advice on whether to replace, rehabilitate, maintain, or abandon facilities

B. The budgeting process should:

1. be coordinated with capital planning
2. assess projects for operating budget impact (short-term and long-term)
3. set priorities for competing projects using for example:
 - project evaluation/cost-benefit analysis
 - needs assessment
 - net present value
 - funding availability
4. evaluate alternative funding: federal, local, other?

C. Principals of capital finance (current best practice):

1. Whenever possible the beneficiaries of a public facility should pay for its development and operation. Payments should be related to the level of use.
2. The cost of a public capital project should be amortized over the life of the project and maintenance and operating costs should not be deferred.
3. The operating and maintenance expenses associated with a project -- operating a classroom building, maintaining a bridge, or repairing and upgrading a hospital -- should be explicitly considered when designing the financing package.
4. Fiscal and administrative responsibility for a public investment project should fall to those jurisdictions most affected by the project.

H. Edward Flentje
Dated 3/7/86

Policy Choices on Capital Finance in Kansas

A. Revise constitutional limitations on capital finance.

1. Repeal internal improvements prohibition (see attached testimony).
2. Update state debt provisions or repeal them (see attached debt provisions in 1970 Illinois constitution).

B. Adopt broader "pay as we use" policy for capital finance.

A pay as we go philosophy has dominated capital finance in Kansas historically. Moving toward pay as we use would expand revenue debt financing of capital improvements and shift financial burden of capital expenditures from current taxpayers to those who use facilities. Revenue debt financing would also allow state government to address the current backlog of capital projects and initiate, for example, new highway construction, purchase of water storage available in federal reservoirs, and systematic preventive maintenance of state facilities, among others.

C. Strengthen state capacity for planning and budgeting capital improvements.

Existing procedures for capital planning and budgeting are decentralized in various state agencies and uneven in quality. Neither the executive or legislative branches have staff capacity for independent review of capital improvements, and current process falls short of best practice in other states. Choices available would include:

1. Providing staff with capital finance and planning expertise to support both the chief executive and the legislature.
2. Creating a Capital Development Authority which would have: 1) authority for revenue debt financing of facilities at state institutions and for the coordination of planning and budgeting of improvements at these institutions; and 2) expertise for capital planning and budgeting, capital finance, and debt management.

C. Other Issues

1. Integration of Kansas turnpike with overall state transportation program.
2. Continued reliance on property taxes for capital improvements at state institutions.
3. Absence of dedicated revenues for improvement of state offices and correctional facilities.

**Statement to
Legislative Commission on Kansas Economic Development**

by
H. Edward Flentje
February 26, 1986

Mr. Chairman, members of the Commission, I thank you for the invitation to testify today on the internal improvements prohibition in the Kansas Constitution. I am taking the liberty of commenting also on the public debt provisions in the state constitution as they are in my view relevant to your work.

As most of you are aware, I am currently conducting a study of capital finance and infrastructure for the Special Commission on a Public Agenda for Kansas. My comments today are based on preliminary findings and conclusions from that study. The views expressed and recommendations made, however, are strictly my own and do not represent the Special Commission or its committees.

Let me begin by stating my recommendations to you:

First, I recommend that you initiate the steps necessary to eliminate the internal improvements prohibition from the Kansas Constitution. This prohibition is a nineteenth century idea which has deterred growth in Kansas for most of the twentieth century. Kansas electors should be given the opportunity to abandon this idea in order that state government may prepare for the twenty-first century.

Second, I also recommend that the public debt provisions in the constitution be revised in a way that protects the Kansas taxpayer but also allows state government to take advantage of its fiscal strength and achieve state purposes more effectively through debt financing. These debt provisions have retarded state initiative in economic development during key periods of the state's history. With time they have become meaningless except as a means to challenge and delay implementation of legislative acts. They should be modernized to enhance state government capacity for financing public infrastructure.

Let me explain the logic of these recommendations by first reviewing briefly how these constitutional provisions came into being and then assessing their impact on development in Kansas.

Our state constitution was written by the Wyandotte Convention in less than four weeks, 20 working days to be exact. As you might imagine, we borrowed heavily from other states. Our internal improvements and debt provisions were lifted with little change primarily from Wisconsin and secondarily from Iowa -- states whose constitutions were adopted in the 1840s. Debate and action on these provisions took our convention delegates less than 30 minutes by my estimate.

My point here is simply this: The constitutional language under consideration here was molded not by careful consideration at the Wyandotte Convention but by national fervor over state debt defaults and debt repudiations resulting from excessive debt financing of internal improvements by state governments in the 1820-40 period. The roots of this debt fiasco are tangled but may be found in financial vacuum left by Andrew Jackson's curtailment of federal aid for internal improvements and his derailment of the U.S. bank which was a stable source of financing such improvements. Encouraged by early successes in state financing of internal improvements, such as New York's underwriting of the Erie Canal, state governments moved into this vacuum often with grandiose plans for road, canals, and financing, piled up monumental debts in a few short years, and then crashed in the depression of 1837. Nine states defaulted on their debts; four repudiated all or part of their debts; and others secured downward adjustments in debt payments. Many states raised taxes to meet their obligations, and debt service became the major component of state expenditures in a number of states. From this point in time on limitations on state debt or on state participation in internal improvements or both were written into every state constitution.

So much for the early history, what has been the impact of these provisions on development in Kansas? My own conclusions are that the internal improvements prohibition and the state debt limits have 1) required that the initiative for economic development in Kansas be with local government rather than state government; 2) forced the bulk of responsibility for developing public infrastructure essential to growth upon local government; and 3) deterred economic growth in Kansas by blocking for several years major state initiatives, such as, state highways, state financing of water resource development, and state assistance in rail service, among others.

First, concerning economic development, the internal improvements prohibition has created an ironic situation in which local governments in Kansas have been authorized by the state to do what the state is precluded from doing. This pattern was established early in statehood as local communities took the initiative with state authority to aid railroad development and provide incentives to a variety of private endeavors. Today, state law provides local governments with an array of tools to aid private enterprise, for example, in acquiring land and capital -- two essential ingredients for economic development. State government, however, continues to be constrained from taking any substantial initiative of direct assistance to industry and has become at best a weak economic development partner with local government. These constitutional constraints will become even more serious handicaps as economic competition grows nationally and internationally and as major development projects require closer cooperation between government and business. While other states are experimenting with a host of industrial incentives, Kansas competes with a shackle on one foot.

One more point concerning economic development: Freeing the state to become an active partner in economic development is particularly

important outside the major metropolitan areas in my judgment. The urban centers, for example, Wichita, Overland Park, and Lenexa, which have developed a capacity to promote economic growth and have economic conditions on their side, can survive, possibly even prevail, economically without state initiative. The second-level cities, the Winfields, Coffeyvilles, Great Bends, Concordias, Colbys, and others like them, are struggling economically against long-term, adverse trends and are in particular need of a strengthened state capacity for economic development.

Second, the internal improvements prohibition aided by state debt limits has made state government less than an equal partner in developing public infrastructure essential for economic growth. For nearly 60 years, that is, until the internal improvements prohibition was first amended in 1920, state government was precluded from aiding in the construction of Kansas roads. For nearly 100 years the state could not assist in providing flood protection, water supply, or sewers. As a result early in statehood the initiative for public infrastructure fell to local communities and mostly remains there yet today. Local government in Kansas spends roughly nine dollars on infrastructure for every dollar spent by state government.

This local focus in infrastructure has retarded the development of projects which are regional in nature, that is, beyond the scope of one local jurisdiction but not of compelling statewide significance. For example, since 1972 laws have been on the books authorizing revenue bond financing of resort facilities at state parks, but no projects have moved forward. In 1974, state lawmakers authorized a southeast Kansas road to be financed by tolls and if necessary through the state highway and state freeway funds; but no road appeared. Actually, four years passed before the Kansas Supreme Court cleared the project from constitutional objections concerning state debt limits. In 1978 Governor Bennett proposed the development of a recreational corridor on the Arkansas River from Hutchinson to Wichita, but protests from local landowners stalled the project in the legislature. In these projects as well as many others, the state constitution has been a drag on state government's ability to move forward on public improvements of regional importance.

Third, the process of amending the internal improvements prohibition has slowed state government's ability to respond when compelling need arises and has thereby deterred economic growth. While documenting the precise economic losses incurred would be difficult, the awkward, time-consuming steps needed for Kansas to build state highways or to finance regional water supply illustrate the problem. In road-building, for example, Kansas trailed most states in planning and constructing state highways. Our first amendment to the internal improvements provision in 1920 must in retrospect be described as ill-conceived and short-sighted; it limited state participation to financial aid for county roads and wrote a rigid funding formula into the constitution. Another eight years were required to generate the political support for a more carefully drafted amendment which authorized a state system of highways and taxes to fund them. Kansas achieved in 1928 what most states had in

place a decade earlier and a few had in place more than two decades earlier.

In the case of water, Kansas had suffered through 90 years of too much or too little water when the 1951 floods devastated property and caused loss of life throughout much of the state. This natural disaster helped bring about the realization that state government should have a stake in water. After seven more years of planning, persuading, and politicking, water resource development became the second major exemption to the internal improvements prohibition. Fifteen years after the constitutional amendment, state officials signed the first agreement making a long-term financial commitment with the federal government in return for regional water supplies. One hundred eleven years had passed before Kansas made its first financial commitment to water development.

In sum, the internal improvements provision of the Kansas Constitution was originally intended to prohibit state government from direct involvement in economic development projects, and this intent has largely been fulfilled. If Kansas is to change this situation and take the initiative in stimulating economic growth, the internal improvements prohibition should be repealed. State initiative in development has also been stunted historically by the constitutional limits on state debt. While these limits have now become nearly meaningless as a result of court rulings, they should be updated to protect taxpayers and yet allow Kansas to finance infrastructure when appropriate through debt financing.

1970 ILLINOIS CONSTITUTION

Article IX, Section 9

Section 9. State Debt

(a) No State debt shall be incurred except as provided in this Section. For the purpose of this Section, "State debt" means bonds or other evidences of indebtedness which are secured by the full faith and credit of the State or are required to be repaid, directly or indirectly, from tax revenue and which are incurred by the State, any department, authority, public corporation or quasi-public corporation of the State, any State college or university, or any other public agency created by the State, but not by units of local government, or school districts.

(b) State debt for specific purposes may be incurred or the payment of State or other debt guaranteed in such amounts as may be provided either in a law passed by the vote of three-fifths of the members elected to each house of the General Assembly or in a law approved by a majority of the electors voting on the question at the next general election following passage. Any law providing for

the incurring or guaranteeing of debt shall set forth the specific purposes and the manner of repayment.

(c) State debt in anticipation of revenues to be collected in a fiscal year may be incurred by law in an amount not exceeding 5% of the State's appropriations for that fiscal year. Such debt shall be retired from the revenues realized in that fiscal year.

(d) State debt may be incurred by law in an amount not exceeding 15% of the State's appropriations for that fiscal year to meet deficits caused by emergencies or failures of revenue. Such law shall provide that the debt be repaid within one year of the date it is incurred.

(e) State debt may be incurred by law to refund outstanding State debt if the refunding debt matures within the term of the outstanding State debt.

(f) The State, departments, authorities, public corporations and quasi-public corporations of the State, the State colleges and universities and other public agencies created by the State, may issue bonds or other evidences of indebtedness which are not secured by the full faith and credit or tax revenue of the State nor required to be repaid, directly or indirectly, from tax revenue, for such purposes and in such amounts as may be authorized by law.