State and Local Finance and Taxation

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I. Introduction

The United States Constitution says very little about federal finance and taxation. The first clause of Article I, Section 8 simply authorizes Congress "to lay and collect taxes, duties, imposts, and excises to pay the debts and provide for the common defense and the general welfare of the United States." This is the constitutional source of Congress' power to raise and spend money. The second clause of Section 8 authorizes Congress "to borrow money on the credit of the United States."

The Constitution imposes two minor procedural constraints on federal spending and taxation. All bills for raising revenue must originate in the House of Representatives (Art. I, § 7), and no money may be drawn from the Treasury "but in consequence of appropriations made by law; and a regular statement and account of the receipts and expenditures of all public money shall be published from time to time." (Art. I, § 9) The Constitution also places a handful of substantive constraints on federal taxation. "All duties, imposts, and excises shall be uniform throughout the United States." (Art. I. § 8) Taxes and duties on exports are barred. (Art. I, § 9) So, too, direct or capitation taxes are barred unless apportioned among the states according to population. (Art. I, § 9) The apportionment requirement was modified by the Sixteenth Amendment's authorization of a federal tax on incomes without regard to apportionment. Apart from the clause authorizing Congress to borrow, the Constitution does not address federal borrowing at all.

The Constitution's brief attention to federal finance and taxation is in sharp contrast to the extensive treatment state constitutions accord to state and local spending, borrowing, and taxing. The typical state constitution devotes at least two articles to state and local taxation and finance. State constitutions limit the purposes for which states and localities can spend or lend their funds, and expressly address specific spending techniques. Nearly all states impose significant substantive and/or procedural restrictions on state and local borrowing. So, too, nearly all states impose significant substantive and/or procedural restrictions on state, and especially local, taxation. Some constitutions limit expenditure levels as well.

The overall thrust of these provisions is to limit state and local government support for private sector activities and, especially, to protect state and local taxpayers from the burdens of state and local debt and state and local taxation. In effect, they constitutionalize both the separation of the public from the private sector, and the norm of financially limited government.

Or at least they would if they were honored according to their apparent terms. But one of the most striking aspects of the state constitutional law of state and local finance and taxation is

the enormous gap between the written provisions of state constitutions and actual practice. The public purpose requirements that ostensibly prevent state and local spending, lending, and borrowing in aid of private endeavors have been largely interpreted out of existence. The substantive and procedural debt limitations have contributed to the emergence of a host of financial instruments which the courts have held to be beyond the scope of these rules, as well as to the rise of public authorities not subject to these constitutional constraints. State and local debts are, thus, far greater than the terms of state constitutions would appear to allow, and most state and local debts are not subject to these constitutional restrictions. The state constitutional constraints on state and local taxation appear to be more effective, and thus directly pose the question of whether taxation should be governed by constitutional as opposed to ordinary political norms. Moreover, state tax limits have been accompanied by the growing use of non-tax revenue sources and of limited purpose governments, such as special districts, not subject to constitutional limitation. Tax as well as debt limits have contributed directly to the complex institutional structure of state and local governance.

The central focus of the State Constitutions Project with respect to the Finance and Taxation articles ought to be (i) identifying the principal provisions and goals of state constitutions in this area; (ii) appraising how these provisions work in light of state court decisions and state and local efforts to evade their reach; (iii) examining recent and pending reform efforts; and (iv) considering whether and how these provisions may be revised in light of both their underlying goals, the difficulties of making them effective in practice, and the consequences for state and local government performance.

II. Public Purpose

A. The Provisions

By one recent count, forty-six state constitutions contain provisions that expressly limit the authority of their states and/or local governments to provide financial assistance to private enterprises and, in some cases, public enterprises.[1] The remaining states appear to rely on judicial doctrines that similarly require that state or local taxpayer funds be spent only for public purposes. The New York Constitution is typical in providing that "[t]he money of the state shall not be given or loaned to or in aid of any private corporation or association or private undertaking,"[2] and that "[n]o county, city, town, village or school district shall give or loan any money or property to or in aid of any individual, or private corporation or association, or private undertaking."[3] Many state constitutions supplement this general "public purpose requirement" for state/local spending and lending with further restrictions on specific forms of financial

[1] Dale F. Rubin, Constitutional Aid Limitation Provisions and the Public Purpose Doctrine, 12 St. Louis U. Pub. L. Rev. 143, 143 n.1 (1993).

[2] N. Y. Const., Art. VII, § 8.

[3] N.Y. Const., Art. VIII, § 1.

assistance, such as the prohibition on the state or locality giving or lending its credit to private and, frequently, public firms, or the ban on state or local government becoming a shareholder in a public or private corporation.[4] In addition, public purpose requirements typically apply to state and local borrowing.

B. History

State constitutional public purpose limitations on government spending, lending and borrowing date back to the middle decades of the nineteenth century, and reflect the disastrous consequences of the states' extensive investments in and assistance to private firms in the 1820s and 1830s. The enormous success of the Erie Canal, which opened in 1825, in energizing New York's economy inspired a massive program of state support for turnpikes, canals, and railroads over the next two decades. Many of these projects blurred public and private lines, with states in partnership with private firms, lending or giving funds to private firms, or providing loan guarantees to firms. The states frequently obtained the funds they used to aid private firms by borrowing. Fueled by interstate competition for economic development, this era of state-supported infrastructure finance was marked by waste, overbuilding, and mismanagement. The Panic of 1837 led to a contraction in economic activity, and eventually to an economic crisis. Many firms that had borrowed from the states were unable to repay their loans, and many infrastructure projects failed to generate projected revenues. The states had great difficulties meeting their obligations to their creditors; nine defaulted on interest payments and four states – Arkansas, Florida, Michigan, and Minnesota – repudiated all or part of their debts.

In reaction, the states in the 1840s and 1850s engaged in a wave of constitutional revision. To limit state financial support for private firms, state constitutions were amended to require that state spending or lending be for a public purpose; to bar the gift or loan of state credit except for a public purpose; and to ban direct state investment in business corporation obligations. Initially, these provisions applied only to the activities of state governments. As a result, they were some times circumvented by state legislation authorizing local governments to provide assistance to private firms, especially railroads. Another round of waste, overbuilding, and economic crisis resulted, and in the late nineteenth century many states amended their constitutions to apply the public purpose and aid limitations to local governments.

C. Changing Interpretations

(1) <u>Public Purpose</u>: The public purpose requirement was never a complete bar to all government financial assistance to the private sector. In the leading mid-nineteenth century case of Sharpless v Mayor of Philadelphia,[5] the Pennsylvania Supreme Court held that aid to a privately owned railroad could serve a public purpose. "The public has an interest in such a road" even if privately owned, because a railroad provides "comfort, convenience, increase of

[4] See, e.g., Colo. Const., Art. XI, §§ 1,2; N.Y. Const. Art. VII, § 8, Art. VIII, § 1.

[5] 21 Pa. 147 (1853).

trade, opening of markets, and other means of rewarding labor and promoting wealth." Other nineteenth century courts, however, treated their states' public purpose requirements as significant barriers to programs that would provide state or local assistance to private firms or individuals.[6]

Starting in the 1930s, state courts began to widen the definition of public purpose. In 1938, the Mississippi Supreme Court upheld a state program of issuing bonds to finance the construction of factories and the acquisition of machinery and equipment for long-term lease to private firms willing to relocate to the state; such an industrial development program was held to serve a public purpose.[7] Over time, as state industrial and economic development initiatives spread, courts came to broaden the notion of public purpose to include increased employment and tax base growth, and to approve programs that provided assistance to individual firms. Initially, many of these programs were funded by revenue bonds, that is, by bonds backed solely by new revenues to be generated by the firms receiving assistance, so that courts could find that taxpayer dollars were not at risk.[8] Other courts did not distinguish between programs financed by revenue bonds and programs backed by treasury funds.[9] Some courts resisted the general trend and continued to invalidate public financial assistance to private businesses.[10] In some states where courts were reluctant to permit direct state assistance to private firms, the state constitutions were amended to permit some forms of industrial development assistance.

By the end of the twentieth century, virtually every state supreme court had upheld at least some economic development programs that involved direct assistance – cash grants, loans, tax breaks – to individual firms.[11] Landmark decisions include *Common Cause v Maine*,[12] in which the Maine Supreme Court upheld the state's plan to commit $15 million in taxpayer funds to improve the facilities of the Bath Iron Works in order to persuade the company to remain in the state, and *Hayes v State Property & Buildings Commission*, in which a closely divided

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[6] See, e.g., Allen v Inhabitants of Jay, 60 Me. 124 (1872) (invalidating aid to factories); Lowell v Boston, 111 Mass. 454 (1873) (financial assistance to private residential housing development violated public purpose requirement); Opinion of the Justices, 291 Mass. 567 (1935) (use of tax revenues to insure banks against loss on home mortgages not within "public purpose" limitation).

[7] Albritton v City of Winona, 178 So. 799, app. dis. 303 U.S. 627 (1938).

[8] See, e.g., Basehore v Hampden Industrial Devel. Auth., 248 A.2d 212 (Pa. 1968).

[9] See, e.g., State ex rel Beck v City of York, 82 N.W.2d 269 (Neb. 1957).

[10] See, e.g., Village of Moyie Springs v Aurora Mfg Co., 353 P.2d 767 (Idaho 1960); Mitchell v North Carolina Indus. Devel. Fin. Auth. 159 S.E.2d 745 (N.C. 1968).

[11] See Maready v City of Winston-Salem, 467 S.E.2d 615 (N.C. 1996) (reviewing cases).

[12] 455 A.2d 1 (Me. 1983).

Kentucky Supreme Court upheld a package of inducements – with direct costs estimated at between $125 and $268 million – to persuade Toyota Motor Corporation to open a plant in the state.[13] Some courts have continued to police economic development programs, invalidating some – such as those aimed at aiding non-industrial economic activities like hotels and restaurants.[14] But for the most part, state courts have found economic development to be a public purpose justifying a wide range of programs channeling aid to the private sector. As one North Carolina justice observed, lamenting the state supreme court's 1996 decision to uphold a new economic development program which would permit taxpayer dollars to be used, inter alia, to pay for spousal relocation assistance when private firms move to the state, there was nothing in the court's decision that would prevent the use of public funds for country club memberships for corporate executives if that would entice firms to relocate to the state.[15]

(2) Lending of Credit and Stock Subscriptions: In some states, the restriction on lending of credit does not apply if the assistance is provided for a public purpose.[16] In those states the expansion in the scope of public purpose has eroded the lending of credit ban. In other states, however, lending of credit is an additional restriction. Even if a program constitutes a public purpose, the technique of lending the state's or locality's credit may still be proscribed. Most state courts find that a lending of credit has occurred when a state serves as a surety or guarantees a loan made by another lender.[17] The constitutional provision, thus, provides protection against the tendency of legislators to discount the risks posed by standing surety when the state is not required to directly commit any funds at the time the suretyship obligation is assumed. Some state courts, however, have gone further and found that a proscribed lending of credit occurs when a state borrows money and provides the proceeds to another entity.[18]

In addition to public purpose and lending of credit requirements, a number of state constitutions prohibit state investment in business corporations. This ban may apply even if the investment is for an economic development purpose.[19] These provisions appear to be a direct response to the nineteenth century practice of state subscriptions to canal or railroad company

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[13] 731 S.W.2d 797 (Ky. 1987).

[14] See, e.g., Holding's Little America v Board of County Comm'rs, 712 P.2d 331 (Wyo. 1985); Purvis v City of Little Rock, 67 S.W.2d 936 (Ark. 1984). But see Hucks v Riley, 357 S.E.2d 458 (S.C. 1987) (public interest in tourism development provides public purpose for use of state funds to finance privately owned and operated lodging and restaurant facilities).

[15] See Maready v City of Winston-Salem, supra.

[16] See, e.g., Alaska Const., Art. IX, § 6; Ill. Const., Art. VIII, § 1.

[17] See, e.g., Barnhart v City of Fayetteville, 900 S.W.2d 539 (Ark. 1995).

[18] See, e.g., Washington Higher Educ. Facilities v Gardner, 699 P.2d 1240 (Wash. 1985).

[19] See, e.g., Utah Technology Finance Corp. v Wilkinson, 723 P.2d 406 (Utah 1986).

stock. As a result, a state may be able to give or lend money to a private firm on a public purpose theory, but may be barred from taking an equity position in the firm which would enable it to share in any appreciation in the firm's value.

D. The Future of the Public Purpose Requirement

The public purpose requirements state a constitutional truism – that government may not act except for a public purpose, and, especially, that tax dollars may not be spent except for a public purpose. Yet, due to the general political and judicial acceptance of a major government role in economic development, and of government support for specific economic sectors and, indeed, individual firms, public purpose requirements are a limited constraint on state economic development practices. They no longer constitute a barrier between the public and private sectors.

The questions for the reform project are (i) whether the collapse of the public purpose requirement as a judicially-enforceable constraint is lamentable; (ii) whether it can be cured by constitutional language that would bar state or local aid to one or a small number of private firms, or define certain types of programs as beyond the scope of public purpose, or require courts to balance the public and private components of aid programs and invalidate those in which the private benefit is too great; (iii) whether, if public purpose is fundamentally a political and not a judicial concept, public purpose requirements should be removed in order to eliminate litigation and the episodic judicial review of economic development programs that occurs in some states; or (iv) whether the constitutional language should be left alone to reflect the public purpose norm, while accepting that in practice the concept of public purpose will primarily be defined politically and not judicially.

III. Borrowing and Debt Limitations

A. The Provisions

The vast majority of state constitutions impose some limitation on the ability of their states and local governments to incur debt. These constitutional limitations take a variety of forms. Some bar state debt outright.[20] Others impose very low limits on the amount of debt a state may incur.[21] Some cap state debt or debt service at a fraction of taxable wealth or revenues.[22] Tying the debt limit to a fraction of property wealth or revenue is a particularly

[20] See, e.g., Ind. Const., Art. X, § 5 (prohibiting state debt except "to meet casual deficits in revenue," repel invasion, suppress insurrection or provide for state defense); W. Va. Const., Art. X, § 4 (same).

[21] See, e.g., Ariz. Const., Art § 5 (total state debt limited to $350,000); R.I. Const., Art. VI, § 16 (total state debt limited to $50,000).

[22] See, e.g., Hawaii Const., Art. VII, § 13 (debt service on state debt limited to 18 ½ % of the average state general fund revenues in the three prior fiscal years; local government debts limited to 15% of total assessed value of real property in each political subdivision); Nev. Const.

widespread way of limiting local government debt.[23] This approach suggests an attempt to limit debt to the "carrying capacity" of the state or locality, so that new borrowing does not result in burdensome taxation or cuts in existing services.

Most commonly, state constitutions rely on a procedural restriction: state and/or local debt may not be incurred without the approval of a majority (or supermajority) in the legislature, of voters in a referendum, or of both.[24] For state governments, the procedural requirements are often the real restrictions on debt. As state constitutions can be amended, an absolute prohibition on debt or a low dollar limit on debt can be circumvented by a constitutional amendment authorizing a specific bond issue. As a result, the legal requirements for a constitutional amendment – typically, a combination of a legislative supermajority and voter approval in referendum – also become the requirements for issuance of debt. Thus, although the Alabama Constitution flatly bars state debt, as of the early 1990s, it contained thirty-three amendments authorizing specific bond issues.[25]

B. Background and Purposes

Like the public purpose requirements, the state constitutional debt limitations date back to the turnpike, canal, and railroad boom of the 1820s and 1830s, the Panic of 1837, and the resulting wave of tax increases, to pay off the state debts blithely assumed in prior years. The first constitutional limits were adopted in the 1840s, and by 1860, nineteen states had adopted debt limitations. Most of the Reconstructed southern states and western states admitted to the Union after the Civil War included debt limitations in their constitutions. When states turned to local governments to borrow the funds necessary to aid private firms, particularly railroad companies, and localities found themselves overcommitted in the aftermath of the economic crisis that began in 1873, most states amended their constitutions to limit local government borrowing as well.

Apart from the specific historical background, constitutional restrictions on debt may be justified as a means of reconciling the conflict between short-term and long-term interests that debt generates. When a government finances a capital project – a bridge, a school building, a

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Art. IX, § 3 (aggregate state debt limited to 2% of assessed valuation of property in state); Wash. Const., Art. VIII, § 1 (debt service on aggregate state debt limited to 9% of average of state revenues over the three prior fiscal years).

[23] See, e.g., Ky. Const., § 158 (permissible local government debt set at between 2% and 10% of local assessed valuation, with debt limit varying according to population of city; county and taxing district limits set at 2% of assessed valuation).

[24] See, e.g., Mich. Const., Art. IX, § 15 (state long-term debt requires approval of two-thirds of members of each house of the legislature and a majority of state voters in referendum).

[25] See William H. Stewart, The Alabama Constitution: A Reference Guide 115-16 (1994).

prison – that has long-term benefits, it is appropriate to spread the costs of the project over the project's useful life. Borrowing the money and repaying the debt over a period of decades spreads the cost to the future generations that benefit from the project. But the ability to shift the costs into the future may also induce elected officials to incur too much debt as some of the benefits will be received immediately while the costs are deferred. A central goal of constitutional limits on debt, then, is to offset the temptations that cause elected officials, and the current generation they represent, to incur debts that bond future generations too easily.

C. Limits and Evasions

Like the public purpose requirements, the state debt limitations have not had quite the effect their terms suggest. Most debt limits do not expressly define the debts to which they apply. Other constitutional provisions, however, may require the state or locality to pledge its full faith and credit in support of its debt. Stimulated in part by the desire to avoid the debt limitations, states and localities have developed financial instruments that enable them to borrow without pledging their faith and credit. Instead, the debt is backed only by a specific revenue source. Such "non-guaranteed" or "revenue bond" debt is frequently not subject to constitutional limitation. Initially, the only revenue bonds exempt from the debt limitations were project finance bonds, e.g., bonds issued to finance a project whose revenues would be used to pay off the debt incurred to finance the project. For example, to build a bridge, the state might issue a bond, promise the bondbuyers to impose a toll on the bridge financed by the bond, and pledge the revenues generated by the bridge toll to repay the bonds. State courts found that as long as the state limits its payment obligation to the "special fund" generated by the project such a revenue bond is not debt subject to the debt limit.

Over time, the special fund concept spread well beyond debts backed solely by charges imposed on facilities financed by borrowing. Many courts found that bonds to finance highway construction were exempt from debt limitations if they were backed solely by taxes on motor fuels and vehicle license fees, on the theory that new highways would generate additional auto usage and thus additional fuel tax and fee revenues.[26] Similarly, a bond issued to finance a convention center might not debt if backed by taxes on hotel occupancy, on the theory that the convention center would promote hotel use and thus generate tax revenues.[27] The cases are not always consistent,[28] but the trend appears to be in the direction of loosening the nexus required between the project financed by the bond and the revenues committed to paying off the obligation in order to avoid the debt limitation.

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[26] See, e.g., In re Oklahoma Capitol Improvement Authority, 958 P.2d 759 (Okla. 1998).

[27] See, e.g. Convention Center Authority v Anzai, 890 P.2d 1197 (Hawaii 1995).

[28] See, e.g., Eakin v State ex rel Capital Improvement Board of Marion County, 474 N.E.2d 62 (Ind. 1985) (holding bond used to finance a convention center and backed by taxes on hotels, motels, and retail food business is "debt" within meaning of debt limit).

Other techniques for avoiding debt limitations include lease-financing and subject-to-appropriation debt. Under lease-financing, a government may be able to finance the construction of a new public facility without having to issue debt. Instead, a private firm or a public authority issues the necessary bonds and builds the facility, and the government enters into an arrangement with the financing entity to lease the facility for a period of time, with the government's lease payments intended to cover the debt service. So long as the government's payment is contingent on the use of the facility and subject to annual legislative appropriation, it is likely to be exempt from constitutional debt restrictions.[29] Subject-to-appropriation debt takes lease-financing one step further and dispenses with the need for the government to lease facilities from the issuer. Instead, a public authority issues a bond, and a state or local government contracts with the authority to make an annual appropriation to the authority equivalent to the annual debt service. If the contract is subject to annual appropriation – and any duty to make an annual appropriation is disclaimed – the government's obligation may not be a debt subject to debt restriction.[30]

Appropriation clause debt is a relatively recent development and a particularly blatant evasion of the constitutional debt limitations. It closely resembles so-called moral obligation debt, which loomed large in municipal finance in the 1960s and 1970s. Under the moral obligation scenario, a public authority issued a bond which would be backed by authority revenues, typically, revenues to be generated by the facility to be financed by the bond. When the authority, or potential investors, were uncertain whether the facility so financed would be able to produce the necessary revenues, the state could make a nonbinding commitment of state funds to cover debt service in the event that revenues from the bond-financed projects fell short. The state's moral obligation provided an important safety net for public authority bond issues for moderate-income housing, hospitals, universities, and mental institutions. State courts generally concluded that the legislature's mere "moral" obligation to appropriate debt service did not constitute a debt triggering the constitutional debt limitations.[31] The moral obligation device, however, came under a cloud in the mid-1970s when New York State had to come to the rescue of its Urban Development Corporation and make good on its moral obligation to support the UDC.

In one sense, appropriation clause debt is less troubling than moral obligation debt since states did not make any initial appropriation to the authority issuing the moral obligation bond. The state's role was only to serve as a safety net. But that may have created the illusion that moral obligation debt was cost free to the state, and may have led states to take on such debt too

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[29] See, e.g., Bulman v McCrane, 312 A.2d 857 (N.J. 1973). But see Montano v Gabaldon, 766 P.2d 1328 (N.M. 1989).

[30] See, e.g., Dykes v Northern Virginia Transportation District Comm'n, 411 S.E.2d 1 Va. 1991); Schulz v State of New York, 639 N.E.2d 1140 (N.Y. 1994).

[31] See, e.g., Steup v Indiana Housing Finance Authority, 402 N.E.2d 1215 (Ind. 1980); Utah Housing Finance Agency v Smart, 561 P.2d 1052 (Utah 1977); State ex rel Warren v Nusbaum, 208 N.W.2d 780 (Wis. 1973).

easily. Contemporary non-appropriation clause obligations dispense with the illusion that they involve no cost to the state. Rather, from the beginning, they involve the expenditure of public funds, and thus can be factored into budget projections and counted as part of regularly recurring government costs. Yet, by treating non-appropriation clause obligations as part of baseline expenses, the new device only heightens the tension with the state constitutional debt restrictions.

As the discussion indicates, public authorities play a major role in the evasion of state constitutional debt limits. Unless the state constitution specifically provides otherwise, state courts have generally found that public authority debt is not subject to state constitutional debt limits as public authorities lack the power to impose taxes or to pledge the full faith and credit of their states. Public authorities play a major role in issuing special fund revenue bond debt. As the lease-finance, moral obligation, and appropriation clause debts indicate, public authorities may also be used by their parent states or localities as conduits for the "backdoor financing" of state debt and the evasion of state constitutional debt limitations. The evasion of debt limits has been a major impetus for the growth of public authorities.

As a result of these various evasive techniques, most state and local debt is not subject to the constitutional debt restrictions. Something like three-quarters of all state debt and two-thirds of city and county debt is non-guaranteed debt. It is, thus, not clear whether the debt limits have affected the total amount of state and local debt, but it does appear that the limits have affected the form of the debt. With non-guaranteed debt usually carrying a higher interest rate and greater administrative and legal costs than full faith and credit debt, the debt limits may generate costs, too.

D. The Reform Agenda

The reform agenda with respect to state and local debt limitations has two strands: (i) raising or modernizing limit levels to permit states and localities to issue more covered debt; and (ii) expanding the scope of such limits to pick up many currently exempt obligations. The two strands go together, as high levels of debt that evade the debt limits demonstrate the lack of fit between constitutional debt limits and current capital spending needs, yet create the very risks of overextension and, ultimately, increased taxation, that debt limits were intended to control. Both strands, however, have complications and permutations and ultimately raise questions about the wisdom and efficacy of any constitutional effort to limit debt.

(1) Modernization/Liberalization: Many of the substantive debt limitations are extremely archaic. Rhode Island, for instance, still retains the $50,000 state debt ceiling it adopted in 1842.[32] This -- or any other absolute dollar ceiling -- is a structural invitation to evasion. More defensible are percentage ceilings tied to some measure of state or local wealth or revenues. The difficulties arise in determining: (a) the appropriate base for state/local carrying capacity, and (b) the appropriate percentage of the base that should be the cap. State constitutions demonstrate an

[32] R.I. Const., Art. VI. § 16.

enormous variation in measures of carrying capacity and in debt levels as a percentage of carrying capacity. Most state constitutions define local carrying capacity in terms of local assessed property valuations, yet many localities rely significantly on other sources of revenue, and property assessments "deviate notoriously from fair market values."[33] More accurate measures of ability to pay than property valuation seem desirable, although there is no clear consensus on what that measure ought to be. There is even less agreement on what percentage cap ought to be placed on debt or debt service relative to capacity.

An additional issue relating to existing limit structures is the voter approval requirement. Some states subject debt to both substantive limitations and voter approval requirements; others rely on substantive limits or voter approval alone. Voter approval may be more flexible than the substantive limitations, since voters can decide in light of current circumstances. Voter approval also operates to constrain elected officials who may be too susceptible to the short-term benefits of debt-financed spending but insufficiently attentive to the long-term costs. Bond issues have long-term consequences and it may be appropriate to require extra procedural steps before debt is incurred. On the other hand, voters may not see the long-term needs for capital investment, and the voters who participate in bond issue referenda may not be representative of the community as a whole, so that debts for social programs may fail to win approval. In a sense, the voter approval requirement recapitulates the debate over direct democracy generally.

(2) Extension to Exempt Debt: There have been many calls to extend debt restrictions to at least some forms of debt currently exempt – usually as a result of judicial decision – from limitation. The issues here involve deciding which debts should be covered, and how to distinguish them from those that should remain exempt. Under most scenarios, traditional revenue bonds backed solely by revenues generated by the projects financed by the bonds would remain exempt from restriction since such bonds pose no risk of becoming a burden to the taxpayers. On the other hand, public authority bonds that are effectively albeit indirectly backed by appropriations from a general purpose government would be subject to restriction – even though defenders of such bonds can accurately argue that the decision whether or not to appropriate the funds necessary to pay the bonds must be made annually by elected officials. The in-between cases involve bonds that finance new facilities that contribute to the growth of taxes used to pay off the bonds but where the revenues for debt service are not directly or exclusively generated by the facility.

A related question concerns the application of debt limitations to public authority obligations. Public authorities lack the power to pledge the full faith and credit of the state, so their debts do not place taxpayers directly at risk. On the other hand, state governments may feel an obligation to come to the rescue of an authority that is in financial difficulty, and states certainly have used public authorities to evade debt limitations. Moreover, it has been argued that public authority obligations may "crowd" state and local general purpose obligations and thereby drive up interest rates.

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[33]Robert S. Amdursky & Clayton P. Gillette, Municipal Debt Finance Law: Theory and Practice 220 (1992).

IV. Taxation

A. Background

State constitutional provisions concerning state and local taxation are marked by far greater state-to-state and intrastate variation than the public purpose requirements and the borrowing and debt limitations. State constitutions have traditionally given their greatest attention to the property tax. Like many other features of state constitutions this is an artifact of history. When states first began to amend their constitutions to address questions of taxation, the property tax was the dominant mode of taxation for state and local government. As late as 1902, the property tax accounted for 82% of total state and local tax collections – including 53% of state tax dollars and 89% of local tax dollars. Over the course of the twentieth century, the role of the property tax declined. The states generally turned the property tax over to local governments, and turned to other revenue sources, primarily sales and income taxes. Today property taxes generate no more than two percent of state revenues and in many states the property tax generates nothing for the state government at all. The property tax remains the leading source of local revenues – about 75% of local tax dollars – although with the rise of other local taxes, intergovernmental assistance, and, especially, local non-tax revenue sources, the property tax generates only about 30% of all local revenues.

State constitutional provisions concerning taxation have two primary strands: (i) equality or uniformity requirements; and (ii) substantive and procedural limitations on levels of taxation. These provisions are addressed primarily, but not exclusively, to the property tax.

B. Uniformity

Almost all state constitutions contain some provisions for uniform or equal taxes.[34] In some states, the uniformity requirement applies to all taxes.[35] In other states, the uniformity or equality requirement is focused on the property tax.[36] The uniformity requirement may apply to tax rates; to the measure of the value subject to tax; and/or to the determination of the persons or activities subject to a tax. The uniformity requirement appears intended to promote equal

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[34] See, e.g., J.R. Hellerstein & W. Hellerstein, State and Local Taxation: Cases and Materials 34 (6th ed. 1997).

[35] See, e.g., Ga. Const., Art. VII, § 1 ("all taxation shall be uniform upon the same class of subjects within the territorial limits of the authority levying the tax."); N.H. Const., Part I, art. 5 ("all taxes [shall] be proportionate and reasonable, . . . equal in valuation and uniform in rate, and just").

[36] See, e.g., Ind Const., Art. X., § 1 ("uniform and equal rate of property assessment and taxation"); Me. Const., Art. IX, § 8 ("all taxes upon real and personal estate . . . shall be apportioned and assessed equally").

treatment of taxpayers. It also operates from the presumption that taxation ought to function as a broad and general means of raising revenues from the community, rather than as a policy tool for subsidizing certain programs, for imposing differential burdens on different parts of the community, or for redistribution. The uniformity requirement, thus, poses a challenge for certain common forms of taxation. "A graduated income tax by its very nature lacks the uniformity of taxation typically required by the state constitutional restrictions. A controversy which raged throughout the country, as states enacted income tax levies, was whether the income tax constituted a property tax that violated the uniformity provisions.[37]

As noted, many states limit the uniformity requirement to the property tax, but uniformity has posed challenges even for the property tax. Many local governments have long imposed higher property taxes on commercial and industrial properties, which can pass their taxes along to consumers, than on residential property. Typically, in tacit deference to the uniformity requirement, this was accomplished by assessing industrial and commercial property at a higher percentage of value and by assessing residential property at a lower percentage of value. Courts long tolerated such de facto variations in assessments, but in the latter part of the twentieth century they more vigorously enforced uniformity rules and analogous provisions requiring property to be assessed at full value. Constitutional controversies concerning assessments have also been triggered by state laws that seek to cushion the burden of property taxes on certain uses, like agriculture or open space, by permitting such property to be assessed at a lower percentage of value or according to "current use value" rather than fair market or exchange value. Some state constitutions now expressly authorize differential tax rates or assessments by providing for the "classification" of property into commercial, industrial, residential, etc, classes and requiring uniformity of tax treatment only within a class. Some state constitutions also authorize, or require, the exemption of certain property (educational, charitable, religious) from taxation. Even in states that authorize classification or exemption, issues continue to arise concerning the definition of classes, whether a property falls within a particular class, or whether the provision of other tax preferences violates uniformity. As a result state courts may be more involved in reviewing the constitutionality of tax differentials and tax preferences than their federal counterparts.

C. Tax Limitations

(1) Substantive Limitations

Most state constitutions impose some substantive limitations on taxation. Until recently, these were focused almost exclusively on the local property tax. Limitations "first appeared in state statutes in the 1870s and 1880s and were later incorporated in many state constitutions." These were aimed at holding down government spending and protecting property owners.[38] A

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[37] Hellerstein & Hellerstein, supra, at 36.

[38] M. David Gelfand, Joel A. Mintz & Peter A. Salsich, Jr., State and Local Taxation & Finance 38 (2d ed. 2000).

"second round of constitutional tax limitations appeared during the Depression of the 1930s. They were aimed at forcing tax reductions, thereby stemming the tide of tax delinquencies and tax foreclosures of residential property."[39] A third wave of constitutional limitation of taxation began with California's adoption of Proposition 13 in 1978, and continues to some degree to this day.

These constitutional tax limitations have taken a variety of forms, including: (i) limitation on the tax rate; (ii) limitation on assessments of particular parcels; (iii) limitation on the rate of increase in assessment or the rate of increase of tax due from a taxpayer; (iv) limitation on the total levy from the locality as a percentage of the community's assessed valuation; (v) limitation on the rate of increase in the community's total levy. Thus, Proposition 13 focused on tax rate and assessments; the measure rolled back assessments, limited assessment increases, and capped property tax rates at 1% of assessed valuation. Massachusetts's Proposition 2 ½, adopted in 1980, focuses on the community-wide levy, by limiting the total property tax yield to 2.5 % of total assessed valuation, and limiting the increase in total revenue raised by the property tax in each locality to 2.5% per year.[40] These different forms of tax limitation can have different incentives for community land use practices, and on local capacity to finance services.

(2) Voter Approval Requirements

Some of the older tax limitations permitted local overrides, and higher rates or levies, if authorized by a local referendum. Proposition 2 ½ similarly permits local voters to override the 2.5% limit on the rate of local property tax revenue increase (but not the 2.5% total levy cap). The round of tax limitations that began with Proposition 13 has given new prominence to the role of the electorate in taxation. Several state constitutions -- California, Colorado, Michigan, Missouri -- make new local taxes or tax increases subject to voter approval. Similar measures were adopted by voters in Montana and Washington, though state supreme courts in these states held the initiatives violated state constitutional single-subject requirements.[41] Efforts to require voter approval of new taxes or tax increases have also been underway in Arizona, Florida, and Oregon.[42] These go beyond the traditional constitutional focus on the property tax and apply to all local taxes. Indeed, the Missouri measure applies to licenses and fees,[43] although the state's

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[39] Id.

[40] Proposition 2 ½ is a statutory initiative, not a constitutional amendment. Many other states, such as New York, have long limit local property levies as a percentage of property values. See N.Y. Const., Art. VIII, § 10. I am less certain whether there are states that impose a constitutional limit on the rate of local levy increase.

[41] See Kirk J. Stark, The Right to Vote on Taxes, 96 Nw. L. Rev. xxx (2001).

[42] Id.

[43] Mo. Const., Art. X, § 22(a).

courts have struggled over the application of the voter approval requirement to non-tax revenues.[44]

(3) Application to the States

In the post-Proposition 13 wave of tax limitation, many states amended their constitutions to constrain state taxation, not just local taxes. The constitutions of a dozen states now require a legislative supermajority (ranging from 60% to 75%) for new or increased state taxes.[45] A number of states have also adopted constitutional or statutory measures that cap either state revenues or state appropriations. Generally, these measures seek to limit any increase in revenues or expenditures to the growth in state personal income, growth in state population, or growth in the cost of living, or some combination of these measures, relative to a baseline year.[46]

Michigan's Headlee Amendment is illustrative. In addition to limiting local taxes, the measure establishes a state revenue limit "equal to the product of the ratio of Total State Revenues in fiscal year 1978-79 divided by the Personal Income of Michigan in calendar year 1977 multiplied by the Personal Income of Michigan in either the prior calendar year or the average of Personal Income of Michigan in the previous three calendar years, whichever is greater."[47] The state legislature is prohibited from imposing "taxes of any kind which, together with all other revenues of the state, federal aid excluded, exceed the revenue limit." In any fiscal year in which total state revenues exceed the revenue limit by one percent or more "the excess revenues shall be refunded pro rata based on the liability reported on the Michigan income tax and single business tax (or its successor tax or taxes) annual returns filed following the close of such fiscal year. If the excess is less than 1%, this excess may be transferred to the State Budget Stabilization Fund."[48] This limit can be exceeded only if the governor's declaration of emergency is confirmed by two-thirds of the members of each legislative house.[49] Missouri's Hancock Amendment is very similar.[50]

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[44] See Beatty v Metropolitan St. Louis Sewer Dist., 867 S.W.2d 217 (Mo. 1993).

[45] W. Valente, D. McCarthy, R. Briffault, et al, State and Local Government Law 536 (5th ed. 2001).

[46] Id. at 537.

[47] Mich. Const., Art. IX, § 26.

[48] Id.

[49] Mich. Const., Art. IX, § 27.

[50] See Mo. Const., Art. X, §§ 16-18. The Colorado Constitution takes a slightly different approach. Pursuant to a voter initiative adopted in 1992, it sets a "maximum annual percentage change in state fiscal year spending" equal to "inflation plus the percentage change in state population in the prior calendar year, adjusted for revenue changes approved by voters after

(4) Effects

Empirical research on tax and expenditure limitations (TELs) has found several broad effects, although the effects vary considerably from state to state according to the terms of the specific restrictions.

First, TELs have contributed to the reduction in property taxes as a percentage of personal income and in the role of property taxes in funding local government.

Second, TELs appear to have contributed to an increase in the role of assessments, fees (including development impact fees) and user and service charges in funding local governments. One study found that for California cities the percentage of current revenue from service charges rose from 25% in 1977-78 to 41% in 1995-96.[51] Nationwide, by the early 1990s, fees and charges accounted for 14.6% of total local revenues and 23% of local own-source revenues.[52] This development has involved not only greater reliance on assessments, fees, and charges, but an expansion in the notion of what constitutes an assessment, fee, or charge. Assessments may now be used to fund traditional government services as well as capital infrastructure, and fees, such as the development impact fee, may be charged for facilities or services long before any feepayer uses the facility or service. In other words, many assessments and fees resemble taxes, especially property taxes, but when courts agree they are assessments or fees in most states they are exempt from limits, uniformity requirements and voter approval requirements. (California, however, now subjects some special benefit assessments to voter approval requirements, and Missouri applies its voter approval requirement to licenses and fees.)

Thus, much as the debt limitations have stimulated the proliferation of new forms of government obligations that avoid the constitutional "debt" label, the tax limitations have contributed to the growth of revenue-raising devices that avoid the constitutional "tax" label. Similarly, like the debt limits, the tax limits may add to the complexity of local government structures. Where tax limitations have applied only to named categories of local governments, such as cities or counties, states and localities have created special districts whose revenue sources are not subject to the constitutional restrictions.

Third, TELs imposed on local governments may have contributed to a shift in power to the states. The fiscal limits on local governments are typically more stringent than those imposed on the states, and they have made local governments more dependent on state aid. For California counties, for example, the share of revenue from intergovernmental transfers rose from 50.6% in 1977-78 to 64.1% in 1995-96.[53]

1991.” Colo. Const., Art. X, §20(B). [51] See Valente, McCarthy, Briffault, supra, at 537.

[52] Id. at 560.

[53] Id. at 537-38.

Fourth, even with the growth in intergovernmental aid, new taxes, and non-tax local revenues, TELs appear to have reduced local revenue growth. For the most part, revenues in states with TELs have grown more slowly than in states without them.[54]

D. The Reform Agenda

The uniformity, limitation, and voter approval requirements raise long-standing and difficult questions concerning the role of constitutions (and courts) in constraining taxation.

The uniformity requirements are intended to promote the equal treatment of taxpayers but they also reduce the ability of states and localities to take into account the differential effects of similar tax burdens, and to use taxation as a policy-making tool (and not just a revenue-raising device). Many state constitutions have modified the uniformity requirement with provisions for classification and exemptions, thereby shifting questions of tax preferences and tax policy back to the political process. Uniformity of taxation, subject to some form of classification, seems to be a well-accepted constitutional norm

The tax limitation and voter approval requirements are more controversial. Tax limits, like debt limits, suppose that the level of taxation is a constitutional matter, rather than one for resolution by current elected officials. Whereas the long-term consequences of debt obligations provide some support for treating debt as a quasi-constitutional matter, tax rates may easily be changed, and politicians who enact high taxes may be punished by the voters in the next election. Moreover, most tax limitations are imposed by states on their localities.[55] Given the disciplining effects of interlocal competition for taxpayers, it is unclear why the decision about local tax rates shouldn't be left to the localities themselves. On the other hand, it has been argued that tax limits can constrain wasteful spending by local elected officials and bureaucrats.[56]

As noted, there is considerable variety in the type of tax limitation, including rate caps, levy caps, levy increase caps, and caps on increases in individual taxpayer liabilities. And, of course, within each category, there is interstate and intrastate variation in the number or percentage of the cap. With respect to the types of limits, there is certainly something to be said for protecting taxpayers from sharp swings in their liabilities -- swings which result from appreciations in the unrealized value of their homes but not from increases in their current

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[54] See John Kirlin, The Impact of Fiscal Limits on Governance, 25 Hastings Const. L. Q. 197, 200 (1998).

[55] I have assumed that the questions of local power to adopt new taxes and new types of taxes and the application of Home Rule to local finances is an issue for the Local Government paper, not this one.

[56] Theresa J. McGuire, Proposition 13 and Its Offspring: For Good or Evil? 52 National Tax Journal 129 (1999).

incomes. On the other hand, limiting tax liability increases can result in two different owners of properties of similar values paying very different amounts of tax. More generally, as with the debt limitations, there is no consensus on either the proper focus of tax limitations – the individual taxpayer, the rate of tax increase, or the fraction of community wealth to be paid in taxes – or the numerical value of the limit.

The most recent trend in the state constitutional treatment of taxation is the requirement of voter approval for new taxes or tax increases. Voter approval may be a more flexible means of controlling taxes than a specific limit carved into the constitution. It may also correspond to the notion that taxation is a fundamental decision for any community and, thus, should be made with the higher level of participation that a referendum requirement may generate. On the other hand, if voter approval is added to a substantive limit, or is required at the state level in states where currently there is no substantive cap on state taxation, it would make the process of raising revenue more difficult. More generally, the debate over voter approval of new taxes or tax increases – like the debate over voter approval of new debt – echoes the longstanding controversy over the wisdom of making the decisions of elected representatives contingent on the further requirement of voter approval.