THE FISCAL PROVISIONS OF AMERICAN STATE CONSTITUTIONS

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I. Introduction

State and local governments are responsible for financing and providing most domestic public services and public infrastructure in the United States. The combined state and local public workforce is six time larger than the federal government's civilian workforce, and state and local spending on domestic programs (other than social insurance programs that involve transfer payments to individuals, and interest on the national debt) exceeds federal domestic spending by a ratio of 2:1. States and local governments finance their programs largely from their own resources. More than 80% of state and local budgets comes from state and local revenue sources, and states and local governments have incurred roughly $1.5 trillion in debts.

Not only are states and local governments largely responsible for their own spending, revenue-raising, and borrowing, but state constitutions regulate these state fiscal practices to a surprising degree. The federal constitution says next to nothing about questions of public finance; it places a handful of restrictions on federal taxation and no restrictions on federal borrowing. By contrast, state constitutions accord extensive consideration – typically, at least two articles – to state and local spending, borrowing. and taxing. State constitutions limit the purposes for which states and localities can spend or lend their funds, and expressly address specific spending techniques. Nearly all state constitutions impose significant substantive or procedural restrictions on state and local borrowing. A considerable number also limit state and local taxation. A few limit expenditure levels. Together, these provisions may be said to advance the goal of taxpayer protection by constitutionalizing 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 is the enormous gap between the written provisions of state constitutions and actual practice. State judicial interpretations have effectively nullified the "public purpose" requirements that ostensibly prevent state and local spending, lending, and borrowing in aid of private endeavors. The substantive and procedural debt limitations have, to a significant degree, been evaded by a host of financial instruments which the courts have held to be beyond the scope of these rules. The constitutional constraints on state and local taxation have been more effective, but their impact, too, has been cushioned by judicial determinations that certain revenue-raising devices are not taxes subject to limitation.

II. Public Purpose Requirements

Nearly all state constitutions contain provisions that expressly limit the authority of their states and local governments to provide financial assistance to private enterprises and, in some cases, public enterprises. Many state constitutions supplement this general "public purpose" requirement with further restrictions on specific forms of financial assistance, such as the prohibition on the state or locality giving or lending its credit to private firms, or the ban on the state or local government becoming a shareholder in a corporation. Public purpose requirements also typically apply to state and local borrowing, so that debts may be incurred only to support public purpose projects.

Public purpose limitations 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 that built turnpikes, canals, and railroads during the 1820s and 1830s.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 repudiated all or part of their debts.

In reaction, the states in the 1840s and 1850s engaged in a wave of constitutional revision, adding the "public purpose," "lending of credit," and other provisions limiting state support for private firms. These restrictions were later extended to apply to the activities of local governments.

In the mid-twentieth century, state courts began to accept state and local efforts to widen the definition of public purpose to permit greater use of public funds for economic development programs intended to attract new businesses and support the retention and expansion of existing businesses. By the end of the twentieth century, virtually every state supreme court had concluded that economic development, job creation, and augmentation of the state or local tax base are public purposes justifying programs that provide aid to the private sector, including direct assistance – cash grants, low-interest loans, tax breaks – to individual firms. Many courts rejected the argument that significant benefits to one or a small number of profit-making firms cause a program to violate the public purpose requirement.

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. More generally, courts have taken a posture of extreme deference to state legislatures, finding that a broad range of goals fall under the rubric of public purpose, and that legislative determinations that a spending, loan, or tax incentive program will promote the public purpose are to be accepted as long as they are "not . . . irrational," and will be rejected "only if it is clear and palpable that there can be no benefit to the public."

III. Debt Limitations

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 also led the states to adopt constitutional restrictions 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. Others impose very low limits on the amount of debt a state may incur. Many cap state debt or debt service at a fraction of taxable wealth or revenues. 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. A legislative supermajority or voter approval requirement may also be combined with a substantive cap on the amount of state or local debt. For state governments, the procedural requirements are often the real restrictions on debt. An absolute prohibition 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.

Like the public purpose requirements, the state debt limitations have not had quite the effect their terms suggest. State constitutions typically require the state or locality to pledge its "full faith and credit" in support of its debt. This means that such a debt is a "general obligation" of the state or locality backed not by a particular revenue source but by the full revenue-raising capacity of the borrowing government. Debt limitations clearly apply to such debt. Stimulated in part by the desire to avoid their constitutional debt limits, states and localities developed financial instruments that enable them to borrow without pledging their full faith and credit. Instead, the debt is backed only by a specific revenue source. As a result of state judicial interpretation, or, in some states, constitutional amendment, such "non-guaranteed" or "revenue bond" debt is not subject to the constitutional limitations that apply to general obligation debt.

In recent years, the revenue bond exemption has grown dramatically. Courts have upheld lease-financing arrangements, in which the debt incurred to finance a new facility is issued either by a private entity or a public authority not subject to the debt limitation. The issuer then leases the facility so financed to a state or local government, in exchange for "rent" payments which will cover the cost of debt service. Such "rent" arrangements have generally been held not to be debt. With "contract" or "appropriation clause" debt, the debt is issued by an entity, typically a public authority or special district not subject to constitutional restriction, which uses the borrowed funds to undertake some project for the state or a constitutionally restricted locality. This need not involve the construction of a leaseable facility or the payment of rent. Rather the state or locality that benefits from the debt simply contracts with the issuer to make an annual payment to cover the annual debt service. So long as the contract is subject to annual appropriation – and any duty to make an annual appropriation is clearly disclaimed – most courts which have considered this financing scheme have held that the government's commitment to make a debt service payment is not a legally binding obligation and thus not debt within the meaning of the state constitution.

In upholding these arrangements, many state courts have candidly acknowledged that the state or locality behind the obligation will do its best to assure that the annual appropriations are made, since failure to make the annual payment would surely have a sharply negative impact on the state's own bond rating. But most courts have relied on the disclaimers of any state legal obligation to pay debt service as conclusively establishing that the dangers for future taxpayers of long-term financial commitments which were the driving force behind the debt restrictions are not presented by appropriation-clause debt.

As a result of these various evasive techniques, approximately three-quarters of all state debt and two-thirds of city and county debt is not subject to the substantive limitations and procedural requirements found in state constitutions. Debt limits have plainly affected the form of state and local debt, but it's far from clear they have affected the total amount of debt. 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 as public authorities lack the power to impose taxes or to pledge the full faith and credit of their states public authority debt is not subject to constitutional debt limits. As a result, in many states public authorities have become conduits for the "backdoor financing" of appropriation-backed debt. Debt avoidance has played an important role in explaining the rise of public authorities at the state and local level.

IV. Tax and Expenditure Limitations

State constitutional provisions dealing with taxation and expenditures levels are less widespread and more diverse than public purpose requirements and debt limitation provisions. Some state constitutions are silent on the subject; in others, the tax provisions, like those in the federal constitution, are primarily facilitative or structural rather than restrictive. They authorize certain kinds of taxation, determine which level of government shall levy what kind of tax, or establish the basic ground rules for taxation. These provisions may have some effect on state and local tax policy and may indirectly limit overall revenues, but their thrust is to define and assure the equal treatment of taxpayers rather than to limit tax levels per se.

Tax limitation, however, is an important theme in the state fiscal constitution, and one of growing significance. More than half the state constitutions include some substantive or procedural limitation on the level of state or local taxing or the level of spending funded by own-source revenues. Although some constitutional measures are addressed to the sales tax, the income tax, or taxation generally, most limitations are focused on the property tax – historically the most important form of subnational taxation and still the single most important form of local own-source revenue.

Like the debt limitations, tax limits take many forms: Limits on the property tax rate; limits on the increase in assessed valuation and thus on the year-to-year change in the tax liability of the property owner; limits on the rate of increase in state expenditures and in the revenues needed to fund them; and requirements that new or increased taxes be subject to either a legislative supermajority or voter approval (sometimes with popular supermajorities).

The earliest tax limitations, which focused on capping property tax rates as a fraction of property values, date back to the late nineteenth century. But the critical event for contemporary tax limitations was California's adoption of Proposition 13 in 1978. A response to soaring property taxes attributable to housing price inflation, Proposition 13 not only capped tax rates, it also significantly limited increases in the assessment of property valuation for tax purposes, adopted a supermajority state legislative voting rule for new or increased state taxes, and a similar two-thirds requirement of approval by local voters for many new local taxes or tax increases.

Proposition 13 sparked a wave of tax limitation amendments across the country. Some states went even further, adding limits on expenditure growth according to a formula based on changes in state population, the cost of living, or some combination of these factors relative to a baseline year.

These restrictions appear to have reduced the role of the property tax in financing local government, and they have to some degree restricted state and, especially, local ability to raise money. They have, however, been offset to some degree by the dramatic growth in the use of fees, user charges, and special assessments that not technically taxes. As with debt, a significant share of state and local revenue is now raised by devices not subject to tax limits, although the tax limits have not been evaded nearly as much as the debt limits.

With many local tax limitations targeting specific categories of local government, such as cities and counties, states and localities have an incentive to create special districts and other new forms of local governments not expressly subject to constitutional limitation. The use of assessments or fees has often been accompanied by the creation of a special purpose government which collects and spends the assessment or fee revenue. The creation of a separate, limited purpose government providing a particular service to the payers will bolster the argument that the charge in question is an assessment or fee and not a tax. Thus, the tax limits, like the debt limits, have added to the complex structure of state and local governance.

The turn to non-tax revenue sources also tends to reduce the ability of states and local governments to engage in redistributive programs. The key to the exemption of fees, charges, and special assessments from the label of "tax" is that they provide the payers with a benefit at least equal to their payments (or to the social costs imposed by the payer's behavior). By definition, this precludes the use of fees and assessments to finance broadly redistributive activities. Assessments and fees enable those willing and able to pay for higher levels of service for themselves to do so, but services for the poor must be funded out of general, redistributive taxation, and those taxes are more likely to be subject to constitutional restrictions.

V. The Reform Agenda

A. Public Purpose

There is much to be said in theory for a constitutional requirement governmental action, particularly spending supported by coercive taxation, serve a public purpose is essential to all government action. Moreover, state and local spending presents the classic problem of concentrated benefits for the politically influential few at the expense of costs diffused across the broad polity of taxpayers. But the public purpose requirement is a dead letter today and probably incapable of resuscitation. The courts are correct in noting the broad expansion over the course of the twentieth century of what constitutes a legitimate public purpose. In particular, there is general political acceptance of the belief that government has some responsibility to promote economic development and, especially, employment. The definition of what are the public purposes of government is a deeply political one, which may appropriately be left to the political process, not the courts.

A closer question involves the degree to which a specific program advances the public purpose of economic development, and what to do about public programs that provide large benefits to specific private firms as part of promoting the public purpose. Should courts strictly scrutinize the fit between the public end and the means chosen, or the balance between the public and private benefits? The courts have largely concluded that such review is beyond their capacity, and that the question of means as well as ends is a political question, not a judicial one. They may be right.

B. Debt Limitations

Debt involves a combination of immediate gain followed by a cost at some point in the future. That cost will be felt by future taxpayers who can respond only by punishing future officeholders – who quite often will not be those who voted to incur the debt in the first place. So, too, it may be difficult for the public to effectively control debt through ordinary electoral control of state and local officials. Future debts are unlikely to be current campaign issues, and concern about debt may be offset by the benefits from debt-funded programs. Constitutional debt limits, thus may be justified by the lack of effective political controls over the borrowing decision.

Yet, state courts have been complicit in the widespread evasion of these restrictions. The courts seem to be quite sympathetic to the programmatic spending goals that the debt limits would thwart. From this perspective, the debt limits appear to get in the way of good government in the era of the modern activist state, not to promote it.

One reason for this lack of judicial sympathy for debt limitation may be the archaic nature of many of the constitutional debt provisions. Absolute debt prohibitions, low dollar limits that date back to the nineteenth century, and percentage limits that are much lower than contemporary debt levels are completely out of step with the needs of modern government. Such provisions inspire, if they do not justify, evasion.

One possible reform of the debt limits thus might look to simultaneously raising the level of the debt limit while redefining the limit to include all debts that would be repaid with public funds. The difficulty would be to decide what is the appropriate debt level relative to revenues as there does not appear to be any theoretical basis for determining this level in theory or any consistency in practice among the states that take this approach.

A separate question is whether debt should be conditioned on a legislative supermajority voter approval. These rules certainly provide an additional hurdle for elected officials who may be too quick to incur debt. Although it is far from clear that voters are better than elected officials in balancing the competing present and future needs raised by the debt decision, a voter approval requirement may be appropriate in light of the long-term binding nature of debt.

C. Tax and Expenditure Limitations

Whereas debt has binding long-term consequences, and the decision of whether or not to incur debt may receive inadequate public scrutiny, tax rates may be easily changed, and taxation is often an extremely salient political issue, with anti-tax forces well-represented in the political process. Politicians who enact high taxes may be punished by the voters in the next election, and few politicians are likely to doubt the political significance of anti-tax sentiment. It is not clear why further constitutional protection needs to be superimposed on the protections provided by the ability of the voters to vote out of office elected officials who raise taxes.

Moreover, because the property tax has long been a central focus of anti-tax movements, tax limitations often bind local governments far more tightly than they bind the states. Although localities have proved inventive in expanding the range of non-tax taxes, the property tax is still central to local finances and in many states property tax limits have really constrained local revenues. As a result, localities have become more dependent on state aid, and states generally account for a greater share of the total of state and local spending. It is unlikely that tax limit proponents desired such a centralization of power from localities to the states but that has often been the result.

Yet, despite the theoretical difficulties with tax and expenditure limitations, they have done much better in the state courts than the theoretically more defensible public purpose and debt provisions. This may be due to their recent nature and continuing popular support. It is no surprise that a constitutional provision that reflects strongly held current political values is more likely to be effectively enforced than measures that are seen as archaic and arcane. So, too, the success of these limits may be due to the fact that, unlike the public purpose requirements, their meaning is relatively clear; and, unlike the debt limits, state and local legislators have not come up with revenue-raising devices that do the work of broad-based taxes as successfully as contemporary revenue bonds have substituted for general obligation debt.

Voter approval requirements are an important theme in contemporary tax and expenditure limits, particularly at the local level. Voter approval is a more flexible means of controlling taxes than a specific limit carved into the constitution. Moreover, for local governments, a requirement that the local electorate approve new taxes or debts is more consistent with home rule than a statewide provision capping local taxes or debt. Whether conditioning new taxes or new debts on voter approval is desirable is also inevitably linked to the more general debate over direct democracy.

Given the intense public concern with issues of taxation, conditioning new or increased taxes on voter approval does not seem necessary to correct political process failures or to promote deliberation concerning levels of taxation. Rather, placing such a voter approval requirement in a state constitution would be based on a substantive determination that hostility to taxation ought to be a constitutional norm.