

Local Governments Navigating the California Constitution:

Rough Waters and Shifting Sands

Presented by The Municipal Law Institute of The League Of California Cities and The California Constitution Center of UC Berkeley School Of Law

Panel: Constitutional Issues Relating to Finance and Revenue

*Presentation: California Local Government Finance:
The Ideal, the Real and the Ideally Real?*

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4. Kirk J. Stark, *The Right to Vote on Taxes*, 96 NW. U. L. REV. 191 (2001) (just the introduction included).

Note: I have not completed an article that directly develops all of the themes of my presentation. I hope to. However, the two pieces of mine included discuss some of the basic issues and the Briffault and Stark are classics in this area.

Clearing Away Roadblocks to Funding California's Infrastructure

by Darien Shanske

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I. Introduction

No one disputes that California, like much of the rest of the country, has a desperate need for infrastructure investment. California's politicians are aware of this and significant additional resources have been committed over the last few years. Indeed, California has been at the forefront of several novel ways of financing infrastructure. Yet the funding gap remains vast. To be sure, significant federal assistance has been forthcoming, but that will not be sufficient, especially to the extent that federal aid only ensures that previously planned projects are not abandoned as California, like most states, endures yet another severe budget crisis. And federal aid will be only for a limited time — coming up with better ways for California to invest in itself is thus an additional (and much needed) form of economic stimulus.

There are highly effective ways to build infrastructure that have been stymied by changes to the California Constitution.

This report began when I was given the opportunity to address California legislative staffers on the issue of infrastructure financing. Given the consensus about the need and California's willingness to

experiment with novel financing techniques, it was unclear what I should talk about. In reviewing the recommendations of others and the history and theory of infrastructure finance, it became clear to me that a major way forward for California lay not in novelty, but in tradition. There are venerable and powerful ways to finance infrastructure that California has allowed to wither away. Or more precisely and sadly, there are highly effective ways to build infrastructure that have been stymied by changes to the California Constitution.

There have already been thoughtful proposals for revising California's Constitution,¹ and the economic crisis may offer a unique opportunity to implement common-sense reforms.² This report will identify provisions that obstruct the building of needed infrastructure in California and elsewhere and then will make proposals as to how those provisions can be improved. Related statutory fixes will also be addressed. The proposals are offered as pragmatic, even technocratic, fixes, and thus should be within the bounds of possibility despite political polarization. Indeed, to the extent that many of the proposals involve empowering local government entities, the same entities that have borne much of the

¹The California Constitution Revision Commission, "Final Report and Recommendations to the Governor and the Legislature," 1996. That report anticipates the proposals contained herein in many ways, in particular through advocating giving local communities more control over their finances, but also striving to make the local governments themselves more efficient. *Id.* at 74-79. The Commission on the 21st Century Economy makes no such proposal (report is available at http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf), despite having heard testimony about the serious problems affecting local finance. See Testimony From the Meeting of April 9, 2009, available at <http://www.cotce.ca.gov/meetings/2009/4-9/testimony/>.

²There are serious discussions about convening a new constitutional convention. See "Repair California: Californians for a State Constitutional Convention," available at http://www.repaircalifornia.org/about_california_convention.php (last visited Aug. 15, 2009).

brunt of the budget cuts,³ these proposals should not be controversial because they are essential to just roughly maintaining the level of infrastructure that we have.

A. The Need

It is unhelpful just to throw paralyzingly large numbers around as to how much additional funding is required.⁴ There are several reasons for that. First, to the extent the California economy is changing, some needs might actually lessen. For instance, less resource-intensive industries are, and should be, California's economic future.⁵ If California's economy becomes more service oriented than manufacturing oriented (and if the manufacturing that remains is more energy efficient), we might not need to increase or even maintain our current level of energy production.

Second, and similarly, we are not passive participants as to our future needs. If we develop more intelligently, we will need less infrastructure — and different infrastructure — the reverse, sadly, is also true. And that is not just a matter of deciding *what* we fund (for example, public transit versus roads), but *how* we fund it. One popular catchphrase in the literature is “demand management.” As for a lot of the resources that we are discussing, we *want* people to consume less, and demand management simply means that scarce resources should generally be priced according to their true cost. Demand-based pricing for water, electricity, and roads makes sense not only as a matter of efficiency or equity, but proper pricing also achieves the independent goal of conservation.⁶

That will be a theme of this article — we need to enter into virtuous cycles. If we have the right

funding mechanisms and incentives in place, that will tend to lead to production of the right amount of proper infrastructure.

B. Where State and Local Funding for Infrastructure Comes From

It would be inaccurate to say that the state budget must meet all our infrastructure needs. In 2006 California local governments issued almost \$40 billion in bonds, most of which were for projects that we would consider infrastructure.⁷ In 2006 the state issued just over \$12 billion in bonds,⁸ though the state spent many more billions on infrastructure directly.⁹ In total, by at least one reliable estimate, local and regional entities account for 80 percent of capital spending in California.¹⁰ Therefore, perhaps the single most effective action the state could take would be to empower more and better local government infrastructure finance.

II. Sketch of an ‘Ideal’ Theory of Infrastructure Finance

We cannot assess how we are doing and what we should be doing without some sort of theoretical baseline. That is especially true for California, which has participated to some extent in every innovative financing technique that I know of. Therefore, to gain some perspective, I will present a thumbnail sketch of an ideal system of infrastructure finance. I put “ideal” in quotes because this system is not necessarily ideal in terms of equity or efficiency, nor is it entirely descriptive of what California now does. Still, pragmatically, it is a reasonable approximation of the system the state should be shooting for.¹¹

³Legislative Analyst's Office, July 2009 Budget Package, p. 2-3, available at http://lao.ca.gov/2009/bud/july_09_budget_package/July_2009_Budget_Package_072909.pdf (shifting \$1.7 billion in redevelopment funds, borrowing \$1.9 billion from local governments, and decreasing funding for transportation); ABX 4-14, ABX 4-15, 2009-2010 Calif. Leg. Sess. (Calif. 2009) (temporarily cutting funding to local governments and allowing them to borrow until repayment by the state).

⁴One common number is \$500 billion. Hanak, “Paying for Infrastructure: California's Choices,” *At Issue* (January 2009), available at <http://www.ppic.org/main/publication.asp?i=863>. This report is the single best and most concise treatment of the problem California is facing and how to solve it; it does not, however, focus on the legal roadblocks. The knee-buckling number at the national level has been recently estimated at \$2.2 trillion. See “Report Card for America's Infrastructure” (2009), available at <http://www.infrastructurereportcard.org/>.

⁵Hanak et al., “California 2025: Taking on the Future,” Public Policy Institute of California, p. 68, June 2005, available at <http://www.ppic.org/main/publication.asp?i=489>.

⁶Hanak, *supra* note 5, at 114-115.

⁷California Debt and Investment Advisory Commission, “California Public Debt Issuance by Type and Refunding for the Period January 1, 2006 to December 31, 2006,” available at <http://www.treasurer.ca.gov/cdiac/debtdata/2006/type.pdf>. That is not at all unusual; for reasons noted below, local governments have taken the lead in providing infrastructure since the 19th century. John Wallis, “Constitutions, Corporations and Corruption: American States and Constitutional Change, 1842-1852,” *J. Econ. Hist.*, 2005, 211, 245.

⁸See California Debt and Investment Advisory Commission, *supra* note 7.

⁹Of course, local governments did as well.

¹⁰Hanak, *supra* note 4, at 5.

¹¹Primarily, I am taking our decentralized system as a given and am advocating policies that will make it work better. See generally, Gruber, *Public Finance and Public Policy*, Worth, 2007, at 268-270 (discussing optimal fiscal federalism). There is considerable evidence supporting decentralizing as a general matter. See Hills Jr., “Compared to What? Tiebout and the Comparative Merits of Congress and the States in Constitutional Federalism,” in *The Tiebout Model at Fifty* (William A. Fischel ed., Lincoln Institute of Land Policy, 2006), 239-263. I am less sanguine regarding our decentralized system, particularly because of the wildly divergent size and nature of the current set of local government

(Footnote continued on next page.)

This little model requires two distinctions and results in a two by two matrix:

| | |
|--|--|
| Self-Supporting, Easily Monetized For example, water fees fund water treatment plant | Not Self-Supporting, Easily Monetized For example, regional highway funded in part by tolls |
| Self-Supporting, Not Easily Monetized For example, school in wealthy district funded by property tax | Not Self-Supporting, Not Easily Monetized For example, school in poorer district subsidized by state |

First, some benefits provided by infrastructure are easily monetized, and second, some benefits can support themselves. Water treatment is an example of an easily monetized and self-supporting benefit — the top left corner of the matrix. Sufficient fees can be charged to finance the building of water treatment plants and to keep them running.

Some other benefits are easily monetized but not self-sustaining — that is the top right corner of the matrix. An example of that might be many public transit systems or a regional highway. That is, it is easy to charge tickets for public transit, but most public transit cannot survive by tickets alone. There are also benefits that are not so easily monetized but can be self-supporting, such as public schools in relatively affluent areas that can be fully financed by local property taxes — that is the bottom left corner. Finally, there are benefits that cannot be easily monetized or support themselves: Public schools in poorer areas might be an example. I should emphasize that these categories in no way imply a hierarchy one way or another.

As to these four general categories, our first general principle is a simple one: *Projects that produce easily monetized, self-supporting benefits, such as water treatment plants, should generally be allowed to support themselves.*

As to those projects that can be self-supporting, but either are not monetizable or where user fees will not likely be sufficient, it is important to come up with creative ways to allow the project to pay for itself. There are traditional ways to do that when the benefit can be spatially isolated. One classic ex-

ample is public schools. As long as the law creates the right relationship between who is in a school district and who is outside,¹² supposing sufficient local resources (we are in the self-supporting quadrant), the residents of the district will pay for adequate schools and do so out of self-interest because local property owners will impound their investment in local education into their home prices.¹³

Another important example of this dynamic involves the assessment district — assessment district financing has a venerable history.¹⁴ For example, one can use an assessment district to build a local road. Everyone with property beside the road can be assessed their pro rata share for the road based on frontage.

This principle of assessing landowners for the benefit received from public infrastructure is important, and not just as a matter of equity. Typically, a new piece of infrastructure increases nearby land values. If that is so, and the benefiting landowners are not paying more for the improvement, but the improvement is instead built using general taxation, limited general tax dollars at all levels of government are being used to subsidize a project that does not need it. I want to emphasize how unfortunate it is to violate what is called the principle of “fiscal equivalence,” that is, having a sound link between benefit and burden (when possible).¹⁵ It is not just relatively unfair and wasteful, but potentially absolutely wasteful because requiring local beneficiaries to pay is a reasonable way to try to assess project need in the first place. The waste goes back the other way because if a sensible project is to be paid for by general tax dollars, taxpayers who do not benefit will resist the expenditure, making the whole community worse off in the long run.¹⁶ Also, if the assessment against property is based (as it should be) on relatively uncontroversial and conservative metrics of how much the property’s value should be increased,¹⁷ it encourages more intensive use of the

¹²The laws must also allow for local financing of schools. After Proposition 13, that is less true in California; a small step to changing that situation is discussed below.

¹³See generally Fischel, *The Homevoter Hypothesis: How Home Values Influence Local Government Taxation, School Finance, and Land Use Policies*, Harvard University Press, 2001.

¹⁴See generally Diamond, “The Death and Transfiguration of Benefit Taxation: Special Assessments in Nineteenth-Century America,” 22 *J. Legal Stud.*, 201, (1983).

¹⁵See generally Weingast, “Second Generation Fiscal Federalism: The Implications of Fiscal Incentives,” 65 *J. Urb. Econ.*, 279, 285 (2009).

¹⁶Wallis, *supra* note 7, at 222.

¹⁷For an example of a thorough study of the increase in land value caused by proximity to transit, see Transportation Research Board, “Economic Impact Analysis of Transit Developments: Guidebooks for Practitioners,” 1998, *TCRP Report*

(Footnote continued on next page.)

land — another plus. And so this is our second general principle: *The benefit principle should be used whenever possible.*

The benefit assessment principle has generally been applied at the local level, and I believe that is where it should continue to be primarily used. But there is important potential for this principle at a regional level, even if that means that the benefit principle cannot cover the entire cost of the project. Consider the following: Virginia has received a lot of attention for using cutting-edge public-private partnerships to fund new transportation infrastructure.¹⁸ But Virginia found that simply using tolls to pay for that new infrastructure was insufficient, and in at least one instance Virginia used a regional assessment to make up the difference — landowners around a new piece of infrastructure agreed to be assessed more to defray part of its cost.¹⁹

The third principle follows from the second, and it relates to those services for which there should be a price to encourage conservation. The principle is simple: *A price should be imposed even if that price is not sufficient to cover the full cost of the improvement.* An example of that would be to put a toll on a highway even if any reasonable toll would be insufficient to maintain that highway.

General tax dollars should be spent only after all self-sustaining projects are paying for themselves and demand pricing has encouraged conservation.

Note that, if working properly, under our model: *General tax dollars should be spent only after all self-sustaining projects are paying for themselves, and demand pricing has encouraged conservation.* That is our fourth principle. For the most part that means that state and federal tax dollars should be

used primarily on large regional projects (or more equitable distribution) not covered by demand pricing, local benefits, or local general taxation. That includes not only physical pieces of infrastructure but also more intangible long-term capital assets, like the education of our children. Obviously, state and federal funding is also good at spurring on and guiding local involvement, and so using some state money essentially as seed money is likely to be a wise investment.

III. Evaluations and Recommendations

Returning to our simple matrix, we will start at the top left. Both as independent entities and as enterprises within other entities, many self-sustaining projects have been allowed to proceed on their own, per our ideal.²⁰ Probably more of our public infrastructure should be paid for in that way. Recently, the U.S. Supreme Court allowed a two-county waste management authority to compel residents to use a state-of-the-art waste treatment center, clearing one obstacle to the greater use of demand management by government entities.²¹

One big obstacle to even maintaining the current level of demand management in California has been the advent of Proposition 218, passed by the voters in 1996. In short, Proposition 218 makes it more difficult for fees to be raised for water service or to generally charge higher fees for more resource-intensive use of property.²² Just last year the Legislature tried to mitigate the impact of Proposition 218 on water fees with AB 2882.²³ However, there are limits to the Band-Aids the Legislature can apply. It is hard to understand why a technical correction to Proposition 218 should be politically impossible.²⁴ Indeed, Proposition 218 already exempts electric utility and gas service from most of its

²⁰Hanak, *supra* note 5, at 136; see also Hanak and Rueben, "Funding Innovations for California Infrastructure: Promise and Pitfalls," *USC Keston Institute for Infrastructure*, Mar. 20, 2006, p. 8, available at <http://www.usc.edu/schools/sppd/keston/pdf/cal-infrastructure-promise-pitfall.pdf>.

²¹*United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 127 S. Ct. 1786 (2007).

²²The details are complicated, but the gist of the problem is that Proposition 218 imposes significant new requirements on local agencies seeking to raise fees, including most especially for the cost of water. See *Bighorn-Desert Water Agency v. Verjil*, 138 P.3d 220 (Calif. 2006); *Pajaro Valley Water Mgmt. Agency v. Amhreim*, 59 Calif. Rptr. 3d 484 (Calif. Ct. App. 2007) (following *Bighorn* and invalidating fee increase); Hanak, *supra* note 4, at 6. Those harmful effects were predicted from the start. See Soldani, "The Impact of Proposition 218 on California's Water Delivery System: Should Water Be 'Above the Law'?" 10 *San Joaquin Agric. L. Rev.* 183 (2000).

²³AB 2882, 2007-2008 Leg. Sess. (Calif. 2008).

²⁴Gov. Arnold Schwarzenegger (R) has already proposed amending Proposition 218 regarding flood control; the reasonable idea is that individuals who purchase homes in flood

35, available at <http://www.trb.org/TRBNet/ProjectDisplay.asp?ProjectID=1137>. For a survey of the many studies conducted around the world on financing transit through value capture, see Smith and Gihring, "Financing Transit Systems Through Value Capture: An Annotated Bibliography," *Victoria Transport Policy Institute*, November 2006, available at <http://www.vtpi.org/smith.pdf>.

¹⁸See discussion of public-private partnerships (P3s) *infra*.

¹⁹*Understanding Contemporary Public Private Highway Transactions: The Future of Highway Finance? Before the Subcomm. on Highways, Transit and Pipelines of the H. Comm. on Transp. and Infrastructure*, p. 23, 109-175 (2006) (testimony of Virginia Gov. Tim Kaine (D)); see also, Muro et al., "MetroPolicy: Shaping a New Federal Partnership for a Metropolitan Nation," *The Brookings Institution*, 2008, p. 76, available at http://www.brookings.edu/reports/2008/06_metr_policy.aspx; Hagman and Mischynski, *Windfalls for Wipe-outs*, 1978, p. 322.

strictures. Thus, article 13D, section 3(b) of the California Constitution, added by Proposition 218, currently reads:

For purposes of this article, fees for the provision of electrical or gas service shall not be deemed charges or fees imposed as an incident of property ownership.

The simplest and best fix of the problem posed by article 13D's limitation on the ability of local agencies to use demand management for water use is simply to add "water service" to the list of exempted services. However, that fix would not necessarily help with the imposition of fees in connection with other natural resource issues, such as charging higher fees to those wishing to locate construction in flood plains. Therefore, my proposal would add the phrase "or any other natural resource related fee, as such service is determined by the Legislature."²⁵ That addition builds in the necessary flexibility and political accountability. Without question, one concern of the proponents of Proposition 218 was that cash-starved local agencies were pushing the concept of an assessment or fee to the limit.²⁶ By requiring legislative approval of any new type of natural resource fee, the taxpayers are assured that any such fee would emerge from the state authorities, providing greater transparency and accountability than many ad hoc decisions made at the local level.

Unfortunately, fixing article 13D is not enough. Article 13C, section 3, also added by Proposition 218, reads:

Notwithstanding any other provision of this Constitution, including, but not limited to, Sections 8 and 9 of Article II, the initiative power shall not be prohibited or otherwise limited in matters of reducing or repealing any local tax, assessment, fee or charge.

That provision has been found to mean that fees for water service can be lowered by initiative.²⁷ This

power is destabilizing and inhibits the proper pricing of natural resources as we move into a more resource-constrained future.²⁸ There are various ways to fix that problem. I think it would be simplest to amend the provision just discussed in article 13D so that neither article 13C nor article 13D applies to natural resource fees.

Thus, summing up, my first proposal is: *Amend the California Constitution to enable better resource management.* A new Article 13D, section 3(b) of the California Constitution would read:

For purposes of this article and Article 13C, fees for the provision of electrical, water, gas or other service related to a natural resource, as such service is determined by the Legislature, shall not be deemed charges, fees or taxes.²⁹

It should be observed that this technical correction is analytically appropriate because those fees are prices for the consumption of valuable resources. The current situation, which analogizes fees for water service to a local tax, is not the correct analysis. In the case of a local tax, voters can interact with the level of taxation through voice (that is, voting) or exit (that is, leaving the jurisdiction).³⁰ These expedients are meant to some extent to mimic an ordinary pricing mechanism, but it is generally understood that a local property tax is still a tax and it cannot be perfectly correlated to the specific benefits that any particular taxpayer receives.³¹ There is no need for such mimicry with the consumption of water — as with any consumer good, if one wants to pay less for water, one can simply consume less. Proposition 218 does not make the pricing of water more marketlike, but *less* marketlike. Again, it is essential that more, not fewer, natural resources are priced properly.

Moving to the bottom left of our matrix — as for projects that can be self-supporting, but not through a straightforward user fee, there is an even more

zones should pay more to take into account the additional costs that they are ultimately imposing on the larger community. See Hanak and Rueben, *supra* note 20, at 20. SB 310, 2009-2010 Leg. Sess. (Calif. 2010), just passed and signed by the governor, gives some local governments the power to impose regulatory fees to protect watersheds; the legislation is, by necessity, careful not to authorize the imposition of fees that would be governed by Proposition 218. That approach should not be necessary. See Calif. Water Code section 16103(a)(3).

²⁵*Cf.* Calif. Const. art. 13, section 8 (permitting the Legislature to define "open space lands" for property tax purposes); Calif. Revenue and Taxation Code section 422 (defining open space land).

²⁶California Ballot Measures Database, "Argument in Favor of Proposition 218," available at <http://library.uchastings.edu/library/california-research/ca-ballot-measures.html#ballotprops>.

²⁷Bighorn, *supra* note 22, at 220.

²⁸That is not an imagined horrible event. In at least one recent case, voters used an initiative to lower their sewer rates, which, not surprisingly, triggered a downgrade of that city's sewer revenue bonds. Ward, "Voters Undercut Sewer Debt," *Bond Buyer*, Feb. 27, 2009. The possibility of that kind of action in the future will no doubt make California revenue bonds more expensive, if they are marketable at all.

²⁹As a matter of drafting, it may well be clearer to omit the clause about the Legislature from this section and just add a new definition of service related to a natural resource into the definitional list in section 2 of article 13C.

³⁰Those options come from Hirschman, *Exit, Voice and Loyalty*, Harvard University Press, 1970.

³¹Two excellent papers that ponder the question of the extent to which the local property tax functions as a price are Galle, "A Republic of the Mind: Cognitive Biases, Fiscal Federalism, And Section 164 of the Tax Code," 82 *Ind. L.J.* 673 (2007); and Kaplow, "Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax," 82 *Va. L. Rev.* 413 (1996).

serious gap. The two-thirds voter requirement for most general obligation bonds and for increasing so-called special taxes has depressed local contributions to projects that people want and that are self-funding in the value they add.³² Proof of the untapped potential comes from the enormous number of school bonds that have been passed since the threshold for school bonds was lowered in 2000 to 55 percent (under some conditions).³³ The number of bond measures more than doubled and almost half of the money finally approved (over \$20 billion) would not have been approved if not for the lower threshold.³⁴

That indicates that the state has not just left real money on the table in connection with other infrastructure, but also that the state has probably not allocated its own limited funds optimally. The state has received authorization to issue over \$20 billion in school bonds since the passage of Proposition 39, and so Proposition 39 not only doubled the local contribution, but has also presumably allowed the state funds to be better targeted toward the projects that really cannot fund themselves.

One way forward on infrastructure finance is to lower the approval threshold for local bonds more generally, though perhaps only for specified projects.

Therefore, one way forward on infrastructure finance is to lower the approval threshold for local bonds more generally, though perhaps only for specified projects.³⁵ There are several such proposals before the Legislature, as there has often been over the last several years.³⁶ It is doubtful that most cities and counties are the right level of government

at which to decide on optimal transportation projects.³⁷ Fortunately, the state has regional transportation planning agencies and regional transportation plans.³⁸ It would be wise to tie any new funding source or lessening of approval thresholds to projects that are found to advance regional needs.

Second proposal: *Lower constitutional bond and tax approval thresholds to 55 percent generally, but pass a statutory requirement that ties these new mechanisms to regional needs.*³⁹

Decreasing those thresholds is not the only way to spur more local participation in projects that increase local land values. Assessment district financing is a time-honored way to use the increase in land values generated by a piece of infrastructure to pay for itself. There are already myriad benefit assessment statutes available under California law, including several that are directly usable by regional transit agencies to capture value near transit stations.⁴⁰ Unfortunately, all of those plans are hamstrung by Proposition 218. Proposition 218 would also prevent the extensive use of a new regional type

one's property in the school district. Such expenditures generally require an increase in taxes for operations, not just the approval of a tax increase to fund some capital projects.

³⁷Cf. Hanak, *supra* note 5, at 147-148.

³⁸See Calif. Gov't Code sections 29532 and 65080. There is another problem mitigated by increased use of long-term regional plans, one pointed out to me by a particularly sharp conference attendee. To the extent that the state and federal governments will provide funding to communities that cannot fund their share of projects, there is a perverse incentive for communities that can fund their projects to avoid doing so. To some extent that problem is insoluble, which is why the fact that there is already a tradition of local initiative in financing is so important. If we had to start from scratch with communities expecting help from the center, we would be in deep trouble. As it is, gamesmanship can be limited by providing bonuses to communities that provide their share of funding. Of course, the question is what is a fair share and how should any incentives be structured so as to make sense to spend central government dollars on them. This is the benefit of large-scale, long-term, professionally drawn regional plans. Communities will have years to know what is expected of them and what they might or might not enjoy if they contribute; that would obviate the need for inefficient ad hoc bargaining as to specific localities and projects.

³⁹The need for such a change is particularly dire because, as noted above, the state has chosen to close its budget gap not only by cutting local funding, but also by enabling these same localities to borrow against the state's promise (and obligation) to make them whole. See *supra* note 3. There is some merit to the state's plan to the extent that it makes sense to borrow during an economic downturn, but the plan is problematic to the extent that the borrowing is entirely reliant on the state's credit. It would have been wise to at least give local governments more power to borrow on their own.

⁴⁰See Calif. Pub. Util. section 33000 (Southern California Rapid Transit District assessment authorization); Calif. Pub. Util. section 99000 (transit district assessment authorization).

³²Calif. Const. art. 13A, section (1)(b)(2); California is one of only eight states that require a supermajority to pass local general obligation bonds. Hanak and Rueben, *supra* note 20, at 6.

³³Calif. Const. art. 13A, section (1)(b)(3); Calif. Educ. Code section 15268.

³⁴Hanak and Rueben, *supra* note 20, at 8-9.

³⁵Cf. Hanak and Rueben, *supra* note 20, at 8-9.

³⁶See, e.g., ACA 9, 2009-2010 Leg. Sess. (Calif. 2009); ACA 10, 2007-2008 Leg. Sess. (Calif. 2007). The wisest of those proposals do not just lower the threshold for bonds as such, but for local taxes (for example, a parcel tax, which is a kind of special tax). First, that is because if governments cannot pay for ongoing services or maintenance, one-time expenditures for infrastructure are of limited value (why build a new school with a track if one cannot increase taxes to pay for a track instructor?). Second, the distinction between a capital expenditure using bond funds and a service expenditure using local taxes is not clear. Again, the school analogy indicates that in many cases an ongoing investment in local schools is an investment not only in one's children, but also in

(Footnote continued in next column.)

of assessment district. Only a constitutional fix seems possible here as well.

It is unobjectionable that Proposition 218 requires more transparency in connection with assessments. Proposition 218 does its mischief in various technical changes it makes to the law. First, it weighs voting by how much each landowner is going to pay should the new assessment be passed.⁴¹ Even worse, Proposition 218 does not require that a majority of all landowners in the district protest to stop an assessment, but only a majority of those who actually vote — thus giving even more power to a determined minority.⁴² There are good arguments that assessment district votes should not be limited to landowners to begin with,⁴³ but weighing the vote of the landowners by the size of their assessment is particularly unjustifiable. If done properly, the whole point of an assessment is that, for each parcel, the assessment levied is proportional to the benefit that parcel is going to receive. In other words, in a properly designed assessment district, each property owner should have the same stake in the vote and so there is no reason to give additional privileges to large landowners. Combined with the rule that gives an effective veto to merely a majority of the weighted ballots *actually* cast, Proposition 218 is designed to prevent the building of infrastructure. This voting regime should be changed — or rather, the voting requirements should be left out of the constitution altogether and the statutory requirements in the various assessments acts should once again be the law.⁴⁴

Proposition 218 mandates a “detailed engineer’s report prepared by a registered professional engineer certified by the State of California” for each assessment.⁴⁵ There is nothing problematic about demanding rigor, though clearly this requirement poses a significant upfront cost to local governments. This provision should therefore be amended to allow for

local governments to impose assessments for some projects within a statutory safe harbor. That legislation should also provide for the possibility of region-wide benefits to enable larger-scale improvements.⁴⁶ There has been considerable work already done estimating the benefits provided to property from local improvements.⁴⁷ The Legislature should take conservative estimates and place them in the law, along with an annual adjustment for inflation. In a statute, the thresholds could be changed generally or specifically if the need arises. The statute should make it clear that local governments are free to reach other arrangements with local landowners. A similar arrangement is already in place in connection with some development impact fees.⁴⁸ It would also be reasonable to establish special presumptions for approved regional projects.

Proposition 218 insists that the benefit conferred on a property by an assessment cannot be a “general enhancement of property value.”⁴⁹ That limitation is incomprehensible. Measurable increase in the value of the property should be the gold standard of assessment law, and thus that provision is hopeless and should be eliminated.

Finally, Proposition 218 shifted the burden of justifying an assessment onto the local government. Proposition 218 did not specify what exactly would be the new standard of review. The California Supreme Court, in a unanimous vote, found that the new standard of review would be *de novo*.⁵⁰ That is, the court has decided to give local governments no deference at all regarding the assessments that they approve. If that rule is not changed, all the other proposed changes would amount to little because of the litigation risk that any assessment now brings with it as a matter of *constitutional* law (that is, a statutory safe harbor will be of little use). I propose a two-part change. First, for any assessment within a statutory safe harbor, the level of review should return to an abuse of discretion standard, which is what it was before Proposition 218.⁵¹ Second, for assessments beyond the safe harbor, local governments should be accorded some, but less, deference. I propose the substantial evidence standard adopted by the intermediate appellate court in the *Santa Clara* assessment case.⁵²

⁴¹Calif. Const. art. 13D, section 4(e).

⁴²For a development of this critique and survey of pre-Proposition 218 assessment law, see Cole, Comment, “Special Assessment Law Under California’s Proposition 218 and the One-Person, One-Vote Challenge,” 29 *McGeorge L. Rev.* 845, 870 (1998).

⁴³One common argument is that there is no reason to believe that an assessment would not be passed onto renters just as much as any property tax increase, and so why should they not get to vote? See also generally Cole, *supra* note 42.

⁴⁴See, e.g., Legislative Analyst Report for Proposition 218, available at the California Ballot Measures Database, <http://library.uchastings.edu/library/california-research/ca-ballot-measures.html#ballotprops> (“state laws generally require local governments to reject a proposed assessment if more than 50 percent of the property owners protest in writing”). If individual statutes do have weighted voting or supermajority requirements, I think they should be changed for the reason stated above, which is that they overprotect large landowners.

⁴⁵Calif. Const. art. 13D, section 4(b).

⁴⁶Hayes, Note, “Rapid Transit Financing: Use of the Special Assessment,” 29 *Stan L. Rev.* 794, 816-818 (1976) (advocating regional assessment districts for regional projects).

⁴⁷See *supra* note 17.

⁴⁸See Calif. Gov’t Code section 65995.5(h) (incorporating a specific report as a means of calculating development impact fees).

⁴⁹Calif. Const. art. 13D, section 2(i).

⁵⁰*Silicon Valley Taxpayers Ass’n v. Santa Clara County Open Space Auth.*, 187 P.3d 37, 50 (Calif. 2008).

⁵¹*Id.* at 46.

⁵²*Id.* at 48.

My third proposal is therefore: *Amend the California Constitution to allow communities and regions to invest in themselves.* That requires abandoning Proposition 218's weighted actual voting regime, creating safe harbors for assessment calculations, eliminating the notion that an increase in property value is not a special benefit, and restoring some measure of judicial deference to local decisionmaking.

The California Supreme Court has decided to give local governments no deference at all regarding the assessments that they approve.

If the Legislature is going to help clear the legal obstacles to greater use of the assessment principle, as I believe it should, I think it should act to clear the financial obstacles to greater use of assessment financing. The logic of assessment financing is that it requires property owners who benefit from the infrastructure to pay for that benefit, but sometimes property owners do not have the liquidity to pay their fair share upfront. Suppose a new piece of infrastructure will increase a piece of property's value by \$20,000. Even if there is no dispute that this is the right amount, the property owner might not have the \$20,000 upfront. Indeed the property owner might well balk at even paying the \$20,000 over some amortization schedule. That seems especially true for property owners on a fixed income.

To resolve that problem, state law allows for payment of assessments to be deferred.⁵³ The moment that a property is sold is the time when the property owner has realized the benefit and has the liquidity to pay for it, and so it is a fair moment for a property owner to have to pay for any benefit received. However, that deferral option is rarely used because projects cannot be built in the first place without a steady projected cash flow. That is, investors will not be able to assess the bonds issued to finance an improvement if the cash flow can be deferred indefinitely. The state can remedy that by creating a deferred assessment revolving fund, which will also be an opportunity to encourage both regional assessments and the bundling of smaller

assessments.⁵⁴ After all, an econometric model can be made to predict home turnover and some property owners will want to pay off their assessments immediately or according to an amortization schedule (as is now the norm).⁵⁵ The more of those financings that get done, the better the market will be able to estimate the correct payment schedule and interest rate. Also, the larger and more diverse the area benefited, the more likely steady cash flows will be to develop.

Fourth proposal: *The state should encourage the use of deferred assessments through the establishment of a deferred assessment revolving fund.* Creating such a fund is consistent with our simple model in at least three ways. First, general tax dollars are being used to plug a structural hole in local resources. Second, general tax dollars are being directed to projects that have at least significant self-funding potential. Third, by providing this stopgap funding on a revolving basis, the state is optimizing the use of its funds relative to projects financed.

The state should encourage the use of deferred assessments through the establishment of a deferred assessment revolving fund.

In trying to clear the way for local governments to fund more good projects, we should consider that we are struggling in part against perverse incentives created by state law.⁵⁶ Take the relationship between public transit and residential development. Clearly, the state wants to encourage housing development by transit stops, and there are programs in place to do this that have had some success.⁵⁷ However, research suggests that local governments have nevertheless encouraged commercial development near mass transit stops.⁵⁸ That makes sense from the local government's perspective because the

⁵⁴That is, in making revolving funds available, the state can and should give a preference to larger-scale assessments.

⁵⁵I would propose that only the smaller commercial property owners be allowed to use that deferred assessment mechanism.

⁵⁶For a more general discussion of this problem, see Shanske, "Above All Else Stop Digging: Local Government Law as a (Partial) Cause of (and Solution to) the Current Housing Crisis," *U. Mich. J.L. Reform*, forthcoming.

⁵⁷See, e.g., Little Hoover Commission, "Rebuilding the Dream: Solving California's Affordable Housing," Report #165, May 8, 2002, p. 25, available at <http://www.lhc.ca.gov/studies/165/report165.pdf>.

⁵⁸Boarnet and Crane, "L.A. Story: A Reality Check for Transit-Based Housing," 63 *Journal of the American Planning Association*, pp. 189-204 (Spring 1997).

⁵³See Calif. Sts. & High. section 10700 (permitting deferred assessments), and Shoup, "Financing Public Investment by Deferred Special Assessment," 33 *Nat'l Tax J.* 413-414 (1980) (proposing the idea of deferred assessments); see also Calif. Const. art. 13, section 8.5 (allowing deferred property assessments for senior citizens); Calif. Revenue and Taxation Code section 20581 et seq. (implementing the Senior Citizens and Disabled Citizens Property Tax Postponement Law).

primary general revenue source still under the control of local governments in California is the sales tax, and any sales tax generated by retail near a transit stop will largely be paid by out-of-jurisdiction shoppers and so is a boon for one jurisdiction at the cost of its neighbors. That kind of wasteful competition mars our whole landscape.

There are different solutions to that problem. Sales taxes could be shared regionally, thus eliminating that perverse incentive.⁵⁹ Or the state could make some additional revenue source (like a local income tax) available to local governments, but only if they share the proceeds regionally or pursue other regionally sensible goals.⁶⁰ The state can also try to fortify other incentives to smarter growth, such as making additional funds available for transit-oriented development. In Maryland some areas are exclusively marked as eligible for state funding.⁶¹ California could do something similar — and perhaps also mandate that local governments cannot use tax-exempt financing except within a specified radius of a mass transit stop. In the United Kingdom, the national government has gone further, essentially requiring that most development occur “in town.”⁶² Another option would be to modulate California’s development impact fee regime, mandating much higher impact fees for sprawl pattern development or development in environmentally sensitive areas, like flood plains.⁶³ In short, my fifth proposal is: *Use any or all of the expedients canvassed above to eliminate the perverse incentives that local governments have to build the wrong infrastructure.* That is particularly important because if my other proposals are adopted, local governments will be enabled more generally to fund new infrastructure. We do not want those new resources to, for instance, be chasing sales tax revenue.

⁵⁹ See, e.g., AB 680, 2001-2002 Leg. Sess. (Calif. 2002).

⁶⁰ Frug and Barron, *City Bound: How States Stifle Urban Innovation*, Harvard University Press, 2008, p. 212 (proposing states offer new revenue source in return for regional cooperation); Stark, “Proposition 13 as Fiscal Federalism Reform,” in *Proposition 13 at 30, 2009*, 1, 13-14 (proposing local income tax for California); AB 1342, 2009-2010 Leg. Sess. (Calif. 2009) (allowing for imposition of local income tax).

⁶¹ Md. Code Ann., State Fin. & Proc. section 5-7B-01 (restricting state funding to priority areas).

⁶² Muro et al., “MetroPolicy: Shaping a New Federal Partnership for a Metropolitan Nation,” *The Brookings Institution*, 2008, p. 49, available at http://www.brookings.edu/reports/2008/06_metropolicy.aspx.

⁶³ Cf. Hanak and Rueben, *supra* note 20, at 21; Kingsley, “Making It Easy to Be Green: Using Impact Fees to Encourage Green Building,” 83 *N.Y. U. Law Rev.* 532 (2008).

A. The Elephant in the Room — Proposition 13

At the heart of California’s woes is Proposition 13’s extreme and extremely rigid limitation on property taxes.⁶⁴ My goal in this report has been to advocate small pragmatic changes that are not ideologically charged, and so I have not addressed Proposition 13. Nevertheless, I will observe, as I have argued elsewhere, that the economic crisis provides an opportunity to reconsider Proposition 13.⁶⁵ That observation is germane to this report on infrastructure financing for several reasons. First, as noted above, the distortion of the property market and of land use decisions created by Proposition 13 contributes to the suboptimal production and use of infrastructure. Most notably, Proposition 13 discourages the use of land for intensive multifamily housing and even for many forms of light industry — big retail is the coin of the realm in post-Proposition 13 California.⁶⁶ Second, if the strictures of Proposition 13 were slowly relaxed and local revenue is increased, there would be an opportunity for a more rational distribution of resources at the local level.⁶⁷

B. Final Evaluation and Recommendations

It is hard to evaluate how well the state is filling in the gaps and funding larger regional projects. That said, failures at the local and regional levels mean without question that the state is funding some local initiatives that it should not be funding while it is neglecting some projects that it should be funding. Further, the state has not fully used demand management on the infrastructure over which it has control, and by that I mean most especially transportation. Using general tax dollars is not an efficient way to finance transportation, though that is generally how California has proceeded. As part of the last budget compromise, California at the last moment chose to avoid raising the gas tax (one form

⁶⁴ I summarize Proposition 13 in Shanske, “Public Tax Dollars for Private Suburban Development: A First Report on a National Phenomenon,” 26 *Va. Tax Rev.* 709, 718-719 (2007).

⁶⁵ Shanske, “What the Original Property Tax Revolutionaries Wanted (and It Is Not What You Might Think),” 1 *California Journal of Politics and Policy* (2009), (review of Martin, *The Permanent Property Tax Revolt: How the Property Tax Transformed American Politics* (2008)).

⁶⁶ Lewis and Barbour, *California Cities and the Local Sales Tax*, Public Policy Institute of California, 1999.

⁶⁷ See Hill, “Reconsidering AB 8,” Legislative Analyst’s Office, Feb. 3, 2000; Therese A. McCarty, Terri A. Sexton, Steven M. Sheffrin, and Stephen D. Shelby, “Allocating Property Tax Revenue in California: Living With Proposition 13,” *State Tax Notes*, Mar. 25, 2002, p. 1047, *Doc 2002-7198*, or 2002 *STT* 57-10.

of demand management), but did increase the vehicle license fee, which at least has some connection to the demand for transportation.⁶⁸

The FasTrak system in California has made it easier to raise tolls; perhaps a similar mandatory, but automatic, system can be used to tax total miles driven.⁶⁹ Such a system seems already to be feasible and certainly will be. Congestion pricing could be used on highways or within urban areas, as in Mayor Michael Bloomberg's ill-fated plan for New York, which was modeled on that of London. Higher taxes can be imposed on downtown parking lots.⁷⁰ Less dramatically, the state could and should simply make it easier for tolls to be imposed on use of its own roads.⁷¹ All those schemes are ways to use demand management to control the use of, and fund, transportation infrastructure. The state income tax provides a relatively easy way to provide rebates so that the demand charges are not too regressive. We do want them to have some bite, however, because we want behavior to be influenced and revenue to be raised.

A related way for the state to more properly finance infrastructure is to tie specific projects to specific revenue increases. Like a local government, the state should put before the voters bond measures to build specific projects using specific (and appropriate) revenue, such as tolls or the gas tax.⁷²

⁶⁸Steinhauer, "In Budget Deal, California Shuts \$41 Billion Gap," *The New York Times*, Feb. 19, 2009, A1. Apparently, the revenue from the increase in license fees is not going to be directed to transportation projects. That said, given that other state general revenue is being (mis)directed toward transportation, it is a (tiny) step forward that the state is increasing the amount of general revenue it is raising from license fees.

⁶⁹*Cf.* Hanak, *supra* note 4, at 10. See also Finkelstein, "E-ZTax: Salience and Tax Rates," National Bureau of Economic Research (September 2008), available at http://www.nber.org/~afinkels/papers/EZTax_Finkelstein_February_07.pdf; Alice Rivlin and Orr, "Road-Use Fees Could Solve Our Transit Woes," Brookings Institution, May 1, 2009, available at http://www.brookings.edu/opinions/2009/0501_congestion_pricing_rivlin.aspx.

⁷⁰*Cf.* Hanak, *supra* note 5 at 150.

⁷¹California has recently done so to some extent in connection with P3-type projects. See SB 4XX, 2009-2010 Leg. Sess. (Cal. 2009). A broader expansion of tolling authority, which would have been preferable, was vetoed by the governor last year. See AB 3021, 2007-2008 Leg. Sess. (Calif. 2008) (attempt to encourage use of tolling through creation of California Transportation Finance Authority); Dyble, "The Proposed California Transportation Finance Authority: An Analysis of AB 3021," USC Keston Institute for Infrastructure, May 20, 2008, available at <http://www.usc.edu/schools/sppd/keston/documents/CommentonAB3021andtheCaliforniaTransportationFinanceAuthority.pdf>.

⁷²*Cf.* Hanak, *supra* note 4, at 6. This has been done. For instance, Proposition 111, passed in 1990, increased the gas

(Footnote continued in next column.)

The current system, which has voters vote for projects with no plan or commitment to raise the required revenue, is folly.

And so my final proposal is: *The state should enable proper pricing for infrastructure financing through the use of tolls and by requiring that all statewide bond measures also include provision for tax increases to pay off the bonds.*

IV. Conclusion

At the heart of these proposals is the idea that a very significant percentage of California's infrastructure need could fund itself⁷³ — if only our legal structures enabled that funding. Once all self-funding projects were taking care of themselves, precious general tax revenue from the state and federal governments could be targeted at the highest-value projects that truly need it. None of the ideas here are particularly novel, and that's a good thing. We do not need to do something entirely new, but something largely old.

V. A Coda on the Silver Bullet That Is Not

The proposed changes outlined above are backwards-looking and pragmatic, even dull. They will take time to implement and to yield results. That is in contrast to the buzz surrounding P3. Major proponents of P3 promise the world — and at little cost or risk.⁷⁴ Why should policymakers make the dry changes I recommend when entering into a P3 arrangement will get more infrastructure built faster for less? The point I want to emphasize is that P3 cannot come close to solving our infrastructure problems.

First we must decide what P3 means. If it means simply contracting with a private party to build a piece of infrastructure, using P3 is neither novel nor controversial. If P3 means that a public project largely looks to private financing, that is also not novel. Every time a public entity borrows on the capital markets, it is using private funds. Further, if a public project (say a road) will rely on the revenue it generates (say tolls) to pay back private parties, as is often the case for infrastructure projects, private parties will scrutinize the project plan carefully, which is clearly salutary.

P3 could refer to the "design-build" method of construction. Design-build is an alternative method of construction in which the same entity is responsible for the design and construction of a project (and

tax for use in transportation projects. California Ballot Measures Database, available at <http://library.uchastings.edu/library/california-research/ca-ballot-measures.html#ballotprops>.

⁷³And some of our need would disappear altogether if resources were priced properly.

⁷⁴See, e.g., Malanga, "Our Spendthrift States Don't Need a Bailout," *The Wall Street Journal*, Nov. 18, 2008, A21.

possibly operation as well). That contrasts with the traditional method in which the design is done by one entity (say an architecture firm) and then other entities (say general contractors) bid to construct that design. Design-build is supposed to produce savings of time and money through having a design-builder contract to provide a completed project at a fixed price. Design-build has been around for a long time and can be efficacious.⁷⁵ But design-build is not a panacea. First, it is generally agreed that the modest savings design-build can produce in some projects are not even close to a solution to the kinds of problems we are addressing.⁷⁶ Second, design-build has its limitations and no one believes that all projects are suitable for design-build.⁷⁷ At any rate, California has been a leader in providing flexibility to its agencies and local governments in using design-build, and so there is little additional benefit to be gained.⁷⁸ That said, if gaps remain in the authority given to public agencies to engage in design-build, there is good reason to consider giving all agencies the same flexibility.⁷⁹

Private-public partnerships cannot come close to solving our transportation problems.

When P3 is trotted out as the solution to our infrastructure needs, what is generally meant is that a government entity enters into a long-term lease (like 75 years) with a private party for a piece of existing infrastructure, like a toll road.⁸⁰ Prominent recent examples of that kind of transaction include the leasing of the Chicago Skyway and the Indiana Toll Road. Proponents suggest that those transactions are a no-brainer. The government gets a huge payout for the long-term lease of the piece of infrastructure and the private party will maintain that infrastructure better than the government could have. California has experimented with ver-

sions of P3 to build new infrastructure,⁸¹ but has been less interested so far in essentially selling existing infrastructure — a position that, as I explain below, I think is wise.⁸²

However, I concede that governments should evaluate P3 opportunities. The United Kingdom already has such a process,⁸³ and soon California will too, thanks to the recent creation of the Public Infrastructure Advisory Commission.⁸⁴

The second point I concede is that such a commission may well find that some uses of P3, particularly in the construction of new infrastructure, are highly consistent with the simple model of infrastructure finance I outlined above and ought to be pursued. For instance, a wise interlocutor observed to me that the state could lease rest areas by state highways for, say, 20 years. The superior rest stops that result could be mandated to have facilities for the recharging of alternative-energy vehicles; that looks like it could be a true win-win situation. Similar leases could be attempted in connection with new mass transit stations and with stops along the new high-speed rail. Such leases follow from the benefit principle discussed above. The state has created (or will have created) value by building the highway or railway, so leasing out state property near the infrastructure is a way for the state to recoup some of its investment through the value it has created. Portland, Ore., did essentially that in connection with financing a transit connection to its airport. The new link was going to make land by the airport much more valuable and so the transit authority raised some of the money for the link by entering into a long-term lease with a private developer for some of this property.⁸⁵

Nevertheless, if evaluated properly, the use of P3, particularly as to pieces of existing infrastructure, will be limited. First, by all accounts, the number of pieces of public infrastructure that can be profitably leased is small because there are not that many

⁷⁵Miller, *Principles of Public and Private Infrastructure Delivery*, Kluwer 2002, 59-60; Hanak and Rueben, *supra* note 20, at 22.

⁷⁶There is evidence, for instance, of about 14 percent time savings. *Public-Private Partnerships: Innovative Contracting, Hearing Before the Subcomm., on Highways, Transit and Pipelines of the House Comm. on Transp. and Infrastructure*, 110-125, at 138 (2007).

⁷⁷*Id.*

⁷⁸*See, e.g.*, AB 642, 2007-2008 Leg. Sess. (Calif. 2008) (expanding permission to use design-build to local government entities).

⁷⁹Hanak, *supra* note 4, at 17 (noting that California has still not authorized its department of transportation to use design-build).

⁸⁰2006 Hearings, *supra* note 19, at 30.

⁸¹Calif. Gov't section 5956; Calif. Sts. and High. section 143.

⁸²Saskal, "California P3 Plans Focus on New, Not Existing Facilities," *The Bond Buyer*, Mar. 28, 2007, 18.

⁸³Puentes, "Bridge to Somewhere: Rethinking American Transportation for the 21st Century," The Brookings Institution, 2008, p. 65, available at http://www.brookings.edu/~media/Files/rc/reports/2008/06_transportation_puentes/06_transportation_puentes_report.pdf.

⁸⁴SB 4XX, 2009-2010 Leg. Sess. (Calif. 2009) (creating Public Infrastructure Advisory Commission by adding Calif. Sts. and High. section 143(b)).

⁸⁵*Public-Private Partnerships: Innovative Contracting, Hearing Before the Subcomm. on Highways, Transit and Pipelines of the House Comm. on Transp. and Infrastructure*, 110-125, at 7, 71-72 (2007).

pieces of infrastructure that are sufficiently self-supporting and discrete.⁸⁶

Second, as a local government lawyer, I find the case for a P3 transaction involving existing infrastructure not very convincing.⁸⁷ If there is a piece of infrastructure that can be operated profitably, there is no need to lease it to a private entity to capture that infrastructure's income stream. California is already full of special districts and authorities designed to capture (and reinvest) value in that way: If an entity does not already exist of the right size and with right powers, the state can create one. That is, the state can create an authority that is limited to collecting tolls on a given road to maintain that road just as if that road had been leased to a private entity. If a private entity has desired expertise, it can be hired by the special authority using toll money. The special authority can issue tax-exempt bonds secured by toll revenue for major improvements, which means that it will be operating with an appealingly low cost of funds.

Much of the infrastructure we are concerned about was built using traditional techniques of public finance, and those are the methods we will need to use to rebuild it.

And so it is hard to see why a long-term lease to a private entity is required. There are esoteric arguments that private investors and management are able to unlock more value than even a specialized authority that can hire the same private firms, but I think those are dubious.⁸⁸ So far as I can tell, those arguments rely on at least one weak premise: that the private investors who invest in P3 are different from those who invest in tax-exempt infrastructure bonds and that those P3 investors are essentially willing to lend more money for a lesser return. One does not have to be a believer in strongly efficient capital markets to find that claim mystifying. It could be true that those nontraditional investors in government bonds are willing to take a greater risk in return for a greater reward, but in that case the government has to ask where the risk really ends up. That is, if the private company is unable to make a profit and walks away or goes bankrupt, or if the

private entity is only able to make a profit by under-maintaining the road, isn't the government still on the hook?⁸⁹ It could also be that P3 investors believe that they will be able to increase revenue more than a public authority could have done. That might be true, though again there is a question about who is bearing the risk in that case. Further, there is an independent political question regarding whether public assets should be privatized so that the public can no longer control how much users pay for them.

Even if the economic arguments for P3 unlocking lots of value are sound, it must be remembered that those long-term leases come with at least one major cost, and that is loss of flexibility.⁹⁰ It is unclear, for instance, that we want any given toll road to remain economically viable for the next 30 years, much less 75 — a typical period for such a lease. It could be a good thing if we end up in a world where it is roads that need a subsidy and not mass transit. That's not just a theoretical problem. The Orange County Transit Authority had to buy its way out of just that kind of lease because of the noncompete clause it had entered into with the private party who had leased a highway.⁹¹

Therefore, in short, there are no silver bullets. Much of the infrastructure we are concerned about was built using traditional techniques of public finance, and those are the methods we will need to use to rebuild it. Nothing will help our ailing infrastructure more than going back to the future. ☆

⁸⁹I think the answer is yes and that essentially these kinds of deals should be understood as a form of "taxless finance" (the phrase is from Wallis) in which the government takes on contingent risk to have the benefit of the infrastructure without raising taxes. The appeal of that kind of structure is obvious and it can certainly work, but the risks inherent to such a system remain and can easily swamp the benefits not least because of the political pathologies caused by this kind of "free" provision of infrastructure. For the embrace and collapse of earlier forms of taxless finance in the 1830s, see generally Wallis, *supra* note 7, at 222-224, 228-233.

⁹⁰*Cf.* Yescombe, *Public-Private Partnerships: Principles of Policy and Finance*, Elsevier 2007, p. 26-27.

⁹¹Hanak, et al., *supra* note 5, at 149. The recently passed legislation to encourage the use of P3, SB 4XX, tries to deal with this problem by limiting the amount of money that a private contractor can receive if its returns are driven down by competition (essentially just enough to cover debt service) and also by limiting the circumstances that can trigger such an obligation to pay (for instance, no compensation for projects identified in regional transportation plans). See SB 4XX, *supra* note 71 (adding Calif. Sts. and High. section 143(i)). Those limitations are sensible, but they increase the risk that the private party faces upfront and therefore, presumably, that will drive up the cost of the initial P3 contract. Compensating a private party for regulatory risk is simply part of the P3 business proposition and I do not think that it can be legislated or contracted away. If a private party does not assess risks properly and gives the public entity a "deal," that is hardly a win for the public because ultimately public entities will be responsible should the private party fail in its obligations.

⁸⁶2006 Hearings, *supra* note 19, at 10-11; Hanak and Rueben, *supra* note 20, at 22.

⁸⁷Since initially making this argument, I have been pleased to find the California Treasurer Bill Lockyer agrees. See Lockyer, "Public-Private Infrastructure Fight Ruinous," *Sacramento Bee*, Jan. 26, 2009, at 13A.

⁸⁸2006 Hearings, *supra* note 19 at 31-32, 37, 44-45, 50.

The Trouble with Tax Increase Limitations

David Gamage¹ & Darien Shanske²

Abstract

In this Symposium Essay, we explore the theoretical implications of one particular type of fiscal limitation on state legislatures – namely, special tax increase limitation rules (TILs). We argue that there is no meaningful content to the term “tax increase” as used in TILs. This incoherence allows legislative majorities who wish to do so to circumvent TILs. This fact about TILs, among others, explains the observed inefficacy of TILs in shrinking the size of state governments.

Furthermore, TILs are not just harmless political theater. When combined with other common features of state fiscal constitutions, particularly Balanced Budget Requirements (BBRs), they tend to amplify revenue volatility. And revenue volatility is far from an imagined horrible, but is currently creating severe challenges for state revenue systems. Moreover, TILs potentially undermine jurisdictional competition, which is a relatively more effective means for controlling the size of government.

I. Introduction

Special fiscal requirements are a common feature of state constitutions.³ In this essay we will make an analytic observation about one type of fiscal requirement – tax increase limitations or TILs. By TILs we mean provisions that require a legislative supermajority in order for taxes to be “increased.” For example, in California:

Any change in state statute which results in any taxpayer paying a higher tax must be imposed by an act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature...⁴

It is well-known that these regimes have questionable effectiveness, at least insofar as their goal is to curb the growth of government or even simply to change the pattern of government expenditures in the applicable state relative to other states not similarly

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³ For a recent catalog and critical perspective see Richard Schragger, “Democracy and Debt,” *Yale Law Journal*, forthcoming, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1943529. Note that Schragger does not specifically address TILs. Note also that TILs are often proposed to be included in the federal Constitution. See, e.g., SJ Res. 23, § 4, 112th Cong. (2011).

⁴ Cal. Const. Art. 13A, § 3a. See also, e.g., Ariz. Const. Art. 9, § 22. Related regimes require voter pre-approval before taxes can be raised. See, e.g., Colo. Const. art. X, § 20(4)(a). Colorado also has a supermajority (2/3) requirement as to raising taxes in an “emergency.” See *id.* at § 6(a).

constrained.⁵ The dominant explanations for this failure of TILs involve the ambivalence of voters and/or conniving of politicians. Without casting doubt on these explanations, we think it important to make an analytic observation that we believe also contributes to the explanation of the observed phenomenon of the ineffectiveness of TILs.

Our key analytic observation is that TILs insert two conceptually vacuous notions – “tax” and “increase” – into the fiscal constitutions of the states that have them. It is at least in part because this combination is incoherent that TILs do not work.

We are not going to focus on evaluating related parts of state fiscal constitutions – provisions that are often grouped together with TILs⁶ – namely: tax and expenditure limitations, state or local debt limitations, special state or local procedural rules for debt issuance,⁷ state and local balanced budget rules, or tax increase limitations at the local level.⁸ This is because all of these provisions, at least arguably, have a different conceptual justification (and content). The various kinds of debt limitation regimes, for example, can be justified as important for generational equity; and local tax rules may reflect a reasonable concern with tax exporting or a desire to enhance local democratic participation.⁹ We will discuss how these provisions interact with TILs, but our purpose is not to evaluate these provisions in their own right.

The problem with tax increase limitation regimes at the state level is that these regimes must successfully define the notion of a “tax increase.” Yet, to borrow a striking image from Daniel Shaviro, attempting to make analytic sense of this concept is like playing a

⁵ See, e.g., Mathew McCubbins & Ellen Moule, “Making Mountains of Debt Out of Molehills: The Pro-Cyclical Implications of Tax and Expenditure Limitations,” 63 *National Tax Journal* 603 (2010); Bruce E. Cain and George A. Mackenzie, “Are California’s Fiscal Constraints Institutional or Political?,” *Public Policy Institute of California*, Dec. 2008.

⁶ As an historical matter, TILs are a relatively recent phenomenon compared to some of these other provisions, particularly BBRs. They have been passed in the last few decades as part of larger tax and expenditure limitations (TEs). Isabel Rodriguez-Tejedo & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises in When States Go Broke* 23 (Peter Conti-Brown & David A. Skeel, Jr. Eds. 2012). We focus our discussion on TILs.

⁷ Rodriguez-Tejedo and Wallis emphasize the difference between absolute limitations on debt and special procedural rules for debt. *Id.* at 20. They go on to argue, convincingly, that the special procedural rules for taking on debt have actually been relatively successful in channeling state and local borrowing. *Id.* at 10, 24-27. We return to debt limitation procedures in section [] *infra*.

⁸ We will initially focus on state-level TILs because, as will become clear, many of the issues with TILs that we discuss, e.g., their interaction with extensive income tax systems, are typical of states and not localities. However, we discuss local-level TILs *infra* ____.

⁹ See, e.g., Richard Briffault, “Foreword: The Disfavored Constitution,” 34 *Rutgers Law Journal* 907, 947-49 (2003) (on debt limitations); Kirk J. Stark, “The Right to Vote on Taxes,” 96 *Northwestern University Law Review* 191 (2001) (on local tax limitation regimes). Neither Briffault nor Stark argues that current versions of these limitations are actually achieving these other goals. See also, e.g., Yilin Hou & Daniel L. Smith, “Do state balanced budget requirements matter? Testing two explanatory frameworks,” 145 *Public Choice* 57 (2010) (finding some effect of certain balanced budget rule regimes).

game of pin the tail on the donkey; we are all spun around and may end up pinning the tail anywhere at all.¹⁰

II. Seeing Through the “Raising Taxes” Mirage

Just as one needs times to adjust one’s eyes to seeing in the dark, so too one must go through several steps to see through the vacuity of TILs.

A. Step 1: Spending through the Tax System

We will begin with a famous example from David Bradford.¹¹ Bradford imagined a “Weapons Supply Tax Credit” granted to arms manufacturers. The arms manufacturers would get a tax credit in the amount of the value of arms they deliver to the U.S. government, say for a maximum of \$100 billion.¹² The U.S. government would then reduce spending by that very same amount (\$100 billion). The government could then claim to have slashed taxes and spending without compromising national security or reducing overall allocations to public services. As Ed Kleinbard observes, this anecdote illustrates the “empty formalism of our concepts of Government revenues and Government expenditures.”¹³ It is easy enough to change the numbers so that taxes decrease and real spending *increases* (say the credits are \$150 billion) or just about any other combination one might imagine.¹⁴

And there is no need to imagine much as governments have frequently engaged in Bradford-type maneuvers. As Kleinbard notes, the IRC is full of tax credits awarded to private entities in return for satisfying the government’s substantive policy goals; these credits are often even administered not solely by the IRS but by the federal agency with substantive expertise (e.g., the Department of Energy for “qualified gasification projects.”).¹⁵ State tax systems are, of course, full of similar credits.¹⁶

¹⁰ See Daniel N. Shaviro, *Taxes, Spending, And The U.S. Government's March Toward Bankruptcy* 16 (2007). See also David Gamage & Jeremy Bearer-Friend, “Managing Fiscal Volatility by Redefining ‘Tax Cuts’ and ‘Tax Hikes’,” 58 *State Tax Notes* 113 (2010).

¹¹ Daniel N. Shaviro, *Do Deficits Matter?* 101-02 (1997).

¹² This simple example assumes the manufacturers have sufficient income; one can also imagine a refundable credit.

¹³ Edward D. Kleinbard, “The Congress Within Congress,” 36 *Ohio Northern University Law Review* 1, 2 (2010).

¹⁴ For further discussion, see David Gamage & Darien Shanke, Three Essays on Tax Salience: Market Salience and Political Salience, 65 *Tax Law Review*, at Part I.B.6.b. (forthcoming, 2012).

¹⁵ Kleinbard, *supra*, at 2 (discussing 2009-16 I.R.B. 802, a notice about implementing I.R.C. § 48B).

¹⁶ See, e.g., Cal. Rev. & Tax. Code § 6010.8 (granting the California Alternative Energy and Advanced Transportation Financing Authority power to grant sales and use tax exclusions). For a full listing of tax expenditures in California, see, for example, Department of Finance, *Tax Expenditure Report 2011-12*. At least 44 states provide some information on their tax expenditures, see http://www.itepnet.org/other_resources/state_tereport.php.

Daniel Shaviro offers a different, real life example of Bradford's insight.¹⁷ In 1993, the Clinton administration proposed taxing a greater proportion of a recipient's social security benefits under the federal income tax. The Clinton administration reasoned that this should count as a "spending cut" because, in effect, the federal government would be out less money. However, this characterization was challenged, including by the Congressional Budget Office, which claimed that this was really tantamount to a "tax increase" because additional revenue would be raised through the tax system rather than smaller checks cut by the Social Security Administration. In terms of policy, the issue of nomenclature was vacuous, but the issue was important in terms of politics precisely because it mattered in what ratio the Administration combined spending cuts and tax increases. State constitutions, through having special rules for tax increases, essentially mandate that legislators contort themselves in similarly parsing taxing from spending.

In the end, our first analytic point relies on the fact that state tax systems, like the federal system, are riddled with so-called "tax expenditures," that is governments are spending money on desired programs through the tax code. Limiting "tax increases" thus does not limit spending through tax expenditures nor does it prevent politicians from raising more revenue by reducing tax expenditures.

B. Step 2: No Ideal Tax Baseline

It could perhaps be objected that this problem can be fixed. If only politicians were barred from using tax expenditures,¹⁸ then they would only have one option if they wanted to fund a new program (without incurring debt): increase tax rates. In such a world, TILs would have more bite. But it is not so simple. First, the search for a firm definition of what constitutes a "tax expenditure" has been elusive; there is no ideal baseline for any tax. Take the example of the deduction allowed for state and local taxes. The federal government lists this provision as a tax expenditure,¹⁹ but it is arguably appropriate on traditional income tax grounds because it reflects the fact that certain taxpayers are less well off to the extent that they pay higher state and local taxes that do not benefit them.²⁰

And so the failure to agree on a tax expenditure budget is not just a matter of politics, but also a result of deep and seemingly intractable conceptual puzzles.²¹ Furthermore, constitutional law or other legal or political constraints sometimes impels federal and

¹⁷Daniel N. Shaviro, "Rethinking Tax Expenditures and Fiscal Language," 57 *Tax Law Review* 187, 192-94 (2004).

¹⁸ Of course, it is not at all clear how this could be achieved.

¹⁹ See, e.g., Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013*, at 49, 50 (Jan. 11, 2010).

²⁰ See generally Louis Kaplow, "Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax," 82 *Virginia Law Review* 413 (1996).

²¹ For a recent summary of the global failure to define tax expenditures or limit their use, see generally Steven Dean, *Zombie Autopsy*, *Zombie Autopsy: Dissecting a Not-Quite-Dead Commitment Device*, UC Davis Law Review, forthcoming.

state legislatures to operate through tax expenditures.²² The recent ACA decision, upholding the ACA as an exercise of the taxing power, is only the most recent and dramatic decision in this line.²³ For instance, last term, the Supreme Court authorized states to subsidize religious schools through the tax code when they could not subsidize them directly.²⁴

C. Step 3: Wrong Question

Perhaps it is possible that some rough baseline could be established for “tax expenditures”²⁵ and that this baseline could be made enforceable²⁶ and that thereby the notion of “tax increase” could be given some practical substance. But the question would then become whether this notion of “tax increases” would be of any use; we think it would not. We will start with the broadest substantive issues made murky by the focus on “tax increases.”

1. Allocation and Distribution: The efficiency and equity of a unified system of taxing and spending are substantive questions. It may not matter whether taxing social security benefits is a “tax increase” or a “spending decrease,” but it matters as a consideration of equity a great deal whether social security is, in effect, means-tested. Furthermore, as a consideration of the efficient allocation of government resources, it matters a great deal whether the SALT deduction is encouraging efficient or inefficient uses of government resources. Whether these issues should be categorized as “tax increases” is beside the point.

2. Tax System or Other Government Bureaucracy?: We have seen that bringing content to the term “tax increases” requires vilifying tax expenditures, but is this appropriate? In many cases, we think not. It can be highly desirable on both allocative and distributive grounds to use the tax system to achieve social ends that could be plausibly characterized as tax expenditures.²⁷ Or, in the alternative, it could be sensible

²² See generally Brian Galle, *The Tragedy Of The Carrots: Economics And Politics In The Choice Of Price Instruments*, 64 *Stanford Law Review* 797, 841-42 (2012).

²³ *National Federation of Independent Business et al. v. Sebelius, Secretary of Health and Human Services*, 567 U.S. ____ (2012); see also <http://blogs.berkeley.edu/2012/06/29/the-supreme-courts-health-care-decision-and-the-problem-with-relying-on-the-taxing-power/>

²⁴ *Arizona Christian School Tuition Organization v. Winn*, 563 U.S. ____ (2011).

²⁵ See, e.g., Edward D. Kleinbard, *The Congress Within Congress*, 36 *Ohio Northern University Law Review* 1, 7 (2010) (“I will say, however, that having read a large swath of the academic literature in this area, I believe much of the criticism has been overblown, and that the legislative process has been the worse for it. Tax expenditure analysis is a pragmatic exercise, and the existence of a handful of close questions should not obscure the fact that literally hundreds of other cases can be labeled as tax expenditures without much controversy.”)

²⁶ We think not, of course, *pace* Kleinbard *supra* note 25, because, among other reasons, almost every tax expenditure becomes a hard question when focused upon. Even if tax expenditure reform can be done at a distance, which is not impossible, see <http://arev.assembly.ca.gov/sites/arev.assembly.ca.gov/files/Testimony%20of%20Darien%20Shanske.pdf>, then the question becomes should we be asking whether a provision is a tax expenditure. As argued in this section, we do not think so.

²⁷ *Cf. Shaviro, March to Bankruptcy, supra*, at 30-40 (applying Musgrave’s allocative and distributive roles of government to analysis of taxing and spending); David A. Weisbach & Jacob Nussim, “The Integration

to use a non-tax agency to achieve a “tax” objective, assuming we could agree on what a tax objective would be.²⁸

Because using the tax system for apparently non-tax ends is more common and because, as discussed above, this is the expedient that is so threatening to TILs, this is the scenario we will focus on and justify, at least as a general possibility. Consider government support for higher education and suppose we would like a government program making higher education more broadly available to be administered in proportion to income.²⁹ To reach this distributive goal most efficiently we might reasonably wish to use the income tax system because the tax bureaucracy is already aware of a taxpayer’s income. This is not necessarily the case, but it is surely plausible and will be true for some programs at least some of the time.

We can go further. We observed above that certain tax expenditures are actually administered (in part) by the agencies with substantive expertise, such as the Department of Energy administering energy credits. This observation clearly goes to the blurry distinction between taxing and spending, but it also goes to the point we are making in this subsection, namely that this blurring may be desirable. The IRS does not have all the expertise to distinguish worthwhile programs and, thus, if it makes sense to subsidize certain programs through the tax system, which seems likely, then administering the program jointly between the IRS and another agency could be highly sensible.³⁰ Viewing all such arrangements as suspect is shortsighted.

In sum, even if we could ban tax expenditures in order to make TILs effective, we should not want to, because tax expenditures may sometimes be the best policy option, at least insofar as labeling a program as a “tax expenditure” facilitates the program being administered through the tax bureaucracy.

3. Taxation or other Governmental Intervention (e.g., Regulation)?: As indicated by our arguments in Step 1, TILs encourage legislatures to use tax expenditures rather than ordinary spending funded by ordinary taxes. Though, as just noted, this can be sensible, it is not always the case, and it is perilous to structure state fiscal constitutions in a way that further encourages the use of expenditures rather than taxes. In particular, as already noted, legislators already have plenty of political and legal incentive to operate through doling out subsidies (carrots) to achieve a desired goal rather than achieving that goal through taxation, particularly Pigouvian taxation, which is essentially a stick to prevent an undesired behavior.³¹ Consider a policy to prevent pollution. Giving

of Tax and Spending Programs,” 113 *Yale Law Journal* 955 (2004) (arguing for pragmatic analysis of whether a program should be administered through the tax code).

²⁸ If it is a tax objective to lower the rate of tax on certain energy investments, then choosing to administer tax credits through federal or state energy agencies, as discussed above, would qualify as an example of using a non-tax agency to administer a tax program.

²⁹ Example drawn from Weisbach and Nussim *supra* note ____.

³⁰ Cf. Daniel Halperin, Tax Expenditures: Budget Control and the Nonprofit Sector, Tax Notes (Jan. 23, 2012), at 447.

³¹ Following Galle, *supra* note ___, at 813 (“Sticks are cheaper, more effective, accord better with our moral intuitions, and avoid unwanted incentives to create new harms.”).

subsidies to polluters *not* to pollute drains the fisc of public tax dollars and makes those harming the environment better off. There can also be unexpected consequences – rich subsidies to a “clean” industry might lead to too many participants in the industry or even more pollution. At the very least, more participants than expected can make the expenditure more expensive than expected.³² Taxing the negative externality will often seem to be the superior choice and yet TILs, by encouraging tax expenditures, will consistently impel states to prefer subsidies.

There is a similar issue as to the choice to use taxation or regulation. It is well understood that regulations can act as substitutes for taxation.³³ This is a specific illustration of the previous point about the continuity between the tax bureaucracy and other parts of the government. The aspect we emphasize in this subsection is the continuity between different kinds of government interventions. Sometimes it makes allocative and/or distributive sense to use a regulation, other times a tax. TILs put pressure on governments to use regulations and not taxes,³⁴ but in many cases taxes might be the more desirable option on allocative or distributive grounds. Thus, for instance, economists tend to favor the use of carbon taxes to combat global warming,³⁵ but such taxes, as “taxes”, are off the table politically in part because a state, such as California, could not impose or increase carbon taxes without a 2/3 majority.

The fixation on avoiding tax increases can do more than influence the choice of government action, it can also shape the choice of tax base. For instance, if tax rates cannot be increased without a super-majority, legislatures have an incentive to favor tax bases that show significant revenue growth. Of course, those tax bases also tend to be more volatile, encouraging a feast or famine pattern of state budgeting where state governments both expand and contract according to ever more severe cycles.³⁶

a. Special Case of Fees: It is not controversial that the price mechanism is the gold standard for achieving allocative efficiency and, not surprisingly, economists have urged government regulators to use the price mechanism to the extent possible – for instance, using tolls to regulate use of a bridge. Such quasi-market levies are based on the benefit principle. That is, each user of a government service is charged in proportion to how much that user benefits. We should note right away that in many ways a toll is as much a top-down command as a regulation as to the number of cars allowed on a bridge (say by permit) would be. Yet the toll, i.e., a tax-like intervention, makes more sense because we do not want to create a new bridge permit bureaucracy (say because of the administrative expense and uncertainty as to the optimal number of vehicles). What we

³² All examples and arguments drawn from Galle, *supra* note __, at 811-27; Galle also notes that there is a place for carrots.

³³ For discussion, see Gamage & Shanke, *supra*, at Part I.B.6.c.

³⁴ A recent (unpublished?) paper found evidence for this. Noel Johnson et al., *Pick Your Poison: Do Politicians Regulate When They Can't Spend?*, <http://ssrn.com/abstract=2035611>.

³⁵ See, e.g., Reuven S. Avi-Yonah & David M. Uhlmann, “Combating Global Climate Change: Why a Carbon Tax is a Better Response to Global Warming than Cap and Trade,” 28 *Stanford Environmental Law Journal* 3 (2009) (summarizing arguments).

³⁶ David Gamage, “Preventing State Budget Crises: Redefining ‘Tax Cuts’ and ‘Tax Hikes,’” 98 *California Law Review* 749, 757-60 (2010).

wish to achieve is to send a (relatively flexible) price signal as to the cost of driving in order to try to cause drivers to internalize the externalities caused by their driving.

Fees, insofar as they are a regulation that raises revenue for government programs, are particularly fungible with taxes. There is no clear line between what is a tax and what is a fee. At the one end is a user fee, say for trash pickup, and at the other end a national tax, say the federal income tax. We will just stipulate that the federal income tax is not a fee, but there is a broad continuum among many other taxes and fees. For instance, take a user fee for trash collection. This user fee is an *average* price, not likely the cost of *your* trash pickup and, indeed, buried in the price of pickup may well be cross-subsidies for other users required by government regulation. Thus even this fee is not a perfect price and thus is “tax-like.” And then consider local property taxes; they are more tied to specific benefits than federal income taxes, but they are less tied to a specific benefit than a trash collection fee. Even state-level taxes are tied to the benefit principle to some extent; there is at least some mobility between states and it would seem that some taxpayers move to the package of taxes and spending that they desire. This perplexity as to the nature of state and local taxes is at the root of the difficulties in analyzing the SALT deduction using ordinary income tax principles. Making the fee-tax question so important puts enormous pressure on tax-fee jurisprudence.³⁷

Special rules about taxes versus fees are a distraction from the hard question of whether fees or taxes are preferable in particular cases. For instance does it make sense to advance the use of recycling by means of regulation or by fees? TILs should not be relevant to this discussion.

D. Step 4: Random Direction, At Best

It could be maintained that at least TILs exert some sort of pressure to shrink the size of government and should therefore be supported even if this would require relying on crude distinctions and giving up on certain desirable policy tools. Yet even this is not so. Suppose, as many critics contend, that TILs encourage the use of regulation when taxing would be more allocatively efficient, then TILs have in effect *increased* the size of government.³⁸ This is because the most rigorous definition of the size of government refers to how much government activity distorts the economy as compared to an

³⁷ In California, for instance, tax limitations of various kinds have encouraged the state and local governments to raise revenue with “non-taxes.” When courts have upheld the use of these non-taxes, additional voter propositions have often followed. Currently California governments are absorbing the latest tax limitation initiative, Proposition 26, passed in November 2010. Proposition 26, which added sections to Articles 13A and 13C of the California Constitution, explicitly aimed to narrow the definition of a “fee,” responding to one California Supreme Court case in particular. See Shanske *supra*. The litigation over the meaning of Proposition 26 has already begun. Kathleen K. Wright, “The Aftermath of California’s Proposition 26,” 62 *State Tax Notes* 471, Nov. 14, 2011. Yet this is far from a California problem; battles over the tax-fee distinction are endemic to other states with TILs. See, e.g., Barber v. Ritter, 196 P.3d 238, 248-50 (Colo. 2008); Keller v. Marion County Ambulance District, 820 S.W.2d 301 (Mo. banc 1991).

³⁸ See, e.g., Shaviro, *Bankruptcy*, *supra*, at 40.

appropriate baseline, and adding new inefficient regulations distorts the economy more, not less.

This confusion extends to considering other government interventions. As we saw in Step 1, tax expenditures, which are not subject to TILs regimes, *expand* the size of a government both allocatively and distributively in much the same way as does direct spending. Banning tax expenditures would not make the situation better, even if that were possible (Step 2). After all, as we discussed in Step 3, a well-designed credit can *reduce* the footprint of the government.

To conclude this Part with an illustration, imagine you obtain an injunction against your neighbor throwing noisy parties. If your neighbor responds to the injunction by instead playing loud music or turning up the television volume, your injunction may have made your neighbor worse off to the extent he would have preferred to throw parties, but you may well fail to reduce your neighbor's adverse impact on you as the music or television may prove even more bothersome than the parties. In order to "starve the beast" of your neighbor's noise pollution, you must be able to prevent all of your neighbor's noisy activities. But when we move to the TILs context, as we will continue to elaborate throughout this Essay, it is simply not possible to prevent all alternatives to government taxing and spending. TILs thus cannot effectively "starve the beast." Instead, TILs mostly serve to make governments less effective without reducing the aggregate impact of government activity.

III. The Interactions Between TILs and Other Components of State Fiscal Constitutions

Might TILs be more or less effective as part of a broader fiscal constitution? After all, as a matter of history, TILs are relatively recent, a response to dissatisfactions with older fiscal constraints.³⁹ Thus perhaps we need to consider how TILs function in a more dynamic system of multiple forms of fiscal constraints. One might believe that somehow two restrictions on governments are better than one.⁴⁰

A. A Note on Hard Budget Constraints

Hard budget constraints at the subnational level are generally deemed essential for the proper functioning of fiscal federalism.⁴¹ Without these constraints, subnational governments have little incentive to live within their means because they can count on bailouts from the central government. If this is the case, then a federalist system with substantial subnational autonomy is about the worst of all possible systems since lower level governments can spend without being disciplined by a central hierarchy or the

³⁹ Rodriguez-Tejedo & Wallis, *supra* note __, at 31-36.

⁴⁰ See, e.g., Geoffrey Brennan & James M. Buchanan, *The Power To Tax* 197-98 (1980) (arguing how limits on the property tax can be a complement to jurisdictional competition as a means of controlling the size of government).

⁴¹ Barry R. Weingast, *Second Generation Fiscal Federalism: The Implications of Fiscal Incentives*, 65 J. URB. ECON. 279, 285 (2009).

market.⁴² Since the 1840s, when the American federal government refused to bailout many fiscally troubled states, it has been commonly understood that the American states operate under a hard budget constraint, much like theory would dictate.⁴³ The exact contours of the hard budget constraint is not entirely clear in 2012 given, for example, the rise of significant state-federal programs such as Medicaid, but this constraint clearly remains formidable.

B. Balanced Budget Requirements (BBRs)

In response to finding themselves in dire fiscal straits with no federal bailout possible, many states enacted BBRs in the 1840s; similar restraints were then commonly imposed on local governments in response to their fiscal woes in the 1870s.⁴⁴ Most American states and local governments currently function under some kind of BBR.⁴⁵

Though mandated by theory and present in practice, it is not actually clear that BBRs have that much of an effect on the size of state governments in the longer term.⁴⁶ What is relatively clear is that a TIL along with a BBR constrains state policy choices in the short term. In other words, legislatures may find ways to avoid BBRs (much like they evade TILs), say by keeping major expenses off the books (e.g., pensions),⁴⁷ but such long-term strategies do not much help states pay their bills in the short term when revenues collapse.

Given a dramatic decrease in revenue and a proscription on passing an “unbalanced” budget, either spending must be cut or revenue must be raised. Yet TILs make it much

⁴² See generally Jonathan Rodden et al., Introduction and Overview in *Fiscal Decentralization and the Challenge of Hard Budget Constraints 3* (Jonathan Rodden et al. eds. 2003); Jonathan Rodden, *Market Discipline and U.S. Federalism* in Conti-Brown & Skeel, *supra* note __, at 123.

⁴³ Robert P. Inman, *Transfers and Bailouts: Lessons from U.S. Federalism* in Rodden et al, *supra* note __, at 56-61.

⁴⁴ Rodriguez-Tejedo & Wallis put the number at 42. Rodriguez-Tejedo & Wallis, *supra* note __, at 31-32.

⁴⁵ Because there is lack of agreement about what exactly constitutes a BBR, there is no consensus as to how many states have BBRs. Nevertheless, many scholars have written that every state except Vermont has some form of a BBR. *E.g.*, James M. Potebra, *Balanced Budget Rules and Fiscal Policy: Evidence From the States*, 48 NAT. TAX. J. 329, 330 (1995). Rodriguez-Tejedo & Wallis put the number at 42. Rodriguez-Tejedo & Wallis, *supra* note __, at 31-32.

⁴⁶ *Id.* at 23; see also Hou & Smith, *supra* note __, at 59 (summarizing inconclusive results). Note that Hou & Smith do find that relatively technical BBRs (e.g., no carrying forward a balance) do have an observable effect – at least on narrow measures of budgetary balance. *Id.* at 60, 70-72.

⁴⁷ It is at this time very commonly believed that states and municipalities essentially violated BBRs through promising their current employees future benefits, particularly pension benefits, that they did not properly account or save for. See, e.g., Olivia S. Mitchell, *Public Pension Pressures in the United States* in Conti-Brown and Skeel, *supra* note __, at 57. On the one hand, this common belief is clearly grounded in fact, as many municipalities have encountered dramatic difficulties funding their pensions (e.g., Central Falls, Rhode Island) and certain state plans are woefully underfunded by any measure (e.g., Illinois). *Id.* at 68. Yet there is a lot of nuance involved in measuring the problem and in particular involving the proper discount rate to apply in connection with current assets. Compare Mitchell, *supra*, at 61-65 with Catherine Fisk & Brian Olney, *Labor and the States’ Fiscal Problems* in Conti-Brown and Skeel, *supra* note __, at 273-278. Furthermore, states and localities have begun reforming their pension systems, especially as to newer employees, and the impact of these (disparate) reforms is also very hard to predict. Mitchell, *supra*, 67-71.

harder for revenue to be raised quickly (but not impossible – see Part IV *infra*). As a matter of both efficiency and equity, increasing tax rates will, however, often be the better answer. This is because a small increase in taxes on the more wealthy can usually be expected to have a smaller impact on the economy and overall societal well being than large cuts in services.⁴⁸ Thus BBRs and TILs combine to prevent a particularly desirable policy expedient.

We can put this point another way. BBRs already represent a constraint on the political process, particularly at moments of fiscal crisis. TILs are a new constraint on the political process, particularly at moments of fiscal crisis. Combining the two kinds of constraints seems to do more than double the restraint on state government, perhaps increasing these problems exponentially – but not in a manner that shrinks the size of government.

C. Debt Limitation Procedures (DLPs), State and Local

The most venerable – and arguably effective – fiscal restraints typical of state constitutions is the special debt limitation procedure (DLP). These procedures operate not by barring debt, but, similar to a TIL, requiring some special procedure, usually a vote of the people, if debt is to be issued.⁴⁹ Also like TILs, debt limitations procedures are easily avoided.⁵⁰ In the 19th century, state-level DLPs were a response to state-level fiscal crises; the advent of state-level debt limitation procedures forced more borrowing to the local level.⁵¹ Trouble with debt at the local level led to local-level DLPs, and this then led to the explosion of borrowing by special entities at both the state and local levels.⁵² And that is where we are.

Given their porousness, it is tempting to see DLPs as failures, but this might not be the right analysis. Taking a broad view, the market for state and local borrowings is large and robust.⁵³ There are very few defaults and the formal debt burden of states seems manageable (versus “hidden” debts, like pension obligations, perhaps).⁵⁴ Furthermore, DLPs have generally succeeded in preventing the regular borrowing for operating deficits at the state and local level; state and local borrowings are almost entirely tied to a specific capital project.

Why have debt limitation procedures had this relative success? One compelling answer⁵⁵ is that the nature of the procedures and the judicial doctrines interpreting them impelled states and localities to better financings. Thus, a requirement that a separate vote be held

⁴⁸ David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIFORNIA LAW REVIEW 749, 772-91 (2010).

⁴⁹ See, e.g., Cal. Const., Art. 16, Sec. 18.

⁵⁰ See generally Briffault *supra* note __.

⁵¹ Rodriguez-Tejedo & Wallis, *supra* note __, at 24-27.

⁵² Id.; Briffault *supra* __; Robert B. Ward, *New York State Government* 289-97 (2d ed. 2006) (vast majority of New York’s debt issued by public authorities not subject to New York’s debt limitation).

⁵³ Rodriguez-Tejedo & Wallis, *supra* note __, at 10.

⁵⁴ Rodden, *supra*, 138-40.

⁵⁵ Following Rodriguez-Tejedo & Wallis, *supra* note __, at 27.

on a borrowing, a vote where costs and benefits were both before the voters, had a salutary effect on political economy. Similarly, the judicial “special fund” doctrine states that DLPs do not apply to debt to be repaid from a dedicated fund “special fund,” that is when repayment is not promised from general taxes.⁵⁶ Utilizing this doctrine to borrow essentially requires financings to be self-supporting because their only means of repayment had to be the project itself, which is a sensible result for fee-producing projects like water treatment plants.

And this gets us to the essential disanalogy between TILs and DLPs and that is that TILs undermine the connection between costs and benefits. We will develop this point further below, but the primary reason that TILs do this should be clear from the argument to this point: because TILs are incoherent they do not make manifest any particular causal chain. TILs may serve to keep tax rates stable, to cut tax liabilities through tax expenditures, to increase the fees owed for government services, and/or to increase other tax-like regulatory burdens. Both with respect to citizens and consumers, TILs garble the signals that government programs might otherwise send regarding costs and benefits. This is in direct contrast to DLPs, which are supposed to put before the voters a specific project, a specific price, and a specific means of raising revenue.

Before proceeding to the interaction between TILs and DLPs, we should observe that we are not uncritical of all DLPs. For instance, DLPs have often been “strengthened” largely because of a perception that they did not sufficiently constrain borrowing. We think that requiring legislators to get an additional majority vote before borrowing is a significant, and generally adequate, check on the issuance of excessive debt. We think requiring a supermajority vote, a common rule at the local level,⁵⁷ gives minorities, which can be quite small, inordinate power. Remember, a local borrowing generally has to be proposed by a democratically elected government and approved by a majority of voters, and so the super majority on top of two levels of democratic safeguards is excessive. In addition, new DLPs that limit the use of assessment financing in particular are similarly excessive. In the traditional case, an assessment must be approved by an elected government body, can be stopped by a majority of those to be assessed, and then is subject to judicial review that the assessment is for a proportional benefit. New DLPs not only fortify judicial review of assessments, but also essentially require a majority vote on top of that.⁵⁸ In sum, a DLP should add one additional level of review, e.g., a majority vote of the people, but ought not require more than that (e.g., also a super majority).⁵⁹

To return to our question, how do TILs interact with DLPs? As with tax-fee jurisprudence and BBRs, what TILs do is put enormous stress on DLPs. Not every judicially-blessed evasion of DLPs makes good sense from a public finance perspective.

⁵⁶ See, e.g., Briffault *supra* note ___ at 918-19; Robert S. Amdursky & Clayton P. Gillette, *Municipal Debt Finance Law* § 4.5 (1992).

⁵⁷ See, e.g., Cal. Const. Art. 16, Sec. 18.

⁵⁸ Cal. Const. Art. 13C (added in 1996 by Proposition 218), Darien Shanske, “Putting the California Constitution (Back) to Work: A Blueprint for Clearing Legal Roadblocks to Proper Infrastructure Finance,” *54 State Tax Notes* 567 (2009).

⁵⁹ One of us (Shanske) plans to return to the question of the appropriate level of review of debt issuance in future work.

For instance, there is a “contingent obligation” exception to DLPs. In general, this reasonable exception states that DLPs do not apply when a government has entered into a contingent obligation.⁶⁰ Thus, if a city has decided that it makes more sense to lease a new photocopier for three years rather than to buy one, then it should be able to do so without holding an election - so too, if a school district wants to lease a portable classroom or the police department a new car. Of course, at some point these leases will be for the kind of long-lived – and expensive - assets for which it makes sense to borrow over the useful life of the asset. Can a city – or state – constrained by a DLP lease finance a new school or even a convention center without a special vote of the people? The majority rule from courts interpreting DLPs is yes, so long as the financing documents are in the form of a lease.⁶¹

As a matter of doctrine, this formalism makes some sense; it is up to state or local legislators to decide when a lease term is too long or not really a good deal. Judges are not well suited to draw these lines. Furthermore, at this point even very large lease financing are understood by the market and, to the extent the market serves as a check on subnational debt issuances, the market also serves to discipline long-term leases. Market participants (generally) understand that leases are to be paid out of operating revenues, and they also know which entities are constrained from increasing operating revenues by TILs. Accordingly, the market charges such entities more when they borrow in the form of a lease than through an ordinary tax increase secured borrowing.

In sum, TILs make it very difficult for governments to pay for any even vaguely capital project (e.g., portable classrooms or busses) with cash on hand, even if it makes sense to do so. DLPs then make it difficult for governments to borrow and secure an additional revenue stream to pay for borrowing (e.g., a property tax increase), perhaps excessively so. Governments accordingly then enter into long-term leases instead of current funding or formally borrowing. Because of TILs and DLPs, the long-term leases will often be more expensive than they would otherwise be, as market participants understand the constraints the government entities are operating under. Finally, the use of (more expensive) leases puts further strain on government operating budgets, and so the next time a required project arises the government will once again feel constrained to use a lease structure rather than current funding. And so when the inevitable fiscal crisis comes, a large percentage of the operating budget will have been promised for long-term capital leases, requiring even more dramatic cuts elsewhere.

D. Jurisdiction Competition (and Local TILs)

As indicated above, the American federal system adheres rather well to the ideals of fiscal federalism, even though that adherence was not planned. This is not only true for the relative credibility of the no bailout pledge in the United States, but also for the large number of jurisdictions in the United States that are competing with each other. In competing with one another, the different jurisdictions, like private actors, are theorized

⁶⁰ See, e.g., *Rider v. City of San Diego*, 959 P.2d 347, 353 (1998); Briffault *supra* note __, at 919-20; Amdursky & Gillette *supra* note __, at § 4.14.

⁶¹ See, e.g., Richard Briffault & Laurie Reynolds, *State and Local Government Law* 868-69 (7th ed. 2009).

to be honing their particular offering of costs and benefits. In so doing, the overall size of government is thought to be restrained – at least at the local level, where there is most competition – homevoters⁶² are only paying for the governmental services that they want. This approach to local government, generally associated with the work of Charles Tiebout,⁶³ is far from indisputable on normative or empirical grounds.⁶⁴ Yet there is little question that, as a theory, the Tiebout model makes at least some sense as a way to restrain government, and there is some evidence that it has done so in practice.⁶⁵

Thus, though not an explicit part of state fiscal constitutions,⁶⁶ jurisdictional competition is certainly a means for controlling the size of government, and a means that, as a matter of theory and practice, has been more successful than TILs.

How do TILs interact with jurisdictional competition? TILs at the local level obstruct the proper functioning of jurisdictional competition because localities cannot modulate their rates in competition with one another.⁶⁷ Now, up to this point, we have been focusing primarily on state-level TILs, but TILs are often in place at the local level as well and, indeed, as limitations in connection with property taxes, many local-level TILs predate state-level TILs. Regardless of the sequence, the two levels of TILs are generally seen as complements. California Proposition 13 is the classic example of this. Proposition 13 is famous for restricting local property taxes, but it also imposed two TILs: one on local governments as to *other* forms of taxation and the other on California's legislature as to *all* forms of taxation.⁶⁸

TILs at the state level have a similar impact on inter-state jurisdictional competition. Suppose, for instance, that California did want to become more like Texas.⁶⁹ California could lower or abolish its non-Texas taxes (e.g., the Corporate Income Tax) by majority vote, but adding a new Texas tax (i.e., the Margin Tax)⁷⁰ or increasing an existing

⁶² This is William Fischel's felicitous phrase and his book is the modern classic embracing jurisdictional competition. William Fischel, *The Homevoter Hypothesis* (2001).

⁶³ Charles M. Tiebout, A Pure Theory of Local Expenditures, 64 J. Pol. Econ. 416, 416 (1956).

⁶⁴ See, e.g., Darien Shanske, "Above All Else Stop Digging: Local Government Law as a (partial) Cause (and Solution) to the Current Financial Crisis," 43 *Michigan Journal of Law Reform* 663, 686-703 (2010).

⁶⁵ See, e.g., Fischel *supra*; Wallace E. Oates, "The Many Faces of the Tiebout Model," in *The Tiebout Model At Fifty* 21, 34-37 (William A. Fischel ed., 2006). Even critics of the Tiebout model on normative grounds acknowledge its relative explanatory power. See, e.g., Richard Briffault, "Our Localism: Part I - Localism and Legal Theory," 90 *Columbia Law Review* 346, 405-06, 416-17 (1990).

⁶⁶ In many ways jurisdictional competition is implicit to both state and federal law. For instance, localities are given extensive powers over zoning and other local regulation by state law which power is then shielded from interference by modern federal (and state) equal protection clause jurisprudence as well as state homerule provisions. See, e.g., Shanske, *supra* note 64, at 682-86, 700-03.

⁶⁷ William Fischel, *The Homevoter Hypothesis* 98-128 (2001).

⁶⁸ Cal. Const. art 13A, §§ 1, 2 (restricting property taxes), § 3 (state-level TIL), § 4 (local-level TIL).

⁶⁹ Pondering shifting California's tax structure to more resemble that of Texas is actually of interest to at least some California lawmakers. See, e.g., http://arev.assembly.ca.gov/sites/arev.assembly.ca.gov/files/Thornberg_Testimony.pdf.

⁷⁰ California's proposed Business Net Receipts Tax resembled Texas's Margin Tax. California Commission On The 21st Century Economy, *Final Report* (2009), available at http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf.

alternative tax (i.e., the property tax) or improving another existing tax (e.g., taxing sales of services) would require a supermajority vote (or, in the case of the property tax, a constitutional amendment). In addition, another debilitating impact of local TILs is that they put pressure on *state* budgets to fund services that could have been more efficiently funded locally. Not only is this a less efficient use of revenues, but states typically rely on more volatile revenue sources, and thus TILs at the local level increase volatility at the state level – yet state level TILs then make it more difficult for states to adjust their tax rates to cope with this combination of greater responsibility and volatility.⁷¹

E. A Concluding Note on Doctrinal Stress and “Completoomania”⁷²

We have now explained multiple ways in which TILs put undue stress on important doctrines relating to taxation and public finance, such as the tax-fee distinction and the debt-lease distinction. We wish to make a few more points about the notion of doctrinal stress. By warning about stress in connection with these doctrines, we are not thereby signaling that we believe that these doctrines are unsound, where “unsound” means, at the very least, unadministrable because there is no tractable conceptual content. There *are* unsound doctrines, such as, in our view, the notion of a “traditional government function.”⁷³ Such doctrines also wither under stress, but we believe they were *always* destined to do so. There is no such dire destiny for sensible distinctions such as that between a long-term borrowing and a lease. This distinction is sound: it is administrable, reasonable, and important. It makes sense that because of concerns over generational equity that debt require additional procedures, and it also makes sense that governments need to be able to lease without going through these procedures. The problem is that judging is an exercise in practical reasoning; there is no algorithm for automatically distinguishing leases from debts.⁷⁴ Yet by slow process of common law reasoning, workable rules of thumb can be developed.⁷⁵ The key is to avoid putting so much stress on governments that they devise so many borderline financings that they overwhelm this piecemeal judicial process. Yet this is what TILs threaten to do.

⁷¹ For further discussion, see David Gamage, “Preventing State Budget Crises: Managing the Fiscal Volatility Problem,” 98 *California Law Review* 749 (2010).

⁷² This phrase is from Marianne Constable and much of the analysis also (loosely) follows from her work. See Marianne Constable, *The Law of the Other* [chapter 4] (1994); see also generally Marianne Constable, *Just Silences* (2005) (particularly Chapter 5).

⁷³ *Garcia v. San Antonio Metro. Transit Auth.*, 469 U.S. 528 (1985); Edward A. Zelinsky, *The False Modesty of Department of Revenue v. Davis: Disrupting the Dormant Commerce Clause Through the Traditional Public Function Doctrine*, 29 VA. TAX REV. 407 (2010).

⁷⁴ The key points here are from Aristotle, *Nicomachean Ethics*, bk. 6, ch. 3 (defining scientific knowledge – *episteme* – as knowledge of necessary truths), ch. 5 (defining practical knowledge – *phronesis* – as knowledge of matters that can be otherwise), ch. 8 (explaining that therefore political science requires practical knowledge).

⁷⁵ To use Karl Llewellyn’s phrase, what great judges possess is “situation sense,” which is what allows them to craft (and revise) functional judicial categories and rules. Karl Llewellyn, *Deciding Appeals* 121-22, 402 (1960); see also Anthony Kronman, *The Lost Lawyer* 34-52, 209-225 (1993) (making the same point, tracing it to Llewellyn and Aristotle and observing that this is the kind of practical wisdom that is being lost); Darien Shanske, *Revitalizing Aristotle’s Doctrine of Equity*, 4 *Journal of Law, Culture, and the Humanities* 352, 376 (2008) (arguing, among other things, that modern jurisprudence systematically suppresses the role of practical reasoning – “We are in a sense defined by practices and norms that deny that we are defined by practices and norms.”).

That TILs frustrate the application of practical reasoning should not come as a surprise. After all, TILs are part of a dynamic where new – and seemingly ever more stringent – *rules* are devised when there is frustration with the ordinary workings of the political process, a process that is irreducibly the domain of (messy) practical reasoning.⁷⁶ Accordingly, TILs, the most current form of a rule-based approach to political decisions, do not work any better than the rules that preceded them, and indeed they work less well because, for little or no gain, they obstruct the functioning of superior ways to limit (or at least channel) the size of government. Note that these superior ways, such as moderate DLPs and jurisdictional competition, give much more sway to the ordinary operation of politics; their success seems largely attributable to making politics “better” in making it clearer to voters what it is that they are voting on.⁷⁷

IV. Thinking More Precisely About the Evasion of TILs

It might be objected that up to now we have assumed too quickly that TILs can be evaded through tax expenditures. Might a more restrictively designed TIL prevent the use of tax expenditures as an evasion strategy? For instance, suppose that the language of a given TIL provision was the following:

[A]ny changes in State taxes enacted for the purpose of increasing revenues collected pursuant thereto whether by increased rates or changes in methods of computation must be imposed by an Act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature . . .⁷⁸

An objector might grant that this provision allows for a state government to spend through the tax code, but how does a legislature evade a provision like this and simultaneously *raise* revenues? We will now explore the evasion of TILs in some depth in order to put an exclamation point at the end of our critique of TILs.

A. The Tax Expenditure Strategy

Returning to the TIL provision we quoted above, note that the central language refers to “any change in State taxes enacted for the purpose of increasing revenues” – this still leaves a lot of room for maneuver. Thus, instead of increasing taxes generally in order to fund new spending, a majority party can just pass a new tax credit to fund a desired program while increasing *other* taxes or reducing other tax expenditures. The overall tax package would be revenue neutral in that it would not increase overall taxes, but it would in effect accomplish the majority party’s spending and taxing goals because the tax

⁷⁶ See also further discussion of fee jurisprudence Sec. IV.C. *infra*.

⁷⁷ Rodriguez-Tejedo & Wallis, *supra* note __, at 38.

⁷⁸ This language is from Cal. Const. Art. 13A, section 3, which was California’s TIL prior to the passage of Proposition 26 in November 2010. *See also, e.g.,* Ariz. Const. Art. 9, section 2.

expenditure would substitute for the increased spending while the tax shift would transfer tax liability to where the majority wanted it to be.⁷⁹

In theory, there are no limits to the types of programs that could be funded in this manner. Businesses and high-income individual taxpayers could be given dollar for dollar tax credits against their higher taxes in exchange for donating to state spending programs (e.g., universities, health programs), thus systematically exchanging public funding for nominally private funding. The more tax instruments a state has the easier this will be, but even a state without an income tax can favor all manner of programs through sales tax expenditures (while simultaneously raising the sales tax on other goods or services).⁸⁰

In short, the tax expenditure strategy relies on TILs not applying to revenue neutral packages that reduce taxes on some taxpayers (through tax expenditures) while increasing taxes on other taxpayers. For most existing state TILs, this strategy should suffice for the majority party to evade TILs to the extent the majority party so desires. But if the tax expenditure strategy is not available, then a majority party might still employ our second strategy – the benefit charges with refundable tax credits strategy.

B. The Benefit Charges with Refundable Tax Credits Strategy

The essence of this second strategy is to transform the funding mechanism for government programs to benefit charges instead of general fund expenditures. To defray the distributional impact of these benefit charges, the state would then provide refundable tax credits against the state income tax (or against some other state tax, for states without income taxes). These refundable credits should ideally phase out with income, so that low-income taxpayers could be completely reimbursed for benefit charges whereas higher income taxpayers would only partially be reimbursed.⁸¹ For example, consider tuition at public colleges and universities. Even today, tuition at these schools is a relative bargain compared to many private schools and yet recent dramatic increases in tuition still undermine the public purpose of these schools to provide affordable public education. The solution to the riddle here could be to allow tuition at public colleges and universities to remain high – or even to become higher – but to then use tax credits to keep these schools affordable for lower-income students. State higher education credits could be administered, for example, through the state income tax and could be modeled on federal higher education tax credits. The credits could be made refundable so that taxpayers without tax liability would still be helped.

Individual taxpayers may still face liquidity issues even with refundable credits because lower income taxpayers could have trouble paying benefit charges, like tuition, upfront and then waiting for a state income tax return. To address this problem, the tax credits

⁷⁹ For some examples, *supra* Section II.A.

⁸⁰ And enacting this strategy through business tax expenditures would be even easier.

⁸¹ For more on this approach, see generally Darien Shanske, “Going Forward by Going Backward to Benefit Taxes,” *California Journal of Politics and Policy*, vol. 3, iss. 2, art. 14, <http://www.bepress.com/cjpp/vol3/iss2/14>.

could be made *advanceable*. The Affordable Care Act's Premium Tax Credits in new IRC §36B is an example of how tax credits can be made advanceable. Under §36B, state Exchanges can make advance payments of the premium tax credits to pay for health insurance for low-income taxpayers, with the taxpayers then reconciling the advance payments with the amount of the tax credits that they are allowed when they file their tax returns.⁸² Similarly, for example, state universities could receive advanceable state tax credits to cover low-income taxpayers' tuition.⁸³

By using the benefit charges plus refundable tax credits strategy, which we will henceforth call "BCPP" (Benefit Charges Plus Progressivity), a majority party can effectively evade TILs because funding can be *increased* for state spending programs without actually needing to raise explicit taxes or spending. The limit on this strategy is the preexisting state income tax (or other preexisting state taxes)⁸⁴. Refundable tax credits can be used to completely alleviate the expense of benefit charges for low-income taxpayers, but positive tax liabilities cannot be assessed on high-income taxpayers in excess of their preexisting tax liability.

Hence, taken to the limit, preexisting state taxes become the mechanism for achieving progressivity in state spending under the BCPP strategy. Furthermore, the preexisting income tax and other general taxes (or other sources of revenue, like federal grants) fund any government programs not entirely fundable through benefit charges.

C. What about California's Proposition 26?

In November 2010, California's Proposition 26 modified its TIL regime partially in response to the success of a version of the tax expenditure strategy.⁸⁵ The new rule is as follows:

Any change in state statute which results in any taxpayer paying a higher tax must be imposed by an act passed by not less than two-thirds of all members elected to each of the two houses of the Legislature . . .⁸⁶

⁸² For further discussion of how this works, see, e.g., Edward A. Zelinsky, *The Health-Related Tax Provisions of PPACA and HCERA: Contingent, Complex, Incremental and Lacking Cost Controls*, CARDOZO LEGAL STUDIES RESEARCH PAPER NO. 301 (2010), available at <http://ssrn.com/abstract=1633556> (summarizing the many tax provisions of the Affordable Care Act). See also David Gamage, *How the Affordable Care Act Will Create Perverse Incentives Harming Low and Moderate Income Workers*, TAX L. REV. (forthcoming) at 15-18, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2067138.

⁸³ There are tradeoffs involved in making tax credits advanceable. Doing so requires a reconciliation process, wherein taxpayers whose income ends up being higher than predicted might be required to pay back excess advanceable credits received, which can create complicated enforcement issues. We cannot fully analyze these tradeoffs here. Instead, we merely mean to point out the possibility of making credits advanceable in order to deal with liquidity issues.

⁸⁴ Refundable tax credits can be implemented through other state taxes in addition to the income tax, although doing so is somewhat more complicated.

⁸⁵ See, e.g., Lenny Goldberg, "California Governor Approves Gas Tax Swap," 2010 STT 58-2 (March 25, 2010) (describing complicated revenue neutral package); Proposition 26, Findings, Sec. 1(d) (new stricter TIL seems to target this "swap"); Cal Const. Art. 13a, Section 3(c) (Proposition 26 is retroactive to January 1, 2010 and thus appears to invalidate the swap).

⁸⁶ Current Cal. Const. Article 13A, section 3(a).

This new rule prevents the simple tax expenditure strategy for evading TILs. The kind of shifts in tax burden required to achieve a revenue neutral package will increase the taxes on at least “any” taxpayer (one will do!), meaning that any such proposal requires a supermajority.

As for this new rule, we should immediately note that its apparent success comes at a great cost. Proposition 26-like TILs interfere with traditional “base broadening plus rate lowering” tax reform – the model for traditional, and efficient, bipartisan tax reform. This is because closing any tax loophole increases the taxes on “any taxpayer” even if the overall package reduces rates on most taxpayers. The Tax Reform Act of 1986 and all the various bipartisan proposals currently floating about Washington and the states would require a supermajority under this new rule.

Moreover, Proposition 26 does *not* prevent the BCPP strategy. Proposition 26’s supermajority rule applies to “taxes,” but taxes are defined to exclude benefit-type charges. For instance, the following is *not* a tax and is thus not subject to the supermajority rule:

A charge imposed for a specific government service or product provided directly to the payor that is not provided to those not charged, and which does not exceed the reasonable costs to the State of providing the service or product to the payor.⁸⁷

Thus, the California legislature (or local governments)⁸⁸ can increase benefit charges by majority vote just as it can add tax expenditures by majority vote, and so even Proposition 26-style TILs can be evaded.

If one is committed to the notion that there is some rule that can be formulated to prevent the BCPP strategy,⁸⁹ then the next step could be for TILs to include *all* possible government charges, as the TIL-provision in Missouri seems to do:

Counties and other political subdivisions are hereby prohibited from levying any tax, license or fees, not authorized by law, charter or self-enforcing provisions of the constitution when this section is adopted or from increasing the current levy of an existing tax, license or fees, above that current levy authorized by law or charter when this section is adopted without the approval of the required majority of the qualified voters of that county or other political subdivision voting thereon.⁹⁰

⁸⁷ Cal. Const. Article 13A, section 3(b)(2).

⁸⁸ Proposition 26 made parallel changes to the ability of local governments to raise taxes. See Cal. Const. Article 13C, section 1(e).

⁸⁹ In other words, if one is suffering from some form of “completomania.” See Constable *supra* ____.

⁹⁰ Mo. Const. Art. X, section 22.

Despite the broad language restricting “any tax, license or fee[],” the Missouri Supreme Court has interpreted this language *not* to require elections in connection with “fee increases which are ‘general and special revenues’ but not a ‘tax,’” specifically holding “that increases in the specific charges for services actually provided by an ambulance district are not subject to [the Missouri TIL].”⁹¹

And even without a favorable judicial interpretation of this sort, a variation on the BCPP strategy would still be viable. All that would be needed would be to partially privatize state spending programs (like universities), while keeping them highly regulated so that they continue to operate in a fashion similar to how they were run as state spending programs, and then providing tax credits for payments made to these new quasi-private entities.⁹² In other words, no fee that could be argued to be a tax would be required.

Moreover, there is a sound reason why proponents of TILs, and courts in interpreting the intentions of these proponents, have not applied TILs to benefit charges, and that is, as noted above, the tax-fee distinction serves an important purpose. Viewed practically, what would it be like for tuition at state colleges, public parking rates, building permit fees etc. all to be subject to a supermajority requirement?⁹³ As a matter of theory, why should the voters impose extraordinary constraints on (elected) legislators in connection with charges that they, the voters, will usually only have to pay by opting to engage in a *voluntary* activity?

D. How Should These Strategies Be Evaluated?

Let us assume that these strategies have been explicitly utilized.⁹⁴ Should we consider these strategies to be unscrupulous dodges? We think not. There is ample evidence that

⁹¹ *Keller v. Marion County Ambulance District*, 820 S.W.2d 301, 303-05 (Mo. banc 1991); see also *Arbor Investment Company, LLC v. City of Hermann*, 341 S.W. 3d 673 (Mo. banc 2011) (reviewing history of tax-fee jurisprudence in Missouri, affirming use of five factor test as useful, and then affirming lower court finding that utility charges were fees and not taxes).

⁹² The eligibility for tax credits for payments to these quasi-private entities could be made conditional on the quasi-private entities complying with state regulations. In this fashion, the state can insure that tax credits are only issued to the extent these entities fulfill a public purpose in a similar fashion to how the entities would have been run had they remained state spending programs rather than quasi-private entities.

⁹³ This is not to say that provisions like Proposition 26 and its predecessor, Proposition 218, do not complicate utilizing benefit-type financing. The ambiguities in both measures have resulted in an enormous amount of litigation and uncertainty – hence the doctrinal stress. See *supra* note 37. On California’s Proposition 218, which specifically targeted special assessments, a particularly venerable and potentially useful type of benefit charge, see, for example Darien Shanske, “Putting the California Constitution (Back) to Work: A Blueprint for Clearing Legal Roadblocks to Proper Infrastructure Finance,” 54 *State Tax Notes* 567 (2009).

⁹⁴ We can only offer educated intuitions as to the extent to which these evasion strategies are actually in use, but we do think that these strategies are used, at least to some extent (if implicitly) and can certainly be used more often. In the last decades, and particularly since the imposition of limitations on the local property tax, there has been an explosion in the use of benefit-type charges. Ross E. Coe, *Federalism’s Vanguard: Local Government User Fees*, 61 *STATE TAX NOTES* 561 (Aug. 29, 2011). State-level tax expenditures have long been – and remain, see note 16 *supra* – very substantial, though we do not know of a specific instances where a tax expenditure was explicitly linked to a higher fee. And, as noted above

voters desire both lower taxes and increased spending on all of the major programs that governments spend significant resources on.⁹⁵ TILs are one outgrowth of this bias in voters' fiscal preferences. This bias is particularly problematic because voters appear to have little understanding of what state governments actually do. And thus these evasions are perhaps just a way of responding to voters' inconsistent demands regarding taxes and spending.

But there is a deeper point to be considered about the shift to benefit-type taxes. The primary mechanism through which state governments have historically functioned in the face of voters' fiscal biases and irrationality is through representative government. Elected representatives made the hard choices that voters were unwilling to make. But TILs undermine the elected representatives model and grow from voters' loss of trust in that model.

The benefit taxes model can also function as a partial replacement for the elected representatives model. In effect, the benefit taxes model relies on the market to determine fiscal priorities, as taxpayers must pay for more of the costs of governance through direct benefit charges. Instead of wholly relying on elected representatives to determine fiscal priorities then, the benefit taxes model relies much more on the choices made by individual state citizens acting as consumers. By using the BCPP strategy – combining benefit charges with progressive refundable tax credits – a state can employ the market-based benefit taxes model for making allocative fiscal decisions while continuing to employ the elected representatives model for making distributive fiscal decisions.⁹⁶ Markets are generally superior to elected representatives at making allocative decisions, but markets on their own are not capable of enacting most forms of distributive policies that voters might desire.

It is generally (and correctly) maintained that, by mimicking the market to the extent possible, providing a service with a benefit charge should usually be more efficient than paying for a service with a general tax.⁹⁷ By directly connecting payments to the services received, benefit charges mitigate the incentives to change behavior that results in traditional forms of taxation creating excess burden (aka, deadweight loss).⁹⁸ The use of the BCPP strategy can thus limit the size of government in at least two ways. First, to the extent benefit charges better reflect the level of government services that people want, then benefit charges are more politically efficacious in shaping the government in accordance with the voter's wishes. Second, to the extent benefit charges raise funds

supra note 85, in at least some instances, state legislatures have explicitly made use of our first evasion strategy, passing revenue neutral packages in order to evade TILs.

⁹⁵ See, e.g., David Gamage & Darien Shanske, "Three Essays on Tax Salience: Market Salience and Political Salience," 65 TAX L. REV. 19, 96 (2011); David Gamage, "Managing California's Fiscal Roller Coaster," 49 *State Tax Notes* 659, 663 (2008).

⁹⁶ For the original distinction between allocative and distributive fiscal policy, see Richard A. Musgrave, *The Theory of Public Finance* (1959).

⁹⁷ See generally, e.g., R.M. Bird & T. Tsiopoulos, User Charges for Public Services: Potentials and Problems, 45 CAN. TAX J. 25 (2007).

⁹⁸ For discussion of these concepts, see David Gamage & Darien Shanske, "Three Essays on Tax Salience: Market Salience and Political Salience," 65 *Tax Law Review* 19, 61-65 (2011).

while creating less excess burden or deadweight loss, then benefit charges reduce the distortionary impact that government activity imposes on the larger economy.

E. Back to Jurisdictional Competition

Ultimately, the BCPP strategy controls the size of government because it is a partial form of jurisdictional competition, which is itself a kind of market mechanism. BCPP controls the size of government because it better matches individual citizens to *individual* services. However, to reach its full potential, the BCPP solution must also match individuals to entire *jurisdictions* (in a Tiebout fashion) – that is, there must be a jurisdictional marketplace. There are only so many government services, such as higher education, that can be provided individually. Key government services, particularly at the local level, tend to come in bundles – e.g., K-12 education and police and parks.⁹⁹ There is a particular local government levy that, to some extent,¹⁰⁰ acts as a blended price for these local amenities, and this is the property tax. Yet, as we have seen in Part ____ infra, TILs at the local level obstruct the proper functioning of jurisdictional competition as to taxes. Furthermore, ever more elaborate TILs (and DLPs), though they do not prevent the use of the BCPP strategy, add stresses to governments trying to levy fees in the manner jurisdictional competition would encourage. The BCPP strategy thus simultaneously illustrates the vacuity of TILs (because TILs can be evaded) while also demonstrating the needless hurdles to sound governance that TILs erect (because the BCPP strategy is likely to lead to lots of tax-fee litigation).

V. Conclusion

There are a few key points we wish to emphasize in conclusion. First, despite their seemingly simple structure (and goal), TILs should not be assumed to shrink state governments – or to even make conceptual sense. Instead, TILs primarily serve to undermine the effectiveness of government programs without necessarily reducing the size of government. This is reason enough to eschew TILs. But there is another reason to avoid TILs and that is that they potentially impede superior means for controlling the size of government – most notably, jurisdictional competition.

The political dynamic that has given us TILs appears to us to represent a general disgust with the operation of ordinary political decisionmaking as to public budgeting. Yet sometimes the most dramatic gestures can leave everything one despises intact, or even make things worse. Imagine a batter taking a home run swing and striking out. Singles can also win games, and so too the political process can be shifted through less dramatic measures. Sticking with our metaphor, one can either swing for the fences and miss with

⁹⁹ Darien Shanske, “Above All Else Stop Digging: Local Government Law as a (partial) Cause (and Solution) to the Current Financial Crisis,” 43 *Michigan Journal of Law Reform* 663, 703-04 (2010) (discussing local amenity “bundling rules”).

¹⁰⁰ See, e.g., Darien Shanske, “How Less Can Be More: Using The Federal Income Tax To Stabilize State And Local Finance,” 31 *Virginia Tax Review* 413, 455-58 (2011) (reviewing the evidence and concluding that there is an argument that property taxes function as benefit taxes at least partially). Other local levies, such as parcel taxes, assessments, and development impact fees can also serve as part of a blended price for a local amenity bundle.

a TIL or bunt the runners forward with jurisdictional competition¹⁰¹ – it turns out to be quite difficult to do both.

¹⁰¹ There other political reforms that we believe are worth considering, reforms that channel the political process sensibly. For example, Leib and Elmendorf propose that, in case of a budget impasse, there should be a direct vote of the electorate on one of two completed state budgets – each budget having been prepared by one of the major political parties. Ethan J. Leib & Christopher S. Elmendorf, “Why Party Democrats Need Popular Democracy and Popular Democrats Need Parties,” 100 California Law Review 69, 100-107 (2012).

FOREWORD: THE DISFAVORED CONSTITUTION: STATE FISCAL LIMITS AND STATE CONSTITUTIONAL LAW

Richard Briffault*

I. INTRODUCTION

The dominant theme in the resurgent state constitutional jurisprudence of the last quarter-century has been the effort of many scholars and jurists to find in state constitutions a progressive alternative to the conservative turn federal constitutional doctrine has taken in the Burger and Rehnquist eras. Following the tone set by Justice William Brennan's path-breaking 1977 article in the *Harvard Law Review*,¹ the state constitutional law literature has sought a more expansive protection of civil liberties through state constitutional provisions dealing with criminal law and procedure,² freedom of expression,³ and equality,⁴ and to ground positive rights to public services in state constitutional measures dealing with such affirmative governmental duties as education,⁵ welfare,⁶ and housing.⁷

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1. William J. Brennan, Jr., *State Constitutions and the Protection of Individual Rights*, 90 HARV. L. REV. 489 (1977); see also William J. Brennan, Jr., *The Bill of Rights and the States: The Revival of State Constitutions as Guardians of Individual Rights*, 61 N.Y.U. L. REV. 535 (1986).

2. See Shirley S. Abrahamson, *Criminal Law and State Constitutions: The Emergence of State Constitutional Law*, 63 TEX. L. REV. 1141 (1985); Robert M. Pitler, *Independent State Search and Seizure Constitutionalism: The New York State Court of Appeals' Quest for Principled Decision-Making*, 62 BROOK. L. REV. 1 (1996); Note, *Developments in the Law – The Interpretation of State Constitutional Rights*, 95 HARV. L. REV. 1324, 1367-98 (1982) [hereinafter *Developments*].

3. See, e.g., *Developments*, supra note 2, at 1398-1429.

4. See, e.g., Robert F. Williams, *Equality Guarantees in State Constitutional Law*, 63 TEX. L. REV. 1195 (1985).

5. See *Developments*, supra note 2, at 1444-59; Michael Heise, *State Constitutions, School Finance Litigation, and the "Third Wave:" From Equity to Adequacy*, 68 TEMP. L. REV. 1151 (1995); Allen W. Hubsch, *The Emerging Right to Education Under State Constitutional Law*, 65 TEMP. L. REV. 1325 (1992); Molly McUsic, *The Use of Education Clauses in School Finance Reform Litigation*, 28 HARV. J. LEGIS. 307 (1991); William E.

With much of the analysis of state constitutional law focused on the failings of federal constitutional law,⁸ far less attention has been paid to a distinctive feature of state constitutions that has little to do with civil liberties or positive rights – the many provisions that seek to protect taxpayers by limiting the activities and costs of government. The Federal Constitution says next to nothing about public finance, and when it does so, it either provides authority for congressional action⁹ or sets procedures for raising and spending money.¹⁰ It places just a handful of substantive constraints on federal taxation¹¹ and no restrictions on federal borrowing at all. By contrast, state constitutions accord extensive consideration 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.¹² These “public purpose”

Thro, *The Role of Language of the State Education Clauses in School Finance Litigation*, 79 EDUC. L. REP. 19 (1993); Paul L. Tractenberg, *The Evolution and Implementation of Educational Rights Under the New Jersey Constitution of 1947*, 29 RUTGERS L.J. 827 (1998).

6. See Helen Hershkoff, *Foreword: Positive Rights and the Evolution of State Constitutions*, 33 RUTGERS L.J. 799 (2002); Helen Hershkoff, *Positive Rights and State Constitutions: The Limits of Federal Rationality Review*, 112 HARV. L. REV. 1131 (1999) [hereinafter Hershkoff, *Positive Rights*]; Helen Hershkoff, *Welfare Devolution and State Constitutions*, 67 FORD. L. REV. 1043 (1999); Burt Neuborne, *Foreword: State Constitutions and the Evolution of Positive Rights*, 20 RUTGERS L.J. 881 (1989).

7. See, e.g., Norma Rotunno, Note, *State Constitutional Social Welfare Provisions and the Right to Housing*, 1 HOFSTRA L. & POL'Y SYMP. 111 (1996).

8. See, e.g., Paul W. Kahn, *Interpretation and Authority in State Constitutionalism*, 106 HARV. L. REV. 1147, 1153 (1993) (citing “the [c]hanged [c]haracter of the [f]ederal [b]ench” as a critical reason for the turn to state constitutional law). The focus on federal constitutional law is equally true of state constitutionalism’s leading critic. See James A. Gardner, *The Failed Discourse of State Constitutionalism*, 90 MICH. L. REV. 761, 780-98 (1992) (examples of state courts’ limited use of state constitutions all involve due process, criminal procedure, or freedom of expression).

9. See U.S. CONST. art. I, § 8, cl. 1 (authorizing Congress to “lay and collect Taxes, Duties, Imposts and Excises”); *id.* § 8, cl. 2 (authorizing Congress “[t]o borrow Money on the credit of the United States”); *id.* amend. XVI (authorizing imposition of the income tax).

10. See *id.* art. I, § 7, cl. 1 (providing that “[a]ll bills for raising Revenue shall originate in the House of Representatives”); *id.* § 9, cl. 7 (providing that “[n]o Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law”).

11. *Id.* § 8, cl. 1 (providing that “[a]ll Duties, Imposts and Excises shall be uniform throughout the United States”); *id.* § 9, cl. 4 (providing that “[n]o Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken”); *id.* § 9, cl. 5 (“No Tax or Duty shall be laid on Articles exported from any State.”).

12. See, e.g., Dale F. Rubin, *Constitutional Aid Limitation Provisions and the Public Purpose Doctrine*, 12 ST. LOUIS U. PUB. L. REV. 143, 143 n. 1 (1993) (finding that forty-six out of fifty state constitutions contain some limits on spending).

provisions narrow the range of government action and limit public sector support for private sector activities. Nearly all state constitutions impose significant substantive or procedural restrictions on state and local borrowing.¹³ A considerable number also limit state and local taxation.¹⁴ These provisions may be said to constitutionalize a norm of taxpayer protection.

Fiscal limits, as well as positive rights, thus characterize state constitutional law. Indeed, the states' fiscal constitutional provisions may offset the more widely heralded positive rights provisions. By giving priority to taxpayers over service recipients, these provisions can make it more difficult for states and localities to raise funds to finance public services.

But the real significance of fiscal limits in understanding state constitutional law is neither the barriers they create for the financing of public programs called for by positive rights advocates, nor the challenge they pose to the progressive image of state constitutional law that has dominated contemporary scholarly writing in the field. Rather, the most important lesson they provide grows out of the uncertain effect these provisions have had in actually controlling state and local finances. There is an enormous gap between the written provisions of state constitutions and actual practice. State legislatures and local governments have repeatedly sought to expand the scope of "public purpose" and to slip the restraints of the tax and debt limits.¹⁵ Increasingly, these efforts have won the approval of state courts.

Judicial interpretations have effectively nullified the public purpose requirements that ostensibly prevent state and local spending, lending, and borrowing in aid of private endeavors. Supreme court decisions in many states have also held that a host of financial instruments are beyond the scope of the constitutional debt limitations. As a result, although debt limits have altered the forms of state and local borrowing, they probably have had only a modest effect on aggregate state and local debt. The constitutional constraints on state and local taxation have been more effective, but their

13. See, e.g., Stewart E. Sterk & Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 WIS. L. REV. 1301, 1315-16 (finding that more than three-quarters of the states have debt limitations in their constitutions).

14. See, e.g., U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM 18 (1992) (noting that all but seven states place some restrictions on local property taxation).

15. See *infra* Parts II-IV.

impact has been cushioned by judicial determinations that certain revenue-raising devices are not taxes subject to constitutional limitation.

This Article examines these fiscal limits and their significance for state constitutional law. I refer to these limits as the "disfavored constitution" for two reasons. First, they have been disfavored by state constitutional law scholars, who have largely ignored the state fiscal constitution in favor of other state constitutional provisions. Second, to a considerable degree, they have been disfavored by state courts, who frequently read the fiscal provisions narrowly, technically, and formalistically – often more like bond indentures than statements of important constitutional norms.¹⁶

Parts II, III, and IV of this Article will sketch out the principal provisions that form the states' fiscal constitution, and examine their contemporary judicial interpretation. In Part V, I will consider why these provisions have often been read so unsympathetically. In Part VI, I will briefly assess whether state constitutions ought to be used to constrain state and local finances. Finally, I will conclude in Part VII by considering the implications of the judicial treatment of state fiscal limits for the study of state constitutional law.

II. PUBLIC PURPOSE REQUIREMENTS: THEIR RISE AND FALL

By one recent count, forty-six state constitutions contain provisions, known collectively as "public purpose" requirements, that expressly limit the authority of their state and/or local governments to provide financial assistance to private enterprises.¹⁷ The New York Constitution is typical in providing that "[t]he money of the state shall not be given or loaned to or in

16. The few state constitutional law scholars who have referred to the fiscal limits have tended to treat them dismissively, too. *See, e.g.*, James Gray Pope, *An Approach to State Constitutional Interpretation*, 24 RUTGERS L.J. 985, 985 (1993) (referring to the difficulty of developing a state constitutional jurisprudence "on a textual foundation that . . . obsesses in excruciating detail over pecuniary matters").

17. *See* Rubin, *supra* note 12, at 143 n.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. *See* Ullrich v. Bd. of County Comm'rs of Thomas County, 676 P.2d 127, 132-33 (Kan. 1984) (noting that expenditure of public money must be for a public purpose); *Common Cause v. State*, 455 A.2d 1, 15-16 (Me. 1983) (public purpose doctrine implicit in the Maine Constitution); *Clem v. City of Yankton*, 160 N.W.2d 125, 130-31 (S.D. 1968) (applying public purpose doctrine not based on specific state constitutional provision); *State ex rel. Hammermill Paper Co. v. LaPlante*, 205 N.W.2d 784, 793 (Wis. 1973) ("No specific clause in the constitution establishes the public purpose doctrine. However, it is a well-established constitutional tenet.").

THE RIGHT TO VOTE ON TAXES

Kirk J. Stark*

The taxpayer revolution has indeed been born without
an analytical blueprint or even an analytical map.

Geoffrey Brennan & James Buchanan (1980)¹

INTRODUCTION

One cannot study American history for long before noticing the conspicuous role of tax revolts. Time and again Americans have turned mutinous against taxes—the Boston Tea Party, the Whiskey Rebellion, the Depression-era tax strikes.² “Tax revolts,” as one commentator put it, “are as American as 1776.”³

This spirit of tax rebellion is once again taking hold. In a handful of states across the country, a new taxpayer movement is quietly underway. Over the past two decades, voters in several states have gone to the polls demanding a more direct role in local tax decision-making. As a result of a 1996 initiative, for example, the California Constitution now requires local governments to secure voter approval before any new or increased tax may take effect.⁴ Several other states have either considered or adopted similar

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¹ GEOFFREY BRENNAN & JAMES M. BUCHANAN, *THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION* 189 (1980).

² See David T. Beito, *Tax Revolts in American History*, 4 HUMANE STUD. REV. 1 (1986-87) (“The United States owes its birth to a tax revolt.”). But see Malcolm Gladwell, *Tea and Sympathy: The Truth About American Taxpayers*, NEW YORKER, Apr. 19, 1999, at 94 (arguing that the Boston Tea Party controversy arose out of a reduction in British import duties). On the Whiskey Rebellion, see THOMAS P. SLAUGHTER, *THE WHISKEY REBELLION: FRONTIER EPILOGUE TO THE AMERICAN REVOLUTION* (1986). On the Depression-era tax strikes (with an emphasis on Chicago), see DAVID T. BEITO, *TAXPAYERS IN REVOLT: TAX RESISTANCE DURING THE DEPRESSION* (1989).

³ Joseph D. Reid, Jr., *Tax Revolts in Historical Perspective*, 32 NAT’L TAX J. 67, 69 (1979).

⁴ CAL. CONST. art. XIII A, § 4 (requiring voter approval for “special taxes”); art. XIII D (requiring voter approval for “general taxes”).

provisions for local taxes.⁵ Additional tax voting initiatives are on the horizon.⁶

In most of these jurisdictions, interest in popular control of taxation can be traced to reforms brought about by the tax limitation movement of the mid-1970s. California's recent emphasis on tax voting has its roots in Proposition 13 ("Prop 13"), the famous property-tax-cutting initiative approved by voters in June 1978.⁷ Prop 13 marked a watershed moment in the evolution of American attitudes toward government and taxation.⁸ The controversial initiative not only inspired similar measures in other states,⁹ but also served as a local precursor to the tax-cutting Reagan revolution that dominated the national political scene throughout the 1980s.¹⁰ As Michael Graetz explains, "this nation has known very few days that have turned American tax politics upside down, but June 6, 1978 was one of those days."¹¹

If Prop 13 was a fiscal earthquake felt throughout the country, then California's local public sector was its epicenter. The initiative rocked the state's system of local public finance, transforming the way cities, counties, and school districts are funded. By limiting access to the property tax, Prop 13 pushed local governments to find new ways of raising money, which they often did through aggressive legal arguments and creative financial engineering. These fiscal machinations spawned litigation over what was and was not subject to the new constitutional limits. Eventually, Prop 13's defenders responded by proposing new initiatives to ensure direct voter control over local tax decisions. In November 1996, California voters adopted Proposition 218—the self-styled "Right to Vote on Taxes Act."¹² As with

⁵ Voters in Colorado, Michigan, Missouri, Montana, and Washington have adopted similar provisions, though the state supreme courts in the latter two states later rejected the initiatives as unconstitutional based on single-subject challenges. Anti-tax activists in Arizona and Oregon have also pursued tax voting initiatives. See *infra* subpart I.C.

⁶ For example, new tax voting initiatives are underway in the states of Washington and Florida. See *infra* Part II.

⁷ CAL. CONST. art. XIII.A. Prop 13 has spawned an enormous literature. For a recent analysis, see ARTHUR O'SULLIVAN ET AL., PROPERTY TAXES AND TAX REVOLTS: THE LEGACY OF PROPOSITION 13 (1995); MICHAEL A. SHIRES, JOHN ELLWOOD & MARY SPRAGUE, HAS PROPOSITION 13 DELIVERED? THE CHANGING TAX BURDEN IN CALIFORNIA (1998).

⁸ In addition, commentators often cite Prop 13 as inaugurating a new era of direct democracy across the country, having an impact well beyond the tax area. See, e.g., Sherman Clark, *A Populist Critique of Direct Democracy*, 112 HARV. L. REV. 434, 468 (1998).

⁹ See Richard Briffault, *Distrust of Democracy*, 63 TEX. L. REV. 1347, 1369 (1985) ("Proposition 13 was followed by a multitude of tax and expenditure limitations propositions on ballots throughout the nation.").

¹⁰ C. EUGENE STEUERLE, THE TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA (1992) (discussing tax policy during 1980s).

¹¹ MICHAEL J. GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 52 (1997); see also WILLIAM FISCHER, THE HOMEVOTER HYPOTHESIS (forthcoming 2001) (Oct. 2000 manuscript at 4-7, on file with author), available at <http://www.lincolnst.edu/workpap/fischel2.html>.

¹² CALIFORNIA LEAGUE OF CITIES, UNDERSTANDING PROPOSITION 218 (1997) (comprehensive

similar initiatives in other states, Prop 218 promised greater “taxpayer protection” by “limiting the methods by which local governments exact revenue from taxpayers without their consent.”¹³

This Article explores the recent upsurge in tax voting¹⁴ and investigates the broader question of what role a right to vote on taxes might play within a fiscal constitution designed to limit the taxing powers of local governments. My analysis departs from traditional methods of examining direct democracy. Most scholars interested in popular lawmaking proceed from the assumption that either the people themselves or their representatives will make political decisions—the question they address is which approach is preferable. Indeed, a rich and valuable literature as old as democracy itself has developed around the debate over which form of decision-making is truer to basic democratic principles. While some discussion of that literature will be necessary to set the stage for my own analysis, my aim is not to analyze whether direct democracy is superior to representative government or *vice versa*. Rather, I intend to examine voter approval requirements as a type of constitutional device that might be deployed by a hypothetical constitutional architect charged with designing rules and institutions to limit the taxing powers of local government.

Modern state constitutions contain a broad array of tax and expenditure limits (“TELs”) that constrain the fiscal exaction powers of local governments.¹⁵ These constitutional provisions have proliferated in the past quarter century, fundamentally altering the nature of local governance, yet little scholarly attention has been devoted to the question of how TELs should be designed. Broadly speaking, TELs fall into two basic categories: (1) *direct limitations*, such as tax rate limits, tax base constraints, and expenditure caps, and (2) *procedural limitations*, such as super-majority rules or voter approval requirements. All TELs limit the fiscal discretion of elected officials, yet the voter approval device serves a quite different function than direct limitations. Unlike a maximum rate or a base constraint, the effect of

analysis of Prop 218).

¹³ Proposition 218: Text of Proposed Law, § 2, at <http://vote96.ss.ca.gov/BP/218text.htm>, reprinted as WEST’S ANN. CAL. CONST. art. XIII C, § 1 (Historical Notes) (2000 Supp.); see also Howard Jarvis Taxpayers Ass’n, Statement of Drafters’ Intent, Right to Vote on Taxes Act (Jan. 1997), available at http://www.hjta.org/content/ARC000025A_Prop218.htm.

¹⁴ I use the term “tax voting” here as shorthand for local referendums on new or increased taxes. There has been some discussion in the economics literature of the new emphasis on direct democracy in local public finance. See, e.g., Steven M. Sheffrin, *The Future of the Property Tax: A Political Economy Perspective*, in THE FUTURE OF STATE TAXATION 128 (David Brunori ed., 1998); see also Kim Reuben & Therese McGuire, *Tax and Bond Referenda in California and Illinois*, 12 STATE TAX NOTES 1181 (1997).

¹⁵ “TEL” is now commonly used in the legal and economics literature to refer to “tax and expenditure limits.” E.g., John J. Kirlin, *The Impact of Fiscal Limits on Governance*, 25 HASTINGS CONST. L.Q. 197, 200 (1998) (using the term to describe various fiscal limits on local taxes in California); see also Mark Skidmore, *Tax and Expenditure Limitations and the Fiscal Relationships Between State and Local Governments*, 99 PUB. CHOICE 77 (1999).

the voter approval device is contingent upon the fiscal preferences of the community's median voter.¹⁶ As a result, the referendum is less reliable as a taxpayer protection device; at the same time, however, it is more respectful of majoritarian preferences and local autonomy.

I argue that these differences have significance for the types of taxes to which voter approval requirements should apply. *If* it is assumed that some sort of constitutional limit must apply to all types of local taxes (a big if), then the case for direct voting on taxes is most compelling where there is substantial correspondence between the population burdened by the tax and those who are empowered to vote in the jurisdiction. Thus, assuming universal resident suffrage, the voter approval device may be more appropriate for property taxes than for hotel taxes; more suitable for a residence-based income tax than a source-based sales tax. These insights, if accurate, have important implications for constitutional design in those states that have adopted TELs. At a minimum, the analysis suggests that California's system—restricting property taxes with direct limitations and requiring voter approval for a variety of miscellaneous nonproperty taxes—is exactly backwards.

This Article is organized as follows: Part I offers a brief history of the rise of direct democracy in local fiscal decision-making, using California's experience as an illustration of how the demand for tax voting is a product of the property tax revolt of the mid-1970s. Part II then examines the arguments advanced in support of tax voting and attempts to situate those arguments within a broader philosophical and normative framework. As we shall see, the right to vote on taxes movement draws normative sustenance from two competing philosophical perspectives. On the one hand, tax voting appeals to a populist instinct. Recalling Rousseau and Jefferson, it evokes the image of plebiscitary procedures such as the Greek *polis* and the New England town meeting.¹⁷ At the same time, however, the right to vote on taxes is rooted in a libertarian concern for limiting government and protecting taxpayers from a revenue-maximizing leviathan.¹⁸ Here, tax voting relies on the political philosophy of Locke and Nozick and economists working in the tradition of voluntary exchange theory.¹⁹ These theories

¹⁶ I use "median voter" here and throughout the Article as a shorthand reference for majority rule. For a discussion of the median voter theorem, see Randall G. Holcombe, *Median Voter Theorem*, THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 236-38 (Joseph J. Cordes et al. eds., 1999).

¹⁷ See THOMAS E. CRONIN, DIRECT DEMOCRACY: THE POLITICS OF INITIATIVE, REFERENDUM & RECALL 38-40 (1989) (discussing Rousseau and Jefferson as forerunners of modern-day advocates of direct democracy).

¹⁸ BRENNAN & BUCHANAN, *supra* note 1, at 13-33 (modeling government as a revenue-maximizing leviathan); see also Wallace Oates, *Searching for Leviathan: An Empirical Study*, 75 AM. ECON. REV. 748 (1985) (presenting and analyzing empirical data concerning Brennan and Buchanan's hypothesis).

¹⁹ JOHN LOCKE, TWO TREATISES OF GOVERNMENT (Peter Laslett ed., Cambridge Univ. Press 1988) (1690); ROBERT NOZICK, ANARCHY, STATE AND UTOPIA (1974). Voluntary exchange theory (sometimes referred to as "fiscal exchange theory") has its origins in the work of 19th-century European economists such as Knut Wicksell. See, e.g., KNUT WICKSELL, *A New Principle of Just Taxation*

lend support to tax voting's central campaign mantra—*taxpayers* should have a right to vote on the taxes they are asked to pay.

Part III turns from the abstractions of philosophy to the details of local taxation and multi-unit public finance. The chief distinguishing feature of taxation at the local level is the possibility that tax burdens imposed by one unit of government may fall on individuals not entitled to participate in that community's decision-making process. Importantly, however, the extent of these fiscal externalities varies depending upon the types of taxes that local governments are permitted to use. Through an examination of the resident-voter's tax price for a variety of common local levies, Part III highlights those features of the local tax base resulting in a divergence between those who vote on taxes and those who pay them. That divergence arises not only from the distribution of the tax burden within a community, but also from the exporting of burdens to persons outside of the community. Because of the existence of multiple jurisdictions and the mobility of consumers and factors among them, some portion of locally imposed taxes may be shifted to nonresidents who are generally not entitled to vote.²⁰ This possibility highlights the weaknesses of the referendum as a yardstick of taxpayer consent.

Through a series of illustrations, Part III demonstrates how the referendum's consent value depends upon the type of tax under consideration and the precise design features of the tax. This analysis suggests a division of labor for alternative tax limitation devices—if a state chooses to limit the taxing power of local governments, voter approval requirements may be more suitable for residence-based taxes (or their equivalents), while alternative limitations may be more appropriate for those taxes with incidence effects that are less certain or more dispersed. It also suggests a link between the right to vote on taxes and an emerging literature in public finance economics concerning the optimal assignment of taxing authority in federalist economies.²¹

Finally, Part IV responds to the argument that voter approval requirements are normatively unappealing and therefore should be rejected altogether. Anticipating criticisms from those who object to any type of restriction on the government's taxing power, I offer an alternative defense

(1896), reprinted in *CLASSICS IN THE THEORY OF PUBLIC FINANCE* 72 (Richard A. Musgrave and Alan T. Peacock eds., 1958). The most prominent contemporary adherent of the Wicksellian philosophy of voluntary exchange is James Buchanan. See BRENNAN & BUCHANAN, *supra* note 1, at 6-8. For a recent discussion, see Bernd Hansjurgens, *The Influence of Knut Wicksell on Richard Musgrave and James Buchanan*, 103 PUB. CHOICE 95 (2000) who quotes Buchanan: "In any overall evaluation of the history of fiscal thought, Wicksell alone commands the heights of genius," *id.* at 97.

²⁰ This observation is subject to an important caveat concerning the ability of local governments to export their tax burdens to nonresidents. The same features of the multi-jurisdictional setting that make tax exporting possible—the movement of people and capital across borders—also limit a jurisdiction's taxing capacity. I discuss these issues in subpart III.C *infra*.

²¹ See *infra* subpart III.E.

of tax voting that takes the idea beyond the libertarian justifications described above.²² Drawing from recent political and economic theory, I argue that involving voters directly in local tax decisions may help improve tax morale, increase popular respect for local fiscal outcomes, and stimulate public debate regarding the allocation of local tax burdens. Under this view, the central purpose of tax voting would not be to protect taxpayers but rather to promote community deliberation regarding the question: *How shall we tax ourselves?* Again, however, the case for tax voting depends crucially on the structure of the local tax base. If tax voting is to serve these alternative functions, then states should generally favor residence-based taxes over alternative revenue sources for local governments.

I. THE EMERGING RIGHT TO VOTE ON TAXES

Direct democracy as a form of state and local fiscal decision-making is not new. Many state constitutions require voter approval before state or local bonds may be issued,²³ and state law not infrequently requires the approval of the local electorate as a condition for overriding property tax limits or levying certain local option taxes.²⁴ In recent years, however, the degree of direct voter involvement in fiscal matters has expanded greatly, especially at the local level. Voters in several states have either adopted or considered laws requiring direct voter approval for all new or increased local taxes.²⁵ Additional initiatives are in process.²⁶ Yet few states have had as much experience with tax voting as California—the birthplace of the modern tax revolt. In subpart A below, I examine the origins of California's tax revolt, which began with the adoption of Prop 13 in June 1978. Subpart B discusses the state's most recent initiative, Proposition 218—the Right to Vote on Taxes Act. Subpart C then offers a brief overview of other states' experiences with the right to vote on taxes.

²² In this regard, my project has some parallels to the political interpretive methodology described by Ed McCaffery. See Edward J. McCaffery, *Tax's Empire*, 85 GEO. L.J. 71, 87 (1996) (“[O]ur actual practices are important sources of workable ideals: we should look to them and attempt to read them ‘in their best lights.’”).

²³ See ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, *MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE* § 2.4 (1992); A. JAMES HEINS, *CONSTITUTIONAL RESTRICTIONS AGAINST STATE DEBT* 9-12 (1963).

²⁴ See Fiscal Discipline Project, *Property Tax Levy Limits—Summary Profile*, available at <http://www.colorado.edu/Economics/taxpolicy/states/tax-limitations/levy-limits.html> (restricted access website, last visited May 16, 2000) (on file with author) (listing states with override provisions). On voter approval for local option taxes, see NATIONAL CONFERENCE OF STATE LEGISLATURES, *CRITICAL ISSUES IN STATE-LOCAL FISCAL POLICY—A GUIDE TO LOCAL OPTION TAXES* 18 (1997).

²⁵ See discussion *infra* subpart I.C.

²⁶ Anti-tax activists in Washington are in the process of gathering signatures for “Initiative 252—The Right to Vote on Taxes.” See <http://www.mrsc.org/focus/righttovote.htm> (last visited Nov. 1, 2001). In Florida, the “Home Rule Committee” has filed a petition for an initiative to be titled “Voter Control of City Taxes.” See <http://election.dos.state.fl.us/initiatives/fulltext/2782-1.htm> (last visited Dec. 3, 2001).