History

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

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

Changing Interpretations

The public purpose requirement was never a complete bar to all government financial assistance to the private sector. In the leading mid-nineteenth-century case of *Sharpless v. Mayor of Philadelphia,*[11] the Pennsylvania Supreme Court held that aid to a privately owned railroad could serve a public purpose. "The public has an interest in such a road" even if privately owned, because a railroad provides "comfort, convenience, increase of trade, opening of markets, and other means of rewarding labor and promoting wealth." Most nineteenth-century courts, however, treated their states' public purpose requirements as significant

barriers to programs that would provide state or local assistance to private firms or individuals.[12]

Starting in the 1930s, state courts began to widen the definition of public purpose. In 1938, the Mississippi Supreme Court upheld a state program of issuing bonds to finance the construction of factories and the acquisition of machinery and equipment for long-term lease to private firms willing to relocate to the state; such an industrial development program was held to serve a public purpose.[13] Over time, as state industrial and economic development initiatives spread, courts came to broaden the notion of public purpose to include increased employment and tax base growth, and to approve programs that provided assistance to individual firms. Initially, many of these programs were funded by revenue bonds, that is, by bonds backed solely by new revenues to be generated by the firms receiving assistance, so that courts could find that taxpayer dollars were not at risk.[14] Other courts did not distinguish between programs financed by revenue bonds and programs backed by treasury funds.[15] Some courts resisted the general trend and continued to invalidate public financial assistance to private businesses.[16] In some states where courts were reluctant to permit direct state assistance to private firms, the state constitutions were amended to permit some forms of industrial development assistance.

By the end of the twentieth century, virtually every state supreme court had concluded that economic development, job creation, and augmentation of the state or local tax base are public purposes justifying programs that provide aid to the private sector, including direct assistance—cash grants, low-interest loans, tax breaks—to individual firms.[17] Courts have specifically rejected the argument that significant benefits to one or a small number of profit-making firms cause a program to violate the public purpose requirement.[18] Landmark decisions include *Common Cause v. Maine,*[19] in which the Maine Supreme Court upheld the state's plan to commit $15 million in taxpayer funds to improve the facilities of the Bath Iron Works in order to persuade the company to remain in the state, and *Hayes v. State Property & Buildings Commission,* in which a closely divided Kentucky Supreme Court upheld a package of inducements—with direct costs estimated at between $125 and $268 million—to persuade Toyota Motor Corporation to open a plant in the state.[20]

Some courts have continued to police economic development programs, invalidating some—such as those aimed at aiding nonindustrial economic activities like hotels and restaurants.[21] More generally, courts have taken a posture of extreme deference to state legislatures, finding that a broad range of goals fall under the rubric of public purpose, and that legislative determinations that a spending, loan, or tax incentive program will promote the public purpose are to be accepted as long as they are "not . . . irrational,"[22] and will be rejected "only if it is clear and palpable that there can be no benefit to the public."[23] As one dissenting North Carolina justice observed, lamenting the state supreme court's

1996 decision to uphold a new economic development program that would permit taxpayer dollars to be used, inter alia, to pay for spousal relocation assistance when private firms move to the state, there was nothing in the court's decision that would prevent the use of public funds for country club memberships for corporate executives if that would entice firms to relocate to the state.[24]

The decline of the public purpose doctrine as a limit on state spending has had some impact on other state constitutional restrictions on public aid to the private sector. In some states, the restriction on lending of credit does not apply if the assistance is provided for a public purpose.[25] In those states the expansion in the scope of public purpose has eroded the lending of credit ban.[26]

In other states, however, lending of credit remains an additional restriction. Even if a program constitutes a public purpose, the technique of lending the state's or locality's credit may still be proscribed. Most state courts find that a lending of credit has occurred when a state serves as a surety or guarantees a loan made by another lender.[27] The constitutional provision, thus, protects against the tendency of legislators to discount the risks posed by standing surety when the state is not required to directly commit any funds at the time the suretyship obligation is assumed. A few state courts have gone further and found that a proscribed lending of credit occurs when a state borrows money and provides the proceeds to another entity.[28] For the most part, however, state courts have distinguished lending of credit from borrowing followed by the provision of public funds to a private recipient, and have limited the lending of credit ban to the former situation.[29]

In addition to public purpose and lending of credit requirements, a number of state constitutions prohibit state investment in business corporations. This ban may apply even if the investment is for an economic development purpose.[30] These provisions appear to be a direct response to the nineteenth-century practice of state subscriptions to canal or railroad company stock. As a result, a state may be able to give or lend money to a private firm on a public purpose theory, but may be barred from taking an equity position in the firm that would enable it to share in any appreciation in the firm's value. These provisions have generated relatively little litigation.

Borrowing and Debt Limitations

Constitutional Provisions

The vast majority of state constitutions impose some limitation on the ability of their states and local governments to incur debt. These constitutional limitations take a variety of forms. Some bar state debt outright.[31] Others impose very low limits on the amount of debt a state may incur.[32] Some cap state debt

or debt service at a fraction of taxable wealth or revenues.[33] Tying the debt limit to a fraction of property wealth or revenue is a particularly widespread way of limiting local government debt.[34] This approach suggests an attempt to limit debt to the "carrying capacity" of the state or locality, so that new borrowing does not result in burdensome taxation or cuts in existing services.

Most commonly, state constitutions rely on a procedural restriction: state or local debt may not be incurred without the approval of a majority (or supermajority) in the legislature, of voters in a referendum, or of both.[35] A legislative supermajority or voter approval requirement may also be combined with a substantive cap on the amount of state or local debt.[36]

For state governments, the procedural requirements are often the real restrictions on debt. As state constitutions can be amended, an absolute prohibition or a low dollar limit on debt can be circumvented by a constitutional amendment authorizing a specific bond issue. As a result, the legal requirements for a constitutional amendment—typically, a combination of a legislative supermajority and voter approval in referendum—also become the requirements for issuance of debt. Thus, although the Alabama Constitution flatly bars state debt, as of the early 1990s, it contained thirty-three amendments authorizing specific bond issues.[37]

Background

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

Apart from the specific historical background, constitutional restrictions on debt may be justified as a means of reconciling the conflict between short-term and long-term interests that debt generates. When a government finances a capital project—a bridge, a school building, a prison—that has long-term benefits, it is appropriate to spread the costs of the project over the project's useful life. Borrowing the money and repaying the debt over a period of decades spreads the cost to the future generations who will benefit from the

project. But the ability to shift the costs into the future may also induce elected officials to incur too much debt. The benefits of the project financed by the debt will be received immediately while the costs of paying off the debt are deferred into the future. As a result, current elected officials may be tempted to approve projects that are not fully cost-justified. After all, they can get the credit for the new project, but the blame for the additional taxes needed to pay off the debt will be borne by their successors. A central justification of constitutional limits on debt is to offset the temptations that can cause elected officials, and the current generation they represent, to burden future generations with unnecessary debt. The constitutional control can provide a constraint likely to be missing from the ordinary political process.

Evasions of the Limits

Like the public purpose requirements, the state debt limitations have not had quite the effect their terms suggest. State constitutions typically require the state or locality to pledge its "full faith and credit" in support of its debt. This means that such a debt is a "general obligation" of the state or locality backed not by a particular revenue source but by the full revenue-raising capacity of the borrowing government. Debt limitations clearly apply to such debt. But today most state and local borrowing does not involve general obligation debt and avoids the pledge of full faith and credit.

Revenue Bonds

Stimulated in part by the desire to avoid the substantive caps and voter approval requirements of their constitutions, states and localities have developed financial instruments that enable them to borrow without pledging their full faith and credit. Instead, the debt is backed only by a specific revenue source. As a result of state judicial interpretation, or in some states, constitutional amendment, such "nonguaranteed" or "revenue bond" debt is not subject to the constitutional limitations that apply to general obligation debt.

Initially, the only revenue bonds exempt from the debt limitations were self-liquidating project finance bonds, for example, bonds issued to finance a project whose revenues would be used to pay off the debt incurred to finance the project. For example, to build a bridge, the state might issue a bond, promise the bond buyers to impose a toll on the bridge financed by the bond, and pledge the revenues generated by the bridge toll to repay the bonds. State courts found that as long as the state limits its payment obligation to the "special fund" generated by the project the debt does not pose a risk to future taxpayers and, thus, is not "debt" within the meaning of the state constitutions.

Over time, however, the revenue bond concept spread well beyond debts backed solely by charges imposed on the use of the facilities financed by borrowing. One extension involves bonds backed by taxes on activities that benefit from the project financed by the bond. Many courts have held that bonds to finance highway construction are not "debt" in the constitutional sense if they are backed solely by taxes on motor fuels and vehicle license fees. In theory, the new highways so financed will generate the additional auto usage and the additional fuel tax and fee revenues that will pay off the debt and thus do not pose a risk to future taxpayers.[38] Similarly, a bond issued to finance a convention center might not be "debt" within the meaning of the constitutional constraint if it is backed by taxes on hotel occupancy, on the theory that the convention center would promote hotel use, generate the necessary new hotel tax revenues, and thus not threaten future taxpayers.[39] The cases are not always consistent,[40] but the trend has been to loosen the nexus required between the project financed by the bond and the revenues committed to paying off the obligation in order to justify avoidance of the debt limitation.[41]

Lease Financing

Lease financing extends the revenue bond concept—and the exemption from debt restrictions—from the creation of new revenue-generating infrastructure to the construction of new government facilities. In a lease-financing scenario, a private firm or a public authority issues the necessary bonds and builds the facility. Private debts are certainly not subject to constitutional debt limits, and virtually all state courts have held that the debts of public authorities are not debt in the constitutional sense since the authorities lack the capacity to impose taxes or pledge the full faith and credit of the state or a locality. To finance the bond, the state or a local government enters into an arrangement with the bond issuer to lease the facility for a period of time, with the government's lease payments covering the annual debt service. So long as the government's commitment to make payments is contingent on its use of the facility and is subject to annual legislative appropriation, most courts have found that the commitment is not "debt" in the constitutional sense. [42]

Subject-to-Appropriation Debt

The closing decades of the twentieth century witnessed the emergence of a new form of revenue bond that dramatically expands the opportunities for evasion presented by the leasing-financing bond. Under this scenario, the debt is issued by an entity, typically a public authority or special district not subject to constitutional restriction, which uses the borrowed funds to undertake some project for the state or a constitutionally restricted locality. This need not involve the construction of a leaseable facility or the payment of rent. Rather the state or locality that benefits from the debt simply contracts with the issuer to make

an annual payment to cover the annual debt service. So long as the contract is subject to annual appropriation—and any duty to make an annual appropriation is clearly disclaimed—most courts that have considered this financing scheme have held that the government's commitment to make a debt service payment is not a legally binding obligation and thus not debt within the meaning of the state constitution.[43]

Subject-to-appropriation debt is a relatively recent development and a particularly blatant evasion of the constitutional debt limitations. It closely resembles so-called moral obligation debt, which loomed large in municipal finance in the 1960s and 1970s. Under the moral obligation scenario, a public authority issued a bond that would be backed by authority revenues, typically, revenues to be generated by the facility to be financed by the bond. If the authority, or potential investors, were uncertain whether the facility so financed would be able to produce the necessary revenues, the state would make a nonbinding commitment of state funds to cover debt service in the event that revenues from the bond-financed projects fell short. The state's moral obligation provided an important safety net for public authority bond issues for moderate-income housing, hospitals, universities, and mental institutions. State courts generally concluded that the legislature's mere "moral" obligation to appropriate debt service did not constitute a debt triggering the constitutional debt limitations.[44] The moral obligation device, however, came under a cloud in the mid-1970s when New York State had to come to the rescue of its Urban Development Corporation and make good on its moral obligation to support the UDC.

In one sense, appropriation clause debt is less troubling than moral obligation debt since states did not make any initial appropriation to the authorities issuing the moral obligation bonds. The state's role was only to serve as a safety net. But that may have created the illusion that moral obligation debt was cost free to the state, and may have led states to take on such debt too easily. Contemporary subject-to-appropriation obligations dispense with the illusion that they involve no cost to the state. Rather, from the beginning, they involve the expenditure of public funds, and they thus can be factored into budget projections and counted as part of regularly recurring government costs. Yet, by treating subject-to-appropriation obligations as part of baseline expenses and treating them like debt from the very beginning, the new device only heightens the tension with the constitutional debt restrictions.

Appropriation-clause debt has become increasingly common in recent years. According to a 2001 statement issued by Standard & Poor's, a leading bond rating agency, "this type of debt issuance is now common in at least 33 states." Default levels have been comparable to those of full faith and credit general obligation bonds. "[W]hile appropriation-backed bonds are not considered debt under a strict legal definition, Standard & Poor's considers all appropriation-backed bonds of an issuer to be an obligation of that issuer and a

failure to appropriate will result in a considerable credit deterioration for all types of debt issued by the defaulting government."[45]

Indeed, in upholding subject-to-appropriation debts, many state courts have candidly acknowledged that the state or locality behind the obligation will do its best to assure that the annual appropriations are made, since failure to make the annual payment would surely have a sharply negative impact on the state's own bond rating. As the California Supreme Court has stated, "we are not naive about the character of this transaction."[46] Courts have repeatedly acknowledged but then rejected the argument that the "practical consequences" of nonpayment will compel states and localities to treat nonbinding appropriation clause debt as binding debt.[47] Instead, courts have relied on the disclaimers of any state legal obligation to pay debt service as conclusively establishing that the dangers for future taxpayers of long-term financial commitments that were the driving force behind the debt restrictions are not presented by appropriation-clause debt.[48]

Not all courts have been happy with this development. Many of the cases in which state supreme courts accepted appropriation-clause debt have been marked by close votes and sharp dissents, with the dissenters decrying the evisceration of the constitutional debt limitations and calling for a "common sense" or realistic interpretation that would recognize that these borrowings are binding in practice.[49] In a dramatic move, the New Jersey Supreme Court recently called into question its acceptance of appropriation clause debt. In its 2002 decision in *Lonegan v. State,*[50] the Court threatened to reverse itself and hold that public authority debt backed solely by state contracts subject-to-appropriation is debt in the constitutional sense. *Lonegan* involved $8.6 billion in bonds for repairing and constructing new public schools—the "largest, most comprehensive school construction program in the nation."[51] The bonds were to be issued by a state authority, and backed by a state subject-to-appropriation contract. The voter approval constitutionally required for new state debt had been neither sought nor obtained. The Court expressed serious doubt about the propriety of the appropriation contract device, but ultimately concluded that since the school construction program involved the "provision of constitutionally required facilities"[52] and was itself a response to the orders of the Court in New Jersey's long-standing school funding litigation, it did not violate the state's debt limitation provision.[53] The Court then set down for reargument the broader question of the constitutionality of subject-to-appropriation debt outside the school construction context.[54]

It is not clear if *Lonegan* will signal a change in the highly deferential approach most state courts have taken to state debt, whether the courts will return to much older practices of limiting the revenue bond to self-liquidating or revenue-generating projects, or whether the lease-financing exemption will be narrowed to require that lease payments reflect fair market rentals rather than

debt service. Certainly, the general trend across the country in recent decades has been one of broad toleration for state and local evasion of constitutional limits so long as the full faith and credit of a government restricted by the state constitution has not been pledged.

Indeed, as a result of these various evasive techniques, approximately three-quarters of all state debt and two-thirds of city and county debt is not subject to the panoply of substantive limitations and procedural requirements found in state constitutions. Debt limits have plainly affected the form of state and local debt, but it is far from clear whether they have affected the total amount of debt. Moreover, evading state constitutions has costs. In order to avoid falling into the category of constitutional debt, these instruments avoid pledging the full faith and credit of the state or locality, and they limit the recourse of lenders seeking principal and interest payments to certain funds. As a result they present a slightly greater risk to investors, and thus usually carry a slightly higher interest rate than general obligation bonds. They also involve greater administrative and legal costs than general obligation debt since issuers not pledging full faith and credit have to provide lenders with other forms of security. Over time, as the bond market has grown familiar—and comfortable—with these debts, the interest rate differential between the guaranteed and nonguaranteed obligations of the same jurisdiction has narrowed, but some distinction usually continues, and the higher administrative costs of issuing these bonds remains.

In addition, as the discussion indicates, public authorities play a major role in the evasion of state constitutional debt limits. Unless the state constitution specifically provides otherwise, state courts have generally found that as public authorities lack the power to impose taxes or to pledge the full faith and credit of their states public authority debt is not subject to constitutional debt limits.[55] In many states public authorities have become conduits for the "backdoor financing" of appropriation-backed debt.[56] Debt avoidance has played an important role in explaining the rise of public authorities and their significant role in state and local governance today.

Taxation and Expenditure Limitations

Background

State constitutional provisions concerning state and local taxation are marked by far greater state-to-state and intrastate variation than the public purpose requirements and the borrowing and debt limitations. State constitutions have traditionally given their greatest attention to the property tax. Like many other features of state constitutions, this is an artifact of history. When states first began to amend their constitutions to address questions of taxation, the property tax was

the dominant mode of taxation for state and local government. As late as 1902, the property tax accounted for 82 percent of total state and local tax collections—including 53 percent of state tax dollars and 89 percent of local tax dollars. Over the course of the twentieth century, the role of the property tax declined. The states generally turned the property tax over to local governments, and came to rely on other revenue sources, primarily sales and income taxes, for state funds. Today property taxes generate no more than 2 percent of state revenues and in many states the property tax generates nothing for the state government at all. The property tax remains the leading source of local revenues—about 75 percent of local tax dollars—although with the rise of other local taxes, intergovernmental assistance, and especially, local nontax revenue sources, the property tax generates only about 30 percent of all local revenues.

State constitutional provisions concerning taxation have two primary strands: (1) equality or uniformity requirements; and (2) substantive and procedural limitations on levels of taxation. These provisions are addressed primarily, but not exclusively, to the property tax.

Uniformity

Almost all state constitutions contain some provisions for uniform or equal taxes.[57] In some states, the uniformity requirement applies to all taxes.[58] In other states, the uniformity or equality requirement is focused on the property tax.[59] The uniformity requirement may apply to tax rates; to the measure of the value subject to tax; or to the determination of the persons or activities subject to a tax. The uniformity requirement appears intended to promote equal treatment of taxpayers. It also presumes that taxation ought to function as a broad and general means of raising revenues from the community, rather than as a policy tool for subsidizing certain programs, for imposing differential burdens on different parts of the community, or for redistribution. The uniformity requirement, thus, poses a challenge for certain common forms of taxation. "A graduated income tax by its very nature lacks the uniformity of taxation typically required by the state constitutional restrictions. A controversy that raged throughout the country, as states enacted income tax levies, was whether the income tax constituted a property tax that violated the uniformity provisions."[60]

As noted, many states limit the uniformity requirement to the property tax, but uniformity has posed challenges even for that tax. Many local governments have long imposed higher property taxes on commercial and industrial properties, which can pass their taxes along to consumers, than on residential property. Typically, in tacit deference to the uniformity requirement, this was accomplished by assessing industrial and commercial property at a higher percentage of value and by assessing residential property at a lower percentage of

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

Substantive Limitations on Local Taxation

Most state constitutions impose some substantive limitations on local taxation. Until recently, reflecting the historic primacy of the property tax in state and local finance, these were focused almost exclusively on that tax. Limitations "first appeared in state statutes in the 1870s and 1880s and were later incorporated in many state constitutions." These were aimed at holding down government spending and protecting property owners. A "second round of constitutional tax limitations appeared during the Depression of the 1930s. They were aimed at forcing tax reductions, thereby stemming the tide of tax delinquencies and tax foreclosures of residential property."[61] A third wave of constitutional limitation of taxation began with California's adoption of Proposition 13 in 1978, and continues to some degree to this day.

These tax limitations have taken a variety of forms, including: (1) limitation on the tax rate; (2) limitation on assessments of particular parcels; (3) limitation on the rate of increase in assessment or the rate of increase in tax due from a taxpayer; (4) limitation on the total levy from the locality as a percentage of the community's assessed valuation; (5) limitation on the rate of increase in the community's total levy.

California's Proposition 13 focuses on limiting tax rates, assessments, and assessment increases. Massachusetts's Proposition 2½, adopted in 1980, addresses the community-wide levy, by limiting the total property tax yield to