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THE TROUBLE WITH TAX INCREASE LIMITATIONS

*David Gamage** & *Darien Shanske***

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ABSTRACT[1]

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. 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.

INTRODUCTION[2]

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, "[a]ny 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

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[1] This essay is an expanded version of two earlier papers the authors previously published in State Tax Notes: David Gamage & Darien Shanske, *On Tax Increase Limitations: Part I — A Costly Incoherence,* 62 ST. TAX NOTES 813 (2011) [hereinafter *Part I*]; David Gamage & Darien Shanske, *On Tax Increase Limitations: Part II — Evasion and Transcendence,* 64 ST. TAX NOTES 245 (2012) [hereinafter *Part II*].

[2] Portions of the Introduction of this article are taken from *Part I, supra* note 1.

[3] For a recent catalog and critical perspective, *see* Richard C. Schragger, *Democracy and Debt,* 121 YALE L.J. 860, 866 (2011). Note that Schragger does not specifically address TILs. Note also that TILs are often proposed to be included in the U.S. Constitution. *See, e.g.,* S.J. Res. 23, 112th Cong. § 4 (2011).

[4] CAL. CONST. art. 13A, § 3(a); *see also* ARIZ. CONST. art. 9, § 22(A) (Arizona

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 constrained.[5] The dominant explanations for this failure of TILs involve the ambivalence of voters and/or conniving of politicians.[6] 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 TILs[7]—namely: tax and expenditure limitations, state or local debt limitations, special state or local procedural rules for debt issuance,[8] state and local balanced budget rules, or tax increase limitations at the local level.[9] This is because all of these

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requires a two-thirds vote when providing for an increase in state revenue through such means as taxation, state fees or assessments). 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, two-thirds, requirement as to raising taxes in an "emergency." *Id.* art. X § 6(a).

[5] *See, e.g.*, Mathew D. McCubbins & Ellen Moule, *Making Mountains of Debt Out of Molehills: The Pro-Cyclical Implications of Tax and Expenditure Limitations*, 63 NAT'L TAX J. 603, 603 (2010); BRUCE E. CAIN & GEORGE A. (SANDY) MACKENZIE, PUB. POL'Y INST. CAL., ARE CALIFORNIA'S FISCAL CONSTRAINTS INSTITUTIONAL OR POLITICAL? 4 (2008), http://www.ppic.org/content/pubs/report/R_1208BCR.pdf.

[6] *See also* CAIN & MACKENZIE, *supra* note 5, at 25–26.

[7] As a 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 (TELs). Isabel Rodriguez-Tejedo & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises*, *in* WHEN STATES GO BROKE 9, 23 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012). We focus our discussion on TILs.

[8] 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 *infra* Part II.C.

[9] 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,

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.[10] 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 game of "Pin the Tail on the Donkey[;]" we are all spun around and may end up pinning the tail anywhere at all.[11]

I. SEEING THROUGH THE "RAISING TAXES" MIRAGE

Just as one needs time 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.[12] 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.

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we discuss local-level TILs *infra* Part II.D.

[10] *See* Richard Briffault, *Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 947–49 (2003) (on debt limitations); Kirk J. Stark, *The Right to Vote on Taxes*, 96 NW. U. L. REV. 191, 216–17 (2001) (on local tax limitation regimes). Neither Briffault nor Stark argue that current versions of these limitations are actually achieving these other goals. *See also*, Yilin Hou & Daniel L. Smith, *Do State Balanced Budget Requirements Matter? Testing Two Explanatory Frameworks*, 145 PUB. CHOICE 57, 78 (2009) (finding some effect of certain balanced budget rule regimes).

[11] *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 ST. TAX NOTES 1, 9 (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1690614## (arguing the labels are often arbitrary and misleading).

[12] DANIEL SHAVIRO, DO DEFICITS MATTER? 101–02 (1997) [hereinafter DEFICITS].

government, say for a maximum of $100 billion.[13] The U.S. government would then reduce spending by that very same amount, $100 billion.[14] 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 "illustrate[s] the empty formalism of our concepts of Government revenues and Government expenditures."[15] 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.[16]

There is no need to imagine much as governments have frequently engaged in Bradford-type maneuvers. As Kleinbard notes, the Internal Revenue Code (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, such as the Department of Energy for "[qualif[ied]] gasification projects."[17] State tax systems are, of course, full of similar credits.[18]

Daniel Shaviro offers a different, real life example of Bradford's insight.[19] 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

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

[14] DEFICITS, *supra* note 12, at 101–02.

[15] Edward D. Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1, 2 (2010).

[16] For further discussion, *see* David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19, 51–53 (2011) [hereinafter *Three Essays*].

[17] Kleinbard, *supra* note 15, at 2 (citing 2009–16 I.R.B. 802, a notice about implementing I.R.C. § 48B).

[18] *See, e.g.*, CAL. REV. & TAX. CODE § 6010.8 (West 1998) (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, e.g.*, DEPARTMENT OF FINANCE, TAX EXPENDITURE REPORT (2011–12), http://www.dof.ca.gov/research/documents/Tax_Expenditure Rpt_11-12-Web.pdf. At least 47 states provide some information on their tax expenditures. *See Tax Expenditure Reports*, INST. ON TAXATION AND ECON. POLICY, http://www.itep.org/other_resources/state_tereport.php (last visited Jan. 16, 2013).

[19] Daniel N. Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 TAX L. REV. 187, 192–94 (2004).

this should count as a "spending cut" because, in effect, the federal government would be out less money.[20] 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 through smaller checks cut by the Social Security Administration.[21] 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," therefore, 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,[22] 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,[23] 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.[24]

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[20] *Id.*

[21] *Id.*

[22] Of course, it is not at all clear how this could be achieved.

[23] I.R.C. § 164 (2008). *See, e.g.*, JOINT COMM. ON TAX'N, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS *2009–2013*, at 44–45 (2010), https://www.jct.gov/publications.html?func=startdown&id=3642.

[24] *See generally* Louis Kaplow, *Fiscal Federalism and the Deductibility of*

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.[25] Furthermore, constitutional law or other legal/political constraints sometimes impel federal and state legislatures to operate through tax expenditures.[26] 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.[27] For instance, last term, the Supreme Court authorized states to subsidize religious schools through the tax code when they could not subsidize them directly.[28]

C. Step 3: Wrong Question

Perhaps it is possible that some rough baseline could be established for "tax expenditures";[29] and that this baseline could be made enforceable,[30] and that thereby the notion of "tax

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State and Local Taxes Under the Federal Income Tax, 82 VA. L. REV. 413, 416–18 (1996).

[25] For a recent summary of the global failure to define tax expenditures or limit their use, *see generally* Steven A. Dean, *The Tax Expenditure Budget is a Zombie Accountant*, 46 U.C. DAVIS L. REV. 265 (2012).

[26] *See* Brian Galle, *The Tragedy of the Carrots: Economics and Politics in the Choice of Price Instruments*, 64 STAN. L. REV. 797, 841–42 (2012).

[27] Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566, 2608 (2012); *see also* David Gamage, *The Supreme Court's Health Care Decision and the Problem with Relying on the Taxing Power*, BERKELEY BLOG (June 29, 2012), http://blogs.berkeley.edu/2012/06/29/the-supreme-courts-health-care-decision-and-the-problem-with-relying-on-the-taxing-power/.

[28] Ariz. Christian Sch. Tuition Org. v. Winn, 131 S. Ct. 1436, 1447 (2011).

[29] Edward D. Kleinbard puts the point this way:

> 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.

Edward D. Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N. U. L. REV. 1, 7 (2010).

[30] We think not, of course, because, among other reasons, almost every tax expenditure becomes a hard question when focused upon. *Pace id.* at 1. Even if tax expenditure reform can be done at a distance, which is not impossible, then the question becomes should we be asking whether a provision is a tax expenditure. *See* Darien Shanske, *Testimony on California's Tax Expenditure Programs and their Effectiveness Joint Oversight Hearing: Assessing Tax Expenditure Programs in Light of California's Fiscal Challenges* 1, 3–4 (2012), http://arev.assembly.ca.gov/sites/arev.assembly.ca.gov/files/Testimony%20of%20Darien%20Shanske.pdf. As argued in this section, we do not think so.

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.[31] In the alternative, it could be sensible to use a non-tax agency to achieve a "tax" objective; assuming we could agree on what a tax objective would be.[32]

Because using the tax system for apparently non-tax ends is more common, and because, as discussed above, it 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

[31] *Cf.* SHAVIRO, *supra* note 12, at 30–40 (applying Musgrave's allocative and distributive roles of government to analysis of taxing and spending); *see generally* David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955 (2004) (arguing for pragmatic analysis of whether a program should be administered through the tax code).

[32] 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.

we would like a government program making higher education more broadly available to be administered in proportion to income.[33] 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.[34] This observation clearly goes to the blurry distinction between taxing and spending; 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. 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.[35] 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 by doling out subsidies, "carrots," to achieve a desired goal rather than achieving that goal through taxation, particularly Pigouvian taxation, which is

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[33] Example drawn from Weisbach & Nussim, *supra* note 31, at 980.

[34] *See supra* Part I.A.

[35] *Cf.* Daniel Halperin, *Tax Expenditures: Budget Control and the Nonprofit Sector*, 2012 TAX NOTES 447, 448–49.

essentially a stick to prevent an undesired behavior.[36] Consider a policy to prevent pollution. Giving subsidies to polluters *not* to pollute drains the fisc of public tax dollars and makes those harming the environment better off.[37] 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.[38] At the very least, more participants than expected can make the expenditure more expensive than expected.[39] 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.[40] 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,[41] 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;[42] however, 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 two-thirds majority.[43]

The fixation on avoiding tax increases can do more than influence the choice of government action; it can also shape the

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[36] Following Galle, *supra* note 26, at 813 ("Sticks are cheaper, more effective, accord better with our moral intuitions, and avoid unwanted incentives to create new harms.").

[37] *Id.* at 799.

[38] *Id.* at 811.

[39] All examples and arguments drawn from *id.* at 811–27; Galle also notes that there is a place for carrots.

[40] For discussion, see *Three Essays*, *supra* note 16, at 53.

[41] A recent working paper found evidence for this. Noel D. Johnson et al., *Pick Your Poison: Do Politicians Regulate When They Can't Spend?* 28 (George Mason Univ. Dep't of Econ., Working Paper No. 12–53, 2012), *available at* http://ssrn.com/abstract=2035611.

[42] *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 STAN. ENVTL. L.J. 3, 6–7 (2009).

[43] Kathleen K. Wright, *The Aftermath of California's Proposition 26*, 62 ST. TAX NOTES 471, 471 (2011)

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."[44] 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.[45]

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.[46] 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, because of the administrative expense and uncertainty as to the optimal number of vehicles. What we 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 a tax is and what a fee is. 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

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[44] *Part 1*, *supra* note 1.

[45] David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 759 (2010) [hereinafter *Preventing State Budget Crises*].

[46] *Id.* at 758.

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.[47]

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.[48] 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 appropriate baseline, and adding new inefficient regulations distorts the economy more, not

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[47] 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* note 30, at 1. The litigation over the meaning of Proposition 26 has already begun. Wright, *supra* note 43. 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 Dist., 820 S.W.2d 301 (Mo. 1991).

[48] SHAVIRO, *supra* note 11, at 40.

less.[49]

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.[50] 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 who is 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.

II. 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.[51] 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.[52]

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[49] *Id.* at 31.

[50] *Id.*

[51] Rodriguez-Tejedo & Wallis, *supra* note 7, at 31–33.

[52] *See, e.g.*, GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION 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).

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.[53] 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 because lower level governments can spend without being disciplined by a central hierarchy or the market.[54] 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.[55] 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.[56] Most American state and local governments currently function under some kind of BBR.[57]

Though mandated by theory and present in practice, it is not

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

[54] Jonathan Rodden, *Market Discipline and U.S. Federalism*, *in* WHEN STATES GO BROKE 123, 123 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012). *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).

[55] Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, *in* FISCAL DECENTRALIZATION AND THE CHALLENGE OF HARD BUDGET CONSTRAINTS, *supra* note 56, at 56–61.

[56] Rodriguez-Tejedo & Wallis, *supra* note 7, at 31–32.

[57] 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. Poterba, *Balanced Budget Rules and Fiscal Policy: Evidence from the States,* 48 NAT'L TAX J. 329, 330 (1995). Rodriguez-Tejedo & Wallis put the number of states at 40. Rodriguez-Tejedo & Wallis, *supra* note 7, at 33.

actually clear that BBRs have that much of an effect on the size of state governments in the longer term.[58] What is relatively clear is that a TIL along with a BBR constrains state policy choices in the short term.[59] 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),[60] but such long-term strategies do not much help states pay their bills in the short term when revenues collapse.[61]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 harder for revenue to be raised quickly.[62] As a matter of both efficiency and equity, increasing tax rates will, however, often be the better answer.[63] 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.[64] 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,

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[58] Rodriguez-Tejedo & Wallis, *supra* note 7, at 23; *see also* Hou & Smith, *supra* note 10, 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. Hou & Smith, *supra* note 10, at 60, 70–72.

[59] Rodriguez-Tejedo & Wallis, *supra* note 7, at 37–38.

[60] 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* WHEN STATES GO BROKE 57, 57 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012). 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 68–69. 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 id.* at 61–65, *with* Catherine Fisk & Brian Olney, *Labor and the States' Fiscal Problems*, *in* WHEN STATES GO BROKE 253, 273–78 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012). 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*, at 67–71.

[61] Rodriguez-Tejedo & Wallis, *supra* note 7, at 37–38.

[62] But they do not make it impossible. *See infra* Part III.

[63] Gamage, *supra* note 45, at 774.

[64] *Id.* at 772–74, 785–88, 90–91.

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.[65]

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

The most venerable—and arguably effective—fiscal restraint typical of state constitutions is the special Debt Limitation Procedure (DLP).[66] 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.[67] Also like TILs, DLPs are easily avoided.[68] In the 19th century, state-level DLPs were a response to state-level fiscal crises; the advent of state-level DLPs forced more borrowing to the local level.[69] 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.[70] 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 borrowing is large and robust.[71] There are very few defaults, and the formal debt burden of states seems manageable (versus "hidden" debts, like pension obligations, perhaps).[72] Furthermore, DLPs have generally succeeded in preventing the regular borrowing for operating deficits at the

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[65] Rodriguez-Tejedo & Wallis, *supra* note 7, at 37 ("State governments grew over most of the twentieth century, despite the proliferation of balanced budget amendments . . . and tax and expenditure limitations.").

[66] Briffault, *supra* note 10, at 947–48.

[67] *See, e.g.*, CAL. CONST. CODE art. 16, § 18 (West 1996 & Supp. 2012).

[68] *See generally* Briffault, *supra* note 10, at 925. Briffault states that:

> As a result of the rise of revenue bonds, lease-financing arrangements, subject-to-appropriation debt, and other various evasive techniques, nearly three-quarters of all state debt and two-thirds of city and county debt are "non-debt debts" exempt from the panoply of substantive limitations on and procedural requirements for debt found in state constitutions.

Id.

[69] Rodriguez-Tejedo & Wallis, *supra* note 7, at 24–25.

[70] *Id.* at 24; *See also* Briffault, *supra* note 10, at 919–22; ROBERT B. WARD, NEW YORK STATE GOVERNMENT 289–97 (2d ed. 2006) (stating that a vast majority of New York's debt issued by public authorities is not subject to New York's debt limitation).

[71] Rodriguez-Tejedo & Wallis, *supra* note 7, at 10.

[72] Rodden, *Introduction and Overview*, *supra* note 54, at 138–40.

state and local level; state and local borrowings are almost entirely tied to a specific capital project.[73]

Why have debt limitation procedures had this relative success? One compelling answer is that the nature of the procedures, and the judicial doctrines interpreting them, impelled states and localities to better financings.[74] Thus, a requirement that a separate vote be held on a borrowing, a vote where costs and benefits were both before the voters, had a salutary effect on political economy.[75] 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.[76] 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.[77]

This then gets us to the essential disanalogy between TILs and DLPs, 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.[78]

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

[73] *See* Rodriguez-Tejedo & Wallis, *supra* note 7, at 26.

[74] *Id.* at 27.

[75] *See id.* at 26.

[76] *Id.*; *see also* ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE 183 (1992); Briffault, *supra* note 11, at 918–19.

[77] Darien Shanske, *Clearing Away Roadblocks to Funding California's Infrastructure,* 54 ST. TAX NOTES 567, 567 (2009) [hereinafter *Clearing Away Roadblocks*].

[78] *See* Rodriguez-Tejedo & Wallis, *supra* note 7, at 26–27.

a perception that they did not sufficiently constrain borrowing.[79] 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,[80] gives minorities, which can be quite small, inordinate power.[81] 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.[82] 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.[83] New DLPs not only fortify judicial review of assessments, but also essentially require a majority vote on top of that.[84] 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).[85]

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. 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.[86] 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

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[79] *See, e.g.*, *id.* at 21.

[80] CAL. CONST. art. 16, § 18(a).

[81] *See, e.g.*, *Clearing Away Roadblocks*, *supra* note 77.

[82] *See, e.g.*, CAL. CONST. art, 13C, § 2(d).

[83] *See, e.g.*, *Clearing Away Roadblocks*, *supra* note 77.

[84] CAL. CONST. art. 13C, § 2(d); *see Clearing Away Roadblock*, *supra* note 77.

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

[86] *See, e.g.*, Rider v. City of San Diego, 959 P.2d 347, 353 (Cal. 1998) (stating that "the debt limitation in section 18 [of the California Constitution] does not apply when a local government enters into a contingent obligation"); *see also* Briffault, *supra* note 10, at 920 (stating that courts do not find governmental commitments to be "debts" in a constitutional sense so long as the payment is a contingent obligation).

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.[87] 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.[88]

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.[89] Furthermore, at this point even very large lease financing is 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.[90] Accordingly, the market charges such entities more when they borrow in the form of a lease than through an ordinary tax increase secured borrowing.[91] In sum, TILs make it very difficult for governments to pay for any even vaguely capital project (e.g., portable classrooms or buses) 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, enter into long-term leases instead of using current funding or formally borrowing. Because of TILs and DLPs, these 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, using 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.[92] And so when

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[87] AMDURSKY & GILLETTE, *supra* note 76, at 216.

[88] *See, e.g.*, RICHARD BRIFFAULT & LAURIE REYNOLDS, CASES AND MATERIALS ON STATE AND LOCAL GOVERNMENT LAW 868–70 (7th ed. 2009).

[89] *See id.* at 870.

[90] *See* Rodriguez-Tejedo & Wallis, *supra* note 7, at 26–27; *see also* Briffault, *supra* note 10, at 919–20.

[91] *See* Briffault, *supra* note 10, at 920.

[92] *See id.*

the inevitable fiscal crisis comes, a large percentage of the operating budget will have been promised to 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.[93] This is true both for the relative credibility of the no bailout pledge in the United States, and for the large number of jurisdictions in the United States competing with each other. In competing with one another, the different jurisdictions, like private actors, are theorized to be honing their particular offering of costs and benefits. In doing so, the overall size of government is thought to restrain—at least at the local level, where there is most competition—homevoters[94] who are only paying for the governmental services that they want.[95] This approach to local government, generally associated with the work of Charles Tiebout,[96] is far from indisputable on normative or empirical grounds.[97] 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 restrained government in practice.[98]Thus, though not an explicit part of state fiscal constitutions,[99] jurisdictional competition is certainly a

[93] *See supra* Part I.A.

[94] This is William Fischel's felicitous phrase, and his book is the modern classic embracing jurisdictional competition. WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS (2001).

[95] Charles M. Tiebout, *A Pure Theory of Local Expenditures,* 64 J. POL. ECON. 416 (1956).

[96] *See generally id.*

[97] *See, e.g.*, Darien Shanske, *Above All Else Stop Digging: Local Government Law as a (Partial) Cause of (and Solution to) the Current Housing Crisis*, 43 U. MICH. J.L. REFORM 663, 682–96 (2010) [hereinafter *Above All Else*].

[98] *See id.* at 686, 691; *see* WALLACE E. OATES, *The Many Faces of the Tiebout Model, in* THE TIEBOUT MODEL AT FIFTY: ESSAYS IN PUBLIC ECONOMICS IN HONOR OF WALLACE OATES 21, 35–36, 42 (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 II — Localism and Legal Theory*, 90 COLUM. L. REV. 346, 405–06, 417 (1990).

[99] 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.*, *Above All Else*, *supra* note 97, at 682–85, 700–01.

means for controlling the size of government, and a means that, as a matter of theory and practice, has been more successful than TILs.[100]

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.[101] Now, up to this point, we have focused primarily on state-level TILs, but TILs are often in place at the local level. 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, famous for restricting local property taxes, 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.[102]

TILs at the state level have a similar impact on inter-state jurisdictional competition. Suppose, for instance, that California wants to be more like Texas.[103] California could lower or abolish its non-Texas taxes (e.g., the Corporate Income Tax) by majority vote, but to add a new Texas tax (i.e., the Margin Tax)[104] or increase an existing alternative tax (i.e., the property tax) or improve 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.[105]). 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

[100] *See id.* at 687–88.

[101] *See* FISCHEL, *supra* note 94, at 98–128.

[102] CAL. CONST. art 13A, §§ 1–4 (§§ 1 and 2 restricting property taxes; § 3 state-level TILs; § 4 local-level TILs).

[103] 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.*, Memorandum from Christopher Thornberg, Ph. D., on Revenue Implications of the Tex. Tax Structure to Cal. Legislative Bodies (Mar. 12, 2012) *available at* http://arev.assembly.ca.gov/sites/arev.assembly.ca.gov/files/Thornberg_Testimony.pdf.

[104] California's proposed Business Net Receipts Tax resembled Texas's Margin Tax. TEX. TAX CODE ANN. § 171.0002 (West 2008) (detailing what is exempt from qualifying as a tax entity under the Tax Code, including sole proprietorships and general partnerships); CAL. COMM'N ON THE 21ST CENTURY ECON., FINAL REPORT 41–42 (2009), http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf.

[105] CAL. CONST. art. XVIIIA, § 3 (requiring a two thirds vote to pass legislation that increases taxes).

locally."[106] Not only is this a less efficient use of revenues, states typically rely on more volatile revenue sources; 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.[107]

E. A Concluding Note on Doctrinal Stress and "Completomania"[108]

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, un-administrable because there is no tractable conceptual content. There *are* unsound doctrines, such as, in our view, the notion of a "traditional government function."[109] 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 requires 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

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[106] *Part II*, *supra* note 1, at 249.

[107] For further discussion, *see generally Preventing State Budget Crises*, *supra* note 45, at 749–60.

[108] This phrase is from Marianne Constable and much of the analysis also (loosely) follows from her work. MARIANNE CONSTABLE, THE LAW OF THE OTHER: THE MIXED JURY AND CHANGING CONCEPTIONS OF CITIZENSHIP, LAW, AND KNOWLEDGE 91 (1994) ("When a 'complete' code exists, new situations raise uncertainties about written law that must be addressed either through interpretation or further legislation"). *See generally* MARIANNE CONSTABLE, JUST SILENCES: THE LIMITS AND POSSIBILITIES OF MODERN LAW 111–31 (2005).

[109] *See* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 539 (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, 421–22 (2010).

algorithm for automatically distinguishing leases from debts.[110] Yet by slow process of common law reasoning, workable rules of thumb can be developed.[111] 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.

That TILs frustrate the application of practical reasoning should not be surprising. 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.[112] Accordingly, TILs, the most current form of a rule-based approach to political decisions, do not work any better than the rules that preceded TILs. Indeed TILs 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.[113] 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" by making it clearer to voters what it is that they are voting on.[114]

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[110] The key points here are from Aristotle. ARISTOTLE, THE 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).

[111] To use Karl Llewellyn's phrase, what great judges posses is "situation sense," which is what allows them to craft (and revise) functional judicial categories and rules. KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 121, 402 (1960); *see also* ANTHONY T. KRONMAN, THE LOST LAWYER: FAILING IDEAS OF THE LEGAL PROFESSION 35–36, 209–10, 224–25 (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 L. CULTURE & HUMAN. 352, 352, 354–55, 376, 381 (2008) (arguing, among other things, that modern jurisprudence systematically suppresses the role of practical reasoning, maintaining that "[w]e are in a sense defined by practices and norms that deny that we are defined by practices and norms.").

[112] For further discussion of fee jurisprudence, *see infra* Part III.C.

[113] *Part II, supra* note 1, at 249.

[114] Rodriguez-Tejedo & Wallis, *supra* note 7, at 38.

III. THINKING MORE PRECISELY ABOUT THE EVASION OF TILS[115]

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 . . . .[116]

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 changes in State taxes enacted for the purpose of increasing revenues"[117]—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 expenditure would substitute for the increased spending, while the tax shift would transfer tax liability to where the majority wanted it to

[115] Portions of Part III of this article are taken from *Part II*, *supra* note 1.

[116] This language is from California's TIL prior to the passage of Proposition 26 in November 2010. *Compare* CAL. CONST. art. 13A, § 3 (1996), *with* CAL. CONST. art. 13A, § 3(a) (2012) (amending the provision to reflect that any higher tax burden must be voted upon prior to implementation as well as detailing key exceptions to the use of the word "tax."); *see also* ARIZ. REV. STAT. ANN. art. 9, § 22(A)–(D) (2001).

[117] CAL. CONST. art. 13A, § 3 (1996).

be.[118]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).[119]

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).[120] Those refundable credits should phase out with income, so that low-income taxpayers could be completely reimbursed for benefit charges, whereas higher-income taxpayers would be reimbursed only partially.[121] For example, consider tuition at public colleges and universities. Even today, tuition at those schools is a relative bargain compared with that at many private colleges, and yet recent dramatic increases in tuition still undermine the public purpose of state schools of providing affordable public higher

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[118] For some examples, *see supra* Part I.A.

[119] And enacting this strategy through business tax expenditures would be even easier.

[120] *See, e.g.*, Darien Shanske, *Going Forward by Going Backward to Benefit Taxes*, 3 CAL. J. POL. & POL'Y 1, 3 (2011), *available at* http://www.degruyter.com/view/j/cjpp.2011.3.2/cjpp.2011.3.2.1133/cjpp.2011.3.2.1133.xml.

[121] For more on this approach, *see id.*

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 those 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 might 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 that problem, the tax credits could be made *advanceable*. The Affordable Care Act's Premium Tax Credits in the new IRC section 36B[122] is an example of how tax credits can be made advanceable. Under section 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.[123] Similarly, for example, state universities could receive advanceable state tax credits to cover low-income taxpayers' tuition.[124]

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.[125]

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[122] I.R.C. § 36B (2006).

[123] 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* (Benjamin N. Cardozo Sch. L. Jacob Burns Inst. for Advanced Legal Stud., Working Paper No. 301, 2010), *available at* http://ssrn.com/abstract=1633556http://ssrn.com/abstract=1633556 (summarizing the many tax provisions of the Affordable Care Act); *see also* David Gamage, *Perverse Incentives Arising From the Tax Provisions of Health Care Reform Why Further Reforms are Needed to Prevent Avoidable Costs to Low and Moderate Income*, 65 TAX L. REV. 669 (2012) [hereinafter *How the ACA Will Create Perverse Incentives*].

[124] 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.

[125] *See, e.g.*, *How the ACA Will Create Perverse Incentives*, *supra* note 123, at

The limit on this strategy is the preexisting state income tax or other preexisting state taxes.[126] 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.[127]

Hence, taken to the limit, preexisting state taxes become the mechanism for achieving progressivity in state spending under the BCPP strategy. Further, 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.[128] 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 . . . ."[129]

This new rule prevents the simple tax expenditure strategy for evading TILs.[130] The kind of shifts in tax burden required to achieve a revenue-neutral package will increase the taxes on at least "any" taxpayer, meaning that any such proposal requires a supermajority.[131] 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

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40 (explaining how this strategy can be used to mitigate certain problems with the Affordable Care Act).

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

[127] *Id.* at 40.

[128] *See, e.g.*, CAL. CONST. art. 13A, § 3(c) (Proposition 26 is retroactive to January 1, 2010 and thus appears to invalidate the swap); 2010 Cal. Legis. Serv. Prop. 26 § 1(e) (West) (new, stricter TIL seems to target this "swap"); Lenny Goldberg, *California Governor Approves Gas Tax Swap*, ST. TAX TODAY, Mar. 26, 2010 (describing complicated revenue-neutral package).

[129] CAL. CONST. art. 13A, § 3(a).

[130] *See supra* Part III.A.

[131] CAL. CONST. art. 13A, § 3(a).

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."[132]

Thus, the California State legislature or local governments[133] 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,[134] 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.[135]

Despite the broad language restricting "any tax, license or fee[]," [136] 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

[132] *Id.* § 3(b)(2).

[133] Proposition 26 made parallel changes to the ability of local governments to raise taxes. *See* CAL. CONST. art. 13C, § 1(e).

[134] In other words, if one is suffering from some form of "completomania". *See* CONSTABLE, *supra* note 108, at 91.

[135] MO. CONST. art. X, § 22(a).

[136] *Id.*

subject to [the Missouri TIL]."[137]

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 provide tax credits for payments made to these new quasi-private entities.[138] In other words, no fee that could be argued to be a tax would be required.

Moreover, there is a sound reason that 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?[139] 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.[140] Should we consider these strategies to be

[137] Keller v. Marion Cnty. Ambulance Dist., 820 S.W.2d 301, 303, 305 (Mo. 1991) (en banc); *see also* Arbor Inv. Co. v. City of Hermann, 341 S.W.3d 673, 675, 678–82 (Mo. 2011) (en banc) (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).

[138] 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 ensure 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.

[139] 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 generally* Halperin, *supra* note 35. On California's Proposition 218, which specifically targeted special assessments, a particularly venerable and potentially useful type of benefit charge. *See, e.g., Clearing Away Roadblocks, supra* note 77, at 569–70.

[140] 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

unscrupulous dodges? We think not. There is ample evidence that voters desire both lower taxes and increased spending on all of the major programs on which governments spend significant resources.[141] 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.

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, 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.[142] Markets are generally superior to elected

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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 ST. TAX NOTES 561, 567 (2011). State-level tax expenditures have long been—and remain—very substantial. *See Three Essays*, *supra* note 16, at 52. However, we do not know of a specific instance where a tax expenditure was explicitly linked to a higher fee. As noted above, 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. *See supra* Part IV.A.

[141] *See, e.g.*, *Three Essays*, *supra* note 16, at 96; David Gamage, *Managing California's Fiscal Roller Coaster*, 49 ST. TAX NOTES 659, 663 (2008).

[142] For the original distinction between allocative and distributive fiscal policy, see RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN

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.[143] 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 (a.k.a. "deadweight loss").[144] 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, benefit charges are more politically efficacious in shaping the government in accordance with the voters' wishes. Second, to the extent benefit charges raise funds while creating less excess burden or deadweight loss, 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, police, and parks.[145] There is a particular local government levy that, to some extent,[146] acts as a

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PUBLIC ECONOMY 17 (1959).

[143] *See generally* Richard M. Bird & Thomas Tsiopoulos, *User Charges for Public Services: Potentials and Problems*, 45 CAN. TAX J. 25 (1997).

[144] For discussion of these concepts, *see Three Essays*, *supra* note 16, at 61–65.

[145] *Above All Else*, *supra* note 97, at 703–04 (discussing local amenity "bundling rules").

[146] *See, e.g.*, Darien Shanske, *How Less Can Be More: Using the Federal Income Tax to Stabilize State and Local Finance*, 31 VA. TAX REV. 413, 456 (2012) (reviewing the evidence and concluding that there is an argument that property taxes function as benefit taxes at least partially). Other local levies,

blended price for these local amenities, and this is the property tax. Yet, as we have seen,[147] TILs at the local level obstruct the proper functioning of jurisdictional competition as to taxes.[148]

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).

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 decision making 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 a TIL or bunt the runners forward with jurisdictional competition[149]—it turns out to be quite

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such as parcel taxes, assessments, and development impact fees can also serve as part of a blended price for a local amenity bundle.

[147] *See supra* Part III.D.

[148] *Part II, supra* note 1, at 247–49.

[149] There are 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 &

difficult to do both.

Christopher S. Elemendorf, *Why Party Democrats Need Popular Democracy and Popular Democrats Need Parties*, 100 CAL. L. REV. 69, 104–05 (2012).