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## The American Fiscal Constitution\*

Kenneth W. Dam†

*The United States Constitution contains relatively few provisions explicitly concerned with the authority of the federal government and the states to tax and spend. Nevertheless, an impressive structure of rules has evolved governing the division of fiscal powers and responsibilities within our federal system. These rules include Supreme Court decisions interpreting the Constitution, key framework legislation, and implicit understandings derived from existing practice. Professor Dam constructs a general outline of the resulting American Fiscal Constitution, and provides a contrasting view of the West German fiscal constitution. He also offers some tentative conclusions about how federal grants-in-aid and revenue sharing have affected the distribution of fiscal benefits and burdens within our system.*

The notion of an American Fiscal Constitution may strike most American constitutional lawyers as odd. The Constitution has little to say about taxation and expenditures, and what it does say is neither detailed nor comprehensive. The Framers were content to

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deal with a few key issues rather than specify the respective fiscal powers and responsibilities of the federal government and the states. In the *License Tax Case*<sup>1</sup> of 1866 Chief Justice Chase was able to summarize the constitutional rules on the federal taxing power rather adequately in a few sentences:

[T]he power of Congress to tax is a very extensive power. It is given in the Constitution, with only one exception and only two qualifications. Congress cannot tax exports, and it must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity. Thus limited, and thus only, it reaches every subject, and may be exercised at discretion.<sup>2</sup>

The constitutional provisions on federal expenditures and on state taxing and spending are even sparser. Yet when one contemplates the Constitution as a whole, considering provisions not specifically directed to fiscal matters and taking into account the federal structure created by the Constitution, an imposing edifice of powers and limitations can be perceived. The result is what I shall call the Fiscal Constitution. By that I mean the sum of the constitutional provisions bearing on taxation and expenditure, including both rules defining the fiscal competence of the branches of the federal government and rules allocating taxing and spending powers between the federal government and the states.

Supplementing the rules of taxation and expenditure found in the Constitution are several statutes that are so far-reaching in their implications for year-by-year fiscal decisions that they deserve to be thought of as quasi-constitutional. The most important are the Budget and Accounting Act of 1921<sup>3</sup> and the Congressional Budget and Impoundment Control Act of 1974.<sup>4</sup> Another statute that may become as historically important is the State and Local Fiscal Assistance Act of 1972,<sup>5</sup> which inaugurated the general revenue sharing program. American constitutional law does not have a separate category to describe these "framework" statutes, though they are increasing in importance.<sup>6</sup> Although such statutes can be amended

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<sup>1</sup> 72 U.S. (5 Wall.) 462 (1866).

<sup>2</sup> *Id.* at 471.

<sup>3</sup> Budget and Accounting Act of 1921, ch. 18, 42 Stat. 20 (codified in scattered sections of 31 U.S.C.).

<sup>4</sup> Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 298 (codified in scattered sections of 1, 2, 31 U.S.C.).

<sup>5</sup> State and Local Fiscal Assistance Act of 1972, Pub. L. No. 92-512, 86 Stat. 919 (codified in scattered sections of 26, 31 U.S.C.).

<sup>6</sup> Consider also the War Powers Resolution of 1973, 50 U.S.C. §§ 1541-1548 (Supp. V 1975). See Casper, *Constitutional Constraints on the Conduct of Foreign and Defense Policy: A Nonjudicial Model*, 43 U. CHI. L. REV. 463, 481-82 (1976).

under the same congressional majority rule as any other statute and must comply with the Constitution, it would be a triumph of form over substance to treat them as ordinary legislation.

When we turn from the formal Fiscal Constitution to fiscal practice, we find that the actual pattern of federal and state taxes and expenditures at any one time reflects some rather clear principles. The federation and the states specialize, each selecting certain taxes and certain subjects of expenditure. There are, to be sure, overlaps on both the taxing and spending sides, and the degree of specialization and the scope of the overlaps change over time. But these changes are slow, well-known, and seldom reversed. As we look back over time, the changes seem motivated much less by partisan political differences than by the gradually changing role of government in society. In short, fiscal realities reveal a clearer inter-governmental fiscal structure than does the Constitution itself. Moreover, although the federal Constitution is not concerned with the devolution of state power to local governments, an analogous pattern of specialization in taxing and spending is to be found between state and local governments, again with gradual changes over time.

This stable yet evolving structure reflects a widespread consensus in American society about the respective roles of the federal, state, and local governments. When there is political controversy over federal and state responsibilities it tends to be limited to one or two items on the public agenda, such as the debate today over the financing of welfare. Usually, when a new issue arises with respect to the scope of governmental activity the locus of responsibility between state and nation is not in doubt. Even the recent financial crisis of New York City, which some observers perceived as a crisis of fiscal federalism, brought forth only a minor financing innovation in the form of a three-year "seasonal" loan from the federal government to the municipality, with full repayment required at the end of each fiscal year.<sup>7</sup> Although the independence of New York City within the New York state system of government has been reduced, no change in the allocation of either taxing or spending responsibilities between federal and state government has as yet emerged.

With the thought that this evolving structure is at least as

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<sup>7</sup> New York City Seasonal Financing Act of 1975, 31 U.S.C. §§ 1501-1510 (Supp. V 1975). Federal loans to states and local governments are common, and some are made on a revolving basis. See OFFICE OF MANAGEMENT & BUDGET, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1978, at 288-89 (Table 0-10) (1977) [hereinafter cited as SPECIAL ANALYSES 1978].

important as the provisions of the Constitution, and perhaps can be described as the constitution (with a lower-case "c") underlying the process of public choice, I shall describe this structure in some detail in Part III. But before doing so, I shall set forth in Part I an overview of the provisions of the formal Constitution and the Supreme Court's interpretations of them. Throughout the article, and in somewhat greater detail in Part II, I shall contrast the American Fiscal Constitution with that of another economically advanced constitutional federation—the Federal Republic of Germany.

### I. THE CONSTITUTIONAL PROVISIONS

The Constitution was drafted in an era when the fiscal responsibilities of governments were very different from today. In 1787 the fiscal problem was not so much to raise and spend large sums of money efficiently as to secure a modest source of revenue to finance limited governmental operations. It was also a Constitution for a new nation, to be formed out of states that already had their own tax systems and their own protectionist tariffs. Thus, one of the principal fiscal objectives of the Constitution was to ensure that state tax and tariff policies did not impede the creation of a free trade area among the states or permit some states to profit at the expense of others.

In light of today's vastly changed fiscal conditions, the adaptability of the Fiscal Constitution is truly remarkable. Because the American Constitution is comparatively difficult to amend,<sup>8</sup> it is fortunate that the Framers included only what they considered the minimum conditions for achieving their limited fiscal objectives. The modesty and lack of specificity of the Fiscal Constitution probably account for its durability. The lacunae in the written Constitution have been filled by Supreme Court interpretations and by statutes, which can be changed when conditions change. As a result, the fiscal provisions of the Constitution have been amended only once, and that amendment—the sixteenth—is generally considered today to have been the result more of a mistaken Supreme Court decision<sup>9</sup> than of any defect in the Constitution itself.

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<sup>8</sup> See U.S. CONST. art. V. Probably the most important barrier to amending the Constitution is that it cannot be amended by Congress alone, however great the majority voting for the amendment may be. In this respect the American Constitution differs from most modern constitutions. In the Federal Republic of Germany, for example, the Basic Law can be amended by the affirmative vote of a two-thirds majority in both the *Bundestag*, the popular house, and the *Bundesrat*, an upper house composed of representatives of the *Länder* (states). GRUNDGESETZ [GG] art. 79(2).

<sup>9</sup> *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, *vacating on rehearing* 157 U.S. 429 (1895), *discussed in text at note 82 infra*.

## A. The Role of State and Nation

In considering the formal structure created by the Constitution, one must bear in mind the role of the states in both constitutional theory and current political reality. From the standpoint of constitutional theory, the American states are considered to exist, in an abstract sense, prior to the federation. Though it was "We the People of the United States" who did "ordain and establish this Constitution for the United States of America,"<sup>10</sup> the legislative powers of the federation are not plenary but limited to those delegated to it in the Constitution. Should anyone miss the point, the tenth amendment to the Constitution declares that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."<sup>11</sup>

The legislative competence of the states thus exists independently of the Constitution. The states are entitled to legislate with respect to any subject whatsoever, except as they are specifically prohibited from doing so by the Constitution or as federal legislation is held as a result of the Supremacy Clause to render state legislation inapplicable.<sup>12</sup> Here and there in the Constitution we do find specific prohibitions, either because retention of a particular power by the states was thought by the Framers to be incompatible with a federal system (as in the case of the prohibition against state treaties with foreign powers)<sup>13</sup> or because the Constitution imposes a restriction as part of its guarantees of individual liberty (as in the case of the prohibition against deprivation of "life, liberty or property, without due process of law").<sup>14</sup> A third possibility is that the delegation of a power to the federal government may be taken by implication to withdraw that power from the states. For example, the delegation to the Congress of power to "regulate Commerce with foreign Nations, and among the several States"<sup>15</sup> has been inter-

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<sup>10</sup> U.S. CONST. preamble.

<sup>11</sup> James Madison, in presenting the first ten amendments to the Constitution to the House of Representatives, noted that several of the state ratifying conventions had been "particularly anxious that it should be declared in the Constitution that the powers not therein delegated should be reserved to the States." 1 ANNALS OF CONG. 458. Although Madison suggested that the proposed tenth amendment was "superfluous" and "unnecessary" since "the whole of the instrument" implied the principle it established, he believed that "there can be no harm in making such a declaration." *Id.* at 459.

<sup>12</sup> U.S. CONST. art. VI, cl. 2.

<sup>13</sup> *Id.* art. I, § 10, cl. 1.

<sup>14</sup> *Id.* amend. XIV.

<sup>15</sup> *Id.* art. I, § 8, cl. 3.

puted to deny by implication the power of the states to regulate foreign and interstate commerce in certain circumstances.<sup>16</sup>

The constitutional theory and political reality of federal-state relations have diverged. The general view in the United States, perhaps especially among academics, is that the federal government, far from acting as a government of limited powers, is in political fact a government of comprehensive powers, and that the states have been left to do what the federal government chooses not to do. Though the change in the role of the national and state governments has been great in this century, the dimensions of the change disguise the extent to which the American government remains genuinely federal in nature. However one looks at the American states, they retain an independence and vitality that is all the more remarkable when compared with the role of the constituent units of other federal nations.

In comparison with the *Länder* (states) of the Federal Republic of Germany, for example, the powers reserved to the American states are considerable. In Germany the great bulk of private law is federal, as can be seen by glancing at the German Federal Civil Code, which sets forth in successive chapters the law of obligations (contracts, torts, and restitution), property, family law, and decedents' estates.<sup>17</sup> Other federal statutes govern criminal law, corporations, commercial law, and insurance.<sup>18</sup> The American states, in contrast, are responsible for most of the law in all of these fields. And although American writers like to emphasize the growing displacement of state law by federal statutory regulation, state statutory regulation of business probably remains more significant in terms of actual economic impact than does federal regulation.<sup>19</sup>

Like the German *Länder*, the states have large bureaucracies. In 1973 about one-eighth of the entire U.S. work force (that is, over 9 million people) was employed by state and local governments.<sup>20</sup>

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<sup>16</sup> See *Southern Pacific Co. v. Arizona*, 325 U.S. 761 (1945); *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 299 (1851).

<sup>17</sup> BGB [Bürgerliches Gesetzbuch] §§ 241-853 (law of obligations); *Id.* §§ 854-1296 (property law); *Id.* §§ 1297-1921 (family law); *Id.* §§ 1922-2385 (decedents' estates).

<sup>18</sup> The *Strafgesetzbuch* is the general criminal code of West Germany. The *Handelsgesetzbuch* governs much of what Americans call commercial law and contains the basic law of associations and corporations, although there are additional statutes in both areas. The *Versicherungs-Vertragsgesetz* governs insurance contracts.

<sup>19</sup> Readers who are surprised by this conclusion should consider, among other factors, the vast amount of licensing of occupations and businesses at the state and local level, see generally Gellhorn, *The Abuse of Occupational Licensing*, 44 U. CHI. L. REV. 6, 10-18 (1976), and the profound economic importance of local land use regulation.

<sup>20</sup> ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL

Unlike the German *Länder*, however, which are responsible for administering most federal legislation,<sup>21</sup> American state bureaucracies administer primarily their own statutory law. Situations in which the states administer federal statutory law, such as the Food Stamp Program,<sup>22</sup> are the exception. The U.S. federal government finances many state programs through conditional grants-in-aid, and thus in practice may dictate the content of those state programs, but this is a topic to which I shall return later.<sup>23</sup> Since most federal programs must be administered by the federal government rather than the states, the federal bureaucracy is also large. Over 2,800,000 people work for the executive branch of the federal government (not including another 2,100,000 in the military services).<sup>24</sup>

The existence of local governments in the United States, again in contrast to Germany, is in no way guaranteed by the Constitution.<sup>25</sup> They owe their competence and whatever self-rule they enjoy to state constitutions.<sup>26</sup> Consequently, the division of state taxing and spending powers between state and local governments is a question of state law.

## B. The Separation of Powers

If we look more closely at the federal government, other important features of the American Fiscal Constitution can be seen. Presidential, as opposed to parliamentary, government places an emphasis on the separation of powers or, perhaps the better phrase, "checks and balances" between the executive and the legislature.<sup>27</sup> The consequence in the United States has been the creation of a set of procedural and jurisdictional principles concerning the manner in which powers concededly vested in the national government as a whole are exercised.

FEDERALISM: TRENDS 31 (Table XXII) (1976) [hereinafter cited as TRENDS]. Just over one-half of these employees are in the public education sector.

<sup>21</sup> GG arts. 83-85; see Kauper, *The Constitutions of West Germany and the United States: A Comparative Study*, 58 MICH. L. REV. 1091, 1150-52 (1960).

<sup>22</sup> 7 U.S.C. §§ 2019, 2024 (1970).

<sup>23</sup> See text and notes at notes 163-74 *infra*.

<sup>24</sup> SPECIAL ANALYSES 1978, *supra* note 7, at 164 (Table H-2). These figures do not include the legislative and judicial branches.

<sup>25</sup> The German Basic Law expressly guarantees the right of municipalities (*Gemeinden*) to self-government. GG art. 28(2). At the same time, it must be recognized that American cities probably have more autonomy in fact than do German municipalities.

<sup>26</sup> See generally J. FORDHAM, LOCAL GOVERNMENT LAW 48-107 (rev. ed. 1975). More than thirty-five states have some form of constitutional home rule for municipalities, while some seventeen afford home rule for counties. *Id.* at 73 nn.1 & 2.

<sup>27</sup> See Casper, *Constitutional Constraints on the Conduct of Foreign and Defense Policy: A Nonjudicial Model*, 43 U. CHI. L. REV. 463, 484 (1976).



The "power of the purse" lies in the Congress as a result of the provision that "[n]o money shall be drawn from the Treasury but in Consequence of Appropriations made by Law."<sup>28</sup> The funds that oil the machinery of the executive branch are thus made available through the same constitutional procedure followed in enacting other statutes. Appropriations bills, like other legislation, must be presented to the President for his approval or veto, with the possibility of an override of any veto by the votes of two-thirds of both Houses of Congress.<sup>29</sup>

Congress has enacted two major pieces of budgetary legislation that are of such importance they deserve to be considered part of the Fiscal Constitution in its larger sense. The first, enacted in 1921, governs the executive part of the budget cycle; the second, enacted in 1974, governs the legislative part. The Budget and Accounting Act of 1921<sup>30</sup> establishes the framework within which the annual budget cycle unfolds. The essence of the Act is that the President is to propose to Congress each January a consolidated budget proposal. This "President's Budget" lays out in massive detail the President's financial plan for the ensuing fiscal year.<sup>31</sup> The Act was designed to substitute central presidential planning for the prior practice whereby individual departments and agencies, or even subordinate bureaus, submitted their appropriation requests directly to the Congress.<sup>32</sup> Although the President in his Budget merely proposes and the Congress by action or inaction disposes, the President's Budget tends to set the framework for the ensuing congressional and public debate, especially when a President is willing to use his political capital and his constitutional veto power in support of his Budget.

As the range of governmental activities has expanded in recent decades, the annual executive branch budget cycle supervised by

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<sup>28</sup> U.S. CONST. art. I, § 9, cl. 7. This clause further requires that "a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." *Id.*

<sup>29</sup> Budget and Accounting Act of 1921, ch. 18, 42 Stat. 20 (codified in scattered sections of 31 U.S.C.).

<sup>30</sup> Until calendar year 1976 (fiscal year 1977) the fiscal year ran from July 1 to June 30; fiscal years now begin on October 1. 31 U.S.C. § 1020 (Supp. V 1975).

<sup>31</sup> For a description of the budgetary process prior to 1921, see U.S. PRESIDENT'S COMM'N ON ECONOMY AND EFFICIENCY, THE NEED FOR A NATIONAL BUDGET, H.R. DOC. NO. 854, 62d Cong., 2d Sess. 13-128 (1912).

<sup>32</sup> Prior to 1939 the Bureau of the Budget was located in the Treasury Department, although even then it reported directly to the President. In 1970 the Bureau of the Budget became the present-day Office of Management and Budget. Reorganization Plan No. 2 of 1970, 31 U.S.C. § 16 (1970).

the Office of Management and Budget (OMB) has become more and more a planning and policy-making process. The budget cycle is typically a bruising bureaucratic and political struggle in which a multitude of executive branch agencies strive to increase their share of the budgetary pie while the OMB attempts to fit proposed outlays within a presidentially-set spending target. When agreement between an agency and the OMB is not possible, the President must decide. Those decisions are in no sense cabinet decisions, as would be the case in many other governments. Nor is the Secretary of the Treasury as important in the process as are finance ministers in other countries. It is characteristic of the U.S. presidential system that the budgetary responsibility is vested in an agency within the Executive Office of the President (that is, the OMB) rather than in a ministry of finance, as in nearly all other countries.<sup>33</sup> Thus, the Secretary of the Treasury plays a role not greatly different from any other cabinet member, except insofar as the Treasury is able, as the taxing department, to advise the President on the revenue side of the revenue-expenditure ledger.

The second major piece of budgetary legislation—the 1974 Congressional Budget and Impoundment Control Act—cannot be understood without some appreciation of the traditional distinction between the authorization and the appropriation of expenditures. Traditionally, an authorization bill, which is also subject to a presidential veto, precedes the passage of an appropriations bill. In effect, an appropriation has to pass muster twice in both Houses, once before a legislative “authorizing” committee and once before an appropriations committee. There was a time when the House and Senate Appropriations Committees were able to pass on the annual budget as a whole. A growing trend, however, has been the development of “backdoor spending” techniques in which the appropriations process is short-circuited by forms of authorization that effectively remove any discretion in either the Congress or the President to refuse to consent to the appropriation.<sup>34</sup> These legislative techniques involve such esoteric fiscal devices as trust funds, contract authority, and entitlements.<sup>35</sup> Some such devices exclude the Ap-

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<sup>33</sup> U.S. CONST. art. I, § 7.

<sup>34</sup> See JOINT STUDY COMM. ON BUDGET CONTROL, RECOMMENDATIONS FOR IMPROVING CONGRESSIONAL CONTROL OVER BUDGETARY OUTLAY AND RECEIPTS TOTALS, H.R. REP. NO. 147, 93d Cong. 1st Sess. 10-12 (1973). See generally HOUSE COMM. ON THE BUDGET, 95TH CONG., 1ST SESS., CONGRESSIONAL CONTROL OF EXPENDITURES (Comm. Print 1977).

<sup>35</sup> Trust funds do not usually involve a trust in the private law sense but simply a statutory earmarking of particular receipts for outlays in a related area, with any surplus of receipts over outlays invested in U.S. Treasury securities. Contract authority permits govern-

appropriations Committees entirely from the process. Others present the Appropriations Committees with the alternative of appropriating funds or forcing the federal government to default on its obligations. Regardless of the device used, appropriations committees are divested of any role in determining the level of public spending.<sup>36</sup>

The growth of backdoor spending techniques cannot be attributed to a desire to circumvent the President's veto power. Backdoor spending does not in theory limit the veto power of the President because the President may veto the original authorizing legislation (although any particular President of course may find that the legislation was enacted during the tenure of one of his predecessors). Instead, the prime stimulus for the development of most backdoor spending techniques has been the aspiration of specialized legislative committees of Congress, many of whom adopt an advocacy posture toward the programs they review, to bypass the fiscally more conservative and legislatively less specialized Appropriations Committees.

Backdoor spending, which now accounts for close to one-half of any year's federal outlays, has increasingly converted the presidential budgetary function from one of proposing to Congress how tax and borrowing revenues should be spent to one of estimating expenditures already effectively committed under prior years' legislation. Today the combination of backdoor spending techniques and the momentum of prior years' appropriations dictates the content of roughly three-quarters of each year's expenditures.<sup>37</sup> These so-called uncontrollable outlays<sup>38</sup> will be made unless legislation is

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ment agencies to enter into construction or procurement contracts, with the Appropriations Committee relegated to the clerical function of paying the obligations when they become due. Entitlement programs create rights in individual citizens, for example to food stamps or welfare payments, with the result that Congress has no option but to appropriate funds to meet those obligations.

<sup>36</sup> Other phenomena that arguably constitute a form of backdoor spending are so-called tax expenditures—the subsidization of specific types of activity through the allowance of income tax deductions or credits for expenses related to that activity. See generally S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* (1973), reviewed in Blum, *Book Review*, 1 J. CORP. TAX. 486 (1975). Congress took a small step toward regulating tax expenditures in the Budget and Impoundment Act of 1974 by requiring the President to prepare an annual "tax expenditure budget" for submission to Congress. 31 U.S.C. § 11 (Supp. V 1975).

<sup>37</sup> OFFICE OF MANAGEMENT AND BUDGET, *BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1978*, at 420-21 (Table 16) (1977) [hereinafter cited as 1978 BUDGET].

<sup>38</sup> Uncontrollability is a technical concept. Much of the remaining one-quarter of the budget may not be controllable as a political matter. For example, most of the Defense Department budget is technically controllable because manpower costs constitute over half of the defense budget, but that does not mean that Congress could be expected to reduce defense budget outlays sharply in any particular year.

enacted to stop them. In practice, therefore, the escalating use of backdoor spending techniques has effectively reversed the textbook notion that Congress through the legislative process affirmatively decides upon the amount and content of each year's expenditures.

The budget portion of the 1974 Congressional Budget and Impoundment Control Act<sup>39</sup> bears an interesting parallel to the 1921 Budget and Accounting Act. Whereas the 1921 Act was designed to permit the executive branch to function as a unit in budgetary matters, the 1974 Act is designed to do the same for the Congress. After the President's Budget is submitted in January for the ensuing fiscal year (to commence on October 1), the Congress is required to pass a concurrent resolution by May 15 establishing a recommended level of budgetary authority and outlays, both for the government as a whole and for each major functional category of spending. The normal appropriations process then proceeds, but by September 15 the Congress must pass a second concurrent resolution, either modifying its earlier resolution to reflect the results of the appropriations process or making recommendations for changes in appropriations or taxation to reconcile them with the overall totals in the second resolution.<sup>40</sup> Perhaps more important than this statutory procedure—which cannot by its own force ensure budgetary control or the adherence of the Congress to its own procedures and deadlines—is the creation of a Congressional Budget Office (CBO) and Budget Committees in both houses.<sup>41</sup> The CBO is expected to develop the kind of expertise that has made the OMB professional staff so important and effective in the executive branch budget process, and the Budget Committees will provide a counterweight to other congressional committees that are more interested in individual programs than overall fiscal policy. Although the mechanisms of the 1974 Act are shot through with exceptions designed to protect some of the same programs that had been the beneficiaries of backdoor spending techniques,<sup>42</sup> the first results under the statute have been gratifying to proponents of fiscal responsibility.

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<sup>39</sup> 31 U.S.C. §§ 1301-1353 (Supp. V 1975).

<sup>40</sup> The procedures prescribed by the new Act are set forth at 31 U.S.C. §§ 1321-1353 (Supp. V 1975).

<sup>41</sup> 2 U.S.C. §§ 601-604 (Supp. V 1975).

<sup>42</sup> Social Security, highway, and most other trust funds as well as general revenue sharing are exempt. 31 U.S.C. § 1351(d) (Supp. V 1975). Moreover, if a program has been sheltered from the current year's budget process by past years' authorizing legislation, an improved budget process can do little more than to estimate (as opposed to prescribe) the amount of spending on that program. Hence, although new entitlement programs are subject to the congressional budget process, see 31 U.S.C. § 1351(b) (Supp. V 1975), an increase in esti-

The impoundment control portion of the 1974 Act<sup>43</sup> was designed to resolve a steadily growing political and constitutional issue concerning the President's duty to spend appropriated funds. Although Presidents had long refused to spend certain appropriated funds pursuant to narrowly circumscribed authority under various statutes,<sup>44</sup> the assertion by President Nixon of a constitutional right to refuse to spend appropriated funds,<sup>45</sup> coupled with a broader presidential view of the relevant statutory authorities, led to the impoundment control provisions in the 1974 Act.<sup>46</sup> The Act requires the President to report all proposals to reserve appropriated funds (broadly called "impoundments") to the Congress. Proposals to *defer* expenditures are effective under the statute unless either House disapproves. Proposals to *rescind*, as opposed to defer, become effective only on approval of both Houses. Unfortunately, a President's deferral may be viewed by a legislator as a rescission, a circumstance suggesting that the 1974 Act has not completely eliminated the impoundment issue from potential separation-of-powers controversies.

### C. Limitations on State Taxation

The Constitution places a number of constraints on state taxation. Most of these constraints are intended to prevent states from

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mated spending under existing entitlement programs tends to result in larger overall congressional budget totals unless the decision is taken to cut other more controllable programs. See CONGRESSIONAL QUARTERLY, GUIDE TO THE CONGRESS 132-33 (2d ed. 1976).

<sup>43</sup> 31 U.S.C. §§ 1400-1407 (Supp. V 1975).

<sup>44</sup> These statutes are collected in *Statement of Information, Hearings Before the House Comm. on the Judiciary to Investigate whether Sufficient Grounds Exist to Impeach Richard M. Nixon*, 93d Cong., 2d Sess., Book XII, 57-75 (1974).

<sup>45</sup> See *Impoundment of Appropriated Funds by the President: Joint Hearings on S. 373 Before the Ad Hoc Subcomm. on Impoundment of Funds of the Senate Comm. on Government Operations and the Subcomm. on Separation of Powers of the Senate Comm. on the Judiciary*, 93d Cong., 1st Sess. 364 (1973) (statement of Joseph T. Sneed, Deputy Atty. Gen.).

<sup>46</sup> Recent court decisions have also been on the whole hostile to presidential impoundments. As a matter of statutory construction courts have been reluctant to find that Congress intended to confer discretion upon the executive branch to withhold appropriated funds. See, e.g., *Kennedy v. Mathews*, 413 F. Supp. 1240, 1245 (D.D.C. 1976); see also *Train v. City of New York*, 420 U.S. 35 (1975). Lower court decisions have also developed a distinction between impoundments for program-related reasons and impoundments for collateral reasons, uniformly invalidating the latter. See *State Highway Comm'n v. Volpe*, 479 F.2d 1099 (8th Cir. 1973); *Dubose v. Hills*, 405 F. Supp. 1277 (D. Conn. 1975); *City of Los Angeles v. Coleman*, 397 F. Supp. 547 (D.D.C. 1975) (collecting cases). Occasionally courts have also applied this distinction to sustain discretionary impoundments. See *Pennsylvania v. Lynn*, 501 F.2d 848 (D.C. Cir. 1974). The contention that the President has inherent constitutional authority to impound funds has been almost uniformly rejected. See *Louisiana ex rel. Guste v. Brinegar*, 388 F. Supp. 1319 (D.D.C. 1975) (collecting cases); *Guadamuz v. Ash*, 368 F. Supp. 1233 (D.D.C. 1973).

using their taxing powers to raise revenue on activities or persons outside the state (sometimes called "tax exporting") or from using taxes to protect local economic interests from out-of-state competition. The former limit corresponds to a territorial conception of state jurisdiction and ensures that state taxation is confined within a state's borders. The latter limit derives from the proposition that the Constitution was intended to create a free trade area and that it is not permissible for the American states to engage in the kind of economic protectionism so commonly practiced by nation-states in the international community. Both of these limits have been derived by the Supreme Court from general language that was placed in the Constitution by the Framers for broader purposes. For example, the Due Process Clause is sometimes invoked to protect the territorial objective,<sup>47</sup> and the Commerce Clause is often invoked to achieve the free trade objective.<sup>48</sup>

The only constitutional limitation directed expressly to state taxation is the Import-Export Clause:

No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports, except what may be absolutely necessary for executing its inspection Laws; and the net Produce of all Duties and Imposts, laid by any State on Imports or Exports, shall be for the Use of the Treasury of the United States; and all such Laws shall be subject to the Revision and Control of the Congress.<sup>49</sup>

Although this express prohibition has been construed to apply only to international and not to interstate trade,<sup>50</sup> it nonetheless serves both the territorial confinement and the free trade objectives, albeit imperfectly. The fear that the great port states would take advantage of their key locations to levy tribute upon imports from foreign lands destined for other states was a prime justification for the Import-Export Clause. Under the Articles of Confederation,

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<sup>47</sup> See, e.g., *Union Refrigerator Transit Co. v. Kentucky*, 199 U.S. 194, 204 (1905).

<sup>48</sup> See, e.g., *Freeman v. Hewitt*, 329 U.S. 249, 252 (1946). Courts often confuse the territorial and free trade objectives, and the Supreme Court has sometimes explicitly refused to distinguish sharply between them. See, e.g., *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753, 756 (1967).

<sup>49</sup> U.S. CONST. art. I, § 10, cl. 2. A related limitation is the provision, found in art. I, § 10, cl. 3, that "no State shall, without the Consent of Congress, lay any Duty of Tonnage." A "Duty of Tonnage" includes "all taxes and duties regardless of their manner or form, and even though not measured by the tonnage of the vessel, which operate to impose a charge for the privilege of entering, trading in, or lying in a port." *Clyde Mallory Lines v. Alabama ex rel. State Docks Comm.*, 296 U.S. 261, 265-66 (1935).

<sup>50</sup> *Woodruff v. Parham*, 75 U.S. (8 Wall.) 123 (1868).

“New Jersey, placed between Philadelphia and New York, was likened to a Cask tapped at both ends; and North Carolina between Virginia and South Carolina to a patient bleeding at both Arms.”<sup>51</sup> Through the Export-Import Clause the Framers sought to eliminate this limited but economically significant instance of state taxation having an incidence beyond the confines of the state.

The Import-Export Clause had another purpose as well—to ensure that the power granted to the Congress to “lay and collect . . . Duties [and] Imposts”<sup>52</sup> would be a monopoly power. The federal government would thus be able to adopt a commercial policy responsive to the overall interests of the new nation, balancing the desire of one state to protect its industries against the desire of another to benefit from the lower consumer prices attainable through free trade. Hand in hand with the objective of giving the national government the sole right to make tradeoffs between producer and consumer interests was the objective of assuring the federal government a secure source of revenues. Since, as we shall see, the power to tax property was to be reserved to the states,<sup>53</sup> the chief source of federal revenue was expected to be (and was in fact until the Twentieth Century) customs revenue. The success of the Founders’ great venture depended upon preserving a national monopoly over customs revenue.<sup>54</sup>

Because the Import-Export Clause applies only to international commerce, the principal constitutional limitations on the states must be implied, as suggested above, from more general clauses. To do so has been one of the great, and never finished, tasks of the Supreme Court. The most interesting development has been the Court’s interpretation of the Commerce Clause. On its face, the Commerce Clause does no more than grant to Congress the power “[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.”<sup>55</sup> But by negative implication the congressional power to regulate interstate commerce has been construed to deprive the states of the power to regulate such

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<sup>51</sup> Madison, *Preface to Debates in the Convention of 1787* in RECORDS OF THE CONSTITUTIONAL CONVENTION OF 1787, at 542 (M. Farrand ed. 1937) (abbreviations in original text are spelled out).

<sup>52</sup> U.S. CONST. art. I, § 8, cl. 1.

<sup>53</sup> See text at note 81 *infra*.

<sup>54</sup> On the purposes of the Import-Export Clause, see *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 283-94 (1976); *Youngstown Sheet & Tube Co. v. Bowers*, 358 U.S. 534, 551 (1959) (Frankfurter, J., dissenting); *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419 (1827); Hellerstein, *Michelin Tire Corp. v. Wages: Enhanced State Power to Tax Imports*, 1976 SUP. CT. REV. 99.

<sup>55</sup> U.S. CONST. art. I, § 8, cl. 3.

commerce in certain circumstances, even with respect to activities Congress has not sought to regulate.<sup>56</sup> Moreover, this implied limitation on the states' regulatory power has been extended to limit state taxation of interstate commerce.<sup>57</sup>

Many thousands of pages of the U.S. Reports have been devoted to the subject of determining just what state taxation is precluded by the Commerce Clause. It would hardly serve our purpose here to review the state taxation cases when no less a scholar and judge than Justice Frankfurter has declared:

The history of this problem is spread over hundreds of volumes of our Reports. To attempt to harmonize all that has been said in the past would neither clarify what has gone before nor guide the future. Suffice it to say that especially in this field opinions must be read in the setting of the particular cases and as the product of preoccupation with their special facts.<sup>58</sup>

But it would be a mistake to leave the impression that goods imported into a state from another state, and the income earned thereby, are totally immune from taxation in the importing state. When a tax is nondiscriminatory and fairly apportioned—and hence does not serve to protect local industry, to impose overtly the burden of taxation on citizens of other states, or to subject interstate business to a cumulative or multiple tax burden not borne by local business<sup>59</sup>—chances are the tax will be upheld against constitutional objections. Certainly, the fact that a business firm operates in interstate commerce will not prevent a state from taxing an aliquot portion of its sales or income.<sup>60</sup> Perhaps the best summary of the situation is still to be found in a half-century old article by Professor Thomas Reed Powell:

Law, like politics, makes strange bedfellows. Among the queer-

<sup>56</sup> *Cooley v. Board of Wardens*, 53 U.S. (12 How.) 298 (1851).

<sup>57</sup> *See, e.g., Case of the State Freight Tax*, 82 U.S. (15 Wall.) 232 (1873). The foreign commerce portion of the Commerce Clause also restricts state taxation and to that extent duplicates the Import-Export Clause. *Brown v. Maryland*, 25 U.S. (12 Wheat.) 419 (1827).

<sup>58</sup> *Freeman v. Hewit*, 329 U.S. 249, 252 (1946).

<sup>59</sup> On the multiple burden test, see *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 258, 260 (1938); Hellerstein, *State Taxation of Interstate Business and the Supreme Court, 1974 Term*, 62 VA. L. Rev. 149, 150-51 (1976).

<sup>60</sup> *Complete Auto Transit, Inc. v. Brady*, 97 S. Ct. 1076 (1977) (sales tax); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959) (net income tax). The Congress has repeatedly attempted without success to enact comprehensive legislation that would provide a formula for allocating the income of interstate businesses among the states. At present many states have adhered to a Multistate Tax Compact with roughly the same objectives. *See Hellerstein, State Taxation of Interstate Business and the Supreme Court, 1974 Term*, 62 VA. L. Rev. 149, 153-54, nn.22 & 23 (1976).



est of such companions are the doctrine that the states cannot tax interstate commerce and the fact that they can. As might be anticipated, the doctrine and the fact do not dwell together in perfect amity. The efforts of the Supreme Court to mediate between them have as a rule failed to give full satisfaction to either. . . . The truth is that there is a wrong way and a right way for the states to tax interstate commerce. When the wrong way is adopted, the doctrine maintains its supremacy. When the right way is chosen, the fact prevails. The doctrine then saves its face by the nominalistic legerdemain of asserting that what is being taxed is not interstate commerce but something else. This something else is usually called property. . . . Thus by renaming, the cabbage becomes a rose, and the doctrine that the states cannot tax interstate commerce still struts as a universal though palpably it is something less.<sup>61</sup>

When a state taxes what is clearly property, income, or activities within its borders, and thus does not raise issues of protectionism, extraterritoriality, or multiple burdens, there are few federal constitutional limitations on its powers. Of course, the states have their own constitutions, and these instruments may impose substantial limitations on a state's choice of the types and maximum amounts of taxes to impose.<sup>62</sup> But the federal Constitution limits neither the kinds of taxes that may be imposed nor the maximum rate of tax. As the Supreme Court has repeatedly said, even a state tax so burdensome as to destroy a business does not violate the Constitution.<sup>63</sup>

Taxation, like any other act of a state, is subject to the constitutional guarantees of individual liberties. Thus, a tax bearing selectively on speech or the exercise of religion would likely run afoul of the first amendment.<sup>64</sup> Perhaps the principal general constitutional

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<sup>61</sup> Powell, *State Income Taxes and the Commerce Clause*, 31 *YALE L.J.* 799, 799-800 (1922).

<sup>62</sup> The Illinois Constitution, for example, forbids the legislature to enact a graduated income tax, prohibits counties from assessing real property used in farming at a higher level than single family residential property for property tax purposes, and mandates the eventual abolition of local ad valorem personal property taxes. *ILL. CONST.* art. 9, §§ 3(a),4(b),5(c).

<sup>63</sup> *Stewart Dry Goods Co. v. Lewis*, 294 U.S. 550, 562-63 (1935); *Rox v. Standard Oil Co.*, 294 U.S. 87, 99-100 (1935); *A. Magnano Co. v. Hamilton*, 292 U.S. 40, 45-46 (1934); *Alaska Fish Salting & By-Products Co. v. Smith*, 255 U.S. 44, 48-49 (1921).

<sup>64</sup> See *Grosjean v. American Press Co.*, 297 U.S. 233 (1936); *Murdock v. Pennsylvania*, 319 U.S. 105 (1943); *Follett v. McCormick*, 321 U.S. 573 (1944). Although the first amendment by its terms limits only congressional legislation, its guarantees have been held applicable to the states by the fourteenth amendment. See, e.g., *Cantwell v. Connecticut*, 310 U.S. 296 (1940).

safeguard used to strike down state tax legislation has been the Equal Protection Clause of the fourteenth amendment.<sup>65</sup> State classifications of taxpayers and their activities for purposes of applying differing taxes or tax rates might be held so discriminatory or arbitrary as to transgress the Equal Protection Clause,<sup>66</sup> but states are ordinarily given wide discretion in these matters.<sup>67</sup> The principal use of the Equal Protection Clause has been to strike down state tax statutes discriminating against out-of-state corporations<sup>68</sup>—a further illustration of the point that the Supreme Court's primary concern has been with restricting the power of the states to cast the burden of local taxation on those outside the state or to protect local business.

#### D. Limitations on Federal Taxation

The taxing power of the federal government is even freer of express constitutional limitations than is the state power. As in the case of the states, the federal government is limited in its power to tax speech and the exercise of religion, and it may not use the taxing power in violation of due process or equal protection.<sup>69</sup> But since the federal government is vested with the power to protect domestic enterprise through the imposition of "Duties" and "Imposts" on imports, and to regulate commerce under the Commerce Clause, there is correspondingly less scope for these protections to operate.

A procedural limitation is placed on the decision to tax: "All Bills for raising Revenue shall originate in the House of Representa-

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<sup>65</sup> The Due Process Clause of the fourteenth amendment has had its principal application to state taxation through its limitation on the territorial reach of a state's taxing power. See note 47 *supra*. But the Due Process Clause is also sometimes held to limit the measure of a tax, as where a state improperly imputes the income of one person to another. *Hoeper v. Tax Comm'n*, 284 U.S. 206 (1931). A provision of some importance in constraining state discrimination against nonresidents is the privileges and immunities clause of art. IV, § 2. See *Mullaney v. Anderson*, 342 U.S. 415 (1952); *Toomer v. Witsell*, 334 U.S. 385 (1948).

<sup>66</sup> See, e.g., *Quaker City Cab Co. v. Pennsylvania*, 277 U.S. 389 (1928).

<sup>67</sup> The Supreme Court in recent decades has refused to hold classifications affecting property, income, or activities that are purely internal to the taxing state unconstitutional. See *Kahn v. Shevin*, 416 U.S. 351 (1974); *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973). Recent cases striking down state taxing statutes on equal protection grounds are state court decisions, usually relying on equal protection clauses in state constitutions. See note 139 *infra*.

<sup>68</sup> *WHYY, Inc. v. Glassboro*, 393 U.S. 117 (1968); *Wheeling Steel Corp. v. Glander*, 337 U.S. 562 (1949).

<sup>69</sup> Although the Equal Protection Clause of the fourteenth amendment does not apply to the federal government, the fifth amendment has been held to prohibit discrimination that "may be so unjustifiable as to be violative of due process." *Bolling v. Sharpe*, 347 U.S. 497, 499 (1954).

tives."<sup>70</sup> It was the practice in Britain for money bills to originate in the lower house, and a similar practice had been followed in the American states.<sup>71</sup> But this limitation had a special significance under the new Constitution since Senators were elected by their state legislatures rather than directly by the people of their states.<sup>72</sup> Moreover, as part of a fundamental constitutional compromise, the more populous states were more heavily represented in the House than in the Senate, where each state had two members.

The only express substantive limitation on the subject matter of federal taxation is the provision that "[n]o Tax or Duty shall be laid on Articles exported from any State."<sup>73</sup> This prohibition, which applies only to exports from the United States and not to exports from one state to another,<sup>74</sup> corresponds in scope to the export half of the Import-Export Clause limitation on state taxation. But the Federal Export Clause had a somewhat different purpose. It was originally intended as a guarantee to the Southern states that the more populous Northern states would not seek to finance the federal government through a levy on Southern agricultural exports.<sup>75</sup>

The most important constitutional provisions bearing on the federal government's power to tax are the Uniformity and Apportionment Clauses. They do not in terms restrict the kinds of taxes the federal government may levy, but they nonetheless do so in practice. The Uniformity Clause requires that "all Duties, Imposts and Excises shall be uniform throughout the United States."<sup>76</sup> The Apportionment Clause, on the other hand, provides that "[n]o Capitation, or other direct Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."<sup>77</sup> The key distinction is whether a federal tax is an indirect tax (that is, a "duty, impost or excise") in which case uniformity is required, or a direct tax, in which case apportionment is required.

<sup>70</sup> U.S. CONST. art. I, § 7. This provision goes on to permit the Senate to "propose or concur with amendments as on other Bills." James Madison explained as follows the reason for this amending power in the Senate: "When you send a bill to the Senate, without the power of making any alteration, you force them to reject the bill. . . . The power of proposing alterations removes this inconvenience . . ." 3 DEBATES OF THE FEDERAL CONSTITUTION 376 (J. Elliot ed. 1836).

<sup>71</sup> D. HUTCHISON, *THE FOUNDATIONS OF THE CONSTITUTION* 73 (1975).

<sup>72</sup> U.S. CONST. art. I, § 3.

<sup>73</sup> U.S. CONST. art. I, § 9, cl. 5.

<sup>74</sup> *Turpin v. Burgess*, 117 U.S. 504, 507 (1886).

<sup>75</sup> See D. HUTCHISON, *THE FOUNDATIONS OF THE CONSTITUTION* 143-44, 151 (1975).

<sup>76</sup> U.S. CONST. art. I, § 8, cl. 1.

<sup>77</sup> *Id.* art. I, § 9, cl. 4. The Apportionment Clause is bolstered by the Census Clause, which states that "Representatives and direct Taxes shall be apportioned among the several States . . . according to the respective Numbers." *Id.* art. I, § 2, cl. 3.

Uniformity is relatively easy to achieve. The requirement refers to geographical uniformity.<sup>78</sup> Wherever an activity or article appears, it must be taxed at the same rate.<sup>79</sup> If liquor, for example, is produced in Kentucky and not in New York, then a tax on the manufacture of liquor is nonetheless uniform though no New York enterprise pays the tax.<sup>80</sup>

Apportionment is another matter entirely. If a tax is a direct tax and therefore must be apportioned in accordance with the previous census, then the amount of tax raised per capita must be the same in each state. Only a capitation tax (involving a per-person levy) would be likely to lend itself to apportionment. Property taxes, which are likewise direct taxes, could meet the apportionment requirement only if the rate were set at a different level in each state so that the yield from the tax was in accordance with population. Apportionment of property taxes would be an administratively difficult undertaking, though property taxes were imposed by the federal government and apportioned among the states on a number of occasions in the Eighteenth and Nineteenth Centuries.<sup>81</sup> The consequence of the Apportionment Clause is to leave the taxation of real and personal property to state and local governments. Property tax collections have consistently been the most important source of local government revenue.

The Apportionment Clause has been modified by the sixteenth amendment. That amendment was a response to the 1895 decision in *Pollock v. Farmers' Loan & Trust Co.*,<sup>82</sup> where the Supreme Court held that the newly enacted federal income tax was a direct tax (on the theory that a tax on income from property is in substance a tax on the underlying property) and hence unconstitutional because it was not apportioned among the states. The sixteenth amendment, ratified in 1913, made clear that Congress might tax "income, from whatever source derived, without an apportionment among the several States, and without regard to any census or enumeration."

Today both the federal government and nearly all of the states (and to an increasing extent local municipalities) derive revenues from income taxes, with the federal government collecting \$173.0 billion and the state and local governments collecting \$28.8 billion

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<sup>78</sup> *Knowlton v. Moore*, 178 U.S. 41, 92 (1900).

<sup>79</sup> *Head Money Cases*, 112 U.S. 580, 594-95 (1884).

<sup>80</sup> S. MILLER, *LECTURES ON THE CONSTITUTION OF THE UNITED STATES* 240-41 (1891).

<sup>81</sup> The statutes are discussed in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 572-73 (1895).

<sup>82</sup> 158 U.S. 601, *vacating on rehearing* 157 U.S. 429 (1895).

from personal and corporate income taxes in 1976.<sup>83</sup> Each jurisdiction imposes its own tax, and the definitions, exceptions, deductions, and rates differ between federal law and state law as well as among the states. Nonetheless, an increasing number of states have conformed their personal income tax statutes to federal law to benefit the taxpayer by eliminating the need to file completely different income tax returns with the two levels of government.<sup>84</sup>

### E. Intergovernmental Tax Immunities

One of the most important constitutional restraints on both federal and state taxation is not to be found in the text of the Constitution at all. This is the doctrine of intergovernmental tax immunities, a doctrine which the Supreme Court has found in the federal structure of government created by the Constitution.<sup>85</sup> The core of this doctrine is that the federal government may not tax the states, and the states may not tax the federal government. "The power to tax involves the power to destroy," said Justice Marshall in the landmark case of *McCulloch v. Maryland*,<sup>86</sup> where a discriminatory state tax on bank notes issued by the Bank of the United States, a federally chartered bank, was held unconstitutional because it interfered with an instrumentality created by the "necessary and proper" exercise of express congressional powers.<sup>87</sup>

As illustrated by this first case, where 80% of the stock of the Bank was held by private parties, the key question in defining the scope of intergovernmental immunities is whether the object of taxation is "so assimilated by the Government as to become one of its constituent parts."<sup>88</sup> In the absence of either constitutional text or any well-defined theory justifying the immunity, this question is not

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<sup>83</sup> ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM 1976-77: REVENUE AND DEBT 10 (Table 5) (1977) [hereinafter cited as REVENUE AND DEBT].

<sup>84</sup> *Id.* at 290 (Table 110).

<sup>85</sup> Earlier cases derived the immunity of states from federal taxation from the tenth amendment, *see, e.g.*, *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871), *discussed in text* at note 89 *infra*. Federal immunity from state taxation is often derived from the Supremacy Clause of art. VI. *See, e.g.*, *United States v. County of Fresno*, 97 S. Ct. 699, 700, 702 (1977). The soundest view, however, appears to be that the doctrine of intergovernmental tax immunity is implied by the overall federal structure created by the Constitution. *See C. BLACK, STRUCTURE AND RELATIONSHIP IN CONSTITUTIONAL LAW* 7, 11, 13-15 (1969).

<sup>86</sup> 17 U.S. (4 Wheat.) 316, 431 (1819).

<sup>87</sup> Art. I, § 8, cl. 18 of the Constitution grants Congress power "[t]o make all Laws which shall be necessary and proper for carrying into Execution" other powers of the federal government.

<sup>88</sup> *United States v. Township of Muskegon*, 355 U.S. 484, 486 (1958).

easily answered. After *Collector v. Day*,<sup>89</sup> an 1871 decision holding the salary of a state judge immune from federal taxation, the scope of intergovernmental immunities gradually expanded until in 1928 royalties on federal patents were held immune from state taxation.<sup>90</sup> Thereafter, the scope of the immunity was drastically reduced by a series of Supreme Court decisions.<sup>91</sup> But something of the doctrine of intergovernmental tax immunities remains, as the Court made clear in the course of denying the State of New York immunity from federal taxation on sales of mineral water from state-owned mineral springs.<sup>92</sup> Chief Justice Stone, speaking for four members of the Court, cited as examples of what would remain immune from federal taxation the "State's capitol, its State-house, its public school houses, public parks, [and] its revenues from taxes or school lands."<sup>93</sup>

Today the principal fiscal consequence of the doctrine of intergovernmental tax immunities is the exemption of interest on state and local bonds from federal income tax. This "municipal bond" exemption will cost the federal treasury over \$5.3 billion in fiscal 1978.<sup>94</sup> Tax-exempt bonds can be sold at a much lower rate of interest than would be required if the interest were taxable to the recipient. Thus the exemption, which has been written into the Internal Revenue Code,<sup>95</sup> can be viewed as a disguised subsidy to municipalities, whose construction programs are financed largely by bonds. Although the Supreme Court in the *Pollock* case unanimously held interest on municipal bonds exempt from federal income tax on intergovernmental immunity grounds,<sup>96</sup> the general view today is that the Court would probably uphold legislative elimination of the exemption.<sup>97</sup>

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<sup>89</sup> 78 U.S. (11 Wall.) 113 (1871).

<sup>90</sup> *Long v. Rockwood*, 277 U.S. 142 (1928).

<sup>91</sup> For example, *Fox Film Corp. v. Doyal*, 286 U.S. 123 (1932), overruled *Long v. Rockwood*, 277 U.S. 142 (1928), and *Graves v. New York ex. rel. O'Keefe*, 306 U.S. 466 (1939), overruled *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871).

<sup>92</sup> *New York v. United States*, 326 U.S. 572 (1946).

<sup>93</sup> *Id.* at 587-88. Justice Frankfurter made the same point in his opinion, joined only by Justice Rutledge, announcing the judgment of the Court. *Id.* at 582. The recent decision in *National League of Cities v. Usery*, 426 U.S. 833 (1976), although not dealing with taxation, demonstrates the continued vitality of the intergovernmental immunity principle.

<sup>94</sup> SPECIAL ANALYSES 1978, *supra* note 7, at 129 (Table F-1). A corresponding exemption of interest on federal bonds from state and local taxation is also of some fiscal importance.

<sup>95</sup> I.R.C. § 103.

<sup>96</sup> *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 583-86 (1895).

<sup>97</sup> For an argument presenting this view, see DEPARTMENT OF JUSTICE, TAXATION OF GOVERNMENT BONDHOLDERS AND EMPLOYEES (1938).

## F. Limitations on Expenditures

The Constitution contains few limitations on expenditures as such. Moreover, the limitations on spending that do exist are only infrequently construed by the courts, since restrictions on the standing of citizens to challenge the constitutionality of spending statutes, though relaxed in recent years, continue to deter litigation.<sup>98</sup>

Congress is empowered to raise revenues "to pay the Debts and provide for the common Defense and general Welfare of the United States."<sup>99</sup> This provision does not, however, impose any effective limit on the scope of the federal spending power. In construing the Spending Clause the Supreme Court has declared that Congress is not limited in spending by the other enumerated powers of Article I but may spend for the "general welfare."<sup>100</sup> And the "general welfare" criterion is not itself a limitation on the congressional power to spend, as the Court made plain in the course of upholding the public financing of presidential campaigns established by the 1974 amendments to the Federal Election Campaign Act.<sup>101</sup> Nevertheless, the Bill of Rights, and in particular the first amendment provision prohibiting Congress from passing laws "respecting an Establishment of Religion," place a limit on particular types of federal expenditures.<sup>102</sup>

Whether the federal government's power to spend is limited in any way by more general considerations of federalism is an open question. In the 1936 decision in *United States v. Butler*,<sup>103</sup> the Supreme Court declared a federal tax-and-expenditure scheme unconstitutional on the ground that the expenditure portion, authorizing payments to farmers who agreed to acreage restrictions, invaded the powers reserved to the states by the tenth amendment. The Court characterized the spending provisions as "a scheme for purchasing with federal funds submission to federal regulation of a subject reserved to the states."<sup>104</sup> Yet one year later the Court severely limited *Butler*, holding that Congress could impose on employers a federal tax reducible by credits for contributions to state unemployment funds conforming to federally prescribed criteria.<sup>105</sup>

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<sup>98</sup> Compare *Flast v. Cohen*, 392 U.S. 83 (1968), with *United States v. Richardson*, 418 U.S. 166 (1974), and *Massachusetts v. Mellon*, 262 U.S. 447 (1923).

<sup>99</sup> U.S. CONST. art. I, § 8, cl. 1.

<sup>100</sup> *United States v. Butler*, 297 U.S. 1, 66 (1936) (dictum).

<sup>101</sup> *Buckley v. Valeo*, 424 U.S. 1, 90-91 (1976).

<sup>102</sup> See *Flast v. Cohen*, 392 U.S. 83 (1968).

<sup>103</sup> 297 U.S. 1 (1936).

<sup>104</sup> *United States v. Butler*, 297 U.S. 1, 72 (1936); see also *United States v. Gerlach Live Stock Co.*, 339 U.S. 725, 738 (1950).

<sup>105</sup> *Steward Machine Co. v. Davis*, 301 U.S. 548 (1937).

The Court's ruling implied that Congress could impose restrictions on a state's right to receive federal grants-in-aid without violating the tenth amendment.<sup>106</sup> The use of both of these techniques has become common.<sup>107</sup>

Nonetheless, the decision in *Butler* has never been overruled, and the Supreme Court would probably recognize an implied limitation on the federal spending power if that power was used to encroach on essential governmental functions of the states. Such a limitation might be either implied from the constitutional choice of a federal system (much in the way that intergovernmental tax immunities were derived) or found in the tenth amendment. That amendment, it will be recalled, provides that "powers not delegated to the United States nor prohibited by it to the States, are reserved to the States respectively, or to the People." Although in the past treated by the Supreme Court as a truism—namely, that powers not delegated are necessarily reserved<sup>108</sup>—the tenth amendment has recently experienced at least a partial reinvigoration. In *National League of Cities v. Usery*,<sup>109</sup> a closely divided Court struck down a federal statute imposing minimum wage and hour regulations on state and local governments, ruling that this exercise of the commerce power violated state sovereignty. The Court specifically reserved the question whether Congress might constitutionally "affect integral operations of state governments by exercising authority granted it under other sections of the Constitution such as the Spending Power . . . ."<sup>110</sup> This language should probably be read in conjunction with the dissenters' reference to the possibility that "Congress may nevertheless accomplish its objectives . . . by conditioning grants of federal funds upon compliance with federal minimum wage and overtime standards . . . ."<sup>111</sup> If *National League of Cities* is interpreted as establishing a balancing test weighing the relative importance of the federal interest against the strength of the

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<sup>106</sup> The Court held that Congress could induce state legislatures to participate in the unemployment insurance scheme by offering local employers a credit against the federal employment tax. The tax credit fell short of the type of "undue influence" or "coercion" of a state that would violate the tenth amendment. *Id.* at 585-93. The Court later extended the noncoercion rationale to sustain the use of conditional grants-in-aid. *Oklahoma v. United States Civil Service Comm'n*, 330 U.S. 127, 142-44 (1947).

<sup>107</sup> For example, the system of unemployment insurance sustained in *Steward Machine Co. v. Davis*, 301 U.S. 548 (1937), is essentially equivalent to the one in use today. See text at note 160 *infra*.

<sup>108</sup> *United States v. Darby*, 312 U.S. 100, 124 (1941). See also note 11 *supra*.

<sup>109</sup> 426 U.S. 833 (1976).

<sup>110</sup> *Id.* at 852 n.17.

<sup>111</sup> *Id.* at 880 (Brennan, J., dissenting).



state's interest in autonomy,<sup>112</sup> then in extreme cases the balance may swing against federal grants-in-aid that impose conditions subverting the independence of state legislatures.

The constitutionally permissible scope of state and local spending has not been widely litigated or discussed. The issue is not addressed in the Constitution. But general principles derived from cases involving state regulation suggest that limits do exist. States could not, for example, create a barrier to interstate commerce through use of the spending power. Similarly, if Congress, acting within its constitutional powers, enacted a spending program to achieve a particular objective, a state spending program that frustrated the achievement of that objective might be held invalid under the Supremacy Clause.<sup>113</sup> The fact that a subject may be *prima facie* national in character does not, however, oust the states. States provide for the common defense by maintaining militias, although today those militias form the National Guard and are financed largely by the federal government. Similarly, although "[n]o state may enter into any Treaty" and foreign affairs is obviously a national concern, many states maintain representational offices in foreign countries for the purpose of stimulating demand for their exports and attracting foreign capital.

## II. THE GERMAN FISCAL CONSTITUTION: A CONTRASTING APPROACH

One can gain a firmer grasp of the distinctive character of the American Fiscal Constitution by looking at the fiscal constitution of the Federal Republic of Germany. The contrast is particularly dramatic between the formal fiscal provisions of the U.S. Constitution and those of the Basic Law (*Grundgesetz*) of the Federal Republic. The provisions of the Basic Law governing the fiscal relations between the Federation and the *Länder* are drawn together in a single chapter,<sup>114</sup> giving fiscal federalism in the Federal Republic a constitutional explicitness and structure almost totally lacking in the United States. The greater detail of the Basic Law is explained in part by the time of its adoption. In 1949 the taxing opportunities

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<sup>112</sup> See *id.* at 856 (Blackmun, J., concurring); Note, *The Clean Air Act Amendments of 1970: A Threat to Federalism?* 76 COLUM. L. REV. 990 (1976).

<sup>113</sup> U.S. CONST. art. VI, cl. 2; cf. *Townsend v. Swank*, 404 U.S. 282 (1971) (ruling that state implementing legislation inconsistent with the federal Social Security Act violates the Supremacy Clause).

<sup>114</sup> GG arts. 104a-115 (Chapter X). This chapter governs not merely fiscal but also budget, audit, and credit matters. Two important fiscal provisions not in Chapter X are arts. 91a and 91b (Chapter VIIIa) on the "joint tasks" (*Gemeinschaftsaufgaben*) of the Federation and the *Länder*. See note 128 *infra*.

and spending responsibilities of the modern state were far greater than they had been in 1787, when the customs were by far the principal source of revenue. Experience under prior German constitutions may also have contributed to the greater specificity of the German fiscal constitution.

The specificity of the Basic Law, if not a mistake, has certainly had its costs. The revenue sharing provisions have at times served as an impediment to the type of financial equilibrium between the Federation and the *Länder* that the governments of both have desired. As a consequence, the fiscal provisions of the Basic Law were amended in 1955, 1957, 1967, and 1969. The last of these amendments compounded the level of detail, although it also increased the flexibility of the provisions governing federal fiscal legislation and Federation-*Länder* cooperation.<sup>115</sup>

The fiscal provisions of the Basic Law carefully divide the taxing competences of the Federation and the *Länder*. The Federation alone benefits from customs duties and from a long list of miscellaneous taxes.<sup>116</sup> The *Länder* in turn have the exclusive benefit of property, estate, and certain other taxes.<sup>117</sup> Receipts from three of the most important taxes—personal and corporate income taxes and the value-added tax—are shared among the Federation and the *Länder*.<sup>118</sup> Thus, in contrast to general revenue sharing in the United States, which is merely a federal spending program,<sup>119</sup> revenue sharing in West Germany is a true division of revenues from constitutionally designated taxes. In keeping with the German tradition of administration of federal laws by the *Länder*, these three shared taxes, which generate about two-thirds of all revenues,<sup>120</sup> are collected by the revenue authorities of the *Länder*.<sup>121</sup>

The Basic Law prescribes that the Federation and the *Länder* share the receipts from personal and corporate income taxes equally.<sup>122</sup> The sharing ratio for the value-added tax, which is much more significant in West Germany than is the sales tax in the

<sup>115</sup> A brief survey of the background of the constitutional changes between 1949 and 1969 is provided by N. JOHNSON, *GOVERNMENT IN THE FEDERAL REPUBLIC OF GERMANY* 120-31 (1973).

<sup>116</sup> GG art. 106(1).

<sup>117</sup> GG art. 106(2). Municipalities (*Gemeinden*) benefit from real property and certain other taxes, as well as from a share of the income tax. GG arts. 106(5), (6).

<sup>118</sup> GG art. 106(3).

<sup>119</sup> See text at notes 176-80 *infra*.

<sup>120</sup> F. STRAUSS, *DIE FINANZVERFASSUNG* 81-82 (1969). Although not an official government document, this book was written while Strauss was Minister of Finance. The two-thirds estimate excludes tax collections by municipalities.

<sup>121</sup> GG art. 108.

<sup>122</sup> GG art. 106(3).

United States,<sup>123</sup> is established by legislation. Such legislation must receive the assent of the *Bundesrat*, an upper house composed of representatives of the *Länder*, and must also comply with specific constitutional principles designed to achieve what is popularly called "vertical equity."<sup>124</sup>

Even more striking to an American observer than the provisions of the Basic Law providing for the sharing of revenues between the Federation and the *Länder* are the provisions designed to redistribute tax receipts among the *Länder*. The Basic Law promotes redistribution among the *Länder* in two ways: vertically, through the mechanism for revenue sharing, and horizontally, through the use of equalization payments among the *Länder*.

One of the constitutional principles governing the sharing of value-added tax receipts between the Federation and the *Länder* is that uniformity of living standards is to be "ensured" throughout the country.<sup>125</sup> To achieve this goal, at least three-quarters of the *Länder* share of value-added tax receipts is distributed on a per capita basis, unlike personal and corporate income tax receipts which are returned to the *Länder* from which such taxes are collected.<sup>126</sup> Thus, the greater the share of value-added tax receipts going to the *Länder* relative to the Federation, the greater the impact revenue sharing will have in offsetting differences among the *Länder* in taxing capacity. In addition, the Basic Law authorizes federal legislation allocating up to 25% of the value-added tax receipts to *Länder* whose per capita revenues from *Land* taxes fall below the average of all *Länder*.<sup>127</sup> There are also other provisions that enable the Federation to make grants of various kinds to the *Länder* out of federal revenues.<sup>128</sup>

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<sup>123</sup> The standard rate of value-added tax in West Germany is 11%. See generally INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, THE TAXATION OF COMPANIES IN EUROPE paras. 309-335, at 105-12. In 1976 the *Länder* received 31% of value added-tax revenues. BUNDESMINISTERIUM DER FINANZEN, FINANZBERICHT 1976, at 131 (1976).

<sup>124</sup> GG art. 106(3).

<sup>125</sup> GG art. 107. The principle of uniform living standards is part of an interrelated group of principles providing for the coordination of the revenue requirements of the Federation and the *Länder* through multiyear planning so that "a fair balance is struck, any overburdening of taxpayers precluded, and uniformity of living standards in the federal territory ensured." GG art. 106(3)(2).

<sup>126</sup> GG art. 107(1); *Gesetz über den Finanzausgleich zwischen Bund und Ländern*, § 2(1), [1969] BGBI [Bundesgesetzblatt] I 1432.

<sup>127</sup> GG art. 107(1); *Gesetz über den Finanzausgleich zwischen Bund und Ländern*, §§ 2(2), (3), [1969] BGBI I 1432.

<sup>128</sup> The Basic Law requires federal financing of at least one-half of the expenditures incurred in "joint tasks" (*Gemeinschaftsaufgaben*) in higher education, regional development, agricultural development, and coastal preservation. GG art. 91a. The Federation is also empowered to grant financial assistance to the *Länder* for "important investments" meeting

The second, and to the American observer even more remarkable, means of redistributing tax revenues is the requirement that financially strong *Länder* make equalization payments directly to financially weak *Länder*.<sup>129</sup> One of the explicit goals of the Basic Law is "reasonable equalization between financially strong and financially weak *Länder*."<sup>130</sup> By statute, equalization payments must bring the financially weak *Länder* to within 95% of a target figure which is roughly equivalent to a national average.<sup>131</sup> As a result, in 1975 four financially strong *Länder* made payments totalling about DM 1.9 billion (1.3% of all *Länder* expenditures) to the remaining five *Länder*.<sup>132</sup>

Another major tenet of German federalism is equalization of tax burdens throughout the nation. Uniform federal legislation governs not only the taxes accruing to the Federation and shared with the *Länder*, but also many of the taxes that accrue solely to the *Länder*. Property and estate taxes are created and regulated by federal legislation, though the *Länder* enjoy all of the proceeds. When the federal legislature acts with respect to these taxes, it normally sets the same rates throughout the country.<sup>133</sup> Indeed, one

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broadly defined criteria. GG art. 104(a)(4). See also GG art. 106(4), providing for federal compensation to *Länder* for increased burdens stemming from the establishment of federal facilities within their borders.

<sup>129</sup> GG art. 107(2). This article imposes a duty on the legislature to pass legislation specifying the conditions under which equalization payments are to be made and the criteria for determining the amounts. Such legislation may also provide for grants of federal funds to financially weak *Länder*.

<sup>130</sup> *Id.*

<sup>131</sup> *Gesetz über den Finanzausgleich zwischen Bund und Ländern*, § 10(3), [1969] BGBI I 1432, 1434.

<sup>132</sup> BUNDESMINISTERIUM DER FINANZEN, FINANZBERICHT 1976, at 141 (1976). The paying *Länder* were Nordrhein-Westfalen, Baden-Württemberg, Hessen, and Hamburg; and the recipient *Länder* were Bayern, Niedersachsen, Rheinland-Pfalz, Schleswig-Holstein, Saarland, and Bremen. *Id.* Additional supplementary federal allocations of value-added tax receipts to financially weak *Länder*, see text at note 127 *supra*, amounted to another DM 800 million in 1975. *Id.*

<sup>133</sup> See H. GRUMPEL, *TAXATION IN THE FEDERAL REPUBLIC OF GERMANY* 1/3.2 (2d ed. 1969) (World Tax Series). Under Article 105(2) the Federation has concurrent legislative powers over not only all taxes that accrue wholly or in part to the Federation but also over all taxes "where the conditions provided for in paragraph (2) of Art. 72 apply." Since Article 72(2) is phrased broadly, the Federation may legislate on substantially all taxes except local excise taxes ("örtlichen Verbrauch-und-Aufwandsteuern"). These taxes are within the exclusive jurisdiction of the *Länder* "as long and in so far as they are not identical with taxes imposed by federal legislation." GG art. 105(2a). Although federal legislative jurisdiction over other *Land* taxes is only concurrent, such federal tax legislation preempts *Land* legislation pro tanto. The result is that tax burdens are virtually uniform throughout the country. One exception is that federal legislation establishing the real property tax permits municipalities to vary the rate within certain limits. INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *THE TAXATION OF COMPANIES IN EUROPE* para. 302, at 93 (1975).

of the criteria permitting federal legislation on taxes accruing solely to the *Länder* is the necessity for "the maintenance of legal or economic unity, especially the maintenance of uniformity of living conditions beyond the territory of any one *Land*."<sup>134</sup> Thus the Basic Law goes far toward making equality of total tax burdens among the *Länder* into a constitutional principle.

### III. FISCAL FEDERALISM IN PRACTICE

The American Constitution, unlike the West German Basic Law, has few provisions governing the fiscal relations between the federation and the states. As the review of the American Fiscal Constitution in Part I showed, relatively few constitutional limitations have been imposed on the taxes that may be levied by either level of government or on the purposes for which either may spend. Moreover, despite the Supremacy Clause, there is no U.S. rule that a particular federal tax—such as the income tax—preempts a similar state tax. Nevertheless, the pattern of taxing and spending in the United States reveals a set of working assumptions about the fiscal prerogatives and responsibilities of each level of government. The federal government and the states have specialized, with the federal government taxing different sources of income from those taxed by the states and spending its funds on different objectives. Although the basic allocation of fiscal authority is remarkably stable, the area of overlap on the expenditure side has been growing as the federal government has assumed increasing financial responsibility for such traditional state activities as education, highways, and welfare.

#### A. Taxation

As we have seen, the Constitution reserves customs duties to the federal government. But the customs today provide only about 1% of total federal revenues. The principal source of federal revenue is the personal and corporate income tax, with the personal income tax accounting for about 44% and the corporate income tax about 14% of federal revenues. By far the most rapidly growing source of revenue is social insurance taxes and contributions, now accounting

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<sup>134</sup> GG art. 72(2)(3). The other criteria for federal legislation are that "a matter cannot be effectively regulated by the legislation of individual *Länder*" or that "the regulation of a matter by a *Land* law might prejudice the interests of other *Länder* or of the people as a whole . . ." GG arts. 72(2)(1), 72(2)(2). When one or more of these criteria are satisfied the federation is given authority to regulate taxes accruing solely to the *Land*. GG art. 105(2); see note 133 *supra*.

for over 31% of federal receipts.<sup>135</sup> Since these social insurance revenues flow into so-called trust funds, which are earmarked for defined expenditures, many Americans do not think of social insurance taxes as federal revenues but rather as a separate tax-and-expenditure system. Indeed, it is conventional to distinguish between general revenues and trust fund revenues, although for purposes of macroeconomics, as opposed to bookkeeping, there is no substantial difference.

The revenues of state and local governments are nearly as large as those of the federal government. If one excludes grants-in-aid, state utility and liquor store receipts, and trust fund receipts, combined state and local revenues are approaching federal revenues (\$182 billion and \$225 billion, respectively, in 1975).<sup>136</sup>

The largest source of state and local revenues has traditionally been the property tax, which provides somewhat over 22% of state and local general revenues.<sup>137</sup> As previously mentioned, this source has been placed beyond the effective reach of the federal government by the Apportionment Clause.<sup>138</sup> Most states have ceded the property tax to local governments, although state court cases ruling that it violates the Equal Protection Clause or the equivalent state constitutional provision to use local property taxes as the principal means of financing local education may lead some states to adopt statewide property tax systems to finance education.<sup>139</sup>

The second largest source of state and local revenues (12.87%), and one growing at a faster rate than property tax revenues, is sales and gross receipts taxes. There is little overlap between federal and state taxation in this category because, although both federal and state governments impose taxes on sales, the federal "excise" tax is limited to sales by manufacturers on a limited number of products

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<sup>135</sup> The statistics in this paragraph are taken from actual revenues for fiscal 1976, reported in 1978 BUDGET, *supra* note 37, at 56-57.

<sup>136</sup> TRENDS, *supra* note 20, at 29 (Table XI). 1975 grants-in-aid were \$48 billion and federal trust fund revenues were \$80 billion; state utility, liquor store, and trust fund revenues amounted to \$33 billion. *Id.* at 29, 35 (Tables XI, XIV). Borrowing is excluded from both federal and state figures.

<sup>137</sup> REVENUE AND DEBT, *supra* note 83, at 30 (Table 16).

<sup>138</sup> See text at note 81 *supra*.

<sup>139</sup> See, e.g., *Serrano v. Priest*, 5 Cal.3d 584, 487 P.2d 1241 (1971) (*Serrano I*); *Serrano v. Priest*, 557 P.2d 929 (Cal. 1977) (*Serrano II*); *Milliken v. Green*, 389 Mich. 1, 203 N.W.2d 457 (1972); *Robinson v. Cahill*, 118 N.J. Super. 223, 287 A.2d 187 (1972), *aff'd on other grounds*, 62 N.J. 473, 303 A.2d 273 (1973). *But cf.* *San Antonio Independent School Dist. v. Rodriguez*, 411 U.S. 1 (1973) (supplementing state financing of public education with local ad valorem property tax does not deprive families residing in districts with low property tax base of equal protection). Certainly decisions like *Serrano I* will lead some states to increase the use of other revenue sources to finance education.

while state and local sales taxes apply to virtually all final sales to consumers. Although an increasing number of cities have imposed sales taxes, the great bulk of sales tax revenue goes to state governments. Thus, within the states, competition for revenues is reduced by the tradition that local governments depend primarily on property taxes while state governments depend heavily on sales taxes. Imbalances tend to be handled by intergovernmental transfers within each state or by arrangements within a state for local governments to receive a portion of state collections within their boundaries.

Personal and corporate income taxes (12.37%) are nearly as important as sales taxes, and are growing at a faster rate than either property or sales taxes.<sup>140</sup> Forty-one states have a personal income tax,<sup>141</sup> and the number of municipal income tax systems is growing.

Competition for tax revenues between the states and the federal government is largely confined to the income tax, but the seriousness of this competition has been limited by the provision of the Internal Revenue Code permitting state income tax payments to be deducted from taxable income for federal personal and corporate income tax purposes.<sup>142</sup> This deduction makes it easier for states and municipalities to increase income tax rates. Part of each dollar of increased state taxation is in effect paid by foregone federal revenues; the percentage thus picked up by the federal government depends upon the marginal federal tax rate of the state taxpayers. Similar indirect assistance is afforded by the federal income tax deduction for state gasoline and property taxes.<sup>143</sup> Revenue foregone by the federal government because of the deductibility of state taxes is estimated to total about \$13.5 billion in fiscal 1978, an amount equal to more than 6% of total federal income tax receipts.<sup>144</sup>

## B. Expenditures

The federal government and the states specialize in expenditures as well as in taxes, but to a much lesser degree. Just over one-

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<sup>140</sup> Statistics on state and local tax revenues in this and preceding paragraphs are taken from REVENUE AND DEBT, *supra* note 83, at 30 (Table 16).

<sup>141</sup> 2 ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, SIGNIFICANT FEATURES OF FISCAL FEDERALISM 99 (Table 66) (1976-77 ed.). Three additional states tax some forms of income, such as dividends, interest, or capital gains. New Jersey is the only state to introduce an income tax since 1971, and such populous states as Florida and Texas do not have any personal income tax. Forty-five states have a corporate income tax. *Id.*

<sup>142</sup> I.R.C. § 164(a)(3).

<sup>143</sup> I.R.C. §§ 164(a)(2), 164(a)(5).

<sup>144</sup> Receipts forgone are tabulated in SPECIAL ANALYSES 1978, *supra* note 7, at 269-70 (1977). For federal income tax receipts, see 1978 BUDGET, *supra* note 37, at 57.

quarter of the national budget goes for national defense and foreign aid, categories in which state spending is minimal. Another one-tenth of the federal budget pays interest on the national debt. Retirement annuities under the Social Security system, which have no direct counterpart in the states, represent another one-fifth of the federal budget. The bulk of the remaining one-third or so of the budget is devoted to functions where both federal and state governments are active. In some of these areas, however, the federal role may consist of making grants to the states, a subject to be discussed separately below.<sup>145</sup>

Historically, the most important categories of state and local expenditure have been education and highways. Grade and high schools are operated by local governments—usually single purpose “school districts”—but the money is provided by both local taxation and aid provided by the states. In 1975, state and local governments spent \$69.8 billion on education, while the federal government spent \$13.1 billion, principally in transfers to states and localities.<sup>146</sup> Thus, the financing, as well as the provision, of education remains predominantly a state and local affair. Highways are also primarily a state and local matter, with the states and localities responsible in 1973 for \$18.6 billion out of a total of \$19.2 billion expended on highways by all levels of government.<sup>147</sup> Included within the state and local spending total, however, is the contribution of a federal highway trust fund earmarked for the construction of the interstate highway system. This fund, financed in large part by a federal gasoline tax, has contributed about \$6 billion per year to state and local spending in recent years.<sup>148</sup>

The greatest interplay between federal and state expenditures is found in the welfare sphere. Welfare has also become the center of intense political debate about the respective roles of the federal and state governments. Both federal and state welfare expenditures have grown rapidly during the last decade. Using a narrow definition,<sup>149</sup> federal welfare expenditures grew from \$5.2 billion (less than

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<sup>145</sup> Federal expenditures are listed by function in 1978 BUDGET, *supra* note 37, at 52.

<sup>146</sup> TRENDS, *supra* note 20, at 25 (Table IX). State and local expenditure totals do not include expenditures financed by federal grants-in-aid, but do include expenditures financed by federal general revenue sharing.

<sup>147</sup> J. MAXWELL & J. ARANSEN, FINANCING STATE AND LOCAL GOVERNMENTS 260-61 (Tables A-4, A-5)(3d ed. 1977).

<sup>148</sup> SPECIAL ANALYSES 1978, *supra* note 7, at 38 (Table B-8).

<sup>149</sup> The narrow definition is the budget category entitled “public assistance and other income supplements.” The largest programs included are Aid to Families with Dependent Children, Food Stamps, and Supplemental Security Income. See note 150 *infra*.



3% of total expenditures) in fiscal 1970 to an estimated \$26.2 billion (more than 6% of total expenditures) in fiscal 1977. Taking a broader measure that includes Social Security retirement and disability payments, "income security" expenditures grew from \$43.8 billion (22% of total expenditures) in fiscal 1970 to an estimated \$116.0 billion (28%) in fiscal 1977.<sup>150</sup>

The federal government bears the bulk of welfare expenditures (even taking the narrower measure). Although federalization of welfare has long been a rallying cry of many social reformers, that goal has in large measure already been reached through innumerable incremental decisions. In 1960 the federal government paid only 44% of the total welfare bill, but by 1970 the federal percentage had reached 71%, and by 1975, 77%.<sup>151</sup>

The principal welfare programs involve interesting examples of federal-state cooperation. The Aid to Families with Dependent Children program (AFDC), is administered by state and local governments, but financed in part by the federal government.<sup>152</sup> It provides cash payments to some 5.6 million mothers with dependent children.<sup>153</sup> The states determine the level of payments, and the federal government partially reimburses the states according to a complex formula. The level of payments consequently varies from state to state, depending upon how much each state is willing to spend. Maximum AFDC payments for a family of four range from \$60 in Mississippi to \$433 in Oregon and \$514 in Hawaii.<sup>154</sup>

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<sup>150</sup> Fiscal 1977 figures are from OFFICE OF MANAGEMENT AND BUDGET, FISCAL 1978 BUDGET REVISIONS 59-60 (1977)[hereinafter cited as 1978 BUDGET REVISIONS]. (These figures reflect Carter Administration adjustments to Ford Administration estimates.) Fiscal 1970 figures are from OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1972, at 81, 158 (1971). Because of changing budgetary categories the figures for the two years may not be precisely comparable. Even the broad definition does not include unemployment insurance benefits, which grew from \$3.4 billion in fiscal 1970 to an estimated \$15.9 billion in fiscal 1977. 1978 BUDGET REVISIONS, *supra*, at 59-60. Nor does it include payments to veterans, public employee retirement payments, and similar programs that keep millions of the aged and disabled off welfare.

<sup>151</sup> TRENDS, *supra* note 20, at 27 (Table X). If state welfare expenditures financed by federal general revenue sharing grants were counted in the federal column, the federal share would be about 79% for 1975. *See id.* at 27 n.3. This calculation is based on an estimate of 1974 general revenue sharing grants.

<sup>152</sup> 42 U.S.C. §§ 601-610 (1970).

<sup>153</sup> SPECIAL ANALYSES 1978, *supra* note 7, at 236 (Table L-7). A few states have AFDC-UF programs for families with unemployed fathers.

<sup>154</sup> NATIONAL CENTER FOR SOCIAL STATISTICS, DEPT. OF HEALTH, EDUCATION AND WELFARE, AID TO FAMILIES WITH DEPENDENT CHILDREN 10 (Table 4)(February 1977). *See generally* STAFF OF SUBCOMM. ON FISCAL POLICY OF THE JOINT ECONOMIC COMM., 93D CONG., 2D SESS., HANDBOOK ON PUBLIC INCOME TRANSFER PROGRAMS: 1975, at 140-70 (Comm. Print 1974) (Studies in Public Welfare Paper No. 20).

Quite different federal-state relationships are found in other welfare programs. In the Food Stamp program, the federal government provides the funds, and the states administer the program.<sup>155</sup> The rapid growth of this program, from \$0.6 billion in fiscal 1970 to an estimated \$5.5 billion in fiscal 1977, accounts for a substantial portion of the increase in federal welfare financing.<sup>156</sup>

Equally important in the movement toward federal financing of welfare is the Supplemental Security Income program (SSI),<sup>157</sup> passed in 1974. This program shifted responsibility for the funding and administration of public assistance programs for the aged, the blind, and the disabled to the federal government. As part of a legislative compromise the states were permitted to supplement the federal payments. Because of these supplemental state payments only 73% of total SSI payments were funded by the federal government in 1975.<sup>158</sup>

Still another relationship is found in the unemployment insurance system,<sup>159</sup> which is not usually classified as welfare because its benefits are available to an eligible unemployed person even if he can support himself from investment income or from the earnings of his spouse. The key to the program is a federal unemployment tax levied on employers at the rate of 3.2% of payrolls. If the state maintains an unemployment insurance program conforming to conditions established in the federal statute (and all states do so), the employer can credit the state unemployment tax against the federal tax. Indeed, the federal statute permits the states to tax employers on an experience rating basis, so that the better the record of the employer in providing stable employment, the lower his tax; to achieve this objective and to provide an incentive for stable employment, the employer is permitted to credit the maximum rate of state tax (up to 2.7%) whether it is actually paid or forgiven under the state experience rating formula.<sup>160</sup> State unemployment tax collections are deposited in individual unemployment trust fund accounts

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<sup>155</sup> 7 U.S.C. §§ 2011-2025 (1970).

<sup>156</sup> Fiscal 1977 figures are from 1978 BUDGET REVISIONS, *supra* note 150, at 59 (1977) (including Carter Administration adjustments to Ford Administration estimates). Fiscal 1970 figures are from SPECIAL ANALYSES, *supra* note 7, at 192 (Table L-9) (1971).

<sup>157</sup> 42 U.S.C. §§ 1381-1385 (Supp. IV 1974).

<sup>158</sup> For further details, see Hawkins, *State Supplementation under SSI, 1975*, SOC. SECURITY BULL., Feb. 1977, at 12.

<sup>159</sup> 42 U.S.C. §§ 501-504 (1970); I.R.C. §§ 3301-3308.

<sup>160</sup> Because of the demands on the trust funds in the recent recession, the net federal tax has been increased temporarily from 0.5% (3.2% less 2.7%) to 0.7% in order to repay loans made to the trust fund out of general revenues. Unemployment Compensation Amendments of 1976, Pub. L. No. 94-566, § 211, 90 Stat. 2667.

in the U.S. Treasury and may be withdrawn only for the payment of benefits conforming to federal criteria. The unemployed worker receives individual payments from a state office.

The amount of unemployment benefits is within the discretion of the states, and varies widely not merely in absolute amount, but also in the percentage of the unemployed worker's former wages replaced by benefits. Although the Nixon Administration twice proposed to the Congress legislation providing for federal minimum standards in order to bring up payments in laggard states,<sup>161</sup> opponents were able to defeat any attempt to achieve what in this context was pejoratively called the "federalization" of the unemployment insurance system. On top of this federal-state structure, Congress has during periods of high unemployment provided for "extended benefits" that continue payments to unemployed workers beyond the 26 weeks involved in the regular program up to a total of 65 weeks. Extended benefits are financed out of the federal unemployment tax and general federal revenues rather than out of state trust funds.<sup>162</sup>

### C. Intergovernmental Transfers

The American Constitution contains nothing resembling the provisions in the German Basic Law that provide for sharing of revenues between the federation and the *Länder* and for equalization payments among the *Länder*. Nevertheless, transfer payments from the U.S. federal government to state and local governments have become a major feature of the informal American fiscal constitution. Although these payments are only partially designed to redress the balance of fiscal power between the federal government and the states, and are not ostensibly intended to redistribute revenues among the states, it is clear that federal transfer payments could at least potentially have a substantial impact on the distribution of revenues.

1. *Grants-in-Aid*. Beginning in the mid-1960's, grants-in-aid became one of the principal tools for federal attempts to cope with a wide range of domestic problems. Although many grants-in-aid are related to welfare programs, transfers from the federal government to the states far transcend the welfare area. Federal grants-in-aid are used across virtually the entire gamut of state activity,

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<sup>161</sup> PUBLIC PAPERS OF THE PRESIDENT 496, 498 (1969); *id.* at 281, 282 (1973).

<sup>162</sup> On the unemployment insurance system, see generally SUBCOMM. ON FISCAL POLICY OF THE JOINT ECONOMIC COMM., HANDBOOK ON PUBLIC INCOME TRANSFER PROGRAMS: 1975, at 50-84 (Comm. Print 1974) (Studies in Public Welfare Paper No. 20).

from environmental protection to education to law enforcement. They finance, at least in part, such diverse state activities as highway beautification, disaster relief, preservation of historic properties, health services, and school lunches.<sup>163</sup>

The increasingly broad use of grants-in-aid has brought about a rapid growth in federal transfers to state and local governments. Grants-in-aid grew from \$2.9 billion in 1954 (0.8% of GNP and 14.6% of the federal budget) to \$10.4 billion in 1964 (1.6% of GNP and 19.5% of the federal budget) to \$43 billion in 1974 (3.1% of GNP and 22.3% of the federal budget).<sup>164</sup> In calendar 1975 alone grants-in-aid grew by about 25% to over \$54 billion<sup>165</sup> and are estimated at over \$70 billion for fiscal 1977.<sup>166</sup>

The total volume of grants-in-aid to states is not planned on any overall basis such as state need. It is simply the sum of a large number of individual federal decisions. Moreover, grants-in-aid are not usually thought of as relieving the states of a burden; on the contrary, state entitlement to federal grants often requires a matching state payment for the program in question. The surplus or deficit of the states as a whole does not appear, at least on casual analysis, to be correlated with fluctuations in the volume of federal grants-in-aid. Rather the states appear to have consolidated surpluses in boom years and deficits in recession years, as tax revenues fall but the momentum of spending continues.

Similarly, little attention is paid to the distribution of the total flow of federal grants-in-aid among the states. Agricultural states do well in the agricultural sector, and urban states do well in the welfare sector, but the overall effect on the state tax burden and state budgets appears to be the outcome of a series of unrelated decisions.

Grants-in-aid nevertheless play a limited redistributive role, as the regression results summarized in Tables I and II show. The lower the per capita income of a state, the higher the per capita grants-in-aid. The same relationship holds between per capita federal personal tax receipts within a state and per capita grants-in-aid. These measures of redistribution do not tell the whole story, however, as the recent flurry of attention over the alleged tendency of the federal

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<sup>163</sup> SPECIAL ANALYSES 1978, *supra* note 7, at 282-87 (Table 0-9).

<sup>164</sup> ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, TRENDS IN FISCAL FEDERALISM 1954-74, at 15 (Table IV)(1975).

<sup>165</sup> ECONOMIC REPORT OF THE PRESIDENT 251 (Table B-68)(1976).

<sup>166</sup> SPECIAL ANALYSES, *supra* note 7, at 270 (Table 0-1) (1977). The grants-in-aid figures in this paragraph include general revenue sharing.

government to favor "sunbelt" states suggests.<sup>167</sup> In order to test the validity of the "sunbelt hypothesis" as applied to grants-in-aid<sup>168</sup> and to determine whether other regional effects might explain the variability in grants-in-aid among states, the nation was divided into four regions (South, West, Northeast, and Midwest).<sup>169</sup> The regression results in Tables I and II hold redistribution effects constant while measuring regional effects and, similarly, hold regional effects constant while measuring redistribution effects.

TABLE I<sup>70</sup>

*Combined Redistribution and Regional Effects  
in the U.S. Grants-in-Aid System, 1975  
(based on per capita income)*

	Northeast	Midwest	South	West
Gain (loss) from redistri- bution effect	(\$20.74)	(\$18.08)	\$31.12	(\$ 7.84)
Gain (loss) from regional effect	\$23.47	(\$19.27)	(\$21.82)	\$30.74
Combined gain (loss)	\$ 2.73	(\$37.35)	\$ 9.30	\$22.90

## Sources:

Grants-in-aid: DEP'T OF TREASURY, FEDERAL AID TO STATES, FISCAL YEAR 1976 AND TRANSITION QUARTER 1 (1976); Personal Income: STATISTICAL ABSTRACT OF THE UNITED STATES 401-02 (Tables 643-44) (1976); Population: *Id.* at 11 (Table 10).

<sup>167</sup> For a strong statement of the alleged tendency of federal spending to favor the sunbelt states, see *Federal Spending: The North's Loss Is the Sunbelt's Gain*, 8 NAT'L J. 878 (1976).

<sup>168</sup> Most discussions of the sunbelt hypothesis are concerned with overall federal spending rather than merely the grants-in-aid portion.

<sup>169</sup> The regional boundaries chosen were the same as those used in the National Journal study of overall federal spending. See *Federal Spending*, *supra* note 167. The Northeast included the New England states plus New York, New Jersey, and Pennsylvania. The Midwest included the Great Lakes states plus Minnesota, Iowa, Missouri, Kansas, Nebraska, and the Dakotas. The South included Delaware, Maryland, West Virginia, Kentucky, Arkansas, Oklahoma, Texas, and states south and east thereof. The West included Montana, Wyoming, Colorado, New Mexico, and states west thereof. Alaska, the state with the highest per capita income in the nation, was excluded from these regressions because its extremely high level of grants proved to affect overall results disproportionately.

<sup>170</sup> These results were obtained by estimating a regression of the form:

TABLE II<sup>171</sup>  
*Combined Redistribution and Regional Effects  
 in the U.S. Grant-in-aid System, 1975  
 (based on per capita personal tax collections)*

	Northeast	Midwest	South	West
Gain (loss) from redistri- bution effect	(\$38.95)	(\$38.16)	\$43.27	\$ 9.68
Gain (loss) from regional effect	\$22.66	(\$19.34)	(\$18.30)	\$26.74
Combined gain (loss)	(\$16.29)	(\$57.50)	\$24.97	\$36.42

## Sources:

Grants-in-aid and Population: *see* Table I; Taxation: STATISTICAL APPENDIX TO ANNUAL REPORT OF THE SECRETARY OF THE STATE OF THE FINANCES FOR THE FISCAL YEAR ENDED JUNE 30, 1975, at 54 (Table II) (1976).

$$G_i = \alpha + \beta_1 Y_i + \beta_2 X_{1i} + \beta_3 X_{2i} + \beta_4 X_{3i} + \mu_i$$

where

$G_i$  = per capita grants-in-aid in the  $i$ th state.

$Y_i$  = per capita income in the  $i$ th state.

$X_{1i}$  = Northeast dummy variable ( $X_{1i} = 1$  if the  $i$ th state is in the Northeast, = 0 otherwise).

$X_{2i}$  = South dummy variable.

$X_{3i}$  = West dummy variable.

$\mu_i$  = Random error term.

	CONSTANT	INCOME	NORTHEAST	SOUTH	WEST	$R^2$
Coefficient	333.05	-.02052	42.74	-2.55	50.01	.29
(T-statistics)	(6.12)	(2.26)	(2.37)	(0.15)	(2.98)	

The F-statistic for the set of dummy variables is 5.27 (3, 44).

<sup>171</sup> The estimated regression was of the form:

$$G_i = \alpha + \beta_1 T_i + \beta_2 X_{1i} + \beta_3 X_{2i} + \beta_4 X_{3i} + \mu_i$$

The results show that regional effects are roughly as important as redistribution effects in modifying the return flow of money to the states from what it would be if grants-in-aid simply transferred money to the states in proportion to personal income, or to federal personal tax collections within each state. The sunbelt hypothesis, however, provides a simplistic and essentially misleading explanation of the regional effects of the grants-in-aid process.

Table I assumes that a neutral grants-in-aid program, involving neither redistribution nor regional effects, would return funds to the states in direct proportion to personal income within the state. In order to give some dimension to the results, it should be borne in mind that for 1975, the year studied, average per capita grants-in-aid for the country as a whole were about \$238.<sup>172</sup> Because of the redistribution effect, the Northeast and the Midwest, the two regions with the highest personal incomes, received about \$21 and \$18 per capita less than the national average, the West received about \$8 less, and the South, the region with the lowest per capita income, received about \$31 per capita more. Regional effects were not, however, consistent with the sunbelt hypothesis. Rather than the Northeast and the Midwest tending to support the South and the West, the grant-in-aid process resulted in the South and the Midwest tending to support the Northeast and the West.

The regional effect favoring the Northeast more than offset the unfavorable redistribution effect there so that the Northeast, the region with the highest per capita income, actually gained a net benefit of about \$3 per person. On the other hand, for the Midwest

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where

$G_i, X_{1i}, X_{2i}, X_{3i}, \mu_i$  are defined as in Table I.

$T_i$  = per capita personal federal tax receipts in the  $i$ th state.

(Since personal federal tax receipts are not reported separately for Maryland and the District of Columbia, the Maryland per capita tax figure was estimated by multiplying the combined area receipts by that fraction of the area population residing in Maryland, then dividing by the Maryland population.)

	TAX					
	CONSTANT	RECEIPTS	NORTHEAST	SOUTH	WEST	R <sup>2</sup>
Coefficient	261.49	.04647	42.00	1.04	46.08	.30
(T-statistic)	(11.4)	(2.45)	(2.35)	(0.06)	(2.74)	

The F-statistic for the set of dummy variables is 4.63 (3, 44).

<sup>172</sup> This figure represents the average of state per capita receipts and therefore may differ slightly from a national average arrived at by dividing total grants-in-aid by the total U.S. population. More generally, the results of the regression treat each state as one unit rather than weighting states by population.

(the second highest income region), the regional effect reinforced the redistribution effect so that the Midwest lost a total of about \$37 per capita. The South, the region with the lowest per capita income, lost nearly as much by the regional effect as it gained by the redistribution effect and enjoyed a net benefit of about \$9 per capita. The West gained more per capita than any other region from the regional effect (about \$31 per capita) and had a net gain of about \$23 per capita.

Federal per capita personal tax collections are used in Table II as an alternate measure of the redistribution effect to determine whether federal tax revenues are redistributed through the grants-in-aid process. The results of using this measure<sup>173</sup> differ from those derived from using per capita income principally as a consequence of two factors. The federal income tax is progressive,<sup>174</sup> and hence Table II shows a greater redistribution from the richer (Northeastern and Midwestern) states to the poorer (Southern) states. A second and rather odd effect stems from the fact that the Western states pay somewhat less in federal personal taxes than one would predict from their per capita income. By one method of calculation, the states in the West pay about \$104 less per capita than they would pay if they were randomly located among the regions, taking into account the interaction of the West's higher per capita income and the progressivity of the federal personal income tax.<sup>175</sup> The

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<sup>173</sup> Federal personal tax collections (including both the personal income tax and employment taxes) were chosen rather than total federal tax collections because of concern about the methods used to allocate corporate income tax collections among the states in the statistical compilations. Using personal taxes also excludes federal excise taxes, which are reported by the location of manufacture. Kentucky, for example, accounts for a disproportionate share of total excise tax collections because of its key position in the manufacture of bourbon whiskey, though the incidence of the tax is more likely to be borne in the consuming states.

<sup>174</sup> Employment taxes, which are included in total personal tax collections, tend on the other hand to be proportional or even slightly regressive because the Social Security tax is levied as a fixed percentage of wages up to a maximum wage base.

<sup>175</sup> This result was obtained by comparing the per capita personal federal tax with the per capita income of each state and the inclusion of a dummy variable for states in the West in the estimation of a regression of the form:

$$T_i = \alpha + \beta_1 Y_i = \beta_2 X_i + \mu_i$$

where

$T_i$  = per capita personal federal tax in the  $i$  th state.

$Y_i$  = per capita income in the  $i$  th state.

$X_i$  = West dummy variable ( $X_i = 1$  if  $i$  is a western state).

$\mu_i$  = Random error term.



West, paying less than average in taxes, therefore gains through the redistribution effect by about \$10 per capita.<sup>176</sup>

The regional effect obtained by using federal tax collections is slightly different from the regional effect measured by per capita income because of the different method of calculating the redistribution effect, but the regional effect in Table II remains roughly of the same magnitude as in Table I. Again, the Northeast and the West gain and the Midwest and the South lose. When redistribution and regional effect are combined under the personal tax method of calculation, the Northeast ends up a net loser by about \$16 per capita, the Midwest loses about \$56 per capita, the South gains about \$25 per capita, and the West gains about \$36 per capita. The results under this method of calculation tend to confirm the sunbelt hypothesis, but they also show that the West gains even more than the South, and that the Midwest, rather than the Northeast, is the big loser from the combined redistribution and regional effects.

However much weight may attach to the precise results of these regressions,<sup>177</sup> it is clear that the amount redistributed constitutes only about one-tenth of the total amount transferred through grant-in-aid programs, and that the redistribution effect is either offset or reinforced by regional effects of somewhat the same magnitude.<sup>178</sup> Even if redistribution from rich to poor can be said to be an implicit function of the grant-in-aid system, it is not of great significance in the total intergovernmental fiscal system. Certainly in comparison with the West German system, where constitutionally mandated

	CONSTANT	INCOME	WEST	R 2
Coefficient	-1102	.3676	-102.01	.68
(T-statistic)	(5.26)	(9.78)	(1.59)	

B<sub>2</sub> is significant at the .90 level.

<sup>176</sup> Why the West pays less is by no means clear. If, for example, state tax collections were higher per capita in the West, then federal personal income tax collections would be less because of the deductibility for federal income tax purposes of certain state taxes. But there are many other possible explanations.

<sup>177</sup> These rather simple regressions are concerned only with the overall effect of all grant-in-aid programs and obviously do not deal with the details of the grants-in-aid system, which is composed of a very large number of individual programs. See SPECIAL ANALYSES, *supra* note 7, at 280-87 (Table 0-9) (listing of grant-in-aid programs).

<sup>178</sup> The redistribution and regional effects combined explain about 30% of the variance in total grant-in-aid receipts of the states. The T-statistics indicate that the redistribution effect is statistically significant. They also indicate that the regional effect is statistically significant insofar as the Northwest and West gain and the Midwest and South lose. However, it is not possible to state with confidence whether the Northwest or West is the larger gainer or whether the Midwest or South is the larger loser.

redistribution operates through revenue sharing between the Federation and the *Länder* and horizontal equalization among the *Länder*, the American fiscal system remains a federal system in practice and not merely in constitutional theory.

2. *General Revenue Sharing.* The introduction of general revenue sharing in 1972 was an important development in intergovernmental fiscal relations. The name is something of a misnomer because revenues are not shared. The general revenue sharing program is simply an expenditure program in which federal grants are made each year to the states without the restrictions and conditions that are the hallmark of conventional grants-in-aid. The 1972 State and Local Fiscal Assistance Act<sup>179</sup> provided for transfers averaging approximately \$6 billion per year for five years (about 2% of federal expenditures). This amount was increased to just under \$7 billion per year in the 45-month extension enacted in 1976.<sup>180</sup>

Although general revenue sharing is often referred to as a "no strings" program, a number of conditions are in fact imposed on recipient state and local governments. Not only may they not discriminate on the basis of race, color, national origin, sex, age, or religion in the expenditure of the funds,<sup>181</sup> but they are subject to a number of other conditions as well. For example, only prevailing wage rates, which means union wage rates, may be paid on projects financed with general revenue sharing funds.<sup>182</sup> Until the 1976 extension, general revenue sharing funds could be used only for "priority expenditures," a term defined to exclude welfare and general administration.<sup>183</sup> But this requirement was abolished<sup>184</sup> when studies showed that, because of the fungibility of money, recipient governmental units had virtually total discretion to spend revenue sharing funds as they liked, and could even use revenue sharing funds to decrease local taxes.<sup>185</sup>

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<sup>179</sup> 31 U.S.C. § 1221-1263 (Supp. II 1972).

<sup>180</sup> State and Local Financial Assistance Amendment of 1976, Pub. L. No. 94-488, 90 Stat. 2341.

<sup>181</sup> 15 U.S.C. § 1242 (1970), as amended by State and Local Financial Assistance Amendments of 1976, Pub. L. No. 94-488, § 8, 90 Stat. 2341. In *United States v. City of Chicago*, 395 F. Supp. 329 (N.D. Ill. 1975), a federal judge enjoined payment of revenue sharing funds to the City of Chicago because of discrimination in hiring in the police department. Cf. *Lau v. Nichols*, 414 U.S. 563, 569 (1974) (sustaining § 601 of the Civil Rights Act of 1964, 42 U.S.C. § 2000d (1970), which forbids discrimination by a program or activity receiving federal financial assistance).

<sup>182</sup> 31 U.S.C. § 1243(a)(6) (Supp. II 1972).

<sup>183</sup> 31 U.S.C. § 1222 (Supp. II 1972).

<sup>184</sup> State and Local Financial Assistance Amendments of 1976, Pub. L. No. 94-488, § 3, 90 Stat. 2341.

<sup>185</sup> See ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, GENERAL REVENUE SHAR-

The allocation of revenue sharing funds among states and among subsidiary governmental units within states was a major issue in the design of general revenue sharing. The resulting formula reflects a series of political compromises rather than any identifiable theory. Indeed, since the Senate and the House of Representatives were unable to agree upon a formula, each state (taken as a whole including its subsidiary units) is allotted the greater of two amounts, namely, what it would receive under the Senate formula or what it would receive under the House formula. This power to choose the more favorable formula is aptly called the "best of both worlds" approach.

Under the Senate formula allocation among states is made on the basis of population, relative per capita income, and "tax effort."<sup>186</sup> The House formula includes, in addition to these three factors, "urbanized" population and state income tax collections.<sup>187</sup> The House formula is thus more favorable to urban states and to states that rely more heavily on income tax relative to sales, property, and other taxes.

The practice of making federal grants directly to municipalities or other local government units predated general revenue sharing. But the potential of this practice for fragmenting state control of local government and for undermining the political position of state governors had previously been masked because grants-in-aid largely supplemented existing state and local funding of specific ongoing programs. Since general revenue sharing funds were by definition not limited to any particular activity and therefore could be used to fund new programs, the design of the sharing formula exacerbated the underlying rivalry among state governors, city mayors, and county executives. This rivalry was at least as large a factor in the legislative outcome as that among the states.

Once a state allocation is determined, one-third of that sum goes to the state government and two-thirds directly to local governments within the state. The allocation among local governments is controlled by a further formula. As a consequence, some 38,000 different governmental units receive revenue sharing checks from the U.S. Treasury. The constitutional principle that the structure

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ING: AN ACIR RE-EVALUATION 2, 11 (1974); COMPTROLLER GENERAL, REVENUE SHARING: ITS USES BY AND IMPACT ON LOCAL GOVERNMENTS 20-58 (1974).

<sup>186</sup> 31 U.S.C. § 1225(b)(2) (Supp. II 1972). The "tax effort" factor for each state is a fraction equal to total revenue from state and local taxes divided by aggregate personal income of residents. 31 U.S.C. § 1228(c)(1)(A) (Supp. II 1972).

<sup>187</sup> 31 U.S.C. § 1225(b)(3) (Supp. II 1972).

of local governments is strictly a question for each state is underscored by the wide differences in distribution patterns from state to state. Among the 38,000 recipient local units are found a wide variety of local government forms—counties, municipalities, townships, native villages (in Alaska), and Indian tribes. Four-fifths of the recipient units have fewer than 2,500 residents. The smallest recipient is the Cortina Rancheria Indian Tribe in California with a population of one.<sup>188</sup>

The “best of both worlds” approach creates incentives and effects that are difficult to measure. One thing is clear however: general revenue sharing provides no *systematic* equalization of revenues between poorer and richer states. Of the five factors found in the Senate and House formulas, only one—relative income—serves a redistributive function. The urbanization factor, though arguably a measure of need, operates in the opposite direction because the urban states are by and large the states with the highest per capita income.

Taking the program as a whole, however, general revenue sharing does not have the potentially perverse redistributive effects that characterize particular grant-in-aid programs. In general, the states with the lowest per capita income receive the largest amount of revenue sharing payments per capita. For example, the poorest state, Mississippi, has received the largest amount of shared revenue per capita, 153% of national average per capita receipts. Similarly, the state with the highest per capita income, Connecticut, has received the fourth smallest amount of shared revenue per capita. On the other hand, the results reveal some remarkable discrepancies. The second lowest per capita amount, for example, was received by Missouri, the median state in per capita income. Similarly, Alabama, fourth from the poorest state, has received almost exactly the national average amount in per capita payments.<sup>189</sup>

Whatever the results, it is clear that redistribution as such was not a major goal of the Congress. Moreover, even if redistribution had been the principal criterion, there are many ways to measure redistribution. The comparisons above, for example, do not consider what would happen in the absence of general revenue sharing (lower federal taxes, higher grants-in-aid, a lower federal deficit, etc.). In

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<sup>188</sup> FRIED, RIVLIN, SCHULTZE & TEETERS, SETTING NATIONAL PRIORITIES: THE 1974 BUDGET 280 (1973).

<sup>189</sup> These comparisons are based on R. NATHAN, A. MANVEL & S. CALKINS, MONITORING REVENUE SHARING 72 (Table 4-3) (1975); REISCHAUER, GENERAL REVENUE SHARING: THE PROGRAM'S INCENTIVES 44-45 (Table 2) (1976) (Brookings Institution Reprint No. 313).

any event, so long as general revenue sharing remains such a small percentage of state revenue—currently about 3%—any redistributive effect will be minor.

General revenue sharing at present levels could never by itself result in “a reasonable equalization between financially strong and financially weak states,” as foreseen by Article 107(2) of the German Basic Law.<sup>190</sup> The discrepancies in per capita personal income among the states are simply too great. Per capita personal income is over 60% higher in Connecticut than in Mississippi. Even between contiguous states one finds remarkable differences; for example, per capita personal income is more than 40% higher in Illinois than in Kentucky.<sup>191</sup> I have chosen per capita personal income as a measure of what equalization would require because it is a measure of propensity and ability to spend and to tax. But if one looks at actual spending and taxing, one finds equally extraordinary disparities among the states. For example, state and local governments in Delaware and Wyoming spend more than twice as much per capita than in Arkansas.<sup>192</sup> Moreover, tastes for self-taxation vary widely. Take the case of Wyoming and Texas. Per capita income was about the same in both in 1974. Yet it would have required about \$2 billion per year to bring Texas up to the Wyoming per capita state and local expenditure level, nearly one-third of the entire general revenue sharing budget.<sup>193</sup> However one wants to measure equality, the present general revenue sharing program would have to be many times larger to make significant headway toward equalization even if the richer states did not receive a penny.

With the 1976 reenactment of general revenue sharing, its future as a permanent feature of American federalism seems assured. Hence, it deserves to be considered as a feature of the Fiscal Constitution in the larger sense. Although the general revenue sharing statute does not create procedures for the resolution of important fiscal decisions as do the Budget and Accounting Act of 1921 and the Congressional Budget and Impoundment Control Act of 1974, it will most likely become a fixed pole around which both federal and state budgeting will take place. But there is no likelihood that general revenue sharing will displace grants-in-aid. On the contrary,

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<sup>190</sup> See text and notes at notes 129-30 *supra*.

<sup>191</sup> BUREAU OF THE CENSUS, GOVERNMENTAL FINANCES IN 1973-74, at 54 (Table 26)(1975).

<sup>192</sup> *Id.* at 48 (Table 22).

<sup>193</sup> Wyoming per capita personal income was \$4,695 in 1974, slightly larger than the Texas figure of \$4,571. Wyoming spends \$478 per capita, Texas \$313. The \$2 billion differential results from the fact that Texas has a much larger population than Wyoming. Texas has more than 12 million residents, Wyoming 360,000. *Id.* at 48, 54 (Tables 22, 26).

grants-in-aid are increasing at a much more rapid rate than general revenue sharing. In fiscal 1978 general revenue sharing will be at a level only about 10% higher than in 1973,<sup>194</sup> but during that same period grants-in-aid will have grown by about 65%.<sup>195</sup>

3. *Categorical and Block Grants.* The greatest controversy in the intergovernmental transfer field is the debate over categorical versus block grants. Most grants-in-aid are categorical in character. This means that any program's funds may be used by the recipient state or local government only for a single narrow purpose. In addition, categorical grants normally have elaborate conditions attached regulating the precise circumstances in which the funds may be spent. Many categorical grants also require recipient governments to match the federal funds out of their own revenues. During the late 1960s hundreds of such categorical grant programs were enacted. Today state and local governments receive assistance through 928 categorical grant programs administered by 55 federal agencies,<sup>196</sup> and the number of such programs will probably continue to grow.

A block grant, in contrast, consolidates a number of related specific-purpose grants into a single grant with a more general purpose. Within the scope of a block grant, state and local governments are normally free to spend the money as they please. Exactly how many block grant programs have thus far been enacted depends on who does the counting. The Advisory Commission on Intergovernmental Relations has identified five such programs for the purposes of its analytical work,<sup>197</sup> but their list includes the grants of the Law Enforcement Assistance Administration (LEAA), a Johnson Administration initiative more accurately viewed as a new grant-making agency designed to stimulate a quantum increase in funding in a particular sector.<sup>198</sup>

<sup>194</sup> Compare 1978 BUDGET, *supra* note 37, at 194, with BUDGET OF THE UNITED STATES GOVERNMENT: FISCAL YEAR 1975, at 146 (1974).

<sup>195</sup> SPECIAL ANALYSES 1978, *supra* note 7, at 273 (Table 0-5).

<sup>196</sup> COMPTROLLER GENERAL, IMPROVED COOPERATION AND COORDINATION NEEDED AMONG ALL LEVELS OF GOVERNMENT 1 (1975).

<sup>197</sup> The Advisory Commission lists the following five statutes as creating block grants: Partnerships for Health, the Omnibus Crime Control and Safe Streets Act, the Comprehensive Employment and Training Act, Title XX of the Financial Security Act, and the Community Development Block Grant portion of the Housing and Community Development Act of 1974. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, BLOCK GRANTS: A ROUNDTABLE DISCUSSION (1976).

<sup>198</sup> See ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, SAFE STREETS RECONSIDERED: THE BLOCK GRANT EXPERIENCE 1968-1975 (1977). An earlier Johnson Administration initiative, the 1966 Partnerships for Health Act, also consolidated a series of categorical programs, but again a principal motivation was a substantial increase in funding. See ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, THE PARTNERSHIPS FOR HEALTH ACT: LESSONS FROM A PIONEERING BLOCK GRANT (1977).

The most ambitious block grant proposals were the Nixon Administration's special revenue sharing plans to consolidate about one-third of all federal assistance to the states into six special revenue sharing programs.<sup>199</sup> The special revenue sharing proposals proved to be anathema to the Congress, in part because they would have disrupted the existing allocation of congressional committee jurisdiction. Thereafter both the Nixon and the Ford Administrations made block grant proposals on a more ad hoc basis. The only block grants to result from that period are the 1973 Comprehensive Employment and Training Act,<sup>200</sup> consolidating 12 categorical manpower programs, and the 1974 Housing and Community Development Act,<sup>201</sup> consolidating seven categorical community development programs (of which the best known were Urban Renewal and Model Cities).<sup>202</sup> The Carter Administration's views on block versus categorical grants are as yet unknown. But if the Carter Administration, in line with its views on reorganization of the federal government, should also attempt to consolidate various categorical grant-in-aid programs, it is not at all clear that the Congress will be prepared to go along.

The principal arguments *for* block grants are that (1) categorical programs cause waste because the precise categories and conditions are not always appropriate for the diverse situations to be found in the states; and (2) categorical programs make it difficult for governors and mayors to govern by relegating them to the status of administrators of federal grant conditions and by restricting their ability to reflect the preferences of their constituents in the allocation of resources. The leading arguments *against* block grants are that (1) categorical grants do not in fact constrain recipient governmental units in any significant way because money is fungible and federal grants-in-aid remain only a fraction of total state and local revenue; and (2) for a variety of political reasons transfers to state and local governments—particularly to large cities—would be smaller under a block grant than under a categorical grant approach. To meet the second argument part way, block grant propos-

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<sup>199</sup> OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1972, at 11-15 (1971).

<sup>200</sup> 29 U.S.C. §§ 801-992 (Supp. III 1973).

<sup>201</sup> 42 U.S.C. §§ 5301-5317 (Supp. IV 1974); see ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS: THE WORKING OF A FEDERAL-LOCAL BLOCK GRANT (1977).

<sup>202</sup> The 1974 enactment of Title XX to the Social Security Act, 42 U.S.C. §§ 1397-1397f (Supp. IV 1974), providing grants to the states for social services has also been characterized as a block grant program. See ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, BLOCK GRANTS: A ROUNDTABLE DISCUSSION 6-9 (1976).

als usually contain a "hold harmless" clause that provides that no recipient unit would receive less under a block grant than it previously received from the total of the categorical programs to be consolidated in the block grant. As suggested above, a political objection to block grants in the Congress is that they would tend to force a redefinition of the jurisdiction of congressional committees and, by eliminating particular categorical programs, they might even eliminate the *raison d'être* of some specialized subcommittees.

#### D. Intergovernmental Planning

Taxing and spending together determine the budget surplus or deficit of each level of government. Since the governmental surplus or deficit is widely regarded as having a crucial impact on the economy, an important question for fiscal federalism is the extent to which federal authorities will join together with state and local authorities to plan an overall budgetary surplus or deficit.<sup>203</sup> The almost total absence of intergovernmental planning in the United States contrasts with the great interest in such planning in West Germany. The Basic Law now commands multiyear intergovernmental planning,<sup>204</sup> and an expert commission on constitutional reform has recommended a far-reaching expansion of such planning.<sup>205</sup>

Whether intergovernmental planning as it presently exists in West Germany is of substantive importance or is merely cosmetic may be questioned,<sup>206</sup> but at least the desirability of such planning is widely discussed. In the United States both the substance and the discussion of intergovernmental planning are largely lacking. The principal point of intergovernmental bureaucratic contact is between grant-making bureaus within the federal executive departments and state or local grant-administering agencies. But these officials are concerned with the terms and conditions of the grants-in-aid and the impact of these terms and conditions on state substantive programs, not with overall fiscal planning.

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<sup>203</sup> This is not to deny that there are significant differences between a surplus or deficit at the federal level and a surplus or deficit at the state or local level. The most important difference of course is that although all levels of government can borrow when they are in deficit only the federal government can finance a deficit by printing money.

<sup>204</sup> GG arts. 106(3)(1), 109(3). It should be noted that intergovernmental planning in West Germany extends beyond macroeconomics to expenditure planning in particular sectors. See *id.* art. 91a(3).

<sup>205</sup> ENQUÊTE-KOMMISSION VERFASSUNGSREFORM, SCHLUSSBERICHT [ENQUÊTE-COMM'N FOR CONSTITUTIONAL REFORM, FINAL REPORT], BUNDESTAGSDRUCKSACHE VII/5924, at 148-93 (1976).

<sup>206</sup> *Id.* at 152; Baade, *Mandatory Appropriations of Public Funds: A Comparative Study* (pt. 2), 60 VA. L. REV. 611, 650-54 (1974).



Government documents, scholarly studies, and the media in the United States devote great attention to the macroeconomic significance of the deficit or surplus of the federal budget. In contrast, the deficit or surplus of state and local governments is normally ignored in these discussions. If state and local deficits are mentioned, they are considered not in terms of their macroeconomic significance but in the context of the "need" for larger grants-in-aid in functional areas where expenditures are growing rapidly (such as welfare). Indeed, even where state and local governments have a combined surplus, this fact is far less important in public discussion than the "need" created by the deficit of certain state and local governments.<sup>207</sup>

The currently perceived inadequacy of conventional macroeconomic theory to explain recent economic events may lead to greater interest in state and local finances. But even if some form of planning should emerge, recent experience indicates that it will not take the form of encouraging state and local governments to follow the lead of the federal government in running a deficit or surplus. On the contrary, most of the recent attention in Congress and the Treasury has been focused on the difficulties of those relatively few states and municipalities (notably New York City) that are near bankruptcy.<sup>208</sup>

Although intergovernmental planning as such is not a feature of American federalism, limited steps have been taken to ensure that federal programs are responsive to state and local needs and preferences. After passage of the Intergovernmental Cooperation Act of 1968,<sup>209</sup> which called in general terms for improved coordination, the Office of Management and Budget issued Circular A-95. The Circular requires the government agencies administering 138 federal programs deemed to have an impact on local communities to notify various state and local institutions of proposed federal

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<sup>207</sup> Although one might gain the impression from the special pleading of state and local governments appearing in the press that state and local governments generally run in the red, state and local governments ran a collective surplus in 1972 and 1973 and again in the last half of 1975. See 1976 JOINT ECONOMIC REPORT 102 (Table VII/1) (1976). One hears of deficits but rarely of surpluses. Indeed, if state and local budgets were calculated on the same "unified basis" the federal government uses, state and local governments ran a combined surplus in every year of the 1970s. In a unified budget presentation, trust funds and general funds are consolidated to reflect the effect of expenditures on the economy. Similarly, on a national income accounts basis state and local governments have been in collective surplus since 1968. ECONOMIC REPORT OF THE PRESIDENT 272 (Table B-73)(1977).

<sup>208</sup> See, e.g., New York City Seasonal Financing Act of 1975, 31 U.S.C. § 1501 (Supp. V 1975).

<sup>209</sup> 42 U.S.C. §§ 4231-4233 (1970).

development projects and to permit them to comment on those projects. In turn, local governments are required to notify state governors and a regional "clearinghouse" before applying for federal assistance so that other affected governments and organizations can be made aware of any project that will have an adverse impact on them and may file comments along with the application. The Circular A-95 process works well when all parties comply with its provisions, but compliance appears to be spotty. Nevertheless, even if the Circular A-95 process worked perfectly, it would still be an information system rather than a planning system.<sup>210</sup>

### CONCLUSION

The past few years in the United States have seen a fundamental shift in public attitudes in fiscal matters. From the period in the early 1960s when the principal problem appeared to be "fiscal drag" (that is, the possibility that the tax system might produce more tax revenues than would be spent and hence drag the economy into recession), the United States has reached a period in the mid-1970s where many, if not most Americans believe that there is no longer any way of financing the basic needs of the country.

No doubt the truth lies somewhere between these extremes. What is significant here, however, is that throughout the entire 1960-1977 period it has never been seriously suggested that the Constitution stood in the way of desirable change. Indeed, one has to go back to the period between the 1894 *Pollock* decision and the 1913 ratification of the sixteenth amendment to find public controversy over the Fiscal Constitution.<sup>211</sup> When the need for fundamental change has become widely recognized, change has taken the form of "framework" legislation, most recently the Congressional Budget and Impoundment Control Act of 1974.<sup>212</sup>

Meanwhile, fiscal federalism has continued to flourish. Even when a crisis like that of New York City erupts, no one seriously questions the future of American federalism. At most, it is assumed that pragmatism will lead to ad hoc accommodations. To be sure, the expansion of federal legislation and the federal budget causes some pessimists to worry about the future of the states. But the

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<sup>210</sup> For further discussion of the Circular A-95 process, see COMPTROLLER GENERAL, IMPROVED COOPERATION AND COORDINATION AMONG ALL LEVELS OF GOVERNMENT (1975); OFFICE OF MANAGEMENT AND BUDGET, CIRCULAR A-95: WHAT IT IS, HOW IT WORKS (1974). The text of Circular A-95 may be found at 38 Fed. Reg. 32874 (1973).

<sup>211</sup> See text at note 82 *supra*.

<sup>212</sup> 31 U.S.C. §§ 1301-1407 (Supp. V 1975), discussed in text at notes 39-43 *supra*.

growth of grants-in-aid offsets the growth of the federal establishment. If the states have anything to fear, it is not that they will dwindle in size relative to the federal government, but rather that their freedom of action will be constrained by the terms and conditions of grants-in-aid. Yet the success of general revenue sharing, the interest in block grants, and recent Supreme Court decisions such as *National League of Cities v. Usery*<sup>213</sup> are straws in the wind suggesting a renewed independence for the states.

Beneath the surface of change are the undeniable facts that state and local governments spend about three-fourths as much as the federal government,<sup>214</sup> that they employ many times as many people, that they continue to pursue widely different expenditure policies in such basic areas as education and transportation, and that there has been no serious attempt to equalize revenues among the states. Whatever the state of health of federalism generally, fiscal federalism is still very much alive.

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<sup>213</sup> 426 U.S. 833 (1976), *discussed in text at notes 39-43 supra*.

<sup>214</sup> *See text and note at note 136 supra*.