

MEMORANDUM

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TO: Howard P. Willens, Esq.
FROM: Howard N. Mantel
SUBJECT: Briefing Paper No. 7: Taxation and Finance (Draft August 20, 1976)
DATE: August 31, 1976

I had asked Jonathan Weiner and Professor Eli Silverman to review the paper. I am incorporating comments by Mr. Weiner into this memorandum and will do so with Professor Silverman's (he is to phone me later this morning).*

At the outset I have one general question, which transcends a number of the reports, but is posed by an initial statement in this paper and then a specific suggestion with respect to this paper.

1. It would be useful to have available a succinct statement on the application of the U. S. Constitution to the formation of the Commonwealth government, and particularly, to the Constitution that will be drafted.** The paper on land alienation dealt in some detail with U. S. Constitutional applications, based on the particular issue posed there and the special provision of the covenant excepting \$805 from "those provisions of the Constitution... applicable to the Northern Mariana Islands..." In the instant paper (p. 1, second paragraph) you indicate that the 10th amendment gives the Commonwealth "... all the powers not reserved by the federal government." There is a seeming

* Jonathan Weiner was trained in public administration and finance at the Maxwell School, Syracuse University. He is a former Assistant Director of the Budget of the City of New York and served as a special consultant to the Comptroller, and currently is consultant to the Municipal Assistance Corporation (MAC). Professor Silverman is chairman of the Department of Government of the John Jay College, City University of New York, and has taught state and local finance.

** See next page.

contradiction between the first sentence of that paragraph and the third one though it is not terribly urgent. More important, however, is the overall question, which confuses me somewhat, on the application of the U. S. Constitution. If there were a succinct statement on the application of the U. S. Constitution to the basic powers of the framers of the Constitution, this would be most helpful. It struck me particularly as I began to read this paper and therefore I am passing the thought along at this juncture.

2. It would be most helpful for this paper to have a brief factual overview on the financial status of the Islands. This involves basic grants from the federal government and changes that will be occurring as a result of the covenant and the separation from the Trust Territory; shifts in such things as social security taxes and federal grants, basic size of the public budget for the Northern Mariana Islands, local tax resources, property values (assuming a property tax is intended), etc.

Much of this cannot be done for this paper, I suspect. But some basic facts in a short page or two would help frame the issues a little more concretely, I believe. Again, I pass this along for whatever it is worth.

Page 1, paragraph 2, second sentence

Is this quite accurate? It may be true that the Commonwealth has substantial fiscal capacity under the 10th Amendment but the authority of the Commonwealth government to exercise that facet of its sovereignty does require either constitutional or statutory authority. Thus, restrictions

** Such a discussion of the application of the U. S. Covenant clearly would start with §501 of the Covenant, followed perhaps by a general statement on application and then any special status such as the exemption clause in §805 of the Covenant.

in the Constitution are constraints on what the operating agencies or officials of government can do or, conversely, grant to them the exercise of the inherent capacity of the Commonwealth. I think the difference is semantic but perhaps some rewording is in order.

Page 2, 3.

Do the privileges and immunities clause apply to relationships between the 50 states and the Northern Marianas? Put another way, is the Commonwealth (once the new government is in effect) a state for the purpose of several of the constitutional provisions referred to?

Page 4, paragraph 2

Since the covenant specifies the taxing capacity of the Commonwealth, is this a contradiction of the first sentence of the second paragraph on page 1?

Page 7, paragraph 1, 3rd sentence

One might introduce in this discussion a political note: once a restriction or a grant of taxing authority is in the Constitution it usually requires voter approval for change. In effect this has the political advantage (for unpopular matters) of passing the buck to the public. It cuts both ways of course, but you may want to make the point. The fourth sentence might be redrafted somewhat more artistically. The problem may be that legislatures are too responsive to public opinion and, therefore, you need more difficult means of avoiding the caprices of the body politic. I suggest that you omit the last sentence on page 7 continuing to page 8. It's a wee bit sophomoric.

Page 8, first full sentence.

What point are you trying to make here? Limitations on local government authority to tax property clearly applies to the special group called property holders. I think if the statement is to have meaning, some examples, perhaps drawn from other state constitutions, might be put in.*

Page 9, top sentence

Does the vesting of "exclusive power to raise revenue by taxation" exclude taxation authority in local governments?

Page 9, paragraph 1

This provision can impede certain aspects of modern budgeting and should be rather carefully reviewed with respect to its consequences. While budgeting matters are dealt with later, it should be recognized that the treatment of fiscal years as absolute divisions both with respect to income and expenditure often is unrealistic.

-----, paragraph 3, footnote 4

The reference to the Connecticut constitution is not entirely correct see, e.g., Article IV, §22, 24 and 26; Article VIII, § 4.

Page 10, paragraph 1

I suppose one could add a fourth item which would be a prohibition on certain types of revenue raising, such as public lotteries, or specific types of taxes.

Page 11, paragraph 1

The first concept of restrictions designed to control abuses has come full circle in light of current state or municipal efforts to encourage

* James M. Buchanan make this statement: "Our fiscal institutions actually chosen under conditions that remotely resemble those postulated here? Are institutional choices made separately from day-to-day choices? Exhaustive research into the political process is not required to establish the general

industrial development. There have been a number of problems under restrictive constitutional provisions and a degree of inventiveness to overcome these restrictions, short of their outright repeal. With respect to the second concept I gather that you are referring to the distinction between the general community benefit of a particular public service and the more individualistic or class benefits that accrue. We generally regard education, for example, as a benefit accruing to the entire community and hence we do not charge the individual who is educated (or his parents). In the case of higher education, costs tend to be shared and the student is expected to pay a portion of his way. In the case of public transportation, the general tendency has been to charge full operating costs, at least, to the transit rider, although this principle has been invaded substantially in recent years, and we now more readily accept the concept of transit subsidies, both for capital and operating expenses. On the top of page 12 you might introduce the notion of cost-sharing by saying "... to bear more directly a portion of the cost of the service."

One needs to distinguish also the issue of cost-benefit principles from earmarking principles. I assume that is dealt with separately infra.
Page 13, paragraph 1, third sentence

It may be wise to caution the delegates that language purporting to illustrate what is meant by "public purpose" may simply increase litigation

conclusion that the models of decision do have considerable relevance for real-world events. Nothing more than every day observation is required to reveal that fiscal institutions are debated, discussed, and finally selected quite independently of public-goods choices. For example, the political discussion on tax reform in the United States in 1963 and 1964 which carried on largely without any consideration of the choices of spending programs that might be consequent to the reform. In part this partitioning of fiscal decision process may well be due to fundamentally irrational or inefficient elements, and a greater allowance for the real interdependence among fiscal variables at all levels might well be highly desirable." Public Finance in Democratic Process, 1967, p. 220.

on the subject. There is a very strong case to be made for brevity in the choice of language.

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Page 15, first full paragraph

One might raise the question, although I do not think it is critical here, of the legitimacy of using industrial development bonds not only to finance construction but for marketing purposes as well. Broadly, one might take the positive view that a "public purpose" is served when the Commonwealth takes actions that have a direct causal link to employment and broadening of the tax base.

Page 17, top paragraph, sentence 2

Jonathan Weiner makes the following comment which may be useful to note: "The text might be even stronger than it is in cautions on uniformity clauses which in some cases have caused havoc in levying sensible income taxes. In the case of the Commonwealth, I think the point may be moot, however, in light of the provisions of the Covenant."

Page 22, b, 1. Property Tax

You might at the outset indicate that while the property tax remains an important source of income for local and state governments, percentage of general revenue derived by state and local governments from property taxes has shrunk considerably as other income sources have increased in popularity and revenue. Thus, for the United States as a whole, property taxes contributed 43.5% of state-local general revenues in 1942, but by 1971, this figure had shrunk to 26.1%.*

I understand that Hawaii has a state property tax administration system as distinguished from practice in the other states.

* The 1942 figure excludes Alaska and Hawaii. Data derived from Advisory Commission on Intergovernmental Relations, Federal-State-Local Finances: Significant Features of Fiscal Federalism, 1973-1974 Edition, Table 22, p. 35. The figures change dramatically on a state-by-state basis. New Jersey, which traditionally relied very heavily on property taxes, saw a shift of reliance of 66% in 1942 to 39.3% in 1971; and this figure will shrink again as the income tax is introduced.

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Page 24

Local only

You might add some discussion on the case for removing restrictions on local taxing powers, particularly property tax authority. The Advisory Commission on Intergovernmental Relations in October, 1962 issued an exhaustive study, State Constitutional and Statutory Restrictions on Local Taxing Powers. The Commission recommended "...the lifting of constitutional and statutory limitations on local powers to raise property taxes...Such limitations are inimical to local self-government and should be lifted." (Page 6) The report also suggested that statutory limitations are preferable to constitutional limitations and that tax rate limitations, if imposed, "...should be in terms of the value of taxable property equalized to full market value rather than fractional assessed value." While the data in this report is merely a decade and a half old, the report itself is quite good.* Finally, with respect to the use of the property tax for Commonwealth purposes, it is interesting to note a comment in the Book of the States (1976-77): "One of the most encouraging effects of the recent activities related to school finance reform has been the increased attention given to property tax reform. There is a growing realization that meaningful school finance reform cannot occur unless its fiscal foundation--the property tax--is administered equitably and structured rationally...A restructuring of the taxes under consideration in some states has been tried in others. A statewide property tax for schools is the most common suggestion. In between that suggestion and the current structure, however, is a two-tiered property tax structure, with one uni-

*The approach recommended in the ACIR report was reaffirmed by the Committee for Economic Development. Its report, A Fiscal Program for a Balanced Federalism, June, 1967, p. 33, said: "Limitations on local powers over property taxes and debt should be removed from state constitutions and, where desirable, should be imposed only by statute."

statewide levy and a smaller, and probably non-uniform, local levy."
(Page 316).

Page 25, paragraph 2

*Added
only*

New Jersey I gather has broadened its homestead exemption as part of the quid pro quo for the imposition of the state income tax. You might mention either here or in the subsequent discussion on exemption the use of the 'circuit-breaker' approach which is, according to the Book of the States, "... a property tax relief mechanism which provides a refund or tax credit based on the amount of the claimant's income and his property tax liability." (Page 283). The Committee for Economic Development comes out flatly against property tax exemptions, stating, "Property tax exemptions for special private interest groups, such as homesteaders and veterans, should be abolished. If states continue to require such subsidies through property tax exemptions, they should reimburse local governments for the revenue losses incurred. State and local governments should also negotiate with private tax-exempt organizations to pay for direct services rendered."*

Page 26

You do not discuss lotteries or gambling as revenue sources. This is likely to arise and it may be better to present some of the experience of state and local governments in recent years with such approaches. New Jersey, I believe, has an item on the ballot this November on legalizing gambling in Atlantic City. One can envision proposals, regardless of their source, to make the Northern Marianas the Nevada of the South Pacific. Finally, you might wish to address at this

*A Fiscal Program for a Balanced Federalism, pp. 33-34. It is interesting to note that one of the members of the CED committee which wrote this report suggested that the abolition of property tax exemptions be extended to exemptions granted for new industrial facilities (p. 53).

point other revenue sources than taxes. You refer to at least one aspect of this indirectly supra in referring to imposing a portion of the cost for services delivered to particular groups of the public. Increasingly, service fees or user charges play an important role in aspects of the local government fiscal pattern and this may increase relative to the total revenue source of such governments.

Page 27, paragraph 2

You might add to the list of dangers: inequity with respect to tax liability. This is especially true of broad scale property tax exemptions for certain classes of individuals which do not necessarily affect capacity to pay, e.g., the elderly. It may also be useful to note that exemption practices often are cumulative, with little comprehension of the cumulative impact on the tax base. Politically, exemptions are usually accomplished through amendment of state legislation even though the impact is felt principally at the local government level.

Page 29, top paragraph, second full sentence

Because it is important both to comprehend on a continuing basis the short and longer term fiscal implications of particularized exemptions, avoiding freezing exemptions in constitutions makes sense, albeit delegation of exemption authority to the legislature opens the door for short-term political bargaining.

Pages 29-30, last paragraph

One problem which arises is the use of user charges as an alternative to taxation for routine local matters such as water supply, sewage disposal, and garbage collection. If these services are provided within the general budgetary scheme of a local government, then non-profit

organizations will be getting these services "free." If such particular services are provided on a partially subsidized or non-subsidized basis, then the non-profits presumably will pay some of these costs, unless they are specifically exempted from such payments.

Page 30, 2, last sentence

You might note that according to the Book of the States (1976-77), page 283, California voters approved a constitutional change to require a \$7,000 homestead exemption.

Page 31, top line

One "far-out" possibility is for the Constitution to mandate a formal review periodically of exemptions granted by law, assuming that route is taken, with a particular reference to the cost implications and consequential tax burden on those who are not in exempt categories. This would have the advantage, hopefully, of revisiting matters which too often creep into statutes or constitutions and multiply as fairly expensive shelters for a wide variety of groups.

Page 34, sentences 3 and 4

This slides rather rapidly over a major principle of public finance, namely, that to the extent feasible the appropriation process should have the widest latitude in setting priorities and distributing available funds according to those priorities. You make the point quite adequately in the third paragraph on page 36. Perhaps that paragraph should be brought up to page 34. Politically (and this is especially true in the highway field) earmarking is a preferred method of keeping it "close to home." Highway advocates, for instance, strongly oppose invasion of the Federal

Highway Trust Fund, for mass transportation purposes. In New York City we recently had the example of a bill (unique because it was the first one in recent history to pass over the Governor's veto) that earmarked a specific percentage of local revenues for public school education in New York City (the so-called Stavisky-Goodman Bill). The bill was opposed strongly by the Mayor, was challenged in court and appears not to be valid.

Page 37, top paragraph, first and second full sentences

I am not sure the statements are entirely correct although they may have that effect. Earmarking doesn't mean unlimited funds and for many purposes earmarked funds may not be the sole revenue source. In a governmental situation in which there is a comprehensive budget (as distinguished from situations which rely heavily on special district financing for a range of services), budget practices still prevail, as well as a variety of accountability and auditing mechanisms.

Page 37, first paragraph

One might mention the prevailing use in suburban parts of the United States of the special district mechanism in which not only are particular services financed by a particular mill levy but, in addition, those services are delivered through a separately created instrument. The most common of course is the fire district.

-----, second sentence

There is a counter argument for the "overriding importance" argument: no sensible government will ignore basic services or minimal levels of support.

Zero-based budgeting is very much in vogue these days. To the extent it reflects sophisticated and analytical approaches to budgeting, it will be immediately stymied by earmarking. That fact might be highlighted for the delegates, but I am not suggesting that we sanctify the zero-based budgeting in the Northern Marianas constitution.

Page 38, Tax Rate Limitations

Again I invite your attention to the ACIR report, State Constitutional and Statutory Restrictions on Local Taxing Powers, 1962 which deals extensively with the subject.

Since you now turn to the subject of debt, it may be useful to pose an issue that is not sufficiently highlighted in the report thus far. This has to do with the concept of separate local tax systems. The delegates should be aware of one feasible option, even assuming there is a local government structure within the Commonwealth. That is, should the Commonwealth be the sole instrument for raising tax revenue rather than dividing such function between the Commonwealth and individual local governments. There are strong pros and cons both ways, but the principal argument in favor of a single tax revenue is the ability to collect revenues from the widest revenue base and then distribute according to equitable formula. (There is a second argument which has to do with efficiency of tax collection, but the two points are separable. That is, even where there is a local tax authority, the Commonwealth could act as the administrative agency for that local government function.)

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Page 43, paragraph 1

You might introduce the two subjects which have caused considerable concern in recent years. The first is the practice of issuing short-term debt in anticipation of tax and other revenues or in anticipation of bond proceeds or simply for deficit finance. The second issue is the matter of moral obligation bonds designed to overcome constitutional or other limitations on full faith and credit bonds. One issue is whether

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the moral obligation bonds should be flatly prohibited by the Constitution in favor of the two traditional types of bonds.

Page 45. A.

Various devices have been invented over the years to overcome constitutional debt limits. This might be elaborated on a bit here or in a subsequent section.

-----, B Footnote

There is considerable evidence in recent years (cf. Book of the States) of voter turndown of referenda on the creation of debt. Doesn't that contradict the statement in the model state Constitution?

Page 46. D.

Jonathan Weiner notes: "The paper does note that restrictions might be imposed upon maturities and repayment of debt without much discussion. One might wish to outline briefly the reasons behind exclusive use of serial issues rather than term bonds with sinking funds and also the several reasons for imposing restrictions on maturity. Again, I don't find constitutional specificity altogether desirable. Yet the issues might be set forth."

Should you have an explicit discussion of the issue of setting interest rate ceilings on public debt? I haven't checked whether any state constitutions so provide but it may be wise to identify the issue.

Page 50, top paragraph, last sentence

Do you really want to retain that sentence?

Page 55, first paragraph, second sentence

Again, the use of "moral obligation bonds" might be noted.

Page 56, paragraph 2, first sentence

I gather that what you mean in the first part of the sentence is that the Constitution can establish the essential structure or offices responsible for fiscal management but no further details. The traditional area of constitutional focus has been on the role and method of selection of auditors.

Page 57, top paragraph

The issue, suggested supra, is the feasibility of institutionalizing a single comprehensive financial management system for all Commonwealth and local governments.

Page 60 (2) Budget, paragraph 1

A more comprehensive statement of what a budget is is critical here. The first sentence of the paragraph starts out well but then you immediately go into concepts of balance sheets and the like which I think loses the thrust of the point. The budget and the appropriation process that follows the budget formulation constitute the most important political decision that any government makes. I think that point ought to be made loud and clearly.

It may be useful to quote from a recent book, Management Policies in Local Government Finance, 1979 (J. Richard Aronson and Eli Schwartz, eds.): "The heart of the budgetary process--a plan for the coordination of expenditures and resources--remains essentially the same as in the days of the Bougette... For thousands of municipal officials the budget gives structure and meaning to the ebbs and flows that are the financial expression of the urban governmental process." (Page 63)

Page 62, paragraph 1, last sentence

Is not the point really that the budget is an executive function while the appropriation of funds remains a legislative function? I think the reference to the legislature's "secondary powers" tends to lower the legitimate legislative role. One recent New York City innovation, incorporated in the 1975 Charter, is for the Mayor to put together a preliminary budget based on departmental estimates and then for the legislative bodies to hold hearings on the preliminary budget before the Mayor submits his formal budget to them. This is not the prevailing practice and is probably too complicated for the Northern Marianas situation, but it is an innovation worth mentioning.

Page 63, paragraph 2, last line

One might also mention that in fact budgeting is an ongoing process and while it must have some metes and bounds in terms of various calendar requirements, it is not always easy to fit all of the expenditure patterns into a single fiscal year arrangement. While biennial budgeting has some advantages, more modern concepts recognize the uncertainties in expenditure patterns, as well as the need in budget administration to have tight control over the allocation of appropriate funds,

either on a quarterly or even on a monthly basis. But this probably gets a little far afield from constitutional requirements.

Page 64, (3) Audit

The most recent term is management or performance auditing.* Emphasis is not only made on whether an expenditure was authorized or whether the goods and services that have been purchased actually have arrived or have been done in a manner consistent with the objective of the expenditure, but the quality of what is being expended. One problem, which may not be apparent in the Northern Mariana Islands, is the constraint on approving vouchers for payment where each such voucher must be approved by a single controller. It may be feasible to divide auditing responsibility between executive branches and more formal post auditors, the burden for voucher reviews and inspection of goods and services prior to payment remaining in the executive branch, subject to certain standards and controls to insure accountability.

Page 66, fn. 1

I suspect that you want to identify the question of selection of controllers or auditors in the text rather than relegating the subject to a footnote.

* You might want to use the following which is taken from the book cited above; Management Policies in Local Government Finance: "Operational auditing has become increasingly prevalent in the past few years. A major factor in its acceptance has been the growth of professionalization in governmental administration and the resulting increase in emphasis on quantitative and qualitative analysis. Moreover, with growing public awareness of the government sector's impact, managers are called upon more often to report upon and justify their administration of public resources." (Page 298) Note that the work was published in cooperation with the Municipal Finance Officers Association by the International City Management Association.

It may be useful as a source for data to review an article by Selma J. Mushkin, "Fiscal Outlook in the States," State Government, 1975, pp. 116-121. Dr. Mushkin is Director of the Public Services Laboratory, Georgetown University, and a leading expert on tax systems. The same volume of State Government contains two additional articles that may be worth referring to at various points, although I did not incorporate them earlier in my comments.

The first is, "Legislative Budgetary Oversight in New York," by Eli Silverman. This is probably worth referring to when reviewing the paper on the legislature.

The second is an article by Kenneth T. Palmer and Roy W. Shin, "Compensatory Payment Plans in the States." The salient point of the article is, "State legislatures, in particular, are now being asked to provide by general statute some form of compensation to localities on account of the tax-exempt status of state-owned facilities."