BRIEFING PAPER NO. 10

TAXATION AND FINANCE

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TAXATION AND FINANCE

The ability of modern government to provide programs and services for its citizens ultimately depends upon the extent to which sufficient revenues can be raised and efficiently utilized. The constitutional article on taxation and public finance provides the guiding principles for this critical function of the government. This paper will address the main issues that must be addressed in drafting such an article and the resolution of these issues in other jurisdictions within the United States. Part I of the paper discusses the limits placed on the Convention by the United States Constitution and the Covenant, the current methods of taxation and finance in the Northern Mariana Islands, and the general policy considerations relevant to decisions on taxation and finance. Part II of the paper presents the specific issues requiring decisions by the delegates. The first section of part II deals with taxation and discusses the power to enact taxes, the available types of taxes, possible tax exemptions and possible limitations on the taxing authority. The second section of part II is concerned with public finance (or public debt) and addresses the Commonwealth's borrowing authority and the most common restrictions placed on debt.

I. BACKGROUND AND GENERAL CONSIDERATIONS

A. Relevant Provisions of the United States Constitution and the Covenant

Article I of the United States Constitution contains express limitations on the taxing power of the states. Only one of these express limitations, that dealing with tonnage taxes,[1/] is applicable to the Commonwealth.

In addition to this specific limitation, other general restrictions apply to taxation as well as other governmental powers exercised in all United States jurisdictions. The most important of these include:

1. Federal statutes and treaties take precedence over state laws;[2/]

2. States may not impair the obligation of contracts;[3/]

1/ Article I, § 10, cl. 3 of the United States Constitution prohibits tonnage taxes. Tonnage taxes in effect are charges for the privilege of entering, trading in, or lying in a port. Clyde Mallory Lines v. Alabama, 296 U.S. 261, 265 (1935).

The Commonwealth of the Northern Mariana Islands is empowered to levy duties in accordance with §§ 603-05 of the Covenant. See Buscaglia v. Ballester, 162 F.2d 805 (1st Cir.), cert. denied, 332 U.S. 816 (1947) (prohibition of duties is applicable only to the states and not to unincorporated territory of Puerto Rico).

2/ U.S. CONST. art. VI; Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 210-11 (1824).

3/ U.S. CONST. art. I, § 10; Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934). The Covenant expressly makes this section applicable to the Commonwealth. COVENANT art. V, § 501.

3. Each state must give citizens of other states the same privileges and immunities given to its own citizens;4/

4. No state shall deprive any person of life, liberty, or property without due process of law;5/ and

5. No state shall deny equal protection of the laws.6/

Three other restrictions are not found specifically in the United States Constitution, but the courts held them to be implied:

1. States may not tax property or instrumentalities of the federal government;7/

2. States may not burden interstate commerce by discriminatory taxes;8/ and

3. States may not impose taxes infringing upon liberties guaranteed by the Constitution.9/

4/ U.S. CONST. art. IV, § 2; Ward v. Maryland, 79 U.S. (12 Wall.) 418, 429-30 (1871). The Covenant duplicates this provision, COVENANT art. III, § 304, and makes the section of the U.S. Constitution applicable to the Commonwealth. COVENANT art. V, § 501. In the context of taxation, this section may be interpreted as prohibiting taxation that discriminates against the citizens of other United States jurisdictions.

5/ U.S. CONST. amend. 14; Lochner v. New York, 198 U.S. 45 (1905).

6/ U.S. CONST. amend. 14; Railway Express Agency v. City of New York, 336 U.S. 106 (1949).

7/ McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819).

8/ U.S. CONST. art. I, § 8, cl. 3; Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938). This section is not made directly applicable to the Commonwealth by the Covenant. COVENANT art. V, § 501(a).

9/ Murdock v. Pennsylvania, 319 U.S. 105 (1943) (freedoms of speech, press and religion); Grosjean v. American Press Co., 297 U.S. 233 (1936) (freedom of press).

Finally, the general principle of the equal protection clause, that citizens are to be protected against arbitrary classifications, has been repeatedly held to extend to taxes as well as other kinds of regulation. The Supreme Court has reiterated the requirement that differences in tax treatment must be based on some reasonable consideration of varying circumstances or policy.[10/]

The Covenant deals extensively with the revenue raising and taxing powers of the Commonwealth.[11/] The Covenant requires a territorial income tax based on the federal Internal Revenue Code.[12/] In addition, the Commonwealth government is specifically empowered to levy such other taxes as is deemed necessary.[13/] The only Covenant

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10/ While the Supreme Court is usually generous of a legislature's power to classify, classifications that tend to impinge on interstate commerce generally stand a greater chance of invalidation by the Court. *E.g.*, *Norfolk W. Ry. v. Missouri State Tax Comm'n*, 390 U.S. 317 (1968); *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967); *Nippert v. City of Richmond*, 327 U.S. 416 (1946).

11/ The whole of article VI is devoted to revenue and taxation.

12/ COVENANT art. VI, § 601 provides: "The income tax laws in force in the United States will come into force in the Northern Mariana Islands as a territorial income tax . . . ."

13/ COVENANT art. VI, § 602 provides: "The Government of the Northern Mariana Islands may by local law impose such taxes, in addition to those imposed under Section 601, as it deems appropriate . . . ."

provision that deals with governmental borrowing, section 607, imposes a 10 percent debt limitation during the first seven years of financial assistance and thereafter as may be agreed upon.

B. Current System of Taxation

Under the Secretarial Order, the Trust Territory laws and the provisions of the Northern Mariana Islands shall remain in effect until altered by the Northern Mariana Islands legislature.[14/] The Trust Territory Code currently imposes a three percent tax on wages and salaries, subject to an annual personal deduction of $1000.[15/] In addition, there is a gross business revenue tax,[16/] license fees,[17/] a scrap metal export tax,[18/] various export and import taxes,[19/] a fuel tax,[20/] authorization for a municipal excise tax[21/] and

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14/ Sec. Order No. 2989, 41 Fed. Reg., pt. IV, § 1, p. 15895 (Apr. 15, 1976).

15/ TRUST TERRITORY CODE tit. 77, ch. 11, § 252 (Supp. 1975) [hereinafter cited as TTC]. The income tax became effective in 1971.

16/ TTC tit. 77, ch. 11, § 258 (Supp. 1975).

17/ TTC tit. 77, ch. 2, § 3.

18/ TTC tit. 77, ch. 3, § 52.

19/ TTC tit. 77, ch. 3, § 53 (Supp. 1975).

20/ TTC tit. 77, ch. 5, § 101. The taxes on motor fuel are transmitted to the municipalities to be used exclusively for the construction and maintenance of municipal roads. MARIANA ISLANDS DIST. CODE tit. 6, ch. 6.36, § 6.36.010 [hereinafter cited as MIDC].

21/ MIDC tit. 6, ch. 6.40, § 6.40.010.

a beverage container tax.[22/] During fiscal year 1975 the income taxes in the Northern Marianas totalled $982,792.53, the import and export taxes $827,863.73, and the license fees $22,423.00.[23/] The revenues raised by taxation are supplemented by an annual appropriation provided by the United States government and by direct grants from a number of federal agencies.

The tax revenues of the Northern Mariana Islands are currently deposited into the treasury of the government of the Northern Mariana Islands, and appropriations against these revenues are made by the legislature.[24/] Taxes imposed by the municipalities are deposited into the treasury of the appropriate municipality.[25/]

C. General Policy Considerations With Respect to Taxation and Public Finance

The tension between faith in representative democracy and reaction to legislative abuses has resulted in a wide variation among the taxation and finance provisions

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22/ MIDC tit. 6, ch. 6.44, § 6.44.020.

23/ Department of State, 28th ANNUAL REPORT, TRUST TERRITORY OF THE PACIFIC ISLANDS 1975 p. 187 (1976). Of the import and export taxes, $361,197.25 went to the Congress of Micronesia. Id.

24/ Sec. Order No. 2989, 41 Fed. Reg., pt. V, § 1, p. 15895 (Apr. 15, 1976). See MIDC tit. 6, ch. 6.08, § 6.08.010.

25/ Sec. Order No. 2989, 41 Fed. Reg., pt. V, § 2, p. 15895 (Apr. 15, 1976).

of present state constitutions. Generally, in the early state constitutions, little was said about the fiscal powers of government. In reaction to the financial difficulties that confronted them during the mid-nineteenth century and again during the early 1930's, many states tended to incorporate detailed limitations upon the taxing and borrowing powers in their constitutions in an effort to prevent over-commitment of state resources in the future.[26/] The current trend, judging by the constitutional revisions of the past twelve years, has been to reduce the length and complexity of constitutional requirements, leaving more discretion to the legislature and the executive in establishing and administering the revenue systems.[27/]

The government's powers with respect to taxation and public finance are at the heart of the financial integrity of the Commonwealth. Limitations on the power to tax may adversely affect the government's ability to market general

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26/ J. Wheeler & M. Kinsey, MAGNIFICENT FAILURE p. 110 (1970).

27/ A few constitutions -- those of Connecticut, Iowa, Rhode Island, Vermont, and American Samoa (proposed) -- contain no clauses specifically addressing the government's power of taxation. The government's ability to incur debt, however, traditionally has received constitutional treatment. For example, Iowa and Rhode Island, which do not address taxation, devote a provision to state borrowing. IOWA CONST. art. VII; R.I. CONST. amend. XXXI. Hawaii treats taxation only generally, but provides extensive regulation of bonds and debt limitations. HAWAII CONST. art. VI, § 3.

revenue bonds and thus to finance certain activities through long-term debt. Conversely, limitations on the power to incur debt are often necessary to convince lenders that the government is financially stable and solvent.

The exercise of the powers of taxation and public debt is also important in creating a favorable climate for investment in the Northern Marianas. If the legislature has unlimited power to tax, investors may be concerned that as soon as their investments begin to show a substantial return, they will be subjected to discriminatory taxation. If the legislature has only very restricted powers to borrow, investors may find the Northern Marianas unattractive. They may believe the government will be unable to provide facilities and services commensurate with the needs of a growing economy and that without that infrastructure, the economy will falter, causing investments to return less than they might elsewhere.

Further, the exercise of the power to tax and incur public debt will have a pervasive effect on the citizens of the Commonwealth. Taxpayers must have confidence that the system of generating governmental revenues is fair and that special interest groups are not unduly favored. If this confidence is not present, popular dissatisfaction with government may occur, and the most talented and productive citizens may look to settle elsewhere.

The Commonwealth Constitution cannot guarantee fiscal integrity and economic stability. There must be trust in the new legislature to act responsibly in enacting taxes and appropriating revenues, and there must be a similar trust in the new executive branch to administer the government's programs efficiently with limited resources. The Constitution should establish the fundamental rules that set the Commonwealth on a proper fiscal course and permit sufficient flexibility to meet changing circumstances in the future.

II. SPECIFIC ISSUES FOR DECISION

A. Commonwealth Taxation

This section first discusses the taxing powers of the Commonwealth government, including the general limitations on that power that may be considered by the Convention. Specific types of taxes -- income, property, corporate, export-import and sales -- are then considered together with various types of tax exemptions. Other devices that affect the taxing system such as earmarking of tax revenues, tax rate limitations and mandatory taxes are discussed in the remainder of this section.

1. Taxing power

a) Extent of the taxing power

In addition to the territorial income tax specifically provided for by the Covenant,[28/] the government of the Northern Mariana Islands is vested with the authority to impose such other local taxes as it deems appropriate.[29/] Moreover, the Covenant assigns to the legislature all power that extends to "rightful subjects of legislation."[30/] Thus, the principal decision for the Convention is whether the Constitution should provide limits on the exercise of the local taxing authority, beyond those already contained in the Covenant.[31/]

At the outset, consideration should be given to the extent that the taxing power is to be given to the legislature. It may be desirable that the Constitution grant general legislative power, which includes the power to levy taxes.[32/] Alternatively, the Constitution can be less

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28/ COVENANT art. VI, § 601. Technically, the § 601 tax operates independently of any taxing power allowed or forbidden to the Commonwealth government.

29/ COVENANT art. VI, § 602.

30/ COVENANT art. II, § 203(c). A discussion of legislative powers is set out in BRIEFING PAPER NO. 3: THE LEGISLATIVE BRANCH § II(A).

31/ Regardless of its authority under the Constitution, the legislature could not enact a territorial income tax that would differ from the income tax specified in § 601 of the Covenant.

32/ The general grant of legislative power is discussed in BRIEFING PAPER NO. 3: THE LEGISLATIVE BRANCH § II(A)(1).

expansive. The Constitution could prohibit any local taxes to supplement the territorial income tax imposed by the Covenant,[33/] or it could specify limited types of local taxes that could be imposed by the legislature.[34/]

Three types of provisions contained in state constitutions deal generally with the taxing power. The first type specifically delegates to the legislature the exclusive power to raise revenue by taxation.[35/] One possible disadvantage of this type of provision is that it could be construed as inconsistent with local (*i.e.*, municipal) taxing authority. If such a result is in fact desired, then it should be so stated and not left to the ambiguity of the granting language.[36/] Generally, however, this type of straightforward delegation of taxing authority may be the most sensible drafting alternative to reliance upon a general grant of legislative authority.

A second type of taxing power provision found in state constitutions is purpose-oriented:

33/ This approach would have the effect of denying the legislature the power to levy the local taxes referred to in § 602 of the Covenant.

34/ COVENANT art. VI, § 602.

35/ For example, the Illinois constitution provides: "The General Assembly has the exclusive power to raise revenue by law except as limited or otherwise provided in this Constitution." ILL. CONST. art. IX, § 1.

36/ The advantages and disadvantages of municipal taxing authority are set out in BRIEFING PAPER NO. 5: LOCAL GOVERNMENT § II(B)(3)(a).

> The legislature shall provide by law for an annual tax sufficient, with other resources, to defray the estimated expenses of the state government for each fiscal year.37/

While stating that the taxing power does exist, this provision's emphasis is basically upon the uses of the money raised. This format, however, conceivably could operate as a restriction on the taxing power; it may suggest that tax dollars may be collected only to defray the annual expenses of the government. The consequence of this construction would be to limit government borrowing since presumably taxes could not be raised to retire long-term debt. Because of these ambiguities, this provision might prove troublesome in future years.38/

37/ COLO. CONST. art. X, § 2; MO. CONST. art. X, § 1; NEV. CONST. art. IX, § 2.

38/ An alternative type of provision does not mention the taxing power in an absolute sense but states that there shall be taxation within certain limits. *E.g.*, N.J. CONST. art. VIII, § 1; S.C. CONST. art. X, § 1; TEX. CONST. art. VIII, § 1. The two principal limits, uniformity and use for a public purpose, are discussed below in § II(A)(1)(b).

Finally, several state constitutions include a provision that at one time was advocated by the National Municipal League:

> The power of taxation shall never be surrendered, suspended or contracted away.39/

This provision is designed to prevent abuses occuring by reason of legislative delegation of taxing authority to non-governmental bodies. It is difficult to foresee a need in the Northern Marianas for delegable taxing authority. Nevertheless, the Convention should consider whether to foreclose legislative flexibillty in this regard at the outset of the new Commonwealth.40/

39/ This provision is found in the constitutions of thirteen jurisdictions, including Alaska, Hawaii, Illinois and Puerto Rico. ALAS. CONST. art. IX, § 1; HAWAII CONST. art. VI, § 1; ILL. CONST. art. IX, § 1; P.R. CONST. art. VI, § 2.

40/ The recently revised edition of the *Model State Constitution*, however, has deleted this type of provision, apparently because the abuses it was intended to prevent never materialized.

b) General limits on the taxing power

The initial limits on the taxing power are those found in the United States Constitution and the Covenant.[41/] Any further limitations on the power of the legislature to raise revenue must be provided in the Commonwealth Constitution. While virtually any constitutional provision operates as a limitation on whatever authority is vested in the legislature, there are two general limitations adopted by the constitutions in jurisdictions within the United States that deserve consideration: public purpose and uniformity. These may be adopted singly, together, or omitted entirely.

i) Public purpose clause. Approximately half the state constitutions provide that the proceeds of public revenues be used "for a public purpose."[42/] These clauses restate the principle long upheld by the United States Supreme Court that public funds derived from tax revenues cannot be expended for private purposes.[43/]

41/ These limitations are outlined in § I(A) above.

42/ E.g., ALAS. CONST. art. IX, § 6; GA. CONST. art. VII, § II, ¶ I; HAWAII CONST. art. VI, § 2; LA. CONST. art. VII, § 1; MONT. CONST. art. VIII, § 1.

43/ Citizens' Sav. & Loan Ass'n v. City of Topeka, 87 U.S. 655 (1875). In the past, these clauses have been held to invalidate the building up of private fortunes, the redress of private wrongs, the improvement of private property and the promotion of private enterprises through a state's taxing powers 71 AM. JUR. 2d State and Local Taxation § 42 (1973).

These provisions impose no new restraints on the governmental power to raise revenues and should be construed merely as a recognition of the obligation that is imposed on them through the Fourteenth Amendment. 44/

The options concerning a public purpose clause are basically two: the insertion of a general clause, similar to that mentioned above, or omission entirely. The first alternative may be desirable as a recognition of the general principle, and serves as an exhortation to the legislature to be circumspect in its choice of recipients of public funds. The second alternative is feasible in view of the applicability of the Fourteenth Amendment and the fact that the courts will generally defer to legislative determination that a public purpose does indeed exist. While a third option conceivably exists -- that of spelling out in the Constitution the various causes to which tax revenues may be allocated -- the great weight of scholarly opinion is against such potential limitation of legislative discretion and inclusion of overburdening detail in the

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44/ Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 514-15 (1937) (state legislatures have broad discretion to determine public purpose, and any Fourteenth Amendment violation "would require a plain case of departure from every public purpose which could reasonably be conceived to justify intervention of a court"); Green v. Frazier, 253 U.S. 233 (1920).

constitutional document.45/

A problem arises in defining "public purpose" and fitting that definition to the particular appropriation in question. While the issue is one for judicial determination, courts that have wrestled with the problem have declined to formulate a standard definition, preferring instead to leave each case to be decided on its own facts.46/

The "public purpose" issue is most controversial in connection with private investor undertakings.47/ For example, one of the changes most widely recommended for the revenue article in the Illinois constitution was one that would have explicitly permitted the use of public funds to support private, non-profit or even profit-making activities that are specifically designed to promote the public purpose.48/ Such a provision, it is argued, is

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45/ The drafters of the 1950 constitution of Hawaii considered incorporating a list of prohibitions in the public purpose clause but finally dropped the idea because of the complexities involved. Legislative Reference Bureau, HAWAII CONSTITUTIONAL CONVENTION STUDIES, ARTICLE VI: TAXATION AND FINANCE p. 19 (1968) [hereinafter cited as HAWAII STUDIES].

46/ See Green v. Frazier, 253 U.S. 233, 240 (1920) (citing with approval treatise that rejected necessity of the expenditure as the criterion).

47/ Public Administration Service, CONSTITUTIONAL STUDIES, vol. 3, ch. IX, p. 5 (1955) [hereinafter cited as ALASKA STUDIES]. See generally Note, State Constitutional Limitations on a Municipality's Power to Appropriate Funds or Extend Credit to Individuals and Associations, 108 U. PA. L. REV. p. 95 (1959).

48/ Fisher, Public Finance, in CON CON: ISSUES FOR THE ILLINOIS CONSTITUTIONAL CONVENTION p. 328 (S. Gove & V. Ranney ed. 1970) [hereinafter cited as ILLINOIS CON CON]. The necessity for this explicit exception was terminated by the omission of a public purpose clause in the revised constitution.

necessary to encourage private capital to undertake ventures earnestly needed by the community but considered so risky that the private sector would decline to accept them without public support. In addition, this form of financing has been justified as a method by which state governments can attract industry to their areas. Conceivably, of course, an argument could be made that as long as the benefits to the community are direct and substantial, even profit-making industrial activity serves a "public purpose." The problem is defining and setting the criteria to determine how "direct" and "substantial" the benefits are. Because the taxation might occur at a stage when the industry or commercial plant is still being planned, determining the public benefit of the particular enterprise would be speculative, if not impossible. In response to these problems, a number of constitutions provide an industrial development exception to their public purpose clauses.[49/]

ii) Uniformity clause. A small number of states restrict the legislature's taxing power by requiring in their constitutions that taxes be "uniform and equal."[50/] Such uniformity clauses, as they

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49/ *E.g.*, ARK. CONST. amend. 49; NEB. CONST. art. XV, § 16 (repealed); OHIO CONST. art. VIII, § 13; VA. CONST. art. X, § 10.

50/ Today, only seven states have a uniformity rule: Alaska, Connecticut, Hawaii, Iowa, New York, Rhode Island and Vermont.

are called, came into existence in an era when real property taxes were considered the basic source of state revenues. Preferential treatment by legislatures accorded to railroads, land developers and corporations in the nineteenth century led to a distrust of differing tax treatments. Uniformity clauses resulted in an effort to prevent discriminatory taxation by requiring that tax rates be applied uniformly within each jurisdiction.51/

The issue before the Convention delegates is basically whether a uniformity clause should be included in the Constitution. The clauses have been under attack in recent years for three reasons. First, many experts feel that such clauses are superfluous in view of the fact that the equal protection clause of the United States Constitution affords the same protection against unreasonably discriminatory tax treatment.52/ Second, it is argued that the clauses are somewhat anachronistic since the principal source of state revenue is now the income tax,

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51/ Matthews, The Function of Constitutional Provisions Requiring Uniformity in Taxation, 38 KY. L.J. p. 31, at 38 (1949).

52/ ILLINOIS CON CON p. 305; see also Walters v. City of St. Louis, 347 U.S. 231, 237 (1954).

which is graduated and, by definition, not uniform.[53/] Third, some experts feel that redundancy and conflicting judicial interpretations aside, constitutions should not be encumbered with provisions that inhibit the flexibility necessary for effective legislative action.[54/]

Proponents of uniformity clauses argue that taxpayer interests should receive the highest protection and that the clauses serve this end. Further, the problems caused by uniformity clauses often result from improper drafting; property taxes can be easily distinguished

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53/ The Commonwealth will have the graduated income tax of the Internal Revenue Code under § 601 of the Covenant.

The conflict is arguably illusory since income taxes are ordinarily not considered a form of property taxes, but are instead excise taxes. See Mills v. State Bd. of Equalization, 97 Mont. 13, 33 P.2d 563 (1934). Other states, however, have rendered different interpretations. See Illinois Legislative Council, CONSTITUTIONAL MANDATES OF UNIFORMITY OF TAXATION p. 5 (1959), cited in Montana Constitutional Convention Commission, MONTANA CONSTITUTIONAL CONVENTION STUDIES, STUDY NO. 15: TAXATION AND FINANCE p. 152 (1971) [hereinafter cited as MONTANA STUDIES]. Montana attempted to solve the problem by specifically allowing income taxes to be graduated. MONTANA STUDIES p. 147.

Hawaii's 1950 constitution contained a uniformity clause specifying that the lands and property of non-residents of the states not be taxed at a rate higher than those belonging to residents. HAWAII CONST. art. VI, § 2 (1950). This clause was omitted in the revised constitution of 1968.

54/ Kresky, Taxation and Finance, in SALIENT ISSUES OF CONSTITUTIONAL REVISION p. 139 (J. Wheeler ed. 1961) [hereinafter cited as SALIENT ISSUES].

in the constitution from income and other taxes by so designating them. Finally, the varying interpretations given "equal protection" today suggest that this clause is not "stable" enough to ensure dependable and continuous taxpayer protection. 55/

Those states that do not have a constitutional uniformity clause usually have some provision empowering the legislature to make reasonable classifications of property for tax purposes. 56/ Classification provisions can vary widely from very limited forms -- primarily relating to mineral and forest lands and homesteads 57/ -- to power to create general "reasonable" classifications. 58/

55/ Gunther, Forward: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection, 86 HARV. L. REV. p. 1 (1972). State tax provisions applying specifically to domestic or to foreign corporations raise special equal protection problems. WHYY, Inc. v. Borough of Glassboro, 393 U.S. 117 (1968).

56/ E.g., MO. CONST. art. X, § 4(a).

57/ G. Braden & R. Cohn, THE ILLINOIS CONSTITUTION: AN ANNOTATED AND COMPARATIVE ANALYSIS p. 432 (1969).

58/ One of the most detailed classification provisions is found in the Missouri constitution:

> All taxable property shall be classified for tax purposes as follows: Class 1, real property; Class 2, tangible personal property; Class 3, intangible personal property. The general assembly, by general law, may provide for further classification within Classes 2 and 3, based solely on the nature and characteristics of the property, and not on the nature, residence or business of the owner, or the amount owned. . . .

MO. CONST. art. X, § 4(a).

[Footnote continued on next page.]

Uniformity and classification provisions, however, are not mutually exclusive since some constitutions expressly make provision for the basic rule that taxes at least be uniform within the same class.[59/]

2. Specific taxes

Once the contours of the Commonwealth taxing power have been determined, it is useful to analyze the different taxes currently levied by the states in order to determine the utility of specific reference to them in the Constitution of the Northern Mariana Islands.

Since the period of fiscal disorder of the 1930's, states have steadily shifted their taxation from the traditional ad valorem taxes on property to specific taxes on income, sales, inheritances or estates. Accordingly, state usage of these taxes varies widely.

The following discussion addresses the principal taxes in effect today and the extent of their use. It should be noted that the only tax mandated by the Covenant is the territorial income tax stipulated in section 601.

[Footnote continued]

The detail reflected in the Missouri example has been criticized as an "attempt to write the essence of legislation into a constitutional document, [which will] produce unforeseen inequities that only constitutional amendment will correct." ALASKA STUDIES p. 18.

59/ *E.g.*, MINN. CONST. art. IX, § 1; MO. CONST. art. X, § 3.

The rest of the taxes discussed below may be enacted by virtue of section 602 and are purely optional.

a) Income tax

The Commonwealth is in a situation different from that of any state with respect to income taxes. The Covenant provides for a two-tiered system: a territorial income tax and a supplemental Commonwealth income tax.

The territorial income tax is required by the Covenant and must be levied in the same terms as the federal income tax.[60/] The tax rates are fixed and the income subject to taxation is defined by the Internal Revenue Code. The revenues derived from this tax are paid to the Commonwealth government.

The supplemental Commonwealth income tax is optional under the Covenant and can be levied at whatever rate and on whatever income is found to be appropriate.[61/]

60/ The Covenant provides that the United States tax laws shall come into force in the Northern Marianas as a territorial income tax in the same manner as they are in force in Guam. COVENANT art. VI, § 601(a). Prior to the effective date, the income tax laws of the Trust Territory will remain in effect. Every resident will be required to file a single income tax return in accordance with the Internal Revenue Code, 26 U.S.C. § 935, except that "Northern Marianas" will be substituted for "United States" whenever the latter appears in the Internal Revenue Code. COVENANT art. VI, § 601(b).

61/ Section 602 of the Covenant allows the Commonwealth to levy additional taxes "as it deems appropriate."

The revenue from this tax is also paid to the Commonwealth government.

The initial question with respect to either of the income taxes is whether to include a provision relating to the tax in the Constitution. Most states impose income taxes, but they do so entirely by statute with no constitutional provision.62/ With respect to the territorial income tax, inclusion of a constitutional provision would reflect the general view expressed in these briefing papers that all of the fundamental powers or responsibilities of the Commonwealth government should be contained in the Constitution. With respect to any supplemental Commonwealth income tax, the Convention has the option to include a provision prohibiting such income taxes, if it is believed desirable to prevent the legislature from creating one. The states that do not have state income taxes do not necessarily prohibit them in their constitutions.63/

62/ Within the United States, all states but nine impose local income taxes. Connecticut, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming are the states that have no state income tax. Assuming an adjusted gross income of $10,000 per year, these rates range from 0.4% in Nebraska to 5.4% in Minnesota. Advisory Commission on Intergovernmental Relations, FEDERAL-STATE-LOCAL FINANCES: SIGNIFICANT FEATURES OF FISCAL FEDERALISM p. 130 (1975) (advance release edition).

63/ *See, e.g.*, TEX. CONST. art. VIII, § 1 (specifically empowering the state legislature to impose an income tax).

Under section 602 of the Covenant, the government of the Northern Marianas has the authority to rebate any taxes "derived from sources within the Northern Mariana Islands."64/ The purpose of this provision is to allow the government to adjust the impact of the territorial income tax to meet local conditions. While section 601 provides that the United States tax laws will come into force in the Northern Marianas, the inclusion of the rebate provision means that the Commonwealth government will essentially have a free hand in structuring the tax code.

For the purposes of considering possible constitutional provisions on taxation, three aspects of the rebate section should be noted. First, the Covenant language is permissive in that it does not require the exercise of the rebate authority. Thus, the Constitution may _prohibit_ any tax rebates or place limits on such rebates.65/ Second, only those taxes derived from sources within the Commonwealth

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64/ COVENANT art. VI, § 601.

65/ The limits could take various forms. For example, larger rebates could be allowed on taxes paid by new businesses, thus encouraging new or developing concerns. Both Guam and the Virgin Islands, for example, have statutory tax rebate provisions for new industry, designed to promote growth of such businesses, new employment, and reduction of imports and consumer prices. GUAM CODE tit. LIV; VIRGIN ISLANDS CODE tit. 29, § 701.

may be rebated. Third, under section 602, the Commonwealth may impose taxes "as it deems appropriate." The rebate provision applies to all section 602 taxes, and the delegates may choose to limit rebate to one type of tax or apply it to more than one tax.[66/]

b) Property tax

The property tax may be utilized by the Commonwealth as a section 602 tax.[67/] A property tax may be levied on either personal or real property, or both, and is usually assessed at a percentage rate of the value of the property.[68/] While the property tax remains an important source of

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66/ Section 602 states that the "Government of the Northern Mariana Islands may by local law impose . . . taxes . . . and provide for the rebate of any taxes received by it . . . ." (emphasis added).

67/ While the Convention delegates have the option of constitutionally prohibiting the legislature from imposing any taxes under § 602, this discussion assumes that the option has not been utilized and that the delegates will want to consider the principal taxes currently used in United States jurisdictions.

68/ Consequently, the property tax necessitates some administrative machinery for valuing the property within the jurisdiction. In the United States, this machinery traditionally has been not at the state level but at that of the political subdivision (*e.g.*, county or municipality). J. Maxwell, FINANCING STATE AND LOCAL GOVERNMENTS p. 126 (1969).

governmental income in the United States, the percentage of general revenue derived by governments from property taxes has decreased considerably as other income sources, principally the income tax, have been used more extensively.[69/]

The Convention delegates have several alternatives regarding the provision for a property tax in the Constitution. First, such a provision can be omitted entirely. This approach would leave the legislature free to deal with a property tax in the future as it wishes. Second, property taxes could be prohibited constitutionally. Third, the taxing power could be delegated to the local governments. The extent to which the delegation would be an exclusive right to levy a property tax would depend on the wording of the delegation provision.[70/] Fourth, the delegates

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69/ For the United States as a whole, property taxes in 1942 contributed 43.5% of state-local general revenues, excluding Alaska and Hawaii. By 1971, however, this figure had shrunk to 26.1%. Every state has shown a drop except Hawaii, which has ranged from 11.1% in 1957, to 10.3% in 1962, to 12.8% in 1967, to 11.1% in 1970, to 11.5% in 1971. Advisory Commission on Intergovernmental Relations, FEDERAL-STATE-LOCAL FINANCES: SIGNIFICANT FEATURES OF FISCAL FEDERALISM p. 35 (1973-74 ed.).

70/ Many states that do leave the power to levy a property tax to their local subdivisions provide either constitutional or statutory restrictions on local taxing authority. For a discussion of restrictions on local authority, see BRIEFING PAPER NO. 5: LOCAL GOVERNMENT § II(B)(1). The restrictions, however, could still be utilized even though the power to levy property taxes is retained by the Commonwealth legislature.

can provide certain limitations on the legislature. For example, a Commonwealth-wide property tax administration could be devised following the pattern of Hawaii. 71/ This would limit the discretion that the legislature has in dealing with the subject.

The most common restriction limits the rate at which property can be taxed. There are two basic types of limitations: (1) overall limitation -- a maximum rate that may be levied by all taxing jurisdictions in the aggregate on the taxable assessed value of property within a given area; and (2) specific limitation -- a maximum rate that may be levied by each of a specified type of local government or that may be levied for each of a

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71/ Hawaii's example has been used to illustrate the current need for reform in the property tax field and as an example to show what direction the reform might take. Hawaii utilizes a state agency to assess all real property, collect tax revenue and turn over the collections to the four counties. The counties determine their own tax rates, and the result has been relative uniformity of assessment and a low degree of dispersion. Hawaii, however, uniquely has a highly centralized government that makes centralization of assessment and collection efficient. J. Maxwell, FINANCING STATE AND LOCAL GOVERNMENTS pp. 148, 155 (1969).

number of particular purposes.72/

Another major restriction limits the property tax to real property only.73/ Although some state property taxes apply to both real and personal property,74/ the real property tax in these states provides the most important source of revenue.

c) Corporate taxes

The growth of the modern corporation, with a legal status separate from its individual owners, has led to the development of an income tax levied directly against the

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72/ Under these two types of limitations, the following is the prevailing pattern of constitutional limitations among twenty-one states that have clauses restricting the property tax powers of local governments:

1. Seven states have overall rate limitations, applicable to all property taxing jurisdiction, including the state. These are Michigan, Nevada, Ohio, Oklahoma, New Mexico, Washington and West Virginia.

2. Nine states have specific constitutional limitations covering all or most classes of local governments. These are Alabama, Arkansas, Kentucky, Louisiana, Missouri, New York, Oregon, Texas and Wyoming.

3. Five states have specific constitutional restrictions applicable to only one class of local taxing unit (counties in Illinois, North Carolina, and Nebraska; school districts in Florida and Georgia).

73/ Hawaii uses this restriction, but by statute rather than by constitutional provision.

74/ Illinois has this type of system. G. Braden & R. Cohn: THE ILLINOIS CONSTITUTION: AN ANNOTATED AND COMPARATIVE ANALYSIS p. 415 (1969).

corporation. While virtually all states have a corporate income tax, the subject traditionally has not been one for constitutional treatment for the reason that it may be necessary to change the structure of corporate taxes occasionally, and a constitutional tax would require a constitutional amendment to effect a revision.

d) Sales taxes

The general sales tax has been the most productive nonproperty tax in subdivisions of the states.[75/] Sales taxes are those levied at the point of transfer of goods or services at the manufacturing level, the wholesaler level or the final retail level. The tax rate is usually a percentage of the dollar value of the transaction or a specified amount per unit of goods being transferred. The sales tax may be general in that it applies to all the transactions of a certain type (for example, a retail sales tax[76/]) or selective in that it is levied on a specified item (for

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75/ J. Maxwell, FINANCING STATE AND LOCAL GOVERNMENTS pp. 159-62 (1969). Virtually all states impose a statutory sales tax, ranging from 2% in Indiana and Nevada to 6.5% in Connecticut. The states that have no sales tax are Alaska, Montana, New Hampshire and Oregon. Advisory Commission on Intergovernmental Relations, FEDERAL-STATE-LOCAL FINANCES: SIGNIFICANT FEATURES OF FISCAL FEDERALISM p. x (1975) (advance release edition).

76/ This type of tax is currently used in the Northern Marianas. MIDC tit. 6, ch. 6.40, § 6.40.010 (municipalities empowered to enact excise taxes on any items other than foodstuffs sold or used in their respective municipalities).

example, tobacco, alcohol or motor fuel 77/). Sales taxes have been criticized as regressive in that they have a greater impact on those with lower incomes. 78/ They are used by many states because they are relatively less costly to collect and produce substantial revenues without great taxpayer resistance. Most state constitutions contain no provision specifically related to the sales tax. The great weight of authority supports leaving the entire matter to the legislature, which is better able to analyze the advantages and disadvantages and to revise the tax system when it becomes necessary. 79/

e) Export and import taxes

The Covenant empowers the government of the Northern Mariana Islands to levy duties on exports from and imports into the Commonwealth. 80/ These excise taxes, however, must be consistent with "the international obligations

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77/ This type of tax is also now used in the Marianas. MIDC tit. 6, ch. 6.44, § 6.44.020 (levy of a one cent tax on each container of beer sold within the Mariana Islands District); MIDC tit. 6, ch. 6.36, § 6.36.010 (motor fuel tax).

78/ J. Maxwell, FINANCING STATE AND LOCAL GOVERNMENTS p. 96 (1969).

79/ SALIENT ISSUES p. 136.

80/ COVENANT art. VI, § 603(b) provides:

> The Government of the Northern Mariana Islands may . . . levy duties on goods imported into its territory from any area outside the customs territory of the United States and impose duties on exports from its territory.

of the United States"[81/] and section 605 of the Covenant. While the Convention delegates can devise constitutional provisions regulating exports and imports, again this is a matter that is usually left to the legislature.[82/]

f) Other taxes

The states have imposed other taxes, for example on deaths, gifts, and lotteries and gambling. Like the taxes discussed above, these are traditionally left for statutory treatment.

3. Tax exemptions

Consideration of tax exemptions requires a decision as to the conditions and circumstances under which the Commonwealth should limit itself in the use of its taxing power.

Generally, the benefits of exemptions are said to be that they: (1) help to attain desirable economic and social objectives; (2) provide needed tax relief to individuals and organizations; and (3) encourage a public service thereby assisting government. Exemptions have drawn criticism

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81/ COVENANT art. VI, §§ 603, 604.

82/ The provision of Guam's proposed constitution relating to export and import duties was merely a cross-reference to the applicable statute. GUAM CONST. § 27 (proposed). Not only is such constitutional referencing unnecessary, but a change in the statute, as did occur because the statute was repealed, renders the constitutional provision obsolete. 19 U.S.C. § 1301a (repealed).

because they add to the tax burden of taxpayers, weaken the tax base and sometimes are of questionable public purpose. Finally, there is often little understanding of the cumulative impact of tax exemptions on the tax base. Politically, it seems that it is much easier to enact an exemption than withdraw one.

The exemption issue can be treated by the Convention in three ways. First, the delegates can omit entirely any reference to exemptions.[83/] Silence on the subject would empower the legislature to authorize or prohibit them as it sees fit, since such authority is deemed inherent in the power of taxation.[84/]

Second, the Constitution could simply prohibit the legislature from creating any exemptions. Arguments favoring this approach underscore the rapid expansion of exemptions, the resultant shift of the tax burden to those properties or persons not exempted, and the weakening of the overall property tax base. It is also argued that exemptions really do nothing more than favor special interests. The opposing argument points out that certain organizations

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83/ For example, the Puerto Rico constitution makes no mention of tax exemptions. A 1968 study of exemptions prepared for Hawaii's constitutional convention reported that the majority of tax exemptions are found in statutes. HAWAII STUDIES p. 11.

84/ The legislature is, of course, bound by the strictures of the Fourteenth Amendment -- it may not act in such a discriminatory manner as to deny equal protection of the laws to the citizens of the Commonwealth.

operate in the public interest and deserve special tax treatment. Beneficial tax treatment may also be accorded new businesses by governments seeking industrial growth. 85/

A third approach to the exemption issue is to permit the legislature to enact exemptions but to mandate a formal periodic review of the exemptions granted, with particular attention given to the consequential tax burdens on those who are not placed in the exempted category. Similarly, the Constitution could designate a specific time period for exemptions and require reenactment. Another possibility in this category would be to place limits on the exemption, either in terms of amount exempted or qualifications for being placed in the exempted category. 86/

The fourth option available to the Convention is to specify the exemptions. This approach allows certain entities favorable treatment and precludes the legislature from expanding the list to the ultimate detriment of the taxpayer. Such a constitutional provision, however, has been criticized since many feel that exemptions should not be "frozen" into a constitution but should vary over time

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85/ *E.g.*, GUAM CODE tit. LIV; VIRGIN ISLANDS CODE tit. 29, § 701. Guam and the Virgin Islands have statutory investment incentive programs involving tax rebates.

86/ For example, the Louisiana constitution of 1974 increased the basic homestead exemption from $3000 to $5000 for households of veterans of the U.S. armed forces and persons sixty-five years or older. LA. CONST. art. VII, § 20 (A)(3).

in accordance with public opinion or even fluctuating monetary values.[87/]

If the Convention delegates decide to provide for at least some exemptions in the Constitution, the following discussion considers those most commonly provided for in state constitutions:

a) <u>Property used for non-profit activities</u>

Exemptions from property tax for non-profit religious, scientific, welfare and charitable activities are the most frequently encountered exemptions in constitutions.[88/] One problem, however, is the nature of the activity and the definition of non-profit. Many constitutions explicitly require the qualifying activity to be <u>exclusively</u> religious, scientific or charitable, and also require the qualifying enterprise to be <u>exclusively</u> non-profit.[89/] The possible need to expand or contract the relevant definition, of course, is a strong argument for leaving the matter to the legislature.

87/ Another important consideration is the extent to which the list of enumerated exemptions might be deemed exclusive by the courts, thereby precluding legislative enactment of "new, innovative" exemptions found desirable through changing societal values. MONTANA STUDIES pp. 79-83.

88/ The California constitution contains such a provision. CAL. CONST. art. XIII, § 1c.

89/ For example, the Alaska constitution provides:

> All, or any portion of, property used exclusively for non-profit religious, charitable, cemetery, or educational purposes, as defined by law, shall be exempt from taxation.

ALAS. CONST. art. IX, § 4.

b) Homesteads

A "homestead" is a legal concept created in some jurisdictions to give protection to a family dwelling against the claims of creditors. It is, essentially, the family house, furnishings and the land on which the home is located.

Homesteads are frequently afforded property tax immunity. The degree of this immunity varies among the states. Homestead exemptions are most common among those states (usually those in the south and southcentral United States) that have tried in the past to attract new residents. Oklahoma, for example, grants an exemption from property tax for homesteads valued up to $5000,[90/] and California recently changed its constitution to increase the homestead exemption from $3000 to $7000.[91/]

c) Public and institutional property

The Alaska constitution illustrates the language of sections granting this type of exemption:

> The real and personal property of the State or its political subdivisions shall be exempt from taxation under conditions and exceptions which may be provided by law.[92/]

90/ OKLA. CONST. art. XII, § 1. *See also* ALA. CONST. art. X, § 205.

91/ Council of State Governments, THE BOOK OF THE STATES 1976-77 p. 283 (1976).

92/ ALAS. CONST. art. IX, § 4. *See also* MO. CONST. art. 7, § 3. Note, however, that Alaska provides for taxation of private leaseholds, contracts or interests in real or personal property owned or held by the state or federal government. ALAS. CONST. art. IX, § 5.

This provision was enacted in spite of a recommendation by the Alaska Statehood Committee that "in the circumstances it would seem unwise to constitutionally exempt from taxation all government owned property. The legislature should be left free to take advantage of whatever changes in federal policy emerge . . . ."93/

d) Federal property

Federal property has been immune from taxation by its political subdivisions since the 1819 decision of McCulloch v. Maryland.94/ While inclusion of an exemption for federal property would appear superfluous, Congress has in fact limited to some extent the immunity of federal property from taxation. This has been effected through a series of congressional acts that require the payment to state and local taxing authorities a varying percentage of federal income generated from public lands, including national forestry, grazing and mineral acreage. Nonetheless, at least 12 states have written into their constitutions explicit tax exemptions for property of the federal government located within their borders.95/

93/ ALASKA STUDIES p. 13.

94/ 17 U.S. (4 Wheat.) 316 (1819).

95/ These states are Arizona, Hawaii, Idaho, Missouri, Montana, New Mexico, North Dakota, Oklahoma, South Dakota, Utah, Wisconsin and Wyoming.

Washington devised a compromise, providing that federal property may be taxed "whenever and in such manner as such taxation may be authorized or permitted under the laws of the United States . . . ." WASH. CONST. art. VII, § 3.

e) Persons in particular categories

Many states have devoted constitutional provisions to exemptions for particular identified segments of the population. These include widows,[96/] married women,[97/] veterans,[98/] disabled veterans[99/] and persons serving in the military.[100/]

4. Earmarking of revenues

Earmarking ties revenue from a specified tax to the financing of a particular governmental project or function. The device of "dedicated" revenues became widespread after the general adoption of the state gasoline tax, originated by Oregon in 1919. The usual justification of earmarking tax receipts is that it guarantees that the yield of the tax will actually be used to benefit the groups subject to taxation, thereby reducing taxpayer resistence. The most common forms of earmarking are the dedication of revenues produced by gasoline and motor vehicle license taxes to road-building

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96/ ALA. CONST. art. X, § 208.

97/ ALA. CONST. art. X, § 209.

98/ CAL. CONST. art. XIII, § 1 1/4.

99/ N.J. CONST. art. 7, § 3.

100/ The delegates to the Guam constitutional convention debated at some length over the military exemption, but finally omitted exemptions altogether from the proposed constitution. *See* PROCEEDINGS OF THE FIRST CONSTITUTIONAL CONVENTION OF GUAM 1969-1970 p. 393.

purposes.[101/] Most states have one or more sources of revenue reserved for specified purposes, although many do so by statute rather than by constitutional provision.[102/]

The mandatory dedication of such revenues is accomplished through two methods: a constitution may require that certain revenues be channeled to certain specified functions, often with no legislative appropriation being required; or the legislature may direct that certain revenues accumulate in special funds to be used for specified purposes. Where earmarking is specified by the constitution, the legislature and the executive have little control over expenditures. In the case of statutory earmarking, the legislature does exercise control.[103/]

101/ *E.g.*, IDAHO CONST. art. VII, § 17; MICH. CONST. art. IX, § 9; NEV. CONST. art. VII, § 5; OHIO CONST. art. XII, § 5a; ORE. CONST. art. IX, § 3; TEX. CONST. art. VIII, § 7-a.

102/ The Tax Foundation, which published studies on the earmarking in 1955 and 1965, found in its later study that the nationwide average proportion of all earmarked funds was 41.1% of tax collections. This figure, however, was down from the earlier study, which reported that over half of tax revenues were earmarked. The Tax Foundation, EARMARKED STATE TAXES pp. 10-11 (1955).

The percentage of state tax collections earmarked range from a low of 2% in New Jersey to a high of 87% in Louisiana and Alabama. Among the states, the most frequently earmarked function is highways with 46 states earmarking funds, followed by local general purposes (34 states) and education (31 states).

103/ Although virtually all states have some earmarking of revenues, only about half do so by constitutional provision. *E.g.*, ALA. CONST. amend. CCLXII (hospital tax), amend. CCX (school tax); CAL. CONST. art XXVI (motor vehicles).

Because the Covenant makes no provision for, or prohibition of, the earmarking of tax revenues,[104/] the delegates to the Constitutional Convention are free to choose from several alternatives.

First, the subject can simply be omitted. This would empower the legislature to deal with the subject as it wishes and would not embed in the Constitution provisions that later should be modified or even eliminated. Another form of this alternative would be specifically to leave earmarking to the discretion of the legislature.

The second alternative is to prohibit earmarking.[105/] This alternative would funnel all funds to the general treasury, and expenditures then would be made upon a legislative determination of need.[106/]

A third alternative is to specify in the Constitution that certain programs will be guaranteed financial

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104/ Article VII, § 702 of the Covenant does earmark portions of the United States federal assistance to be used for certain purposes and for specific islands within the Northern Marianas Commonwealth. This earmarking does not apply to monies received as tax revenues.

105/ Georgia is unique in prohibiting earmarking by providing that all revenue "shall be paid into the General Fund . . . and shall be appropriated therefrom . . . ." GA. CONST. art. VII, § 2.

106/ Alaska's constitution provides a possible variation of this approach by permitting earmarking only if (1) the federal government requires it for state participation in federal programs; or (2) such dedication existed prior to the effective date of the constitution. ALAS. CONST. art. IX, § 7. The first alternative follows the suggestion of the Model State Constitution. National Municipal League, MODEL STATE CONSTITUTION art. VII, § 7.03(a) (6th rev. ed. 1968).

support from certain taxes. Under this alternative, the financing of certain specified programs would be removed from legislative control.

One criticism leveled against earmarking is that even when it meets a test of direct payment-benefit linkage, it removes a portion of governmental revenues from legislative control. This disadvantage becomes more pronounced when financing of a general function of government is separated from other functions. In such a situation, the legislature's control over budgetary review and the appropriation process is severely curtailed. To this end, many experts argue that the executive and the legislature must have the flexibility to weigh changing needs against changing resources so as to prevent situations where surpluses are allowed to accumulate in certain funds, while other programs suffer because those excess funds are not legally accessible.[107/] Further, earmarking may result in a tendency by the legislature to minimize budgetary and legislative review of the earmarked programs, thereby inhibiting financial efficiency and economy.

Those who favor earmarking stress that the clear relationship of tax revenues to the specific benefits to be derived from such revenues helps to win public support for

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107/ ILLINOIS CON CON p. 327; SALIENT ISSUES p. 138; Landers, Constitutional Provisions on Taxation and Finance, 33 STATE GOVERNMENT p. 39 (1960).

the needed program.[108/] In addition, it may be argued that certain programs are of such overriding importance that they need to be assured of a minimum level of financial support without having to win periodic legislative approval.[109/] The supporters of earmarking also point out that because the practice commits funds for longer than a single legislative term, long-term planning is aided -- there is no need to wait to see if the program wins legislative approval.

5. Tax rate limitations

Some states specifically place limits on tax rates, usually the general property tax rates. Tax rate limits came about as a result of vigorous lobbying by taxpayer organizations in the depression years of the 1930's.[110/] These limits were often written into state constitutions,[111/] providing

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108/ Landers, Constitutional Provisions on Taxation and Finance, 33 STATE GOVERNMENT p. 42 (1960).

109/ Of course, it may be argued that programs of such importance are assured of governmental support through the normal political process.

110/ Legislative Reference Bureau, MANUAL ON STATE CONSTITUTIONAL PROVISIONS, HAWAII CONSTITUTIONAL CONVENTION p. 236 (1950).

111/ *E.g.*, ALA. CONST. art. XI, §§ 214-15; FLA. CONST. art. VII, § 2; N.C. CONST. art. V, § 2(4); W. VA. CONST. art. X, § 1. One study reports that rate limitations are found in approximately a third of the state constitutions. MONTANA STUDIES p. 8.

Both Florida and North Carolina have revised their constitutions in recent years, 1968 and 1971 respectively, and have included tax rate limitations. Florida's limit applies only to intangible personal property (for example, stocks and bonds) and is designated as "two mills on the dollar of assessed value." FLA. CONST. art. VII, § 2. North Carolina's limit applies to both state and county property taxes and is 20 cents per $100 value of property. N.C. CONST. art. V, § 2.

limits on tax rates that could be imposed by state governments.

The Convention delegates basically have two alternatives: either leave the matter to the legislature or specify the rate limits in the Constitution. The first approach has found favor with many state governments because of the practical difficulties involved in devising limits that can have beneficial long term significance. Tax rates should respond to changing conditions, such as inflation or recession. Freezing rate limits into the Constitution can only restrict the legislature and executive in devising programs to fit current conditions. It has even been suggested that if tax rates are limited, governments might resort to nuisance taxes if they are forced to find new revenue sources.[112/]

The argument favoring tax limitations first points to the ever expanding burden placed on taxpayers: a check on the taxing power is a check on government spending. The government should be encouraged to use existing resources more effectively and limitations are a built-in method of doing just that. In addition, tax limitations, it is argued, help enhance the potential for economic growth since they indicate stability of the tax rates and provide an attractive climate for new investment.[113/]

112/ MONTANA STUDIES p. 8.

113/ HAWAII STUDIES p. 7.

6. Mandatory taxes

The provision of mandatory taxes in a constitution results in a limitation on the taxing power since it commands that certain taxes be levied regardless of legislative judgment. A mandatory tax is the converse of another limitation on the taxing power, the tax exemption,[114/] both of which are often the target of criticism by tax and finance specialists. The mandatory levy is usually another form of property tax, but on a special class of property. The most common examples are the mandatory tax on motor vehicles[115/] and school taxes.[116/]

Virtually none of the state constitutions specify mandatory taxes. The weight of opinion is that this matter is clearly legislative in nature and that the constitutional document is not the place to specify taxes. The primary reason for this is the regularity with which tax rates change; it is therefore inefficient to provide for specific taxes, or even limits or ranges, in a constitution. Further, the legislature is capable of determining what taxes should be levied and at what rates, and history has shown that the potential for abuse is minimal. The opposite argument maintains that certain levies are so strategic that it is best to maximize permanency. The constitution, the proponents assert, is the ideal vehicle for this.

114/ Tax exemptions are discussed above in § II(A)(3).

115/ *E.g.*, COLO. CONST. art. X, § 6.

116/ *E.g.*, WYO. CONST. art. XV, § 17.

B. Commonwealth Debt

This section of the briefing paper describes the issuance of bonds, which is a major form of governmental finance, and the constitutional restrictions that some jurisdictions have placed on such public borrowing. The paper will briefly address the history of debt limitations, the methods of borrowing, the limitations already imposed by the Covenant and the traditional constitutional means by which governments have attempted to limit debt. Finally, the paper will discuss the alternatives available to the Convention delegates, ranging from omission of any kind of control on borrowing to a debt limitation actually expressed in terms of a percentage or dollar amount.

1. Background

Debt limitations arose in an era of undertaking by governments of large-scale public works projects.[117/] In order to finance these tremendously expensive projects, government bonds were sold with a repayment guarantee, in addition to interest at a specified rate. The proliferation of bond issues, coupled with financial difficulties of the times and the projects, led to public concern that individual states could borrow themselves into insolvency

117/ It is believed that New York started the trend of issuing long-term debt instruments by using this method to finance construction of the Erie Canal in 1817. The canal's success persuaded other states that this method of raising tremendous amounts of revenue was not only feasible, but profitable. MONTANA STUDIES pp. 262-63.

by heavily mortgaging on their ability to repay. The result was the adoption in all but a few states of limitations on the amount of debt that could be incurred by the state.[118/]

The bonds issued by state governments fall into two broad classes: general obligation bonds, which are secured by the full credit (from tax receipts and other revenue sources) of the issuing government and revenue bonds, which are secured by a pledge of the revenues produced by specific assets that have an earning capacity. Revenue bonds are not backed by the total resources of the issuer.[119/]

Before surveying the different ways governments have imposed limitations on borrowing, it is useful to look at the restrictions already contained in the Covenant. The Covenant contains a limitation on general obligation debt during any periods in which the United States provides financial assistance:

118/ *E.g.*, HAWAII CONST. art. VI, § 3; P.R. CONST. art. VI, § 2; UTAH CONST. art. XIV, § 1; VA. CONST. art. X, § 9; WASH. CONST. art. VIII, § 1; WIS. CONST. art. VIII, § 6; WYO. CONST. art. XVI, § 1. The present discussion is limited to debt that may be incurred by the Commonwealth government. For a discussion of local debt, see BRIEFING PAPER NO. 5: LOCAL GOVERNMENT § II(B)(3)(b).

119/ A third type of bond is the moral obligation bond, which is not backed by the full faith and credit of the government and therefore is not subject to the traditional constitutional restrictions that apply to general obligation and revenue bonds. If the principal or interest on a moral obligation bond is not paid, the bondholder has no recourse against the issuer. These bonds are called "moral obligation" bonds because if the issuer defaults, it will be unable to sell these (or perhaps other types of) bonds in the future.

> [T]he Government of the Northern Mariana Islands will authorize no public indebtedness (other than bonds or other obligations of the Government payable solely from the revenues derived from any public improvement or undertaking) in excess of ten percentum of the aggregate assessed valuation of the property within the Northern Mariana Islands.120/

The first issue before the delegates, then, is whether the Constitution should include this provision. The argument against this is that including the provision in the Constitution is unnecessary since the Covenant applies of its own force.

The second issue is whether to provide for additional limitations on Commonwealth debt in the Constitution. The following discussion is addressed to this issue.

2. Types of constitutional debt provisions

A wide variety of debt limitation provisions have been drafted for inclusion in state constitutions to meet particular problems. This section divides these provisions into seven categories.

a) No provision for debt limitation

One way to deal with debt is simply to omit any

120/ COVENANT art. VI, § 607(b). Note that the 10% limit applies during any periods of federal assistance either as provided in article VII, § 702 or during "subsequent periods of federal assistance as may be agreed."

constitutional controls over Commonwealth borrowing.[121/] Those supporting this view argue that not only is the legislature traditionally entrusted with matters of public finance, but state experience has shown that constitutional restrictions do not eliminate debt; they only make it more difficult and expensive. In addition, it has been pointed out that the conditions of the municipal bond market and behavior of lenders operate as built-in controls that are as effective as formal constitutional restrictions.[122/] Those opposing elimination of restrictions stress the need for some control on legislative discretion, and emphasize the fundamental nature of a constitutional directive that governmental spending should not exceed governmental tax resources except in specified circumstances or amounts.

b) Prohibition of debt

A second alternative is to prohibit debt. Such a prohibition would require that debt be incurred only through constitutional amendment. Those arguing in favor of this approach favor a "live within our means" policy in order to avoid the problems that some governments have had recently

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121/ As of 1971, 10 states -- Connecticut, Delaware, Illinois, Louisiana, Maryland, Massachusetts, Minnesota, New Hampshire, Tennessee and Vermont -- provided no constitutional limitations other than legislative approval. Advisory Commission on Intergovernmental Relations, FEDERAL-STATE-LOCAL FINANCES: SIGNIFICANT FEATURES OF FISCAL FEDERALISM pp. 155-56 (1974).

122/ The municipal bond market, however, has been described as a perfect market, "in that bonds can always be sold, provided that the issuing government is willing to pay the price demanded by the market." HAWAII STUDIES pp. 48-49. Thus, the "built-in controls" may not restrict borrowing effectively.

in their attempts to pay the principal and interest on outstanding bonds. Most experts, however, take the opposite view that the issuance of bonds is a sound, efficient and relatively less costly way to finance some governmental activities and therefore should not be prohibited. All United States jurisdictions apparently are in agreement since no government flatly prohibits borrowing, although some allow it only for "casual deficits" and public defense.123/ The latter approach, of course, automatically raises definitional difficulties with the phrase "casual deficits."

c) Requirement that debt be incurred only after popular referendum

Twenty-two states permit borrowing only if approved in a popular referendum.124/ Under this system, the legislature is free to permit borrowing of any type and in any amount, but the legislation with respect to the borrowing must be submitted to a referendum. A discussion of the advantages and disadvantages of the referendum is contained in Briefing Paper No. 8: Eligibility to Vote and Election Procedures § II(C)(2). In the context of approval or rejection of

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123/ *E.g.*, IND. CONST. art. X, § 5; W. VA. CONST. art. X, § 4.

124/ *E.g.*, ALAS. CONST. art. IX, § 8; FLA. CONST. art. VII, § 11. Many of the states that use this method, however, state a dollar limit and require a referendum for any debt exceeding the stated limit. The revised *Model State Constitution* eliminated the referendum requirement, stating that it "has not proved to be much of a restriction upon the creation of debt . . . since voters are asked to pass judgment with limited or no knowledge of the complex fiscal and general policy issues . . . ." National Municipal League, MODEL STATE CONSTITUTION art. VII, § 7.01 (Comment) (6th rev. ed. 1968).

debt measures, the referendum may have the additional disadvantage of timing. Timeliness in authorizing and issuing bonds may be critical in obtaining the best interest rates.

d) Requirement that the legislature approve debt measures by an extraordinary majority

Another type of constitutional limitation requires that debt measures be passed by an extraordinary majority of the legislature[125/] -- either two-thirds of the quorum, a majority of all members, or two-thirds of all members. The Montana Constitutional Convention Commission suggested the alternative of subjecting debt authorization to approval of two successive legislative sessions: "Through such a requirement hasty borrowing would be curbed and legislators would have an opportunity to inform themselves of voter sentiment between legislative sessions."[126/] This approach recognizes the importance of legislative discretion but requires that this discretion be exercised only with a broad base of support.

e) Limitation of the amount of debt

This type of limitation may be expressed as a fixed dollar amount or as a ratio of some base. As long as there is U.S. financial assistance to the Marianas, the Covenant limits general obligation bonds to ten percent of

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125/ LA. CONST. art. VII, § 6 (2/3 approval). Illinois has worked out a combination of two approaches by allowing the bond issue if supported either by referendum or legislative vote. ILL. CONST. art. IX, § 9.

126/ MONTANA STUDIES p. 281.

total assessed valuation. The delegates may wish to impose more stringent limitations on general obligation bonds during the period of U.S. assistance or to anticipate the need for limitations on general obligation bonds after the period of U.S. assistance.127/

The Commonwealth's current debt limit, provided by the Covenant, is based upon a percentage of the aggregate assessed valuation of all the property within the Northern Mariana Islands.128/ Six states -- Nevada, New Mexico, South Dakota, Utah, Wisconsin and Wyoming -- in addition to Guam and Puerto Rico, provide for this method of calculating the debt limit. The 10 percent limit used by the Covenant, Guam and Puerto Rico is quite generous compared to those used by the above states which ranges from one-half of one percent (South Dakota) to one and one-half percent (Utah).129/ The argument favoring this approach is that real property valuation is a traditional method that has long received general investor acceptance. Some critics have attacked real property valuation, however, as being too susceptible to

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127/ Revenue bonds are not restricted by § 607(b) of the Covenant. Nor are such bonds restricted by the debt limitation provisions of most state constitutions. The delegates should consider whether special limitations should be applied to revenue bonds.

128/ COVENANT art. VI, § 607(b). This restriction, applicable as long as the Commonwealth receives U.S. financial assistance, is roughly the same as that applied to Guam. See 48 U.S.C. § 1423a. Guam's restriction, however, appears to be permanent and does not depend upon periods of United States financial aid.

129/ S.D. CONST. art. XIII, § 1; UTAH CONST. art. XIV, § 1.

fluctuation and inequality. A variation of this approach could tie the percentage of valuation limit in with another limit, for example, 10 percent of the real property valuation so long as the debt does not exceed eight percent of gross revenues.

A few states, Florida, Hawaii, Michigan, Pennsylvania and Virginia, tie their limits to revenues received.[130/] This approach has drawn criticism because of the difficulty in defining "revenue" and the possible illogical result of borrowing capacity tied to revenue resources when, in times of depressed economy, the former may be needed to compensate for the latter.[131/] A variation of this type of debt limit is the New Jersey provision, which limits new debt to one percent of the year's total appropriation.[132/]

A number of states that have constitutional limitations on the amount of debt that can be authorized by the legislature also permit additional debt if it is authorized by popular referendum.[133/]

130/ *E.g.*, FLA. CONST. art. VII, § 11; HAWAII CONST. art. VI, § 3; MICH. CONST. art. IX, § 14. For a complete listing of the limits, see Advisory Commission on Intergovernmental Relations, FEDERAL-STATE-LOCAL FINANCES: SIGNIFICANT FEATURES OF FISCAL FEDERALISM pp. 155-56 (1973-1974).

131/ HAWAII STUDIES p. 51.

132/ N.J. CONST. art. VIII, § II, ¶ 3.

133/ *E.g.*, CAL. CONST. art. XVI, § 1; MO. CONST. art. III, § 37; WASH. CONST. art. VIII, § 3.

The final alternative is that used by the majority of states: a debt limit expressed in terms of a fixed dollar amount. This approach has drawn extensive criticism because of the inflexibility of the amount, which conceivably can bear little or no relationship to the economic realities of the day. The debt limit thus remains the same whether the government is experiencing good or ill economic health.

f) Regulation of bond maturities and repayment

A few states have attempted to regulate borrowing by imposing constitutional limitations on maturities and repayment. For example, the New York constitution requires that debt be repaid in equal annual installments and be contracted "for a period [no] longer than the probable life of the work or purpose for which the debt is to be contracted . . . ."[134] Theoretically, this approach also could encompass the setting of interest rate ceilings on debt.

g) Prohibition against borrowing to aid private individuals or groups

These prohibitions originated in the pre-Civil War era and were aimed at the abuses in state aid to banks, railroads and canals.[135]

134/ N.Y. CONST. art. VII, § 12.

135/ SALIENT ISSUES p. 140. *E.g.*, CAL. CONST. art. XIII, § 25; N.Y. CONST. art. VII, § 8. These prohibitions have sometimes given rise to problems in state welfare aid to private citizens, necessitating the inclusion of lists of specific exemptions. N.Y. CONST. art. VII, § 8, ¶¶ 2, 3.

h) Effectiveness of constitutional debt provisions

The effectiveness of the foregoing controls, some experts argue, has been undermined by the expansion of nonguaranteed debt.[136/] One study on state debt restrictions concluded that states have effectively circumvented constitutional provisions through such finance tools as revenue bonds, public authorities and lease-purchase agreements.[137/] This authority argues that the major effect of constitutional debt limitations is that they promote the use of methods of borrowing other than general obligation bonds, and that these methods entail higher interest and other costs of debt service. The net effect is that the

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136/ Generally, bonds that are not guaranteed by the full faith and credit of the issuing government are not "debt" within the meaning of state constitutions. By issuing these types of bonds (generally revenue and moral obligation bonds), governments are able to incur indebtedness while circumventing constitutional strictures. This avenue is left open under the Covenant because revenue bonds are not included within the limitation set out in § 607(b). The problem of what constitutes a pledge of the credit of the government can become complicated, however, and state courts have rendered various interpretations. This problem is discussed in HAWAII STUDIES p. 34.

137/ A. Heins, CONSTITUTIONAL RESTRICTIONS AGAINST STATE DEBT pp. vi-vii (1963). A public authority is a corporate body created to serve a public purpose and empowered to issue revenue bonds to be serviced and secured by the income of the authority. Originally used to finance port and power development and toll bridges, authorities are now created to construct and operate toll roads, school buildings, hospitals, parks, state office buildings and other improvements.

state receives the same amount of capital, and the taxpayers pay a higher premium.138/

There is some evidence supporting the argument that constitutional restrictions tend to lower the amount of debt incurred: the greater the restrictions, the lower the debt. The expert studies done for the Hawaii Constitutional Convention cited an analysis for the fiscal year 1965-1966 that showed states requiring constitutional amendments to incur debt had the lowest long-term per capita debt, $100.94, a figure that includes both general obligation bonds and nonguaranteed borrowing. States that require a popular referendum but not a constitutional amendment had a per capita debt of $129.23, while states where the legislature may authorize debt without referendum or constitutional amendment had the highest per capita debt, $281.23.139/

138/ *Id*. The increasing utilization of nonguaranteed borrowing methods has had a significant impact on the structure of state debt. Of nearly $25 billion in net long-term debt outstanding among the states at the end of fiscal year 1965-66, nonguaranteed debt was $14.5 billion, nearly 60% of the total. This proportion is sharply higher than in previous years. In 1950 nonguaranteed debt comprised 17.9% of total debt. In 1940 it was only 6.2%. U.S. Bureau of the Census, STATE GOVERNMENT FINANCES IN 1966, Series GF - No. 11 p. 40 (1967).

139/ HAWAII STUDIES p. 36.

Because the Constitution cannot conceivably address all the potential problems in an area as complex as governmental finance, a strong argument exists for leaving these issues for the legislature. This does not mean that the deficiencies inherent in setting limits on government spending render such limits useless or create more problems than they attempt to solve. The primary value of restricting spending backed by full faith and credit, as well as setting a tone for the government's financial course, remains despite the shortcomings.