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State Control over Local Finance Under the N.I.R.A.

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STATE CONTROL OVER LOCAL FINANCE UNDER THE N. I. R. A.

The present economic situation has created a serious industrial emergency which the federal government has undertaken to relieve through legislation. To this end Congress has enacted the National Industrial Recovery Act, the stated intention of which is, "To encourage national industrial recovery, to foster fair competition, and to provide for the construction of certain useful public works, and for other purposes."[1] The act necessarily conflicts with the powers of the states and undertakes to regulate matters which have heretofore been recognized as coming within the exclusive jurisdiction of the state, as opposed to the federal government.

One of the provisions which has attracted a particular amount of discussion is section 203(d) of the Public Works Division of the National Recovery Act. The act provides for the creation of a Federal Emergency Administration of Public Works by the President to prepare a comprehensive program of public works and authorizes the President to construct, finance or aid in the construction or financing of any public works project named and to make grants to states, municipalities or other public bodies up to 30 per cent of the cost of the labor and materials employed. The particular section referred to in this note states that, "The President, in his discretion, and under such terms as he may prescribe, may extend any of the benefits of this title to any state, county or municipality notwithstanding any constitutional or legal restriction or limitation on the right or power of such state, county or municipality to borrow money or incur indebtedness."[2]

A great many state constitutions expressly prohibit municipalities and other subdivisions of the state from incurring indebtedness above a certain amount.[3] These restrictions upon the borrowing power of the cities and counties are for the purpose of curbing the taxing power and restraining excessive expenditures

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[1] Public Law No. 67, 73d Cong. 1st Sess., approved June 16, 1933.

[2] N. I. R. A., Title 2, sec. 203 (d).

[3] The Missouri Constitution affords a typical example of such a prohibition. Article X, sec. 12, provides that no county, city, town or other political subdivision of the State be allowed to become indebted in any manner to an amount exceeding in any year the income and revenue provided for such year, without consent of two-thirds of the voters voting on such proposition; and if the voters have assented, indebtedness may not be incurred to an amount exceeding 5 per cent of the value of the taxable property therein; except that cities having a population over 75,000 may become indebted up to 10 per cent on the value of the taxable property therein. There are certain exceptions relating to the City of St. Louis and to indebtedness for construction of roads and in the provision for sinking funds, but as a whole the matter of municipal indebtedness is rather closely limited.

entailing tax burdens and defaults upon indebtedness. They were the outgrowth of necessity. During the period after the Civil War cities grew with great rapidity. But because the progress of municipal institutions and services failed to keep pace, their growth was accompanied by graft, bossism and debt, the results of governmental inefficiency, corruption in municipal office and the spoils system. Also, it was an era of extensive railroad building, and counties and towns, in their eagerness to secure the right of way, subsidized the railroads far beyond their financial ability. The period between 1860 and 1870 is known as the dark ages in municipal development and led to a complete reorganization of local government by the states.[4] One of the measures adopted was the placing of constitutional restrictions upon the creation of indebtedness of cities, counties, and towns in order to preserve the good credit of the local subdivisions.

The question at once arises as to whether the National Industrial Recovery Act can supersede state constitutional provisions in this matter of prescribing debt limitations. Municipalities are instrumentalities of the state, created by it for the purpose, among others, of exercising some of the sovereign powers of the state. The power to create municipalities properly belongs to the several states and the federal government has no control over them whatsoever. The Federal Constitution contains specific grants of power to Congress and imposes definite limitations upon the exercise of its authority. The Constitution expressly declares that all powers not given to Congress or prohibited to the states are reserved to the states or to the people.[5] The courts have repeatedly recognized the proposition that "it is a necessary condition of our dual form of government over the same territory that neither the national nor the state governments should interfere with the proper functioning of the other."[6] The theory of the division of powers between federal and state governments is a fundamental element of political organization in the United States.

Nevertheless the federal government has increasingly extended its power into fields which formerly were recognized as subject to state control exclusively. The commerce clause in the Constitution, giving Congress the power to regulate interstate commerce, has been used to justify interference by the federal govern-

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[4] Munro, Government of American Cities (4th ed. 1931) p. 32; Munro, Government of the United States (1919) p. 580; A. F. MacDonald, American City Government and Administration (1929) p. 64.

[5] Constitution of the United States, Amendment X.

[6] Willcuts v. Bunn (C. C. A. 8, 1929) 35 F. (2d) 29; Weston v. City Council of Charleston (1829) 2 Pet. 449; McCulloch v. Maryland (1819) 4 Wheat. 316; Macallen Co. v. Massachusetts (1929) 279 U. S. 620.

ment in functions formerly executed by the states when the purpose of legislation was not actually the protection of interstate commerce, but was intended for the purpose of providing a solution of some social problem, such as the operation of lotteries and examination of foodstuffs.[7] The power to establish police regulations within the states belongs to the states exclusively but they cannot exercise such power if it in any way interferes with the power of Congress to control interstate commerce. Thus it has been held that while a state may pass sanitation laws, and laws for the protection of life, liberty, health or property within its borders; while it may prevent persons and animals suffering under contagious or infectious diseases from entering the state; while for the purpose of self-protection it may establish quarantine and reasonable inspection laws, it may not interfere with transportation into or through the state, beyond what is absolutely necessary for its self-protection. It may not under cover of exerting its police powers, substantially prohibit or burden either foreign or interstate commerce.[8] City ordinances regulating traffic are subject to review to determine whether or not they interfere with interstate commerce.[9]

Possibly the closest analogy to the present problem is in the field of taxation. It is a recognized principle of constitutional law that the agencies by which either the state or the federal governments immediately and directly exercise their sovereign powers are immune from each other's taxing power.[10] But, as Mr. Justice Stone points out, in his opinion in the case of *Metcalf v. Eddy and Mitchell*,[11] just what instrumentalities of either a state or the federal government are exempt from taxation by the other cannot be stated in terms of universal application. Thus the employment by the federal and the state governments of officers who are agents to administer their laws, or their obligations sold to raise public funds are so intimately connected with the necessary functions of government as to fall within the established exception.[12] But it is apparent that not every person who uses his property or derives a profit, in his dealings with the govern-

[7] 2 Willoughby, Constitution of the United States (1929) p. 746.

[8] Hannibal and St. Joseph R. R. Co. vs. Husen (1877) 279 U. S. 620; Must Hatch Incubator Co. v. Patterson (1927) 32 F. (2d) 714; Evans v. Chicago and N. W. Ry. Co. (1909) 109 Minn. 64, 122 N. W. 876; M., K. and T. Ry. Co. v. Haber (1897) 169 U. S. 613.

[9] People's Rapid Transit Co. et al. v. Atlantic City (1929) 105 N. J. L. 286, 144 A. 630.

[10] McCulloch v. Maryland, n. 6, above; Dobbins v. Erie (1842) 16 Pet. 435; Purnell v. Page (1903) 133 N. C. 125, 45 S. E. 534.

[11] (1926) 269 U. S. 514.

[12] Pollock v. Farmers' Loan and Trust Co. (1895) 157 U. S. 429; Collector v. Day (1870) 11 Wall. 113.

ment, may clothe himself with immunity from taxation on the theory that either he or his property is an instrumentality of government within the meaning of the rule. "As cases arise, lying between the two extremes, it becomes necessary to draw the line which separates those activities having some relation to government, which are nevertheless subject to taxation from those which are immune. There is no formula by which that line may be plotted with precision in advance. The guiding principle to control its operation is the reason upon which the rule rests. The essential requirement of our constitutional system is that the federal government must exercise its authority within the territorial limits of the states and the rule rests on the conviction that each government in order that it may administer its affairs within its own sphere, must be left free from undue interference by the other. Neither government may destroy the other nor curtail in any substantial manner the exercise of its powers. Hence the limitation upon the taxing power of each, so far as it affects the other, must receive a practical construction which permits both to function with the minimum of interference each with the other; and that limitation cannot be so varied or extended as seriously to impair either the taxing power of the government imposing the tax, or the appropriate exercise of the functions of the government affected by it."[13]

Similarly, the problem raised in the quoted clause of the National Industrial Recovery Act is to determine whether or not the provision so interferes with the exercise of state powers as to be contrary to our constitutional system of government. On the one hand we have the power of the state to control local government and on the other, the right of Congress to provide for the general welfare.[14] Just where the line is to be drawn between the two depends in each case upon a practical construction and should have regard to the circumstances disclosed. In this case the power of municipalities to borrow money and incur indebtedness is essential to their existence and, therefore, one

[13] Metcalf v. Eddy and Mitchell, n. 11, above.

[14] Art. 1, sec. 8, of the Constitution of the United States provides that Congress shall have the power "to lay and collect taxes, duties, imposts and excises and pay the debts and provide for the common defense and general welfare of the United States." Among the purposes enumerated in the preamble for the securing of which the Constitution is ordained and established is the promotion of the general welfare. The general nature of the Constitution and end sought to be obtained was to subserve the national interests of the people who framed and adopted it. 1 Willoughby 78. The federal welfare clause is used to finance those subjects of legislation which Congress in its wisdom determines are for the general welfare of all of the people generally and any program to relieve unemployment and stimulate business is of such nature.

of the most important subjects of control by the state. Lending money to the states and their subdivisions to construct public works ought not to be considered of such importance to the general welfare as to sanction interference with the exercise of this power by the state. Nor will the public works program fail if Congress does not advance loans to municipalities which are prohibited from borrowing. Not all state constitutions limit the borrowing power and where there is only a statutory prohibition the state legislature can find means of avoiding it. New York,[15] Rhode Island[16] and Virginia[17] have already enacted measures to overcome statutory loan bars.

The doctrine that constitutional limitations may be ignored during an emergency cannot properly be invoked to justify the provision under discussion. Although the presence of an emergency is an important factor in constitutional interpretation and may result in the restriction of the normal rights of the individual, it does not afford a blanket exemption from constitutional limitations, nor convert a federal into a strongly centralized system of government.[18]

A related problem involving the power of the federal government to legislate with reference to local government has been presented by the proposed Wilcox Bill.[19] This bill provides for a municipal debt readjustment amendment to the Federal Bankruptcy Act to permit a municipality that is financially embarrassed, or its creditors of any class, to enter a federal court and apply for relief. The court may appoint a receiver for the municipality, collect its finances, disburse them, repudiate the remainder or adjust them, and, in effect, discharge the city or town in bankruptcy in the same manner as an individual. The object of the bill is to check the growing list of municipal defaults. However, the American Bar Association has opposed the measure, claiming that it is an invasion of state powers and that it will encourage tax delinquencies. In stating his objections to the bill, Clarence E. Martin, former President of the American Bar Association, declared that, "This is giving the federal courts a power over subdivisions created for the purpose of exercising one of the sovereign powers of the state. If the federal government can be given that power, why not lodge within the jurisdiction the other powers of municipal government, and completely destroy and eradicate the thought of local government. If any of the

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[15] Mandelbaum Bill. Laws of 1933, chap. 782.

[16] Chap. 26 of the Acts passed by the extra session of the General Assembly of Rhode Island in 1933.

[17] Public Laws of 1933, chap. 2078.

[18] 3 Willoughby, Constitution of the United States (1929) sec. 1035.

[19] New York Times, March 19, 1933.

states have permitted municipalities within them to become indebted beyond their power to pay, the state which created them, having given the power, must assume the responsibility."[20]

One procedure in dealing with bankrupt municipalities has been for the state legislature to repeal the city charter and appoint a receiver to administer its financial affairs and pay the claims of creditors. Upon repeal of the charter the public property of the city passes under the immediate control of the state and such property is held, therefore, not to be subject to the payment of the debts of the city.[21] Nor may private property of individuals within the territory of the city be subjected to the payment of the debts of the city, except through taxation.[22] The Supreme Court of the United States, in the case of *Meriwether v. Garrett,* decided that taxes levied according to law before the repeal of the charter of the city of Memphis, other than such as were levied in obedience to the special requirement of contracts entered into under the authority of law, and such as were levied under the judicial direction for the payment of judgments recovered against the city, cannot be collected through the instrumentality of a court of chancery at the instance of the creditors of the city. The power to levy taxes is one which belongs exclusively to the legislative department and it necessarily follows that the regulation and control of all the agencies by which taxes are collected must belong to it.[23] Thus the courts can reach and apply to the payment of the debts of the municipal corporation only the private property of the corporation, such as it held in its own right for profit or as a source of revenue, not charged with any public use or trust.[24]

The Public Works Administration itself realizes that any attempt to override state constitutions in respect to the limitations on the borrowing power of municipalities would be futile. Section 203(d) absolutely states that the President may, in his discretion, grant loans notwithstanding contrary provisions in state constitutions. Yet in a memorandum prepared by Assistant General Counsel Foley of the Public Works Administration it is stated that "Where the restrictions are constitutional,[25] it is of course necessary to go through the cumbersome process of constitutional amendment. And in such a case the Public Works Administra-

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[20] Martin, The Growing Impotency of the States (Oct., 1933) 19 A. B. A. J. 531.

[21] Meriwether v. Garrett (1880) 102 U. S. 472.

[22] Lyon v. City of Elizabeth (1881) 43 N. J. L. 158; Meriwether v. Garrett, n. 21, above.

[23] Meriwether v. Garrett, n. 21, above.

[24] Meriwether v. Garrett, n. 21, above.

[25] St. Louis Post-Dispatch, Oct. 19, 1933, at p. 1, sec. II.

tion is helpless, because the much discussed section 203(d) does not give the President blanket power to override state constitutions." The change of policy on the part of the administration with respect to this provision is very significant. Although Secretary Ickes had previously announced that as a matter of policy the federal government would not make loans to municipalities where such action was prohibited by the state constitution, this statement goes farther and practically admits the complete lack of power to do so.

These considerations point to the conclusion that the attempt by Congress to advance public work funds to any state, county or municipality, notwithstanding any constitutional or legal restriction on the right or power of such state, county or municipality to borrow money or to incur indebtedness is unconstitutional, since it is an encroachment by the federal government upon the sovereign powers reserved to the states.

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PRECEDENTS FOR FEDERAL BANK DEPOSIT INSURANCE

The Banking Act of June, 1933, creates a Federal Deposit Insurance Corporation the stock of which is to be subscribed for by the United States Treasury, the Federal Reserve Banks and members of the Federal Reserve system. Federal Reserve Banks are required to own shares to the amount of one-half of their surplus on January 1, 1933; member banks to the amount of one-half of one per cent of their total deposit liabilities, to be adjusted annually, subject to emergency assessments of an additional one-fourth of one per cent. Dividends may be declared. Upon the closing of an enrolled bank the Corporation is to act as receiver and pay insured depositors 100 per cent of their claims up to $10,000, 75 per cent thereafter up to $50,000, and 50 per cent of the amount of the claim in excess of the last sum. It is then subrogated to the rights of these depositors until the amounts of the insurance payments are recovered. The act is to go into effect July 1, 1934. A temporary Deposit Insurance Fund is provided to begin January 1, 1934. State non-member banks may participate in the scheme for a period of two years from this date.[1]

This specimen of the new legislation, unlike many of its companion pieces, possesses a definite parentage and history. The guaranty of deposits is not new in state annals; early appear-

[1] 12 U. S. C. 264.