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Charles T. DuMars*

Evaluating Congressional Limits on a State's Severance Tax Equity Interest in Its Natural Resources: An Essential Responsibility for the Supreme Court

The capacity of states to levy taxes on extractive industries[1] operating within their borders has never been questioned.[2] But when the level of these taxes gives the appearance of an attempt to capture "economic rent"[3] at the apparent expense of the resource poor states, with declining industrial tax bases, the debate becomes intense. In support of Montana's 30% severance tax on coal, Senator Marcus recently remarked:

> Montanans have long experience with natural resource development. We know that the costs of development do not end when the resources are gone. Fabulous gold deposits and then fabulous copper reserves were exploited—and then sent out of state. Today these resources are largely gone. But the environment and social damage remain—and is still being paid for by Montanans. Montanans also watched the coal boom in Appalachia. We saw what happened when the boom turned to bust—the abject poverty. Mr. President, Montanans believe that we should not come to the federal government for help in dealing with the problems of energy development. So,

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1. This article concerns itself with taxes levied on the mining of leaseable minerals, such as coal and on the mining of hard rock minerals, such as copper. There are numerous other types of taxes levied on both the severance and processing of natural resources with a state, to which this discussion is also relevant. *See, e.g.*, N.M. STAT. ANN. §7-25-4 (Mitchie 1978) (resource excise tax); N.M. STAT. ANN. §7-25-5 (Mitchie 1978) (processing tax); N.M. STAT. ANN. §7-26-1 (Mitchie 1978) (severance tax).

2. *See* Carmichael v. Southern Coal and Coke Co., 301 U.S. 495 (1937). Any such tax would, of course, be subject to invalidation if it was found to be so arbitrary as to constitute an unlawful confiscation of property. *See* A. Magnano Co. v. Hamilton, 292 U.S. 40, 44 (1934). Absent this restraint, this power has been assumed to be at the heart of state sovereignty.

3. The concept of "economic rent" is variously described in the literature. In general layman's terms, this means the capacity of a market participant to capture a uniquely high profit from the sale of his commodity because its unique nature causes a high demand. This high demand, coupled with the inability of buyers to shift to other fuel sources, yields economic rent to the seller greater than the normal profits that can be expected by market participants. For an excellent discussion of the concept of economic rent, *see* Church, *Conflicting Federal, State and Local Interest Trends in State and Local Energy Taxation: Coal and Copper—A Case in Point*, 31 NAT'L TAX J. 269, 278 (1978).

> we have moved to fill that void by imposing reasonable and responsible taxes on coal.[4]

While Montanans legitimately seek not to duplicate the poverty level in Appalachia, other non-resource producing states with declining economies legitimately seek to avoid that fate as well. Senator Durenburger of Minnesota has argued equally vehemently in support of federal legislative attempts to curb severance taxes:

> This matter now takes on increased importance in light of President Reagan's efforts to return more responsibility to the states—the philosophy of devolution. As the transfer of income and tax base continues from energy rich to energy poor states, we must carefully consider the increased burden devolution carries with it. Is it feasible to return responsibility to states so widely different in their economic base without a corresponding federal policy designed to compensate for these disparities. Is it fair to expect the states and localities that suffer from a declining economy to provide the same level of public services as those states flush with energy generated revenues? Is it desirable in a federal system to accept the vastly different levels of public services that will inevitably result from an unabated flow of energy dollars?[5]

Senator Durenberger raises a number of difficult income distribution questions at the heart of federalism. In this article I do not propose to answer all of these questions or survey the law of resource taxation. This has been thoroughly done elsewhere.[6] Rather, this article examines the Supreme Court's role in the inevitable litigation should Congress act to place a ceiling on state severance taxes. It also discusses the impact of *Commonwealth Edison v. Montana* [7]should such a case arise. Finally, it explores the policy implications of such a ceiling.

The Supreme Court's opinion in *Commonwealth Edison Co. v. Montana*[8] is the crucial starting point in any discussion of state resource taxation. There, Montana faced a challenge to its severance tax on coal. Although it has imposed a severance tax since 1921 on the output of coal mining

4. Senator Marcus is quoted in L. Parker, Energy: Limiting State Coal Severance Taxes, Issue Brief at No. IB 80060 (Wash. D.C. Library of Congress, Congressional Research Service, No. 1980).

5. Opening statement by Senator Dake Durenberger, Subcommittee on Intergovernmental Relations, Fiscal Disparities Hearing on the Commerce Clause and Severance Taxes (July 15, 1981) *quoted and discussed in* Kneese, *Typical Cases Involving Natural Resources*, REGIONAL CONFLICT AND NATIONAL POLICY Ch. 4 (Price, Ed.) (in press, 1982).

6. One of the best surveys in this area can be found in Hellerstein, *Constitutional Limitations on State Taxation*, AM. BAR FOUNDATION RESEARCH J. 1 (1982). *See also*, Browde and DuMars, *State Taxation of Natural Resource Extraction and the Commerce Clause: Federalism's Modern Frontier*, 60 OR. L. REV. 7 (1981) [hereinafter cited as Browde].

7. 101 S. Ct. 2946 (1981) [hereinafter cited as Commonwealth Edison].

8. *Id.*

on both private land and federal land, in 1975 it markedly increased the level of tax. The increased severance tax is levied at varying rates depending on the value, energy content, and method of extraction, and may equal a maximum of 30% of the "contract sales price."[9] Under a 1976 constitutional amendment, effective in 1979, at least 50% of the revenues generated by this severance tax must be paid into a permanent trust fund, the principal of which can be invaded only if supported by a vote of three-fourths of the members of each house of the legislature.

Four Montana coal producers and eleven out-of-state utilities who purchased coal from these producers filed suit in state court in Montana seeking injunctive relief and recovery of taxes paid under this provision. They argued that the 30% tax violated both the Commerce Clause and the Supremacy Clause. The trial court sustained a motion to dismiss for failure to state a claim. This decision was affirmed by the Montana Supreme Court,[10] which held that the Commerce Clause was not implicated because a tax on coal production was not "in commerce" or alternatively, that the 30% level of taxation did not burden commerce because it was fairly related to services provided by Montana to the coal industry. The Montana Supreme Court rejected the Supremacy Clause argument because it found no federal statute in conflict with the tax. The appeal to the United States Supreme Court raised three basic issues: 1) whether the Montana Supreme Court reliance on the 1920s *Heisler v. Thomas Colliery*[11] holding that mining activity is not "in commerce" was proper; 2) if mining was in commerce, whether the *Complete Auto Transit v. Brady*[12] "fairly related to services" test should be applied to severance taxes, and 3) whether the state tax was preempted by federal law.

To very few people's surprise,[13] the 1920s mechanical test for application of the Commerce Clause was rejected. Rather, the court found the Commerce Clause applicable to the severance of coal destined for interstate commerce and went straight to the test adopted in *Complete Auto Transit v. Brady. Complete Auto Transit* had adopted a four-part test for determining the constitutionality of state taxes on goods in interstate commerce. Under this test, to sustain a tax on commerce the state must show: nexus with the taxing state; proper apportionment between states; non-discriminatory application; and that the tax is fairly related to services provided by the taxing state. Obviously, the severance of minerals within

9. The "contract sales price" is defined under Montana law as the price of coal extracted and prepared for shipment F.O.B. mine, excluding the amount charged by the seller to pay taxes paid on production. Commonwealth Edison, 101 S. Ct. at 2951, n. 1.

10. Commonwealth Edison v. Montana, 615 P.2d 847 (1980).

11. 260 U.S. 245 (1922). For a discussion of the history of this case, *see* Browde, note 6, *supra*, at 18–22.

12. 430 U.S. 274 (1977).

13. *See* Browde, *supra* note 6 for a discussion of the "resource isolation" cases.

a state's borders provided sufficient nexus with the taxing state. Since the coal could be severed only once, it was properly apportioned—no similar taxable event could occur in any other state. The statute applied to severance of all coal irrespective of state of destination, so it was found to be nondiscriminatory. This was true even through 90% of the coal affected was shipped out of state.

While the conclusion that the court would not imply a discriminatory purpose because of disproportionate impact on sister states seems clear, the court's reasoning on this point was far from clear. The court has held since *West v. Kansas Natural Gas*[14] that "resource isolationism"[15] by states is virtually *per se* unconstitutional because it is destructive of the interstate free market found protected by the dormant Commerce Clause. A state can rationally discriminate between two intra-state consumers of a product and be subject only to equal protection analysis[16] but discrimination against a consumer because he lives across the state line is subject to the strictest scrutiny.[17] Simply put, the court looks at any statute to determine whether the discrimination is based on the fact a state line separates those who receive benefits from those who do not.

Justice Marshall, surprisingly, cited the "free market cases" as authority for *not* looking into the discriminatory impact of the Montana statutes.

> As the Court stated in *West v. Kansas Natural Gas*, 221 U.S. 229, 255 (1911) "in matters of foreign and intrastate commerce there are no state lines. See *Boston Stock Exchange v. State Tax Comm.* supra at 331–332. Consequently, to accept appellants' theory and invalidate the Montana tax solely because most of Montana's coal is shipped across the very state borders that ordinarily are to be considered irrelevant would require an significant, and in our view, unwarranted departure from the rationale of our prior discrimination cases.[18]

All would certainly agree that in an ideal, free interstate market state lines should be considered irrelevant *by states* in drafting legislation. But the consumer who is being denied benefits, solely because he lives across such a line, should be surprised to find his argument rejected because *the court* views these state lines as irrelevant. Indeed, the existence of the state line has traditionally been at the heart of the court's inquiry: If the

14. 221 U.S. 229 (1911).
15. Browde, *supra* note 6, at 30.
16. The equal protection analysis in matters of economics is extraordinarily light handed and is in substance whether there was any rational basis for the classification. *See* Perry *Modern Equal Protection: A Conceptualization and Appraisal*, 79 COLUM. L. REV. 1023 (1979).
17. *See* Hughes v. Oklahoma, 441 U.S. 322 (1979).
18. Commonwealth Edison, at 101 S. Ct. 2954.

statute denies access to private resources such as coal solely because the consumer lives across the state line, it violates the Commerce Clause.

The court ultimately turned to the fairly related to services test of *Complete Auto Transit* and effectively eliminated it from future consideration in constitutional adjudication, when an industry attacks a nondiscriminatory severance tax. This legal test was set to rest along with its "substantive due process" antecedents of the '20s.[19]

While on its face "fairly related to services provided by the state" suggests that one should measure the tax levied against the services provided by the taxing state, the court flatly rejected this contention. It held this phrase simply means that the "measure of the tax must be reasonably related to the extent of the contact."[20] Since the "measure" of the Montana tax was "a percentage of the value of the coal taken," the court concluded that "the Montana tax is in 'proper proportion' to appellant's activities within the state and, therefore to their consequent enjoyment of the opportunity and protections which the state has afforded."[21]

It hardly seems clear that a tax is always proportional to opportunities afforded by the taxing state because it is levied in proportion to the rate of extraction or the value of the resource. Under the court's view,a proportional 90% of gross value tax on natural gas would be related to benefits afforded by the taxing state even if the extraction caused no environmental damage and the state provided no support services. Yet, a flat annual fee for coal extraction equal to only 1% of the gross value of the coal extracted would not be related to services, even though the state provided extensive police and fire protection and the mining activity caused extensive environmental disruption.

While the court abandoned the mechanical approach of *Heisler,* it has now adopted the mechanical approach of *Commonwealth Edison.* This was succinctly stated by Justice Blackmun in dissent:

> No trial will ever be necessary on the issue of fair relationship so long as a state is careful to impose a proportional rather than a flat tax rate; thus, the court's role is no less "mechanical" than the approach entertained in *Heisler v. Thomas Colliery Co.*, 260 U.S. 245 (1922) . . .[22]

After "emasculating"[23] the fourth prong of the *Complete Auto Transit*

19. The court has declined to evaluate statutes on "substantive due process" grounds since the mid-1930s. *Compare* New State Ice Co. v. Parrish, 300 U.S. 379 (1937). *See also* WRIGHT, THE GROWTH OF AMERICAN CONSTITUTIONAL LAW (1942).

20. Commonwealth Edison, 101 S. Ct. at 2958.

21. *Id.*

22. *Id.* at 2968.

23. *Id.* This was Justice Blackman's view of the majority opinion.

test by holding that any tax is fairly related to services provided by the taxing state if it is levied in proportion to the rate of extraction, the Court gave its reasons for doing so. It in effect held that evaluating the level of a state severance tax under the dormant Commerce Clause was not an appropriate judicial function. It reached this result based on two independent but related rationales. One was that calculation of the degree of monopolistic advantage created by a state's application of a facially neutral severance tax would involve the application of economic principles the court was not equipped to decipher:

> The threshold questions whether a state enjoys a "monopoly" position and whether the tax burden is shifted out of state, rather than borne by in-state producers and consumers, would require complex factual inquiries about such issues as elasticity of demand for the product and alternate sources of supply. . . . It has been suggested that "the formidable evidentiary difficulties in appraising the geographical distribution of industry, with a view toward determining a state's monopolistic position might make the Court's inquiry futile."[24]

The second rationale was that this balancing of interests between states was in its very nature political and for that reason the balance should be struck by Congress:

> But even apart from the difficulty of the judicial undertaking, the nature of the fact finding and judgment that would be required of the Courts merely reinforces the conclusion that questions about the appropriate level of state taxes must be resolved through the political process. Under our federal system the determination is to be made by state legislatures in the first instance, and if necessary by Congress when particular state taxes are thought to be contrary to federal interests.[25]

The court rejected the Supremacy Clause argument that the Montana tax frustrated national energy policy reflected in federal legislation or conflicted with the Mineral Lands Leasing Act.[26] by finding no evidence of conflict with any federal legislation.[27]

The state of Montana tax still stands, not because the majority concluded it did not unduly burden commerce, but rather on the assumption

24. Commonwealth Edison, 101 S. Ct. at 2955 n. 8. The Court stated further: . . . "it is doubtful whether any legal test could adequately reflect the numerous and competing economic, geographic, demographic, social, and political considerations that must inform a decision about an acceptable rate or level of state taxation, and yet be reasonably capable of application in a wide variety of individual cases." *Id.* at 2959./

25. *Id.* at 2959.

26. 41 Stat. 437. The court was persuaded particularly by Section 32 of the 1920 Act, 30 U.S.C. §189 which expressly authorizes severance taxes on minerals severed from the public domain.

27. *Id.* at 2962.

Congress was the appropriate forum for determining its constitutionality. Justice White went even further in his concurring opinion: "There is particular force in the argument that the tax is here and now unconstitutional. . . ."[28] (But the Court did not have to address that concern since, when Congress considers it, Congress will strike it down because) "surely Montana and other similarly situated states do not have the political power to impose their will on the rest of the country."[29]

Justice White's observation is undoubtedly true—Montana and other resource producing states cannot impose their will on the majority of resource importing states and Congress could strike it down. But, who stands to protect the minority of resource exporting states if the majority of resource importing states impose their will on them? Here may lie the danger in the Court's holding. If, as the Court seems to hold, the amount of "state's equity" a state is entitled to capture from nonrenewable resources through a severance tax is a nonjusticiable political question for Congress—when Congress does act, Montana and other states may have found their fate sealed by their "victory" in *Commonwealth Edison.* A sudden upturn in the price of oil or deregulation of natural gas prices may create a great demand for coal. If consuming states view the coal price as too high, the Court's decision may leave Congress with a ready handle on the coal spigot—lower the total price by repealing state severance taxes with federal legislation.

The significance of the court's holding regarding its role on such a fundamental issue suggests the need for an analysis as to its constitutional implications should the justiciability issue come up in the context of a state challenge to a federal ceiling on state taxes.

The issue of the respective roles of the Court and Congress requires examination because *Commonwealth Edison* does not stand alone in suggesting deference to Congress where the dormant commerce clause touches on state sovereignty. In *Hughes v. Alexandria Scrap,*[30] the court refused to balance Maryland's interest in its environment, reflected in its in-state preferential purchasing policy against the interests of a free interstate market: "Nothing in the purpose animating the Commerce Clause forbids a state, *in the absence of Congressional action,* from participating in the market and exercising its right to favor its citizens over others."[31] The Court reached the same result in *Reeves Inc. v. Stake,*[32] when it refused to balance South Dakota's in-state preference for cement purchasers against the dormant Commerce Clause interest in a free market:

28. *Id.* at 2964.
29. *Id.*
30. 426 U.S. 794 (1976).
31. 426 U.S. at 810.
32. 447 U.S. 429 (1980).

> The competing considerations in cases involving state proprietary actions often will be subtle, complex, politically charged and difficult to assess under traditional commerce clause analysis. Given those factors *Alexandria Scrap* wisely recognized that, as a rule, the adjustment of interests in this context is a task better suited for Congress than this court.[33]

This author suggests that, contrary to the suggestion in *Commonwealth Edison,* if some form of taxes on nonrenewable resources is essential to the survival of some states in the federal system, the task of protecting those states from exploitation by more populous states may ultimately be a role that must be filled by the Court and not Congress. If Congress acts to limit state severance taxes unreasonably, the Court will have to evaluate that legislation. While the Court is correct in concluding that setting the appropriate level of a severance tax is a legislative task "in the first instance," determining whether a federal limit on state taxes is so excessive as to put too much stress on the constitutional fabric of federalism is, in the final analysis, a task for the court.

To sustain the argument that the Court has such a function, it must first be established there is a constitutional limit on congressional activity in this area. It can be persuasively argued that in some states with non-renewable resources, excise taxes are essential to state survival in the federal system. Stated another way, principles of federalism do not tolerate "ghost states" when a state's non-renewable resources are depleted. Rather a state has a duty to its citizens to continue to exercise the powers reserved to it under the tenth amendment—it cannot constitutionally go out of business. For some states, reinvestment of revenue from a resource excise tax placed into a trust fund such as Montana's may be the only way a state can continue to function after its depletable resources are removed. The court in *Commonwealth Edison* recognized the state's right to raise revenue for the loss of tax base:

> There can be no doubt that Montana may constitutionally raise general revenue by imposing a severance tax on coal mined in the state. The entire value of the coal, before transportation, originating in the state, and mining of the coal depletes the resource base and wealth of the state, thereby diminishing a future source of taxes and economic activity.[34]

The Court's holding, however, raises a serious question whether the Court would support that right in the face of an act of Congress destroying it.[35]

33. 447 U.S. at 439.

34. Commonwealth Edison, 101 S. Ct. at 2957.

35. The language of the court in Commonwealth Edison is strong: "The simple fact is that the appropriate level or rate of taxation is essentially a matter for legislative, and not judicial, resolution." Commonwealth Edison, 101 S. Ct. at 2959.

The arguments in favor of state severance taxation are supported not only by basic principles of federalism; they make sense in terms of basic theories of capital. As each ton of mineral is consumed from resource exporting states, the state moves inevitably toward a future dramatic contraction of its tax base. This removal of the resource from the state is the equivalent of depletion of a capital asset. The financial reserves necessary to offset this loss can therefore be termed the equivalent of the "replacement cost" which must be captured by a resource excise tax.

It is possible to make a comparison between a state's economy and its need to meet its replacement costs and a private business's needs to replace capital stock. Among other things, the private decisionmaker is concerned with the amount of his capital stock; it is this capital stock upon which the private decisionmaker depends to produce his income. That is, the private decisionmaker is interested in conserving or making plans for replacing his capital stock. In fact, accounting practices are designed to force firms to report more accurately their financial condition by estimating the cost of replacing their capital stock, rather than simply charging off a portion of the original purchase price of this capital stock. Similarly, it can be argued that the capital stock which produces the income of a state must either be conserved or plans should be made to replace it with new kinds of capital in the future. For states or localities whose economies are based on activities that are indefinitely renewable, this task is not particularly burdensome, although even in these cases lack of foresight can allow the development of an outmoded and exhausted industrial base. For states whose economies are based on the extraction of resources that are unequivocally nonrenewable and exhaustible, this task is formidable. Although no certain date may be set for the eventual depletion of its economic assets, that depletion is inevitable and must be anticipated. Since, in a federal system a state is not free to keep its nonrenewable resources from other states, it must look for replacement capital.

Thus, the public interest in asset depletion in the case of nonrenewable resources can be viewed as a special case of the economic theory of capital. The key to developing this concept in the context of capital theory revolves around the cost accounting for the nonrenewable resource. It is instructive, at this point, to draw the analogy, once again, with the private decisionmaker's cost-accounting decisions for a nonrenewable resource. First of all, a nonrenewable natural resource exhibits the characteristic that current-period uses will affect the availability of the resource in future periods. The exploitation of this type of resource in the current period will force the private decisionmaker to replace the unit of resource at some point during the future if he expects to continue in business, thereby implying that the cost of this resource is the expenditure that is necessary to replace the unit of resource. As noted above, in industry this cost is

called replacement cost. In this case, the price the private decisionmaker should accept for the resource should cover not only the operating cost of extracting the resource but also the replacement cost.

Now suppose the nonrenewable resource asset is owned by a public agency. In particular, assume that the public agency is a state government, and exploitation of the nonrenewable resource within the state's jurisdiction is subject to the state government's decisionmaking process. In this case we no longer need to be concerned with the entrepreneurial profit necessary to make the resource available, as is the case with the private decisionmaker, but the public decisionmaker must still cover his costs. In particular, the public decisionmaker requires that payment for the resource cover both the operating cost and the replacement cost to the public.

For a state government whose tax base is heavily dependent on resource-related activities, failure to charge this replacement cost will inevitably lead to a shrinkage in the tax revenues necessary for the conduct of public business. In the extreme case of a state that is entirely dependent on non-renewable resources, the contraction would be complete thereby creating a "ghost state" analogous to the numerous "ghost towns" that dot the western United States. Yet, as noted above, this result is constitutionally unacceptable.

From a national or international perspective this local contraction could conceivably be economically justified on the grounds that it would be cheaper to vacate the geographic area that is no longer productive and pay to remove the indigenous population than to pay the replacement cost charges. However, it is not at all clear that the cost of such a massive relocation would be cheaper. Certainly the larger the area, the less likely that the evacuation alternative would be socially acceptable, even on narrow grounds of dollar cost. Therefore, a state government must charge these replacement costs and take these steps to ensure a financial continuity to its services.[36]

Constitutional support for a state's right to capture an equity interest from its non-renewable natural resources may also be found in the state

36. A state government may decide, as did Montana, to establish a permanent fund and to contribute a portion of resources tax revenues to the fund so that this permanent fund will be available in the future as a source of income to replace the tax revenue that will be lost once a given resource is exhausted. To quantify this objective, one would have to determine the amount of income, C, that on an annual basis must be derived from the permanent fund in order to make up for the loss of the resource industry. If β is the rate of return on financial investments achieved by state government, the fund size, K, must have reached a level by the end of the resource life as determined by equation: $C = \beta K$. States would argue that before the resource leaves the state they should be able at a minimum to extract a tax that will ultimately yield a fund equal to K, so that it can generate revenue equal to C in this equation. In L. BROWN, *et al.*, LEGAL ISSUES IN STATE TAXATION OF ENERGY DEVELOPMENT (1978), economics professor Lee Brown makes the above argument very clearly. He gives specific examples of how such a tax might be calculated to derive a "replacement cost" for uranium.

as "market participant" Commerce Clause cases.[37] While the state as market regulator cannot prefer its business interests over out-of-state interests, the court has taken a different view when the state participates in the market place either by selling its products[38] or distributing its wealth.[39] When the state assesses a nondiscriminatory severance tax to cover its replacement costs, it is acting more as a market participant than a regulator. The tax rate it sets is the price it will accept for allowing the resource to leave the state. And, as noted above, that price must be, at a minimum, sufficient to insure the state's viability in the federal system. Further, if a resource excise tax is essential to a state's survival and that survival is threatened by majoritarian domination by Congress, then the court is the only forum to which the state can turn.[40]

The words of Justice Brandeis suggest that the court has not taken lightly its role of protecting the states' opportunity to prosper in the federal system:

> To stay experimentation [by States] in things social and economic is a grave responsibility. Denial of the right to experiment may be frought with serious consequences to the Nation.[41]

Indeed, if the minority of exporting states are as politically powerless as Justice White indicates, the obligation to protect their interests is suggested even further by the now famous footnote 4 in *United States v. Caroline Products,* where Justice Stone concluded that domination of "discrete and insular minorities may be a special condition which tends seriously to curtail the operation of those political processes ordinarily to be relied upon to protect minorities and *which may call for a correspondingly more searching inquiry.*"[42]

A small state with its future vested in nonrenewable resources may well be even more subject to the potentiality of exploitation by Congress than the less loosely politically organized associations that have been afforded this "searching judicial inquiry."[43] The fact that the exploitation may involve domination by majoritarian politics in the Congress rather

37. Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976); Reeves Inc. v. Stake, 447 U.S. 429 (1980).

38. In *Reeves,* the court concluded that South Dakota's "protectionist" measure of discriminating against non-residents in allocation of cement from a state operated plant was constitutional because it reflected "the essential and patently unobjectionable purpose of state government—to serve the citizens of the State." 447 U.S. at 442. States would certainly argue that a state severance tax is precisely the same type of "protectionist" but essential measure.

39. Hughes v. Alexandria Scrap, 426 U.S. 794 (1976).

40. *See* text and accompanying notes 43–48 *infra.*

41. New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932). *See also* Reeves Inc. v. Stake, 447 U.S. at 437.

42. United States v. Carolene Products Co., 304 U.S. 144, 152–53 n. 4 (1938).

43. *See, e.g.,* Williams v. Rhodes, 393 U.S. 23 (1968).

than at the state level is not a persuasive argument to insulate it from review.[44] Further, the argument that the court cannot address economic theory[45] and determine monopolistic advantage is undercut by its decisions in the antitrust field where the central issue is the potential for market monopoly.[46] Nor, does the fact that evaluating a tax may involve line drawing serve as a valid distinction in light of the courts extensive involvement in the reapportionment [47] and school busing cases.[48]

In *Commonwealth Edison,* the court may have gone far in curtailing its role in determining the appropriate amount of "equity" a state may retain when its nonrenewable resources are severed. If in an energy crisis an act of Congress unreasonably curtails severance taxes and threatens total exploitation of the resource exporting state's "minority" position, the court will be called upon to review Congress's action. It is hoped that the broad non-justiciability language of *Commonwealth Edison* does not foreclose that review.

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44. Indeed, the fact that it is Congress exercising the domination makes the argument even more compelling that the court is the appropriate forum. When it is Congress curbing the state's power, the issue is placed in the court's lap by default. The Federalist no. 78, at 508 (A. Hamilton) (sesquicentennial ed. 1937) recognized this point in discussing the need for judicial review.

> [The] independence of the judges is equally requisite to guard the Constitution and the rights of individuals from the effects of those ill humors, which the arts of designing men, or the influence of particular conjectures, sometimes disseminate among the people themselves, and which, though they speedily give place to better information and more deliberate reflection, *have a tendency in the meantime to occasion dangerous innovations in the government, and serious oppression of the minority party in the community.*.

45. The inability to calculate the possible economic impact of a state severance tax is by far the most persuasive argument against judicial action in this area. These problems are summarized nicely in the excellent survey article by Professor Walter Hellerstein: Hellerstein, *Constitutional Limitations on State Tax Exportation,* 1982 AM. BAR FOUND. RESEARCH J. 3, 29–42. In this article, Professor Hellerstein argues persuasively that the court should not intervene in this controversy because of the complexity of the factual issues and the political nature of the case. While indeed this may be the correct choice where Congress has not acted, if the Congress acts to set a ceiling on state taxes then it will be the court's duty to act to evaluate the ceiling for encroachment on state sovereignty. In this event, the words of Justice Blackmun in dissent in *Commonwealth Edison* will be appropriate: "The complexity of a properly presented federal question is hardly a suitable basis for denying federal courts the power to adjudicate." Commonwealth Edison, 101 S. Ct. at 2971, n. 17 quoting dissent in Milwaukee v. Illinois, 101 S. Ct. 1784, 1809, n. 25 (1981). Indeed, if whether a tax is, in fact, exported to sister states is so complicated as to deny rational proof, then there is legitimate question whether Congress should enact a ceiling. If one is nevertheless enacted, if states are entitled to levy at least enough severance taxes to constitutionally stay in business, the states tax need would certainly appear to be susceptible of proof. *See* BROWN, *supra* note 36 and text preceding notes 35 and 36 *supra.* The inability of the Congress to prove the ceiling is correct should not foreclose the states from proving it is not.

46. *See* M. DUGGAN, ANTITRUST AND THE UNITED STATES SUPREME COURT (1972).

47. *Compare* Kirkpatrick v. Preisler, 394 U.S. 526 (1969) *with* Mahan v. Howell, 410 U.S. 315 (1973).

48. *See, e.g.,* Swann v. Charlotte-Mecklensonburg Board of Education, 402 U.S. 1 (1971). The supposed inability to draw lines in this area is further undercut by cases such as Wickard v. Filburn, 317 U.S. 111 (1942). In *Wickard v. Filburn,* the court had no trouble sustaining federal legislation based entirely on the economic theory that to bolster the interstate wheat market it was necessary to curtail on-farm consumption of home grown wheat.

A congressional limitation on resource excise taxes raises other policy questions in addition to those of federalism. If a state has a constitutionally protected equity interest in its resources, then a state's resource excise tax reflects part of the true cost of the resource—what the state is demanding as compensation for loss of its resources. If this is true, some economists persuasively argue that external market factors will ultimately determine the state's ability to levy the tax.[49] If a severance tax pushes the price of coal to a level greater than the market will pay, then in theory the consumer will shift to alternative markets. If the state is injured by the market shift, it will eventually lower the tax. In New Mexico, the dramatic downturn in the market for uranium has caused a reduction in the severance tax.[50]

If a state is forced by Congress to allow its resources to go out of state at an artificially low price (bearing a severance tax that does not meet the cost of state government), the state will ultimately have to take other measures to cut production or otherwise attempt to indirectly leverage higher tax rates. At the same time, consumers will expect the commodity at an artificially low price (free of tax) and invest heavily in the resources. When and if the state is politically able to collect its tax, it will be levied in the face of disproportionate investment by consumers who have committed capital resources based on an expected low tax rate. Certainly the current problems with the long history of natural gas price ceilings[51] suggest that Congress may not be the appropriate vehicle for making long-term decisions regarding prices to be set on natural resources.

Industries need to know with certainty what severance taxes may be over the life of resource extraction. When substantial investments of capital are involved, reliance on an unrealistic ceiling can be costly to industry and consumer alike.[52]

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49. *See* R. F. CONRAD and R. B. HOOL, TAXATION OF MINERAL RESOURCES (1980) and Gillis, *Evolution of Natural Resource Taxation in Developing Countries* (This Issue), and M. GILLIS, TAXATION AND MINING (1977). *Compare* Gulley, *Severance Taxes and Market Failure* (This Issue). *See also* A. CHURCH, TAXATION OF NON-RENEWABLE RESOURCES (1981). For a concise summary of these issues a lawyer can understand, *see* Hellerstein, *supra* note 6.

50. N.M. STAT ANN. §7-36-25 (1978) *as amended* June 1982; Senate Bill 75, ch. 29 (1982). This reduction in severance taxes occurred notwithstanding the substantial externality costs associated with uranium extraction and processing. Erickson and Gillis, *High Level Enterprise and Low Level Radioactivity: Two Hazards in Developing Country Uranium Concessioons*. VI J. OF ENERGY AND DEV. 39 (1980).

51. For a discussion of some of the practical market impacts associated with rapid price escalation of natural gas prices *see* Ellis and DuMars, *The Two-Tiered Market in Western Water*, 57 NEB L. REV. 333 (1978).

52. While a federal ceiling may appear to provide certainty, states with a vested interest will undoubtedly struggle to get their equity elsewhere through income taxes, *ad valorem* property taxes and, if the minerals are on state land, through royalties. While it is true an outside industry may not have a substantial political constituency within a particular state and in that sense be at a disadvantage, it may gain much better information if it deals directly with the state legislature than through an end-run through Congress.

The principle of federal ceilings on state taxes on all goods destined for interstate commerce also seems frighteningly limitless.[53] Would the auto industry be entitled to a federal ceiling on state production, and ad valorem property taxes? Finally, would a flat 12.5% tax limit be appropriate for a state like Alaska where virtually all of its coal is destined for international markets in Southeast Asia?[54] For those states who presently have a low severance tax, would the 12.5% become the national standard to which they should raise their tax with immunity from legal or political challenge? If Texas raised its 4.6% severance tax on oil and gas to 12.5%, and there was no significant demand shift, 1979 revenues of slightly more than a billion dollars would rise to 2.5 billion dollars per year.[55] These questions raise serious concerns about a congressional ceiling. Further, in light of recent criticism of federal spending and the need to shift fiscal responsibility back to the states, it seems somewhat inconsistent to suggest limiting the state's ability to raise revenue.

Ironically, the arguments for federal legislation under the Commerce Clause have been traditionally aimed not at foreclosing states from being too protective of their resources but rather at keeping states from engaging in destructive competition which causes them to sacrifice their most precious resources. When Congress perceived that destructive market competition between states was causing them to sacrifice the resource of child labor, Congress acted under the Commerce Clause to limit their competition:

> The motive and purpose of the present regulation is plainly to make effective the Congressional conception of public policy that interstate commerce should not be made the instrument of competition in the distribution of goods produced under substandard labor conditions, which competition is injurious to the commerce and to the states from and to which the commerce flows.[56]

This principle is illustrated in the recent Supreme Court decision of *Hodel v. Virginia Surface Mining and Reclamation Association*.[57] The

53. This point and others discussed at notes 54–55 *infra* are thoughtfully and thoroughly discussed by Kneese, *supra* note 5.

54. *See* Brody and Devris, coal policy paper: Leasing and Taxation, House Research Agency Report 80-4 (1981). Surely the same considerations militating against the so-called capture of "economic rents" do not apply when the coal is sold on the competitive international market rather than for consumption in sister states.

55. *See* Kneese *supra* note 53 at 25.

56. United States v. Darby, 312 U.S. 100 (1941).

57. 452 U.S. 264 (1981). *Hodel* raises other fascinating questions regarding the tenth amendment far beyond the scope of this article. Chief among these is whether National League of Cities v. Usery, 426 U.S. 833 (1976), is a resurrection of the tenth amendment or a one-time lapse into history. In *Hodel*, the court stated that the tenth amendment was a bar to congressional action that "regulates states as states," that addresses matters that are indisputably "attributes of state sovereignty" and if applied would directly impair the states' ability "to structure integral operations in

Court expressly recognized that interstate competition for coal would have the direct effect of preventing states from engaging in state programs for environmental protection. Unregulated interstate competition would mean that to "compete" with sister states, the states with good environmental protection laws would have to abandon them. Congress was held to have power to prevent this destructive competition under the Commerce Clause. Specifically, it held that the Surface Coal Mining Reclamation Act was enacted to ensure that "[c]ompetition in interstate commerce among sellers of coal produced in different states will not undermine the ability of the several states to improve and maintain adequate standards on coal mining operations within their borders."[58] The prevention of this sort of destructive interstate competition is a traditional role for congressional action under the Commerce Clause.[59]

If states are reluctant to levy severance taxes to insure the prosperity of future generations, the result may someday be more extensive federal spending than is now occurring in Appalachia.

Eastern seaboard cities with presently large populations and declining tax bases could have benefited by planning earlier for alternative funding from sources other than the federal government or attempting to curtail their growth over time. The argument could thus be made that if federal legislation is to be drafted at all, there is constitutional and historical support for legislation requiring severance taxes rather than curtailing them. Whether future legislation curtails severance taxes or supports them, when Congress acts in this area it will be the court's duty to measure these provisions against the principles of federalism reflected in the Commerce Clause and the constitutional history that has given it life.

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areas of traditional functions." A prohibition against severance taxes would seem to fit squarely under this criteria. How the court would balance the federal and state interests; the relationship between the tenth amendment and the property clause article IV §3 (*see* Kleppe v. New Mexico, 426 U.S. 529 (1976)) if severance taxes were prohibited only on federal property; and the extent of Congress's power to prohibit taxes on state owned coal (*see* Reeves, Inc. v. Stake, 447 U.S. 429 (1980)) are beyond the scope of this article.

58. 30 U.S.C. §1201(a).

59. *Hodel*, 452 U.S. at 282–282.