

# Understanding the Anti-donation Clause: A Historical Perspective<sup>1</sup>

Alan Hall  
Rodey, Dickason, Sloan, Akin & Robb, P.A..  
Albuquerque, New Mexico

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## Part 1: Early Railroad Finance

In theory, the Anti-donation Clause of the New Mexico Constitution forbids, with a few specific and limited exceptions, all state and local government subsidies:

Neither the state, nor any county, school district, or municipality ... shall directly or indirectly lend or pledge its credit, or make any donation to or in aid of any person, association, or public or private corporation ....

At first blush, this may seem reasonable, and even satisfying. Surely, public monies should be spent for public purposes, and not private ones. But when one starts to consider specific aspects of our mixed economy, things become much more complicated. For example, public funding of college scholarships has long been considered to be a violation of the Clause. Does this mean that the popular lottery scholarship program is unconstitutional? The state builds highways to support vehicles weighing ten times as much as ordinary automobiles. Isn't this an obvious, and illegal, subsidy of the trucking industry? How about below-market rentals of public facilities to charitable and civic organizations like the Kodak Albuquerque International Balloon Fiesta®, or to profit-making ones like triple-A baseball teams? How about Albuquerque's free graffiti removal program?

Deciding what is or is not an illegal "donation" is in fact very difficult. The question has confounded the New Mexico courts since statehood, and the worst may still be ahead. How can one make sense of the Anti-donation Clause?

It is clear that the Clause cannot be comprehended from its mere terms; they are far too broad. Rather, the best way to understand the Clause (and perhaps the only way) is to understand the history of the evil that the Clause was intended to counter. This requires a diversion into the amazing world of nineteenth-century railroad finance.

It is hard for the modern mind to fully appreciate the difficulties of transportation in the eastern U.S. prior to railroads. For the most part, cities and towns along the coast had practicable communications, but people living in the interior were economically isolated. Overland transportation meant wagons pulled by horses or oxen, but maintained roads rarely extended

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more than a few miles outside of the larger towns. Rural roads were rutted tracks in the summer and impassable bogs in the winter. Bridges were few, and fords were treacherous. The conveyance of anything heavy or bulky across the Appalachians was not a journey, but an expedition.

In light of these difficulties, the development of the railroad, starting in 1830, sparked incredible excitement. Perhaps no other technology---including automobiles, airplanes, the telephone, computers and space travel---has played such a role in the public imagination, or generated such immediate enthusiasm. The railroad was not just a curiosity, or a rich man's toy, or an incomprehensible abstraction. Rather, it was something that everyone instantly understood would improve their individual lives. It would raise prices received by producers, and simultaneously cut prices paid by consumers. It would increase wages and profits, open huge new markets, and tie the country together as never before. The railroad was like a new god, beneficent and all-powerful, or better yet, a new lover: ardent, beautiful---and rich.

However, the degree of personal benefit that the railroad would bestow would obviously depend on where the lines went. Lucky would be he whose town or farm had a railroad nearby. On the other hand, being off of the rail network was soon seen as an economic death sentence. There would have to be lots of rail lines if expectations were to be satisfied, but railroad construction was expensive, and capital was scarce. Thus, from the very beginning a potent mixture of hope and fear fed an intense demand for public subsidies for railroad construction.

“The people,” a chronicler noted in 1832, “were crazed,” and their legislators were in an equivalent state. They readily approved the issuance of large amounts of state “railroad aid bonds.” The Panic of 1837, in which numerous states defaulted, soon delivered a jolt of reality, and many states responded by inserting anti-subsidy provisions in their constitutions. But so powerful was the promotional juggernaut that these provisions were generally interpreted as applying only to the states themselves, and not to their political subdivisions. Cities and counties remained free to subsidize railroad development, and over the next several decades they did so in a persistent atmosphere of hoopla, popular excitement and imprudence.

Local aid to railroads took a number of forms. Some counties and towns made outright donations to railroad companies, consisting of gifts of land, or money, or government securities issued expressly for that purpose. Other local governments made loans to railroads, or guaranteed corporate bonds. The most common method of subsidy, however, involved swaps of railroad stock. Typically, a city would issue general obligation bonds, payable without limitation from property taxes, which would be exchanged for a nominally equivalent amount of railroad company shares. The railroad promoters would then sell the municipal bonds on the open market. Since buyers (at least) were not insensible of the speculative nature of the underlying investment, the bonds generally bore very high interest rates for the time, and even so, often could be sold for no more than 65 or 70 cents on the dollar. Thus, even if a projected line were built, municipal taxpayers suffered an immediate initial diminution of their investment of as much as a third. Furthermore, after the Civil War there were many years of significant deflation. As a result, municipal debt during this period had to be repaid in dollars that were increasingly dear. As the debt obligations became heavier and heavier, less and less of the tax base was available for streets and waterworks and other basic functions of local government.

The incurrence of excessive debt, however, was not the only defect in these schemes of governmental speculation. In their optimism, city fathers and county commissioners failed to carefully investigate the feasibility of the projected lines or the experience of the railroad entrepreneurs, and compounded this incaution by neglecting to insist on any safeguards on how the public monies that they so readily offered up were spent. Large sums were typically handed over for no security other than the naked promises of railway officials. Fraud and mismanagement consumed significant amounts of the contributions, resulting in many publicly-funded lines never being built, while others were hopelessly uneconomic from the day of their opening.

## **Part 2: The Debtors' Revolt**

When it finally matured, the public reaction against the abuses arising from governmental railroad financing was very strong. Notwithstanding their previous credulity, disillusioned taxpayers, now in genuine economic distress, saw themselves solely as victims. If they had entered into the whole adventure with some element of reservation, perhaps they could have come out of it with some element of philosophy. But their original ardor had been unchecked, and their ensuing resentment was unbounded. Their new god had failed them; their new lover had spurned them; and one thing was certain: they weren't going to pay those bonds.

In addition to banks, corporations, foreign governments and other plutocratic suspects, the bondholders included tens of thousands of ordinary citizens. That did not matter. Large numbers of cities and counties defaulted on their obligations, and sought to justify their actions by claims that the bond issues were invalid, due to fraud or any other legal argument they and their lawyers could devise.

State court judges, subject to recall and retention elections, often sided with the repudiating debtors. The following quotation, from an 1870 Michigan Supreme Court opinion, reflects the full flavor of the popular indignation:

We know ... the history of these municipal and county bonds; how the Legislature, yielding to popular excitement about railroads authorized their issue, how grand jurors and county commissioners and city officers were moulded to the purposes of speculators; how recklessly railroad officers abused the overwrought confidence of the public, and what burdens of debt and taxation have resulted to the people. ... When the State once enters upon the business of subsidies, we shall not fail to discover the strong and powerful interests are those most likely to control legislation, and that the weaker will be taxed to enhance the profits of the stronger.

But federal courts, more isolated from public pressure, generally sided with the creditors. The solicitude of the federal courts towards bondholders is illustrated most dramatically by the 1889 U.S. Supreme Court case of *Comanche County v. Lewis*, which, like the Dred Scott case before it, served only to inflame the public outrage, and gave even conservative thinkers the sense that the country was facing a situation that was untenable.

*Comanche County* upheld the validity of bonds issued the day after a sparsely-settled county in southwestern Kansas was organized, even though the stipulated facts were that

... said organization was effected solely for purposes of plunder by a set of men intending to secure a de facto organization and issue the bonds of said County, register and sell them to distant purchasers ignorant of the facts, and enrich the schemers, while plundering the future inhabitants and taxpayers of the County; and upon the consummation of such scheme, in the spring and summer of 1874, all of said schemers, together with those who were the said de facto officers of the said County, left said County and never returned, and said County remained with said organization totally abandoned until in February, 1885, when said County was [organized again].

In other words, the whole affair was a swindle. There had been no bond election, and the citizenry had been given no inkling of what was afoot. The Supreme Court acknowledged this fully, and yet decided that the bonds were legal. The cheated inhabitants of the county were left with a debt exceeding \$1000 a head, at a time when one dollar a day was a common wage for an unskilled laborer. What could the Court have been thinking?

The legal doctrine underlying the *Comanche County* decision was “estoppel by recital.” It had developed out of a concern that municipal paper would not be liquid unless purchasers could have assurance that the bonds were enforceable obligations. Of course, without liquidity, most bonds would not be salable in the first place, and capital improvements by local governments would be difficult if not impossible to finance.

The theory was that although potential purchasers of municipal bonds had the ability to check state constitutions and statutes to affirm that a local government had fundamental authority to issue its debt, there was no practicable way for the purchasers to know that all the procedural requirements of a local bond election had been complied with. That was a factual matter. Accordingly, “estoppel by recital” provided that so long as there was statutory authority for a bond, and the bond merely *recited* (i) that it was issued pursuant to that statute and (ii) that all applicable procedures had been satisfied, and, in addition, the bond was signed by someone who *purported* to have appropriate authority, then the governmental issuer would be prevented from denying the validity of the bond, even in *Comanche County* circumstances.

Although *Comanche County* was a particularly egregious case, a large portion of the railroad bonds suffered from varying degrees of procedural defects. There were cases where bonds had been issued even though they had been voted down in the election, and a few cases, like *Comanche County*, where no election had been held. Judicial waiver of those infirmities---or, depending on the viewpoint, judicial acquiescence to naked fraud---added to the public’s disgust.

In any event, court approval of a bond issue is something entirely different from collection of taxes to pay the bonds. Taxpayers, and more importantly, local county officials, engaged in widespread civil disobedience to frustrate payment of railroad bonds. In certain counties in Missouri and Kansas, for example, “one qualification for office ... was that the candidate be willing to go to jail rather than be party to a levy, and to keep in hiding during his term of office. Between midnight and morning seems to have been a favorite time for the transaction of county business in some localities,” and even then that business was transacted not at the courthouse, but in barns and under bridges. In many counties, there was a universal

refusal, perhaps often motivated by fear, to bid on any property that had been seized to pay railroad bonds.

Moreover, these activities were not in the nature of a temporary protest. They continued year after year, and in some cases, decade after decade. Many bondholders finally resigned themselves to settling for pennies on the dollar. Some of the railroad bonds are still outstanding, unpaid to this day.

### **Part 3: The New Mexico Experience**

Compared to other parts of the United States, the railroad came late to New Mexico. Not until 1878 did the Atchison, Topeka & Santa Fe cross Raton Pass. The Southern Pacific, pushing east from Tucson, entered the territory two years later. New Mexicans therefore had ample opportunity to consider the political storms ignited elsewhere by railroad aid bonds. This may have averted some problems, but not all, for at least two New Mexico jurisdictions nevertheless issued railroad bonds, and both of these (Santa Fe and Grant Counties) soon defaulted.

The ensuing lawsuits and recriminations dragged on for years. They featured many of the populist arguments honed in other locales, plus some peculiar to New Mexico. For example, New Mexico Supreme Court Justice Alfred Freeman complained, in a dissent to an 1890 decision upholding the Santa Fe bonds, that “the pretended contract” between the county and the railroad had been written in a language (i.e., English) that two-thirds of the electorate could not understand. Justice Freeman passionately argued that courts had a duty to see that the homes and property of an unsophisticated populace were not “confiscated to satisfy the greed of corporations.”

As it was, the legal disputes over the two bond issues were not settled until 1912, when, at the insistence of Congress and as a condition of statehood, revenues from certain public lands were dedicated to pay off the bonds.

In light of this history, it is unsurprising that the drafters of New Mexico’s constitution included an anti-subsidy provision. In doing so, they merely followed the prior example of numerous other states. But their reason for adopting the Anti-donation Clause is much clearer than how they imagined it would work in practice. As noted at the beginning of this article, a literal application of the Anti-donation Clause seems fundamentally inconsistent with the existence of a mixed economy, whether in 1912 or today.

One possibility is that the drafters assumed that the Clause would be adapted and made workable by court decisions. The federal Bill of Rights, for example, features many concepts, like “freedom of speech,” that had no commonly understood meaning when the U.S. Constitution was ratified. Those concepts, however, were subsequently fleshed out by extensive federal caselaw.

Unfortunately, New Mexico courts have not provided a similar service with respect to the Anti-donation Clause. Shortly after statehood, in 1915, the Chief Justice of the New Mexico Supreme Court proclaimed that the Clause should be applied literally and, apparently, with as little thought as possible: “The language of [the Clause] is so clear and explicit that it does not

require [interpretation]; all that need be done is to read it and apply the language in its ordinary sense.” Although the Anti-donation Clause has been construed in thirty-some later cases, the Court has never quite gotten away from this fundamentalist strain. While the Court has indulged in plenty of ad hoc dodging and weaving, it has failed to really question or seriously examine the logic underlying the Clause. For example, what is the relationship between equal protection and the Anti-donation Clause? Is a governmental benefit a donation because it is unequally distributed, such as the significant subsidy the PRC gives to rural telephone users, at the expense of all other telephone users generally? Ninety years after statehood, that fundamental question remains unanswered.

No matter what the Court thinks, however, it seems clear that the legislature has decided that the Anti-donation Clause is an outmoded rule that it will no longer respect. Take, for example, the Groundwater Protection Act, enacted in 1992. Under this law, a tax is imposed on gasoline and diesel fuel at the wholesale level. The tax is dedicated to a certain fund, which is used solely to reimburse private expenditures that are legally required for the clean-up of leaking underground storage tanks. The GPA is a popular act that has worked well to speed environmental clean-ups and protect innocent parties against overwhelming liability. On the other hand, it would be hard to imagine a more clear-cut direct subsidy, or a more certain violation of the Anti-donation Clause.

Or take another example, the lottery scholarship program. Although New Mexico courts have never specifically held that scholarships are unconstitutional donations, it has long been assumed that they are. In fact, two amendments to the Anti-donation Clause were adopted in the 1970s for the purpose of carving out exemptions for tuition assistance for certain medical students and Vietnam veterans. Unless those amendments were done for no reason, it would seem that the lottery scholarships--which are not covered by a similar amendment--are illegal.

There has been a considerable decrease over the past couple of decades in appellate court decisions involving the Clause. This is not the fault of the courts, but rather simply reflects a lessening in the number of litigants who wish to contest governmental actions on Anti-donation Clause grounds. Historically, New Mexico Attorney Generals have seen enforcement of the Clause as an important part of their function, but that no longer seems to be true.

It is by no means clear what stance the current Court might take if it were presented a case that challenged the constitutionality of the Groundwater Protection Act or the lottery scholarships. A serious complication for the Court is that the remedy for a violation of the Clause is restitution, which in the case of these two laws would require repayment of many millions of dollars by thousands of beneficiaries.

The net result is that there is increasing uncertainty about the effect of the Anti-donation Clause. The Local Economic Development Act (LEDA), which was authorized by an amendment of the Clause in 1994, provides an exemption from the Clause for certain economic development activities of municipalities and counties. But LEDA does not cover many of the issues that continually bedevil city and county attorneys. (A few years ago, the staff attorney of the Municipal League was requested to advise the Village of Cimarron whether providing coffee at council meetings offended the Anti-donation Clause. Strictly speaking, the answer is probably “Yes, it does.”) It is increasingly evident that the Anti-donation Clause badly needs clarification. That such clarification will eventually occur there is no doubt. The key question is whether the

court will recognize the importance of settling the matter in a single case that establishes a practicable rule, or whether it stumbles through a succession of vague opinions that sow confusion far and wide.

#### **Part 4: Reforming the Anti-donation Clause**

The Anti-donation Clause could evolve in a number of ways. At some point, the state Supreme Court will be called upon to rule on the constitutionality of a law that, by traditional measures, clearly violates the Clause, but where enforcement of the violation would be deeply unpopular.

How the Court will respond to such a dilemma is unknown. Most likely, it will attempt to resolve the constitutional question on the narrowest possible grounds, which is usually good judicial practice. The fundamental difficulty with the Clause, however, is that its very breadth generally precludes narrow answers. If the Court wishes to avoid policy discussions, its only choice may be to keep the rationale for its decision as vague as possible.

As much as the Court may wish to be cautious, it does have the alternative of being bold. Just how bold is illustrated by the Colorado Supreme Court's decision in *McNichols v. Denver*, a 1955 case. The Colorado constitution contains a provision that corresponds almost word-for-word to the Anti-donation Clause. Prior to *McNichols*, the Colorado court had basically tried to give the provision real effect. In that decision, however, the court simply declared that notwithstanding its prior decisions, the Colorado clause only meant that public funds had to be spent for a public purpose. This was revolutionary, because under the public purpose doctrine, courts will almost never question a legislative body's finding that a particular statute or ordinance is being done for the public benefit. In other words, *McNichols* was no less than a judicial repeal of that particular provision of the Colorado constitution. The New Mexico Supreme Court, if it were so inclined, could do the same thing.

There is also, of course, the alternative of direct amendment or repeal. A repeal would constitute a definitive resolution of all Anti-donation Clause controversies. But whether New Mexico voters would approve a repeal, and whether a repeal would be a good idea, are separate questions.

Many of the factors that contributed to the railroad subsidy abuses in the 1800s are no longer a part of our world. "Estoppel by recital," for example, has long been supplanted by bond counsel opinions. This does not mean, however, that the painful lessons of the railroad era should be ignored. Attempts to direct special benefits to select groups for reasons that have nothing to do with the public good will always be a threat to good governance. The issue is how to avoid throwing the baby out with the bath water.

One important lesson from the railroad era is that different subsidies caused very different degrees of harm. In general, gifts of property--whether real estate or cash--resulted in the fewest problems. Those donations, after all, had an absolute limit. Citizens could not give more than they had, and what they did give they gauged against their other, more immediate needs. From wealth in hand, the populace rarely gave more than it could afford.

The real problem, rather, was the bonds, which had a something-for-nothing quality. The assumption was that the railroad would raise property values to such an extent that debt service would be paid from the increased value alone. Thus, the bonds were seen as a debt in name only, which is a viewpoint shared by all too many guarantors and other obligors of contingent liability. They think, and the people who voted for the railroad bonds thought, “Well, the contingency will never really come.”

This suggests that the best course might be an amendment of the Anti-donation Clause that distinguishes between subsidies paid from present funds and subsidies that are to be paid from funds that are not yet in hand. The latter, which would include contingent obligations, would remain illegal, but the former would be permissible, subject, however, to some procedural safeguards.

The Local Economic Development Act, a current exception to the Anti-donation Clause, provides an example of the procedural safeguards that might be employed. Under that Act, any subsidies proposed by municipalities or counties must be adopted by a series of ordinances. This means that the public is given notice of the proposed subsidy, and is afforded a hearing to object to it. This is a thoroughly desirable procedure. The promise of a hearing by itself goes a long way towards deflecting schemes that are unrealistic, or that have an underlying political purpose.

While public comment can play an effective role at the local level, this is not as true at the state level. The way in which the Legislature operates, with the rush of business at the end of each session, is in certain respects hostile to public involvement. This emphasizes the need for restricting subsidies to those payable from specifically identified, fully funded accounts.

Not many years ago, Arizona supplied a sterling example of the sort of abuse that may occur if a subsidy is not limited. Due to the connivance of the Speaker of the Arizona House, and the inattention of the other members of the legislature and the Governor, that state enacted a law at the very end of its 2000 legislative session that gave a remarkably generous subsidy to persons who converted their vehicles to use, in addition to gasoline, alternative fuels like natural gas. The assumption was that only a relative handful of motorists would take advantage of the offer. However, the bill was written so sloppily that the subsidy was triggered by the installation of a purely symbolic one or two gallon canister, even on the largest SUVs. The result was an exploding demand that cost Arizona taxpayers \$140 million before the spigot could be turned off, with the overwhelming portion of the benefit going to higher income people.

That sort of waste is something that the Anti-donation Clause protects us against, and even if it is amended to eliminate some of its more problematical features, that hard core of protection should be retained.