Spending Clause Conditions and the Coronavirus State Fiscal Recovery Fund

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The American Rescue Plan Act of 2021 (ARPA) tasks the Department of the Treasury (Treasury) with disbursing to states more than $190 billion appropriated for the Coronavirus State Fiscal Recovery Fund (“CSFRF”). States may use CSFRF dollars to cover a wide range of costs incurred by December 31, 2024. States must certify that they will comply with statutory conditions on the use of CSFRF funds. States that violate a condition must repay Treasury “an amount equal to the amount of funds used” in the violation. Treasury may recover funds by reducing states’ CSFRF payments, in the event Treasury decides to “split” payments to states, or (perhaps) through offsets applied to other federal funds owed to states.

One condition has attracted legal controversy. ARPA prohibits states from using CSFRF funds to “directly or indirectly offset a reduction in the net tax revenue of such State” resulting from “a change in law, regulation, or administrative interpretation” that reduces “any tax” or delays the imposition of any tax or tax increase. The statute lists relevant changes to include “a reduction in a rate, a rebate, a deduction, a credit, or otherwise.” For states participating in the CSFRF program, this tax condition applies during a “covered period” that began on March 3, 2021, and ends on the last day of the fiscal year in which a state spends or returns all CSFRF funds or Treasury recovers improperly spent funds. States must periodically report to Treasury “all modifications” to their “tax revenue sources.”

At least 25 States (the “States” or “objecting States”) contend that the tax condition exceeds Congress’s authority under the U.S. Constitution’s Spending Clause. Sixteen of these States have filed suit in federal district courts located in Alabama, Arizona, Missouri, and Ohio. Among other relief, these lawsuits ask the federal courts to declare the tax condition unconstitutional and enjoin its enforcement. The remaining nine States joined a March 16, 2021, letter to Treasury Secretary Janet Yellen. In general, States objecting to the tax condition argue, in part, that the condition is impermissibly coercive and ambiguous. This Sidebar examines both contentions and considers what might be next for the tax condition.

Spending Clause Doctrine

Arguments over the tax condition invoke key components of the constitutional design. The states are one half of the Constitution’s “dual sovereignty” system. Under the Tenth Amendment, all “legislative power”...
not conferred on Congress by the Constitution “is reserved for the States.” The Supreme Court has described a state’s power to “promulgate regulations of its choosing” as “central” to its role in the federal system. Thus, Congress may not “commandeer” a state’s legislative processes by dictating “what a state legislature may and may not do,” whether by ordering the state to enact a federal program or by prohibiting a state from adopting certain legislation. In other words, the Constitution does not generally confer on Congress “the power to issue direct orders to the governments of the States.”

The Constitution does confer on Congress enumerated legislative powers, including authority under the Spending Clause to raise revenue and provide for the “general Welfare of the United States.” Subject to various limitations, Congress may pursue its policy objectives by gifting federal funds on the condition that the funds’ recipient, including a state, take certain actions. In this way, Congress may influence a state’s policy choices, even by conditioning funds on a state taking certain actions that Congress could not otherwise order a state to take. Conditions may affect a “fundamental” aspect of state sovereignty, such as (according to federal courts of appeals) a state’s general immunity from suit. Acceptance of the federal funds entails “an agreement to the actions.” A state that violates a valid condition has “no sovereign right to retain funds without complying” with the condition.

There are limits on Congress’s power to condition a state’s receipt of federal funds. The Court has described these limits as “critical to ensuring that Spending Clause legislation does not undermine the status of the States as independent sovereigns in our federal system.” The States objecting to the CSFRF tax condition invoke at least two of these limits: (1) the financial inducement that Congress offers states—that is, the federal funds the state would lose if it rejected Congress’s conditions—must not be coercive; and (2) Congress must state its conditions unambiguously.

Is the Tax Condition Coercive?

The objecting States first contend that the tax condition is impermissibly coercive. The notion that Congress’s conditional offer of funds to states could be coercive first appeared in Spending Clause case law in 1937. Thereafter, the Court has reaffirmed the anti-coercion rule and applied it, in South Dakota v. Dole, to sustain a condition that put at stake a relatively small amount of federal funds (5% of specified federal highway funds, equal to “less than half of one percent of South Dakota’s budget”) and thus gave only “mild encouragement” for states to accept federal conditions. It was not until 2012, in National Federation of Independent Business v. Sebelius (NFIB), that the Court used the rule to invalidate part of a statute, namely, the Affordable Care Act (ACA).

The ACA presented states with the following choice: expand Medicaid coverage to new populations and receive additional federal Medicaid funds, or refuse expansion and lose all Medicaid funds. Writing for a three-Justice plurality, Chief Justice Roberts held that this choice violated the anti-coercion rule. A four-Justice joint dissent reached the same general conclusion. The dissent reasoned that given the amount of federal funds at stake and the “heavy” federal taxes levied to support the program, as a practical matter states could not “refuse to participate in the federal program” and then “substitute a state alternative.” Lower courts have applied the plurality’s reasoning because it rests on narrower grounds than the dissent. Similarly, the objecting States appear to invoke the NFIB plurality.

The NFIB plurality stressed the amount of funds that a state would lose if it rejected Congress’s condition (“over 10 percent of a State’s overall budget”). The plurality also appeared to place weight on the fact that Congress’s condition threatened both new federal funds and existing federal funds for what the plurality determined was a different program and did not govern use of those funds. Conditions on the use of federal funds are upheld, the plurality reasoned, because those conditions are “the means by which Congress ensures that the funds are spent according to its view of the General Welfare.” Conditions that do not “govern the use of the funds” cannot be justified on that basis. When Congress threatens “to terminate other significant independent grants,” the conditions “are properly viewed as a means of
pressuring the States to accept policy changes” through use of a penalty. If Congress’s conditions are coercive, a state cannot be said to have voluntarily agreed to the condition by accepting the federal funds.

How a court might resolve the objecting States’ coercion argument is unclear. The NFIB plurality stressed the magnitude of funds affected by the Medicaid expansion provision. Some states could forgo a large amount of federal funds by rejecting the tax condition. While Treasury has not yet released state allocations, the allocations will likely be significant for many objecting States. For example, Arizona expects to receive about $4.7 billion from the CSFRF, a figure equal to approximately 40% of its annual general fund budget. The pandemic has caused state revenues to decline and demand for state services to increase. The objecting States therefore contend that no state “can turn down” ARPA’s “financial inducement.”

The NFIB plurality also stressed the nature of the condition and the funds at stake: a condition on receipt of new as well as existing federal funds that did govern the use of those funds. Given this relationship between the condition and threatened funds, the NFIB plurality agreed with states that the choice they faced under the ACA “serve[d] no purpose other than to force unwilling States” to accede to the expansion condition. The States stand to lose only CSFRF funds by rejecting the tax condition, and the condition governs the use of those funds. By crafting a condition governing the use of only new funds, a court might conclude that Congress had a purpose beyond threatening states to accept the tax condition. For example, if the goals of a conditional spending program include supplementing state spending in particular areas, that goal can be undermined by fiscal substitution, the practice of using federal funds to replace state dollars for a given program. In narrower grant programs, Congress might include, as part of the bargain presented to states, a condition that requires states to use federal funds to supplement and not supplant spending from nonfederal sources.

Is the Tax Condition Ambiguous?

The objecting States also contend that the tax condition is impermissibly ambiguous. The Supreme Court has likened Spending Clause legislation to a contract whose legitimacy depends on states knowingly and voluntarily accepting Congress’s conditions. There can be no “knowing acceptance if a State is unaware of the conditions or is unable to ascertain what is expected of it.” Thus, Congress must speak with a “clear voice” when imposing conditions on federal funds offered to states. Here, the objecting States contend that the tax condition lacks the requisite clarity.

In perhaps the leading case on this clear-statement rule, the Court held in Pennhurst State School and Hospital v. Halderman that a “bill of rights” provision in a federal grant statute merely expressed “congressional preference” for certain types of treatment for the developmentally disabled (i.e., “appropriate treatment” in the “least restrictive” environment that would maximize “developmental potential”). The bill of rights provision did not require, as a condition of the federal grant, that states actually fund such treatment. In deciding no such obligation existed, the Court cautioned that the judicial task is not to ask “whether a State would knowingly undertake” the alleged obligation. Rather, the crucial inquiry is “whether Congress spoke so clearly that we can fairly say that the State could make an informed choice,” considering the requirements in effect when the grant was made.

Pennhurst vindicated a state’s claim that particular statutory language was only precatory and imposed no condition on federal funds whatsoever. Courts have also considered ambiguity contentions when a state could not deny the general existence of a condition but instead argued that the condition was not sufficiently defined to inform the state how it might apply in particular cases. Four years after Pennhurst, in Bennett v. Kentucky Department of Education, the Court held that Kentucky had sufficient notice of a condition requiring use of federal education funds to supplement and not supplant nonfederal education spending. The Court explained that the existence of the condition was clear and that Pennhurst did “not suggest that the Federal Government may recover misused federal funds only if every improper
expenditure has been specifically identified and proscribed in advance.” The application of a condition on the use of funds may be clear in one context but unclear in another.

Here, the States objecting to the CSFRF condition appear to concede that it would impose some limitation on their use of CSFRF funds in connection with changes to state tax law. In other words, the States do not argue, as was the case in Pennhurst, that the tax condition is precatory only. The States argue instead that the tax condition is ambiguous because its application to particular state tax reductions is unclear. The States contend that the tax condition could be read merely to prohibit states from expressly earmarking CSFRF funds as offsets to the revenue decline associated with a particular state tax reduction. The States also contend that the condition might prohibit Treasury from undertaking any tax reduction. ARPA prohibits states from “indirectly” offsetting such measures with CSFRF funds. Money is also fungible, meaning that each CSFRF dollar is interchangeable with a dollar received on account of state tax laws. On this view, by receiving CSFRF funds and then reducing a state tax, a state could have “indirectly” violated the tax condition, even if the change had no connection to the availability of CSFRF funds or the state’s pandemic response. Certain States contend that an unintentional reduction in net tax revenue may violate the tax condition.

It is unclear how the States’ Pennhurst arguments might fare. The Supreme Court last expressly applied Pennhurst in 2006, when, in Arlington Central School District Board of Education v. Murphy, it considered a statute authorizing courts to award “reasonable attorneys’ fees as part of the costs” to parents who prevail in an action under the Individuals with Disabilities Education Act. The Court held that the statute lacked clear notice that a state would be liable for a prevailing parent’s expert fees. The Court explained that a statute must provide “clear notice regarding the liability at issue” in a particular case when the state decided to accept the federal funds, perhaps pointing to a more demanding application of the clear-notice rule than in earlier cases. Murphy involved the liabilities that a state might owe to private parties based on the obligations the state assumed by accepting federal funds. Murphy did not consider how particularly a grant statute must define allowed costs. Bennett cautions that in complex conditional spending programs, a category that undoubtedly includes the CSFRF program, “the Federal Government simply could not prospectively resolve every possible ambiguity concerning particular applications of the requirements” of the grant statute. The Court has variously described Pennhurst’s ambiguity test, providing both the objecting States and the federal government room to argue that the tax condition fails or passes that test.

What Is Next For The Tax Condition?

ARPA directs Treasury to begin distributing CSFRF funds to states, to the extent practicable, not later than 60 days after a state certifies that it will comply with the conditions placed on those funds. The Act also grants Treasury authority “to issue such regulations as may be necessary or appropriate” to carry out the CSFRF program. On March 23, 2021, Treasury previewed for the objecting States forthcoming “guidance” on the CSFRF program. According to Treasury, nothing in ARPA prevents states from enacting a broad variety of tax cuts,” so long as CSFRF funds are not used to offset a reduction in state tax revenues on account of those measures. Thus, states may modify state tax laws so long as they replace “the lost revenue through other means.” While the import of this statement is not clear, it suggests that Treasury reads the tax condition as requiring states to pair state tax reductions with offsetting tax increases. Treasury says that its guidance will be available before states must decide whether to certify future compliance with the tax condition. Though Treasury’s guidance likely will not affect the objecting States’ coercion arguments, the guidance could factor in the States’ ambiguity arguments. Supreme Court case law suggests that “regulations” and “other guidelines” can help clarify statutory conditions, though certain States may contest that proposition.
As noted above, to date sixteen States have filed suit challenging the tax condition. Other States might file challenges of their own or participate in a pending suit. Ohio has requested a preliminary injunction barring the federal government from enforcing the tax condition pending the outcome of Ohio’s lawsuit. The federal government has not yet substantively responded in any of the pending suits. The Ohio district court is scheduled to hear oral argument on Ohio’s preliminary injunction request on April 30, 2021. Hearings have not yet been scheduled in the other cases.

Author Information

Sean M. Stiff
Legislative Attorney

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