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INTRODUCTION

In times of national fiscal distress, cities suffer multiple wounds. States tend to compensate for reduced tax revenues by decreasing aid to their political subdivisions. In recent months, for example, New York's Governor has proposed closing an anticipated $15.4 billion deficit in part by reducing school aid to localities by $698 million and cutting an additional $240 million in aid to New York City.[1] California has considered proposals to address its budget crisis by withholding appropriated funds from counties.[2] These proposals have materialized just as cities experience declines in their own revenues. New York City's Independent Budget Office has estimated that city tax revenues will fall by $2.8 billion in fiscal year 2009 to $34.7 billion and by an additional $380 million in 2010.[3] New York City may be an extreme example in the current environment, given the demise of the financial sector that has recently generated a significant percentage of New York City's revenues. But the phenomenon, if not the degree, is common to other municipalities as faltering property values and job losses reduce tax and business receipts on which cities depend.

In theory, these reductions could be offset, at least in part, by local revenue-raising initiatives. Wholly apart from the limited fiscal capacity that localities enjoy to increase revenues without inducing firms and individuals to exit the jurisdiction, however, the legal capacity of home rule cities to raise revenue is a prime example of the diverse meanings of local autonomy. In some jurisdictions, the constitutional grant of home rule entails the power to impose taxes. In others, however, authority to impose taxes is explicitly exempted from the constitutional grant. In still others, home rule cities are allowed to impose some taxes, but not others. Judicial interpretation of home rule has imposed further restrictions. For example, the Colorado Supreme Court has narrowly interpreted the scope

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1. *See* Conor Dougherty & Amy Merrick, *States Squeeze Cities, Spreading the Economic Pain*, WALL ST. J., Dec. 18, 2008, at A4, *available at* http://online.wsj.com/article/SB122955325187415831.html.

2. *See* Loretta Kalb & Robert Lewis, *Revolt Brews in Counties*, SACRAMENTO BEE, Feb. 5, 2009, at 1A, *available at* http://www.sacbee.com/capitolandcalifornia/story/1600656.html.

3. N.Y. INDEP. BUDGET OFFICE, FISCAL OUTLOOK: AS ECONOMY WEAKENS, CITY'S BUDGET GAPS SWELL 1 (2009), http://www.ibo.nyc.ny.us/iboreports/FiscalOutlookJan2009.pdf.

of fiscal home rule to deny cities the capacity to enact a local income tax.[4] Finally, even where the home rule grant is silent with respect to revenue raising, general provisions of state constitutional law—such as debt limitations, tax limitations, balanced budget requirements, and limitations on fees and charges—may restrict municipal fiscal powers.

In a sense, the very notion of restricting revenue raising by home rule municipalities seems oxymoronic. Chief Justice Marshall's equation of the power of states to tax a federal entity as the power to destroy it[5] has an unspoken corollary: the power to deny taxing authority has the same effect. Shorn of the capacity to raise revenue, the ability of home rule municipalities to realize the objectives of decentralized governments would be vulnerable to the very interference by the state that home rule presumably displaced. For a state to embrace home rule as a doctrinal matter, but then to maintain a monopoly over the means of financing the projects that localities wish to pursue undermines much of the purpose of local autonomy. Any justification for *legal* restrictions on revenue raising, such as to constrain inefficient expenditures by public officials, must still be compared to potential alternatives for achieving the same objective, such as the market for residence and mobile capital, that might have different impacts on the objectives of decentralization.

To see why this is the case, consider the various rationales that are proffered for decentralization. The primary economic justification for decentralization is reflected in the enormous body of literature that followed Charles Tiebout's pure theory of a market for residence. In this account, the variety of local governments allows prospective residents and firms (at least those who have mobility and information about different jurisdictions) to migrate to areas that offer a preferred bundle of goods and services at a particular tax price. In this idealized competition for mobile capital, localities are induced to provide local public goods at prices that reflect the same marginal cost principles that would prevail in a market for private goods under perfect competition. Failure to deliver desired services, or to finance services that are provided through a mechanism consistent with residents' preferences, means losing residents and tax base to competitors. In the happy version of the Tieboutian story, interlocal competition creates a race to the top: localities strive to offer preferred goods and services in as efficient a manner as possible in order to avoid exit by mobile capital to more hospitable jurisdictions, and individuals and firms locate in those jurisdictions where they can be most socially productive. The variety of local governments that efficiently offer different bundles of local public goods increases welfare, as more individuals are able to realize their preferences than would be possible in a more heterogeneous centralized jurisdiction. In a jurisdiction of 1,000

4. City & County of Denver v. Sweet, 329 P.2d 441, 447 (Colo. 1958).
5. McCulloch v. Maryland, 17 U.S. 316, 327 (1819).

residents, 600 of whom desire municipal funding of a new stadium and 400 of whom do not, the majority can impose its will on the minority. If the dissidents live in a jurisdiction of their own, the majority can fund the stadium it desires, while the minority can forgo that project altogether.

The assumptions that one must make in order to realize the Tiebout result—concerning perfect mobility, absence of externalities, and information about a large number of jurisdictions—are obviously too heroic to reflect real world conditions. Nevertheless, with some caveats that I will discuss, there does exist significant empirical evidence to support this happy story of race-to-the-top fiscal competition.[6] To the extent that the assumptions of the Tiebout model can be realized, local governments can provide the goods and services that residents prefer or define the functions of the community that presumably favor decentralized government over regional or statewide alternatives.

Pursuit of decentralized conceptions of local autonomy, however, typically entails a funding mechanism. Constraints on the fiscal tools that municipalities are allowed to utilize necessarily interfere with the Tiebout sorting that recommends the use of decentralized governments to attract residents who desire certain goods and services and therefore provide local public goods efficiently. That is, the restrictions interfere with interlocal competition for residence and mobile capital by privileging some forms of revenue raising and disfavoring or prohibiting others, notwithstanding that local decisions about these matters would better serve municipal purposes. As Wallace Oates notes, models of local government competition that lead to efficient results rely on assumptions that the localities have access to the full range of fiscal and regulatory policy instruments.[7]

One does not have to accept the Tiebout hypothesis as either a descriptive or normative matter to understand that constraints on the fiscal tools available to a locality interfere with the ability of local governments to realize the benefits of decentralization. The recent investigation by Professors Gerald Frug and David Barron, who reject many of the implications of the competitive model of local government, into the scope of autonomy enjoyed by different municipalities decries the constraints on revenue raising that the city of Boston suffers compared to other cities such as Chicago and Denver.[8] Frug and Barron contend that arguments about local autonomy are misconceived insofar as they focus on longstanding debates about whether cities should pursue developmental

6. *See, e.g.*, WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS 40-42 (2001); Wallace E. Oates, *The Effects of Property Taxes and Local Spending on Property Values: An Empirical Study of Tax Capitalization and the Tiebout Hypothesis*, 77 J. POL. ECON. 957, 960-70 (1969); John Douglas Wilson, *Theories of Tax Competition*, 52 NAT'L TAX J. 269, 289 (1999).

7. Wallace E. Oates, *Fiscal and Regulatory Competition: Theory and Evidence*, 3 PERSPEKTIVEN DER WIRTSCHAFTSPOLITIK 377, 379-80 (2002).

8. GERALD E. FRUG & DAVID J. BARRON, CITY BOUND 75-92 (2008).

or redistributive policies, growth or no-growth policies, or use-value or exchange-value policies.[9] Urban institutional structures, they argue, should permit cities to consider a more robust set of opportunities that transcend the dichotomous choices that conventional theory has imposed on them. Even if cities desire to explore novel options for their environments, the authors recognize, the success of the venture will largely depend on the legal authority of cities to implement their visions. Among the primary mechanisms that Frug and Barron identify as prerequisites to local imagination is fiscal autonomy. As they conclude, the set of revenue tools that a city employs necessarily affects the policies it is able to implement. Property taxes, sales taxes, and income taxes impose different burdens on different constituents and thus affect the decisions a locality makes about what resources to attract and what resources to abandon. According to Frug and Barron, the constraints that Massachusetts places on its home rule jurisdictions are all the more troublesome because Boston procures a larger percentage of its revenues from the primary tax used by cities—the property tax—than do cities with broader taxing power. Perhaps Boston would, if granted greater leeway, prefer a different mix of financial instruments, some of which are currently beyond its authority, to pay for city services, and thus create a different set of incentives for private activity that are affected by different revenue devices. To the extent that the state controls revenue raising, it necessarily constricts the set of policy choices available to the city. While Frug and Barron do not advocate "local autonomy on tax issues," because the state may have an interest in the level of taxes any of its cities imposes, they do endorse a rethinking of the allocation of revenue-raising power among state and local jurisdictions.[10]

Withholding taxing power from home rule cities, moreover, does not simply threaten to forestall particular projects that the locality has identified as worth pursuing. It has a more subtle and potentially more notorious consequence of instantiating a particularly limited view of the proper role of cities. The power to tax is typically defined in a manner that pertains only to those exactions that meet two conditions: the proceeds of the exaction flow into the general fund of the local treasury, and the amount payable is not based on the provision of specified goods or services to the payer. Exactions that do not satisfy these criteria, such as tolls, service charges, assessments, and user fees that are benefit-based, typically fall outside restrictions on taxes. The inherently ambiguous distinction between a fee and a tax gives rise to a wealth of litigation, as municipalities seek to circumvent limitations on taxing authority

9. *Id.* at 23-30.
10. *Id.* at 87.

by denominating as valid fees exactions that payers then challenge as invalid taxes.[11]

My primary concern here is not the proper resolution of those cases. Rather, my concern is what the distinction itself says about the proper scope of local autonomy. Part of my argument in this Article is that the disparate treatment of taxes and fees implies a distrustful view of redistributive municipal expenditures that are necessarily funded through taxes rather than through benefit-based fees. A legal regime that privileges the use of benefit-based exactions over taxes implicitly affirms that distrust. It may be that skepticism about municipal redistribution is justified.[12] For current purposes, I am agnostic on that issue. My claim here is only that we must recognize that the differential treatment of local legal capacity to impose taxes and non-tax revenue obligations assumes that the two categories have different degrees of legitimacy.

I. THE SCOPE OF FISCAL HOME RULE

Home rule, which too frequently is used as a generic term to characterize the capacity of local governments to initiate legislation without the prior approval of the state legislature, means very different things in different jurisdictions. Home rule cities in some jurisdictions have the authority to trump state legislation in matters of mixed local and state concern, while in other jurisdictions home rule provides no such supremacy. In some jurisdictions, home rule status confers the ability to legislate extraterritorially or with respect to civil relationships; in other jurisdictions, not. And in some jurisdictions, home rule means that localities can decide how to pay for publicly provided goods and services without legislative constraint, while in other jurisdictions home rule implies far less fiscal authority.

A few examples illustrate the variety of provisions that govern fiscal home rule. The Massachusetts Home Rule Amendment withholds taxing power from home rule cities, in apparent disregard of the principle that "home rule without money is meaningless."[13] Iowa and Tennessee permit home rule cities to impose only those taxes that the legislature preapproves.[14] Illinois requires legislative approval for home rule cities to license for revenue, or to impose taxes measured by income.[15] As I indicated above, ambiguous constitutional provisions are vulnerable to

11. Laurie Reynolds, *Taxes, Fees, Assessments, Dues, and the "Get What You Pay For" Model of Local Government*, 56 FLA. L. REV. 373, 425-30 (2004); *see also* Emerson Coll. v. City of Boston, 462 N.E.2d 1098, 1100-02 (Mass. 1984).

12. *See* Clayton P. Gillette, *Local Redistribution, Living Wage Ordinances, and Judicial Intervention*, 101 NW. U. L. REV. 1057, 1085-88 (2007).

13. FRUG & BARRON, *supra* note 8, at 77.

14. IOWA CONST. art. III, § 38A; TENN. CONST. art. XI, § 9.

15. ILL. CONST. art. VII, § 6(e).

narrow judicial interpretation of home rule, which may deny cities the capacity to enact taxes that local officials prefer.[16]

Even those home rule jurisdictions that do have the capacity to tax are subject to state constitutional provisions that restrict the set of fiscal policy choices and the set of fiscal tools that they are able to employ. In their excellent compendium of the scope of home rule, Krane, Rigos, and Hill report a variety of constraints on the discretion of home rule municipalities to structure fiscal arrangements.[17] Constitutional limitations on property tax rates, balanced budget requirements, debt limitations, and the like all remove from the locality the ability to rely on market mechanisms alone to decide basic fiscal issues; that is, what services to provide and how to pay for them. Even states, such as Colorado, that provide a strong form of home rule—that is, a form that allows local ordinances to trump conflicting state statutes with respect to municipal affairs—have adopted state constitutional provisions to constrain local revenue-raising power.[18]

For the most part, restrictions apply to taxing authority, but not to non-tax revenue raising. That is, even if a home rule municipality is not entitled to impose an income tax or an ad valorem property tax in excess of state constitutional restrictions, it may still impose user fees or service charges for services it provides. This distinction instantiates a particular, contestable view of what cities should do. Fees and charges are typically required to be benefit based. That is, fees and charges can be imposed in amounts that reflect the cost of the service conferred on the payer or the benefit received by the payer, but no more.[19] This is a perfectly rational mechanism for defraying the cost of publicly provided services. Localities provide local public goods such as garbage collection or road paving in order to solve collective action problems that would cause these goods to be undersupplied, relative to demand, if their provision were left to the marketplace. Once the locality decides to provide a local public good, however, it may be perfectly appropriate for the locality to charge for that service using the same principles of marginal cost pricing that a private provider would charge under ideal competitive circumstances.[20] Any other pricing mechanism would cause residents who would be willing to pay the cost of providing the service to avoid it (if the governmentally imposed charge is too high), or would cause residents who don't value the service as much as it costs to utilize it anyway (if the charge is too low). If the good is being publicly provided to compensate for a pri-

16. City & County of Denver v. Sweet, 329 P.2d 441, 447 (Colo. 1958).

17. DALE KRANE, PLATON N. RIGOS & MELVIN B. HILL JR., HOME RULE IN AMERICA 4-6 (2001).

18. HCA-Healthone, LLC v. City of Lone Tree, 197 P.3d 236, 241-42 (Colo. App. 2008).

19. *See* Clayton P. Gillette & Thomas D. Hopkins, *Federal User Fees: A Legal and Economic Analysis*, 67 B.U. L. REV. 795, 800 (1987).

20. *See* Jerome W. Milliman, *Beneficiary Charges: Toward a Unified Theory*, *in* PUBLIC PRICES FOR PUBLIC PRODUCTS 27, 33-35 (Selma J. Mushkin ed., 1972).

vate market failure, either of these results would cause a misallocation. In addition, benefit-based charges with marginal cost pricing provide signals to local officials concerning the preferences of residents for particular services, as evidenced by their willingness to pay for them.[21] Because these signals are based on charges for individual services, they may provide more accurate signals about resident preferences than elections, which are infrequent and require binary votes on an entire bundle of services. In short, fee-based services are likely to improve the efficiency of government provision by mimicking competitive pricing models and delivering only those services that residents value in amounts at least as great as their cost. This is not to say that government should never vary from competitive pricing in order to redistribute wealth. It is only to say that when localities act to correct a market failure rather than for redistributive purposes, marginal cost-based fees are a reasonable means of exacting payment.

Perhaps these advantages of benefit-based exactions explain the decreasing importance of property taxes, and the narrow use even in home rule localities of local sales or income taxes. According to Krane, Rigos, and Hill, property taxes account for more than 75 percent of municipal revenues in only three states, and for less than 40 percent in eight states.[22] Charges and user fees account for between 30 and 50 percent of municipal revenues in twelve states.[23] One might initially believe that these exactions dilute any claim about municipal impotence for home rule municipalities that lack taxing authority, since taxes comprise a substantial, but incomplete, share of municipal revenues. But the distinction between taxes and fees informs the point that I am making about the conception of cities implicit in the denial of home rule authority to tax. To conclude that home rule local governments properly utilize benefit-based exactions where they desire to match benefits and burdens seems a far cry from saying that they should be constrained from using alternative revenue-raising devices, such as taxes that *are* predicated on ability to pay, should local officials believe that the alternatives will advance other policy objectives. The greater constraints that many jurisdictions suffer in utilizing taxes induces localities to employ alternatives, even where doing so is less consistent with municipal policy objectives concerning the incidence of payment for municipal services. While local governments have a crucial role to play in the allocation of local public goods, the effect of privileging fees over taxes is to deny home rule municipalities the same discretion to engage in redistribution or to encourage or discourage favored or disfavored local activities.

21. *See* Gillette & Hopkins, *supra* note 19, at 800-01.
22. *See* KRANE ET AL., *supra* note 17, at 490 tbl.A15 (results not reported for six states).
23. *Id.*

From the perspective of the market for residence and mobile capital, these restrictions seem particularly anomalous. I have suggested above that localities can thicken the market for residence by selecting fiscal tools that they believe will attract desired firms and individuals. State constraints on the set of fiscal tools that localities can select perversely restrict that market. For example, localities may seek to attract populations that require redistributive services in order to provide support services for high-income earners, where doing so increases a population that increases net local revenues. Those of us who experience the joys of New York understand that the predicate for the diversity of culture, restaurants, and intellectual stimulation that the City offers depends heavily on attracting both national and international immigrants, many of whom will require redistributive services in the short run.[24] To the extent that restrictions on fiscal home rule imply that localities should do nothing other than address market failures, they artificially confine the ability of cities to experiment with distributive programs that are explicitly related to attracting mobile capital and that can serve as models for more centralized levels of government.

Moreover, those constraints have what, at least initially, appear to be perverse consequences. A common critique of market-for-residence analyses of local governments is that they encourage localities to concentrate on goods and services that disproportionately benefit the relatively wealthy.[25] On this understanding, a city would prefer to enact benefit-based fiscal policies that attract development and the wealthy rather than redistributive policies that underwrite programs that disproportionately benefit the relatively poor. Indeed, the orthodox theory of urban finance suggests that local governments should not engage in redistribution because those who pay redistributive taxes can too easily exit the jurisdiction for benefit-based suburbs, while still exploiting the central city for employment, entertainment, and shopping.[26] But if localities and local officials already have significant incentives to avoid redistributive taxes, then there might be less need for legal restrictions that have the same effect. In light of the disincentives to use local redistributive taxes, one might conclude that a locality that chooses to do so is presumptively involved in advancing the kind of unique program or local preference that home rule is intended to encourage. Of course, local officials may be using redistributive taxation for less desirable purposes, such as to divert public funds to favored groups, notwithstanding that the expenditures

24. *See* John M. Quigley, *Urban Diversity and Economic Growth*, 12 J. ECON. PERSP. 127, 136 (1998).

25. *See* Reynolds, *supra* note 11, at 374-75.

26. *See* WALLACE E. OATES, FISCAL FEDERALISM 131-40 (1972); *see also* JOHN CULLIS & PHILIP JONES, PUBLIC FINANCE AND PUBLIC CHOICE 303-05 (2d ed. 1998); PAUL E. PETERSON, CITY LIMITS 182-83 (1981); PAUL E. PETERSON, THE PRICE OF FEDERALISM 27-28 (1995); Richard A. Musgrave, *Fiscal Federalism*, *in* PUBLIC FINANCE AND PUBLIC CHOICE: TWO CONTRASTING VISIONS OF THE STATE 155, 160-61 (James M. Buchanan & Richard A. Musgrave eds., 1999).

will deviate from residents' preferences.[27] But recognizing the possibility that local officials may misbehave does not entail the kind of presumption of misconduct that is implicit in the constitutional constraint on local taxation.

Indeed, constraints on local taxation may have a more nefarious effect. Since most state constitutional constraints do not prohibit local taxation, but only make it subject to state legislative preapproval, there is a risk that state legislators will use their plenary power over taxing authority in ways that serve the objectives of their constituents while disserving the interests of the state as a whole. It is plausible, for instance, that state legislators could refuse to authorize a commuter tax for a central city, notwithstanding that the tax would properly reimburse the city for the net costs of providing services to commuters. Legislators who are responsive to their suburban constituents will have tendencies to vote against additional taxes of which the central city is the primary beneficiary. Unless one believes that state legislators will systematically be more publicly interested in deciding the proper scope of local taxation than are local officials themselves, there is a risk that making local taxing power hostage to state discretion will disserve the interests of both jurisdictions.

II. THE ARGUMENT FOR LIMITED FISCAL HOME RULE

To say that restraints on home rule are problematic is not necessarily to say that unlimited fiscal home rule is desirable. A variety of arguments support the proposition that fiscal home rule poses its own dangers, and that those dangers will be minimized by allowing the state some discretion over the scope of local revenue raising. One argument could rely on the standard justification for restricting home rule authority—the generation of negative external effects of local action. Home rule localities typically have authority to act only within the sphere of local or municipal affairs. Thus, if local financial decisions have sufficient implications for neighboring municipalities or for the state, then some centralized constraint might be appropriate.

I have thus far told a happy race-to-the-top story about interlocal fiscal competition. But some theories suggest that interlocal competition will generate a race to the bottom that imposes adverse external effects. There are two separate stories along these lines. In the first, the decision of one locality to decrease its tax rate and thus to attract mobile capital will adversely affect the jurisdiction from which mobile capital departs, and that loss will not necessarily be offset by production gains in the new locality. As a result, localities will compete with low tax rates and low

27. *See infra* text accompanying notes 31-34. *See generally* Gillette, *supra* note 12 (discussing the distinction between beneficial and more malign uses of local redistribution).

service levels in order to discourage mobile capital from exiting.[28] Alternatively, a locality may generate spillovers by failing to provide services that have positive effects in other jurisdictions. But those extramural effects will not be taken into account by any locality in deciding its own levels, because the nonresident beneficiaries cannot easily be taxed for the services they receive. As a result, a locality will set a tax rate and public service level that, from a social perspective, is too low.[29]

These effects, however, do not support constrained fiscal home rule. The first problem, failure to tax mobile capital sufficiently, suggests that the locality is not taxing enough. But restrictions on fiscal home rule emanate from just the opposite problem: a concern that the locality will tax too much. The concern for underprovision from a regional perspective is similarly unrelated to fiscal constraints on localities. If localities create spillover benefits, then it is not at all clear why they, rather than the nonresident beneficiaries, should pay for them. The state may wish to subsidize local activity in order to solve the problem of underprovision. Alternatively, the state could explicitly authorize taxing of nonresidents to obtain reimbursement to the locality that provides the services. But that strategy as well entails enhancing the revenue-raising authority of localities, not restricting it.

An additional externality argument that may support tax constraints involves the possibility that local taxes will adversely affect state taxes. An increase in local taxes that encourages exit by mobile capital can reduce the tax base that is available to the state, and thus force a reduction of state services or require further increases at the state level.[30] Alternatively, increased local taxes will likely reduce tolerance for increased state taxes. Vertical tax competition, that is, may be less desirable than horizontal tax competition. But this argument assumes that taxing at the state level is more efficient and will be used for better purposes than taxing at the local level. As I have suggested above, it is not necessarily the case that state lawmakers are more prone to spend wisely than local lawmakers. One might believe that state legislators are better positioned to determine the optimal level of taxation for local governments because the state internalizes both the costs and benefits of local taxation, while the local governments will consider only intramunicipal effects. I have suggested above that localities are typically viewed as taxing mobile capital too little, not too much, so that the fears of encouraging exit seem misplaced. But more to the point, there is little reason that the assumed myopia of local legislators has no state analogue. State legislators who wish to maximize state budgets in order to obtain credit for funding

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28. *See* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 379-80 (1996).

29. David Wildasin, *Interjurisdictional Capital Mobility: Fiscal Externality and a Corrective Subsidy*, 25 J. URB. ECON. 193, 194-96 (1989).

30. *See* Wilson, *supra* note 6, at 289.

projects may constrain local spending below the optimal level if they perceive local taxes as competitive with state taxes. The fact that state legislators have the authority to limit local taxes, in short, may be a function of the allocation of authority between state and local governments generally, but it does not suggest that either set of actors is more likely to spend in the interests of its constituents.

Thus, the argument for constrained fiscal home rule must ultimately come from a belief that greater local fiscal autonomy will generate adverse *internal* effects that legal restrictions can avoid. The underlying assumption is that unbridled fiscal authority will cause local government officials to impose taxes that are too high, in the sense of providing goods and services that have a value to residents less than their tax price.

One strain of this argument derives from the claim that cities should avoid redistributive functions. I suggested above that, in light of the incentives that cities already face to avoid local redistribution in order to forestall exit, one should presume that any local redistributive taxation conforms to resident preferences. But one could draw the opposite conclusion. That is, consistent with theories that local government officials seek to maximize either public budgets, or their personal chances of reelection, or post-public service employment, one could infer that *any* instance of local redistributive taxes is presumptively an effort to subsidize projects favored by dominant interest groups within the city or to maximize budgetary discretion for local officials.[31] The implicit claim on this theory is that local officials will systematically direct redistributive spending to projects that do not enjoy popular support. While this threatens to induce mobile residents and capital to emigrate, exit is always constrained by assets invested in the current locality as well as ties to jobs, friends, and family, and the agglomeration effects of being located where other competitor firms and support industries (lawyers, bankers, accountants) are located.[32] Thus, officials can exploit residents at least up to a point without fearing that inefficient taxation will cause exit. This more pessimistic public economy story suggests that local revenue raising should be severely limited, or at least subjected to state supervision. The implication is that in the absence of state fiscal restraints, local governments would overtax their constituents in order to fund goods and services that their constituents did not want to pay for.

One might initially conclude that electoral constraints on public officials preclude them from overtaxing residents, or from using forms of revenue raising that residents disfavor, or from expending funds in ways

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31. *See* Edward L. Glaeser & Andrei Shleifer, *The Curley Effect: The Economics of Shaping the Electorate*, 21 J.L. ECON. & ORG. 1, 2 (2005).

32. *See* EDWARD L. GLAESER, CITIES, AGGLOMERATION AND SPATIAL EQUILIBRIUM 116 (2008); David Schleicher, *Why Are There Cities? Agglomeration and Sorting in Local Government Law* (forthcoming) (manuscript at 3, on file with author).

inconsistent with residents' preferences. But electoral constraints are notoriously porous. First, as I suggested above, local officials face only occasional and binary elections. If residents believe that officials are doing a good job overall, no single policy is likely to lead to electoral defeat for the official. A voter who believes that the schools are well run and the garbage is collected on time may forgive the mayor for furnishing her office with a solid mahogany desk or funding a new golf course used only by wealthy residents.

Second, electoral checks arise only in the presence of political competition, and there is significant evidence that local politics are less competitive and less partisan than politics at more centralized levels of government. Local officials who enjoy a monopoly obviously have broader discretion to impose taxes for projects that serve their own purposes, even though they would not survive a direct vote by residents. Jessica Trounstine demonstrates that monopolistic local officials target spending towards their supporters more than non-monopolists.[33] The possibility that expenditures can be distorted to assist non-representative subgroups of residents is similarly reflected in models that suggest local officials can influence the budget for favored projects by controlling the expenditure agenda. For instance, Romer and Rosenthal indicate that agenda setting by local officials can increase spending beyond what is optimally preferred by residents.[34] Assume, for instance, that a city council that has a monopoly over proposing expenditures advocates an expenditure of $100,000 for a project. Assume further that most voters prefer the project, but would prefer to fund it for no more than $80,000. If the $80,000 expenditure is not on the table, the choice is now between a $20,000 overexpenditure or abandonment of the project, which would cause an $80,000 underexpenditure. Romer and Rosenthal suggest that most voters will prefer the excessive expenditure. Thus, the ability of government to propose a single alternative to the status quo permits, and perhaps induces, excessive spending.

It is plausible, therefore, that electoral politics alone will insufficiently discipline local officials against the use of fiscal tools that their constituents disfavor. In theory, limitations on the taxing power can serve as a corrective. Because local officials are likely to make expenditures on basic services, restricting access to taxes will not harm recipients of those services. Instead, the constraints will limit the pool of available expenditures, and thus preclude those disfavored by a majority of residents.

Unfortunately, even if it is appropriate to impose some corrective on officials' incentives to diverge from residents' fiscal preferences, broad

33. *See* JESSICA TROUNSTINE, POLITICAL MONOPOLIES IN AMERICAN CITIES 148-61 (2008).

34. *See generally* Thomas Romer & Howard Rosenthal, *Bureaucrats Versus Voters: On the Political Economy of Resource Allocation by Direct Democracy*, 93 Q.J. ECON. 563 (1979).

legal restrictions on fiscal authority provide a rather blunt instrument that can have perverse effects. Consider the constitutional restrictions on property tax rates that several states have instituted. The literature that has analyzed the effects of these limitations suggests that they have led to significant unintended consequences. For example, David Figlio and Arthur O'Sullivan find some evidence to support the proposition that local governments manipulate service cuts in order to persuade voters of the need to vote in favor of tax limit overrides by allowing observable services to deteriorate, while continuing to fund less observable expenditures that are likely to diverge from resident preferences.[35] Other studies raise questions about whether tax limitations effectively limit the size of government or officials' access to revenues, rather than inducing officials to substitute unconstrained sources for constrained sources. As Richard Briffault has noted,[36] some studies purport to demonstrate that tax caps shift burdens to other fiscal tools, such as user fees. This shift is not necessarily invidious, since, as I suggested above, user fees can provide beneficial means of gauging preferences and increasing efficiency. But user fees may also be regressive in ways that property taxes are not, and the shift to benefit-based finance surely reduces flexibility to engage in redistributive spending. Other studies, moreover, purport to demonstrate that tax caps have had a selective restraining effect on the growth of government. For instance, one study suggests that the tax limitation in Illinois had a restraining effect on school district operating expenditures, but no effect on school district instructional spending.[37] Still other studies indicate that limitations on property taxes significantly constrain spending, but that those reductions are accompanied by increases in property values only if the locality is able to find non-tax mechanisms to avoid reductions in school spending.[38] Limitations imposed during times of fiscal surplus, when the state may be able to compensate for reductions in local revenues that tax limitations cause, may be less available during times of fiscal distress. Constitutional limitations, however, are unwieldy to adjust or reverse. Any regret that residents come to feel in leaner times likely comes too late.

The literature on unintended consequences may actually understate the problem of tax limitations. The implicit claim of that literature is that those who impose tax limits are myopic about the long-term conse-

35. David N. Figlio & Arthur O'Sullivan, *The Local Response to Tax Limitation Measures: Do Local Governments Manipulate Voters to Increase Revenues?*, 44 J.L. & ECON. 233, 233-34 (2001).

36. Richard Briffault, *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 932 (2003); *see also* Richard F. Dye & Therese J. McGuire, *The Effect of Property Tax Limitation Measures on Local Government Fiscal Behavior*, 66 J. PUB. ECON. 469 (1997).

37. Dye & McGuire, *supra* note 36, at 487.

38. Katharine L. Bradbury, Christopher J. Mayer & Karl E. Case, *Property Tax Limits, Local Fiscal Behavior, and Property Values: Evidence from Massachusetts Under Proposition 2 ½*, 80 J. PUB. ECON. 287, 309 (2001).

quences of their current choice to limit the discretion of their local officials. But there is a plausible argument that, even in the short term, the electorate affected by tax limits is insufficiently represented in the decision making process. It is one thing to permit residents of a locality to constrain the taxing authority of their officials; it is quite another to contend that local autonomy is served by permitting nonresidents to impose the same limits. The referenda that have compelled state constitutional tax limitations have been held at the state level. The limits themselves, however, tend to apply to municipalities that impose property taxes, rather than to the state itself. This creates opportunities for strategic behavior, as nonresidents have opportunities to constrain the taxing capacity of localities in which they have investments that could be positively affected by limits. Jacob Vigdor's analysis of Proposition 2 ½ in Massachusetts reveals the likelihood of just that voting pattern. Vigdor finds that referenda on statewide property tax limits are used by voters to influence tax and spending decisions in neighboring jurisdictions where they would otherwise have no voting power. Nonresident voters tend to vote to limit taxes in neighboring jurisdictions in order to maximize the value of nonresident employment and nonresident land ownership, and to alter the characteristics of the target jurisdictions.[39] Any such result is not easily reconciled with a claim that tax limitations make local officials more accountable to their constituents.

Would greater fiscal home rule reduce these difficulties without increasing the risk that local officials would deviate from residents' preferences? The literature on interlocal competition for residence and mobile capital suggests a tentative answer in the affirmative. First, increasing taxes for goods and services that residents disfavor raises incentives for migration and deters investment by mobile capital that otherwise could ultimately increase the locality's tax base. The literature on "revenue hills" indicates that cities that increase taxes past a tipping point will generate net decreases in tax collections as residents exit for more financially hospitable jurisdictions, leaving city officials with fewer funds to allocate to city services or to redistribute to favored groups.[40] This suggests that residents are sensitive to taxes and services in a manner that limits the ability to local officials to use unpopular fiscal tools. Because these effects are constant and dynamic, they serve as more effective constraints than occasional, binary elections. Local officials who have a full array of financial tools can experiment with them all, and seek to balance different allocations of burdens to react to the successes and failures of other fiscal plans. Even political monopolies cannot resist these effects: if political monopolists want either to maximize budgets or to maximize

39. Jacob L. Vigdor, *Other People's Taxes: Nonresident Voters and Statewide Limitation of Local Government*, 47 J.L. & ECON. 453, 472 (2004).

40. Andrew Haughwout, Robert Inman, Steven Craig & Thomas Luce, *Local Revenue Hills: Evidence from Four U.S. Cities*, 86 REV. ECON. & STAT. 570, 582-83 (2004).

their reputations, they will want to avoid the financial deterioration that attends misuse of revenue raising.

Finally, any defects in the local political process should not lead us into a Nirvana fallacy concerning state regulation of municipal fiscal autonomy. There is little reason to believe that state legislators are sufficiently pure of motive that they will necessarily correct the overreaching of local officials without introducing distortions of their own. Instead, the same interests that might lead local officials to deviate from the interests of their constituents could equally affect state officials. State imposition of unfunded mandates that appear to impose fiscal obligations on localities largely to avoid state responsibility for the concomitant expenditures demonstrates that state officials can suffer from the same strategic behavior that distorts local budgetary decisions.[41] The willingness to allow localities to exercise a particular revenue-raising authority will not necessarily be granted freely. Rather, it may become a valuable object of logrolling or an opportunity by representatives of suburban districts to exercise influence over decisions in the central city.

I am not suggesting that interlocal competition is a perfect constraint on local officials. Local officials who place a priority on economic development may favor exchange value over use value and thus ignore residents' preferences in the hope of attracting a tax base that serves more personal purposes.[42] The question, however, is not whether markets for residence are perfect, but whether they better constrain local officials than constitutional restrictions on fiscal home rule. My claim is that reliance on market mechanisms that signal both officials and residents of the propriety of different fiscal tools may be more responsive to local conditions than less narrowly tailored legal restrictions that are lumpy and sticky, or state control that is responsive to its own set of interests that may interfere with the local market for residence without producing any offsetting benefit.[43]

III. FISCAL HOME RULE AND DEBT

Virtually every state constitution imposes limits on the amount of debt that its political subdivisions can issue in order to fund capital projects, whether those subdivisions are granted home rule authority or not. Typically, municipalities are restricted to an amount that is linked to

41. *See, e.g.*, Bd. of Educ. of Me. Twp. High Sch. Dist. 207 v. State Bd. of Educ., 487 N.E.2d 1053, 1055-57 (Ill. App. Ct. 1985).

42. For analysis and critique of the differences between use value and exchange value, see JOHN R. LOGAN & HARVEY L. MOLOTCH, URBAN FORTUNES 41-42, 103-11 (1987).

43. Note, however, that my argument about the disutility of tax limitations applies to localities more than to the state. Because I rely on the market for residence, and that market is thicker among localities than it is among states, I venture no view about whether tax limitations on states should similarly be relaxed.

the assessed property value in the jurisdiction.[44] These limitations are outgrowths of nineteenth century debacles in which local governments borrowed heavily for capital improvements that were supposed to generate sufficient revenues to defray the costs of debt service, but that ultimately defaulted. When those capital improvements, primarily railroads, failed to materialize, local taxpayers were left holding the proverbial bag. The result was an array of constitutional provisions such as public purpose requirements, prohibitions on lending of credit, and debt limitations, that restricted relationships between public and private entities.[45]

In theory, there is a justification for constitutional debt limitations that makes them more acceptable than tax limitations, even for home rule municipalities. Current residents do not necessarily internalize both the full costs and full benefits of debt. Projects constructed with bond proceeds will return immediate benefits, but the costs will be borne largely by future residents who must pay debt service at a time when the project may or may not be desirable. As a consequence, unless one believes that future debt service is fully capitalized into the current tax structure and property values of the locality, current residents have an incentive to utilize too much debt and to impose a temporal externality on future residents. Legal constraints may be appropriate to prevent localities from becoming overextended for projects of dubious future value if future residents who must pay the debt cannot protect themselves.

The relevant question, then, is not whether there is a need for a constraint on officials who might wish to issue debt, but whether constitutional debt limits best fulfill that role. There are multiple reasons to believe that they do not. First, legal debt limitations do not preclude localities from issuing all debt. Rather, they preclude issuance of debt that falls within the meaning of that term as it is used in interpretation of the constitutional clauses. A century and a half of judicial construction of these clauses has dramatically reduced the significance of debt limitations. The early exclusion of obligations secured solely by revenues generated by operation of the project financed with bond proceeds made sense, insofar as payment of those debts was not secured by the municipal treasury and thus did not expose residents to the risks of financial distress that the limitations were intended to preclude.[46] But subsequent judicial contraction of the scope of constitutional "debt" has exposed the municipal treasury to risk by validating evasive forms of financing that testify to the imagination of intelligent bond lawyers and investment bankers, rather than to the suitability of debt limitations. Machinations for circumventing debt limits include "moral obligation" bonds or bonds

44. *See* ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, MUNICIPAL DEBT FINANCE LAW 171-74 (1992).

45. *See* ALBERTA M. SBRAGIA, DEBT WISH: ENTREPRENEURIAL CITIES, U.S. FEDERALISM, AND ECONOMIC DEVELOPMENT 44-59, 80-85 (1996).

46. *See, e.g.*, Robertson v. Zimmerman, 196 N.E. 740, 744-45 (N.Y. 1935).

the payment of which is "subject to appropriation" by the local legislature. These schemes technically allow the issuing locality to cease making payments should the project prove inappropriate, although the subsequent loss of creditworthiness means that payment is likely compelled as a practical matter. Nevertheless, courts have distinguished between that practical effect and the absence of a legal obligation in order to exclude the related bonds from the constitutional limitation.[47] Tax increment bonds permit an issuer to dedicate property taxes in excess of a baseline amount to payment of debt service without violating the constitutional limit. The justification is that the funded project increases property values, so that tax receipts above the baseline are directly related to the expenditure. But typically there is no requirement that the relationship between the funded project and the increase in property values be proven in order to remove the obligations from constitutional limits.[48] The creation of special authorities to issue debt separate from that of the general municipality creates overlapping jurisdictions with concomitant increases in the size of government.[49] One might contend that these devices reveal that debt limits are ineffective and thus do no harm. But circumventing debt limitations by devising alternative financing mechanisms imposes additional costs on municipalities that issue debt, both because discovering and testing the legality of alternatives requires additional expenses, and the interest rates payable on debt that purports to be payable from more limited sources is likely to be higher than interest rates on general obligations of the same issuer. Should a debt avoidance mechanism be declared improper, the results may cause financial distress to the issuer.[50] Moreover, circumvention of debt limitations obfuscates the locality's true debt position by making it more difficult to discover the total obligations of the issuer.[51]

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47. *See* Lonegan v. State, 819 A.2d 395, 397 (N.J. 2003); Colleton County Taxpayers Ass'n v. Sch. Dist. of Colleton County, 638 S.E.2d 685, 689-90 (S.C. 2006); AMDURSKY & GILLETTE, *supra* note 44, at 214-19; Briffault, *supra* note 36, at 920-25.

48. *See, e.g.*, Denver Urban Renewal Auth. v. Byrne, 618 P.2d 1374, 1382 (Colo. 1980). *But see* Okla. City Urban Renewal Auth. v. Med. Tech. & Research Auth. of Okla., 4 P.3d 677, 679-80 (Okla. 2000).

49. *See, e.g.*, Gould v. Barton, 181 S.E.2d 662, 669-70 (S.C. 1971). For findings that overlapping jurisdictions increase the size of the local public sector, see Christopher Berry, *Piling on: Multilevel Government and the Fiscal Common-Pool*, 52 AM. J. POL. SCI. 802, 802 (2008).

50. *See* Chem. Bank v. Wash. Pub. Power Supply Sys., 666 P.2d 329, 331, 342-43 (Wash. 1983), *cert. denied*, 471 U.S. 1075 (1985). The invalidation of the contracts in *Chemical Bank* caused default on bonds of the Washington Public Power Supply System. *Id.* at 331.

51. For example, an initial inquiry into New York City's fiscal state reveals that the city has in excess of $35 billion in long-term indebtedness. *See* BOND OFFICIAL STATEMENT ARCHIVE, CITY OF NEW YORK, $308,000,000 GENERAL OBLIGATION BONDS, FISCAL 2009 SERIES G, at 54 (2008), http://nycbonds.org/NYC/pdf/2009/NYC_2009_G.pdf. Only further examination reveals that the figure does not include a significant amount of debt for which the City is not nominally responsible, but which is payable from revenues that otherwise would have been available to the City. For instance, the figure does not include the debt of the Transitional Finance Authority. That authority has issued $13.5 billion of debt secured by New York City personal income tax and sales tax revenues. *Id.* at 56. The City also has entered into agreements to pay the indebtedness of other governmental

These restrictions might be more acceptable if we believed that municipal debt limitations reflected some sophisticated analysis of the optimal level of debt that a locality should incur. But the variety of limitations placed on municipalities belies that proposition. State constitutional limitations on municipal debt are typically tied to assessed property values within the municipality, and one might imagine that, over time, experience and financial theory have caused convergence around an ideal percentage that reveals debt affordability. One would be disappointed. South Dakota localities can issue debt up to 5% of assessed property value, although school districts (which may overlap with localities) can issue debt in amounts up to 10% of assessed property value.[52] Localities in Georgia[53] and counties in Arkansas[54] can issue debt up to 10% of assessed property value, while non-county municipalities in Arkansas[55] and localities in Alabama[56] can incur debt up to 20% of assessed property value. These restrictions are often accompanied by, or can be exceeded by, a vote of municipal residents. There, too, variety defies any conclusion that the requirements serve to impose scientifically derived optimal constraints on local debt. Where elections are required, some states permit bonds to be issued with a simple majority vote, but Washington[57] and West Virginia[58] require a 3/5 supermajority, and Idaho[59] and Texas[60] require a 2/3 supermajority.

My point is not that debt limitations are irrational, although they lack the cohesion and consistency that one might expect if they really provided appropriate constraints on localities. Rather, my point is that municipal debt limitations, like restrictions on taxes, reflect a view of local governance that is unnecessarily in tension with the autonomy-enhancing objectives of home rule. The application of debt limitations to general obligation bonds but not to revenue bonds may make economic sense, insofar as revenue bonds do not expose the issuing locality to the same risks of project failure that gave rise to the demand for constitutional limitations in the first instance. But, like restrictions that apply to taxes and not to fees, the separate treatment of general obligation debt and revenue debt favors allocative functions of local governments over redistributive functions, notwithstanding that the locality itself may prefer redistribution. Indeed, the payment mechanisms for these revenue

issuers, the proceeds of which benefit the City. Those agreements fall outside the debt limit of the City because they are "subject to appropriation." *Id.* at 53.

52. S.D. CONST. art. XIII, § 4.
53. GA. CONST. art. IX, § 5, ¶ I(a).
54. ARK. CONST. amend. 62, § 1(b).
55. *Id.*
56. ALA. CONST. art. XII, §§ 222, 225.
57. WASH. CONST. art. VIII, § 6.
58. W. VA. CONST. art. X, § 8.
59. IDAHO CONST. art. VIII, § 3 (regarding water, sewer, or electrical system bonds).
60. TEX. CONST. art. III, § 52(b) (regarding improvement of rivers, irrigation, drainage, and roads).

bonds typically consist of fees and taxes the amounts of which are tied to debt service. Thus, the restrictions apply only when a locality is engaged in a project that entails a degree of innovation and entrepreneurial risk that may require a commitment of the municipal treasury in order to attract bondholders and that underlies the preference for home rule. But the fact that such projects must compete with more traditional capital expenditures for a limited amount of permissible debt discourages or increases the costs of municipal innovation.

Second, the need for debt limitations to constrain local overextension is more dubious than was the case when these limitations were promulgated. Debt can be a dangerous tool in the hands of local officials who have incentives to spend money in the short term, especially money that has to be repaid only when they have left office. As a result, one can make an argument for external checks on debt, even those that vary widely among jurisdictions, in order to counter the incentives of officials—and of voters who do not fully internalize future costs into their calculations of whether a project is beneficial—to impose costs on future generations.

But it is a more open question just what that external check should be. If legal restrictions tend to be artificial and more costly than effective, then contemporary market mechanisms may provide sufficient (or more accurate) constraints on the incentives of local officials to overextend their local treasuries. Debt restrictions arose in an era prior to the advent of sophisticated bond markets, accounting standards for government issuers,[61] federal disclosure requirements, the development of bond counsel as a legal specialty to pass on the legality and validity of bonds, the birth of rating agencies to track the financial stability of issuers, and the creation of a thick secondary market for bonds that provides bondholders with additional incentives to monitor performance of issuers. The recent performance of financial markets and rating agencies do little to recommend them as perfect monitors of local decisions about debt. But, again, the presence of perfection is not the proper question. Rather, the relevant inquiry is whether debt limitations that seem haphazard and that are systematically, but expensively, evaded add anything to admittedly imperfect market based constraints, or whether they simply further distort local financing decisions. My tentative conclusion here, as in the area of taxation, is that even flawed market constraints on local officials may be better suited than legal constraints to balance the objectives of home rule against the risks of local fiscal impropriety. If potential bondholders, informed by disclosure and accounting requirements, have incentives to monitor issuers, and if the market for debt, augmented by

61. The Government Finance Officers Association promulgates generally accepted accounting practices and standards for governmental accounting, auditing, and financial reporting. *See, e.g.*, STEPHEN J. GAUTHIER, GOV'T FIN. OFFICERS ASS'N, 2005 GOVERNMENTAL ACCOUNTING, AUDITING, AND FINANCIAL REPORTING (8th ed. 2005).

disclosure and accounting requirements, is sufficiently thick, then one would anticipate that interest rates for any municipal issuer of debt will reflect creditworthiness and the risk of overextension. Thus, market and regulatory constraints that provide information and allow potential investors to evaluate a locality's fiscal position may substitute for state constitutional constraints that purport to preserve the safety of the municipal treasury by limiting the amount of debt. Moreover, interest rates that reflect capacity to pay are more nuanced and responsive to the current circumstances of the issuer than blunt legal limitations. Unlike interest rates, debt limitations cannot be adjusted to take into account municipal resources that are not reflected in assessed property value. In short, interest rates based on significant amounts of information are likely to send a strong signal about the affordability of debt, a measure for which debt limitations presumably do no more than serve as a rough proxy. Interest rates provide a secondary benefit to the extent that they indicate the relative health of a municipality. Since interest rates for municipal debt are readily observable and can be compared to interest rates paid by other localities, reliance on interest rates also provides a mechanism by which residents can monitor the fiscal performance of their officials relative to officials in other jurisdictions.

Explicit reliance on market mechanisms rather than debt limitations to achieve optimal debt levels may also reflect current reality. After reviewing the ease with which state debt limitations can be avoided and their lack of connection with governmental needs, D. Roderick Kiewiet and Kristin Szakaly conclude that "it is the discipline of the credit market that is the real constraint on issuing debt, not the state constitution."[62] There seems little reason to believe that the analysis would be different for local rather than state debt. Their result seems consistent with the findings of Bayoumi, Goldstein, and Woglom.[63] They tested a market discipline hypothesis for sovereign debt and concluded that yields on state debt within the United States rise at an increasing rate with the level of borrowing, and that at some level of borrowing, the market stops supporting a sovereign's debt issuance. They infer that borrowers have market incentives to avoid issuing excessive debt.[64] This does not necessarily mean that public officials properly respond to market incentives.[65] Moreover, the market constraints may suggest only that borrowers review per capita debt burden of the issuer, which may be a very rough surrogate for quality of debt. These studies do, however, suggest that

62. D. Roderick Kiewiet & Kristin Szakaly, *Constitutional Limitations on Borrowing: An Analysis of State Bonded Indebtedness*, 12 J.L. ECON. & ORG. 62, 66 (1996).

63. *See* Tamim Bayoumi, Morris Goldstein & Geoffrey Woglom, *Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States*, 27 J. MONEY CREDIT & BANKING 1046, 1057 (1995).

64. *Id.*

65. *Id.*

potential creditors somewhat utilize information obtainable from the market about sovereign borrowers.

Finally, creditors of municipalities are able to negotiate bond covenants that restrict local officials from engaging in conduct that might jeopardize the public treasury in a more direct way than the imposition of a debt limit, which assumes that constrained public officials will surrender inefficient projects, not those that they may favor for more personal purposes.[66] The interests of creditors, of course, will not always perfectly coincide with those of residents. But bond covenants are possible whenever municipalities issue debt, so the presence of debt limitations does not prevent the possible inconsistency. The relevant point is that creditors' and residents' interests in the health of the public treasury are often consistent; to the extent that is true, contractual arrangements between bondholders and issuers may provide better protection for residents than flat prohibitions on debt issuance. Indeed, I have suggested elsewhere that under plausible conditions, bondholders will not only serve as useful monitors of local debt, but will also be able to compensate for some of the slack in monitoring by the electorate of local officials' performance.[67] Relaxing legal constraints on debt, of course, increases the incentives for bondholders to engage in that monitoring role, since they cannot rely on even artificial limits to deter fiscal overextension. In addition, to the extent that legal limits require circumvention through obfuscating funding devices, elimination of those limits could render the amount of indebtedness more transparent.

CONCLUSION

If home rule is desirable, and if its exercise requires fiscal discretion, then legal constraints must be justified by some countervailing objective. There certainly exist reasons to be wary of unfettered fiscal discretion, since local officials may make budgetary decisions that adversely affect either their own residents or nonresidents. But even in an era where markets have revealed their imperfections, one should not necessarily resort to legal doctrines to provide optimal solutions to questions of institutional design. The bluntness and inflexibility of legal doctrine may prove to impose relatively high impediments on the exercise of home rule for relatively little benefit. Reliance on market checks may allow local governments more fiscal flexibility, while simultaneously encouraging more transparency and less political divergence from resident preferences than legal constraints. If I am correct, a greater degree of fiscal home rule promises greater realization of the objectives that lead us to favor decentralized government in the first instance.

66. *See, e.g.*, U.S. Trust Co. of N.Y. v. New Jersey, 431 U.S. 1, 9 (1977).

67. Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 WM. & MARY L. REV. 937, 942 (2008); *see* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1213 (2006).