THE (NOW URGENT) CASE FOR STATE-LEVEL MONITORING OF LOCAL GOVERNMENT FINANCES: PROTECTING LOCALITIES FROM TRUMP'S "POTEMKIN VILLAGE OF NOTHING"

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The financial crisis of 2008 demonstrated that local governments often do not have the expertise to use debt wisely, much less the expertise to reform their use of pensions or to design tax systems that can raise more money with less economic distortion. Yet local governments must do all of these things and more, as they are squeezed by pension obligations and the need to reinvest in infrastructure. The expected Trump Administration's infrastructure plan would make billions of dollars in funding available to local governments but would also require them to negotiate extremely complicated public-private partnerships (P3s). There is no convincing policy reason for structuring a public infrastructure plan so as to profit private parties in this way, leading former Treasury Secretary Lawrence Summers to aptly describe the plan as a "Potemkin village of nothing." The Trump plan would create a greater likelihood that local governments will be swindled without any discernible benefit.

Laws that protected less financially sophisticated consumers are hardly unknown. There are many consumer protections for individuals (though, admittedly, many of those protections are also at risk from the Trump Administration). Yet when those same individuals are asked to make much more complicated decisions when they sit on local government boards, they receive much less protection. This is a mistake, and state governments have all the power they need to protect their local governments from being fleeced.

Furthermore, we do not want local governments to make merely non-disastrous financial decisions; we want them to make good decisions. There is useful expertise available, and the question is how we can aggregate this knowledge and make it available to local decisionmakers in a manner consistent with the political and economic norms and goals of local democracy. For this, we need new institutions. There are examples of such institutions, such as North Carolina's Local Government Commission, but their role—

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and the reasons for their success—has not yet been adequately theorized. That is the task of this Article.

In short, I will argue that a new state-level institution can succeed in improving local government financing in a manner consistent with preserving local autonomy if its expertise is used at the outset to design default rules that are both simple and (mostly) correct. Beyond the default rules, there should be expert review to allow for exceptions, but, in most cases, the default rules should provide a workable set of options with which a local government can achieve its goals.

INTRODUCTION

Warren Buffett famously quipped, "You only find out who is swimming naked when the tide goes out."[1] The financial crisis of 2008 revealed a lot of naked swimmers, including many local governments. The phenomenon I am pointing to is *not* the unprecedented but still small number of municipal bankruptcies that have occurred since

1. Letter from Warren Buffett, Chairman of the Bd., Berkshire Hathaway, Inc., to the Shareholders of Berkshire Hathaway, Inc. (Feb. 28, 2002), http://www.berkshirehathaway.com/2001ar/2001letter.html.

2008.[2] Rather, I am pointing to a less well-known but much broader phenomenon: Many localities were revealed to have managed their fiscal affairs poorly, though not to the point of insolvency. For example, many localities used inappropriately risky financial instruments, such as interest rate swaps, that went south during the fiscal crisis.[3] The typical result was a lot of wasted taxpayer dollars at a time when governments were particularly short on money and time to deal with a self-inflicted crisis. For instance, just one failed type of instrument apparently cost local governments four billion dollars.[4]

There is little reason to believe that the choice to issue these financial instruments was somehow anomalous. Given that financial illiteracy is endemic among the population in general,[5] it should not be surprising that the level of government closest to the people should turn out to be truly "of the people" in its approach to fiscal matters.[6] Indeed, only thirty-eight percent of state and local government elected officials consider *themselves* "very knowledgeable" about public finance.[7] There is thus good cause to believe that there are many fiscally naked local governments swimming in now calmer seas; but the tide will surely recede again. In fact, other concrete signs of fiscal

2. *See, e.g.*, Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially Failed Cities*, 114 COLUM. L. REV. 1373, 1376 (2014) (listing recent municipal bankruptcies and crises).

3. Gretchen Morgenson, *The Swaps That Swallowed Your Town*, N.Y. TIMES, Mar. 6, 2010, at BU1.

4. Michael McDonald, *Wall Street Takes $4 Billion from Taxpayers as Swaps Backfire*, BLOOMBERG (Nov. 10, 2010, 12:01 AM), http://www.bloomberg.com/news/articles/2010-11-10/wall-street-collects-4-billion-from-taxpayers-as-swaps-backfire. *See generally* Lori Raineri & Darien Shanske, *Municipal Finance and Asymmetric Risk*, 4 BELMONT L. REV. 65 (2017).

5. *See* Marianne A. Hilgert et al., *Household Financial Management: The Connection Between Knowledge and Behavior*, 89 FED. RES. BULL. 309, 311 (2003); *see also* Annamaria Lusardi & Peter Tufano, *Debt Literacy, Financial Experiences and Overindebtedness* (Nat'l Bureau of Econ. Research, Working Paper No. 14808, 2009), www.nber.org/papers/w14808.pdf.

6. Darrell Preston, *Governments Using Swaps Emulate Subprime Victims of Wall Street*, BLOOMBERG (Nov. 14, 2011, 12:01 AM), http://www.bloomberg.com/news/articles/2011-11-14/governments-using-swaps-emulate-subprime-victims-of-wall-street ("Ask a Nobel Prize-winning economist what's the difference between the mayor of Baltimore losing taxpayer money with derivatives sold by Wall Street and millions of Americans defaulting on subprime loans and he'll say there isn't any: State and local governments are victims of opaque financing they don't understand, the same way individuals go broke on borrowing at rates too good to be true.").

7. JUSTIN MARLOWE, GOVERNING, GUIDE TO FINANCIAL LITERACY: CONNECTING MONEY, POLICY AND PRIORITIES 5 (2014), http://www.governing.com/papers/A-Public-Official-s-Guide-to-Financial-Literacy.html.

trouble at the local level abound.[8] It is well known, for instance, that many localities promised pensions and other benefits that they cannot afford.[9] It is also becoming increasingly well-known that many localities have entered into complicated public-private partnerships that have failed to meet expectations.[10]

In response to the Great Recession, and as part of the Dodd-Frank Act, the federal government took concrete steps to protect local government finances. These reforms were meant primarily to impose greater obligations on financial intermediaries when they propose transactions to local governments.[11] While such changes clearly make sense, they could only ever have a limited impact. Consider the pension problem: no changes to the duties of financial intermediaries as to a specific transaction could have much effect on the broader question about how a locality budgets its resources. Or consider the example of whether a locality should enter into a long-term partnership with a private party to build or maintain a piece of public infrastructure. Again, it is not clear how increasing the duties of *transactional* advisors would help much here. In fairness, Dodd-Frank was not intended to correct these sorts of problems, but they are big problems nonetheless.

With the election of Donald Trump, even the modest Dodd-Frank protections are now in danger.[12] Further, the structure of the Trump Administration's infrastructure plan would put enormous additional pressure on local governments to enter into bad deals. Rather than spending federal dollars directly, the Trump plan will apparently give private parties tax credits in return for partnering with local govern-

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8. *See generally Cities on the Brink: Monitoring Municipal Fiscal Health*, LINCOLN INST. OF LAND POL'Y: AT LINCOLN HOUSE BLOG (Jan. 15, 2016), http://atlincolnhouse.typepad.com/weblog/2016/01/cities-on-the-brink-monitoring-municipal-fiscal-health.html (summarizing large scale survey of municipal finance managers and reporting that even well after the Great Recession "most cities say they are on the brink of [fiscal] crisis").

9. *See, e.g.*, PEW CHARITABLE TRUSTS, THE FISCAL HEALTH OF STATE PENSION PLANS: FUNDING GAP CONTINUES TO GROW (2014), http://www.pewtrusts.org/en/research-and-analysis/analysis/2014/04/08/the-fiscal-health-of-state-pension-plans-funding-gap-continues-to-grow.

10. *See, e.g.*, Danielle Ivory et al., *In American Towns, Pumping Private Profit From Public Works*, N.Y. TIMES, Dec. 25, 2016, at A1.

11. *See generally* U.S. SEC. & EXCH. COMM'N, REPORT ON THE MUNICIPAL SECURITIES MARKET 96–98 (2012) (summarizing changes); *see also* 15 U.S.C.A. § 78o-4(b)(2)(L)(i) (West 2017) (imposing fiduciary duties on municipal advisors).

12. Glenn Thrush, *Trump Vows to Dismantle Dodd-Frank "Disaster,"* N.Y. TIMES (Jan. 30, 2017), https://www.nytimes.com/2017/01/30/us/politics/trump-dodd-frank-regulations.html.

ments on infrastructure projects.[13] As has been extensively reported and will be analyzed later, these types of arrangements are unlikely to result in even decent deals for local governments.[14] Accordingly, former Treasury Secretary Larry Summers describes Trump's plan as a "Potemkin village of nothing."[15] Thus, with the advent of the Trump Administration, local governments are likely to receive less federal protection from bad deals and more federal seduction into bad deals.

It is also notable that, as a matter of constitutional law, states are on very strong ground when it comes to controlling the actions of their localities. In fact, states must consent to their localities' taking advantage of the protections offered by federal bankruptcy law.[16] Preemption problems might complicate the ability of the states to protect their individual consumers if, as is likely, the federal government rolls back protections, but there should be no such problems when it comes to protecting their localities.

Even if the Trump Administration were to maintain the status quo and there were never to be another major financial crisis, however, we would still want local governments to improve the management of their fiscal affairs. There are at least two reasons for this. First, even if local governments can manage to cover the costs of their promised pension benefits, the cost of paying these benefits is going to cut into funds available for current operations and other projects.[17] Increasing the financial efficiency of funding these benefits could potentially free up significant sums that can be reallocated and repurposed.

A second reason that local governments must do better is that governments at all levels have systematically underinvested in infra-

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13. Melanie Zanona, *Trump's Infrastructure Plan: What We Know*, HILL (Jan. 13, 2017, 6:00 AM), http://thehill.com/policy/transportation/314095-trumps-infrastructure-plan-what-we-know ("Trump and his team have shown a strong preference for drawing in money from the private sector to pay for infrastructure priorities.").

14. *See infra* notes 103–107 and accompanying text.

15. *See, e.g.*, Leanna Garfield, *Larry Summers "Sees No Merit" in Trump's $1 Trillion Infrastructure Plan*, BUS. INSIDER (Jan. 9, 2017, 1:46 PM), http://www.businessinsider.com/trump-infrastructure-plan-larry-summers2017-1.

16. Ashton v. Cameron Cty. Water Improvement Dist. No. 1, 298 U.S. 513, 531 (1936) (striking down first municipal bankruptcy law for impinging on the power of the states).

17. D. Roderick Kiewiet & Mathew D. McCubbins, *State and Local Government Finance: The New Fiscal Ice Age*, 17 ANN. REV. POL. SCI. 105, 106 (2014) ("What we are experiencing is the onset of the New Fiscal Ice Age, a period in which a given level of state and local tax revenue purchases a considerably lower level of current services. The fiscal climate confronting state and local governments will not improve during the lifetime of anyone reading this article.").

structure for a very long time, and the bills are coming due.[18] Thus, regardless of whatever may come of the Trump infrastructure plan, something still needs to be done. It seems prudent to correct the identified weaknesses in local fiscal management before placing these entities in the middle of billions of dollars of additional debt financings.

To date, the legal literature has focused on what to do once a local government's fiscal crisis has become acute,[19] which is the policy equivalent of treating a chronic disease only when it lands a patient in the emergency room. This is unfortunate. Legal scholars, most notably Senator (and once Professor) Elizabeth Warren, took the lead in developing institutional protections for *individuals* making major financial decisions.[20] Why should there not be similar protections for the local governments that, by design, are supposed to be run by those same individuals? This Article addresses this gap by theorizing how a rough analogue to the Consumer Financial Protection Bureau (CFPB) could be set up to protect local governments.[21]

There is another way this Article fills a gap in the literature. Local government scholars tend to think in terms of jurisdictional lines, even if only to critique them. Cities are argued to need more power[22]—or less.[23] Sometimes, counties are argued to need more

18. *See* STATE BUDGET CRISIS TASK FORCE, FINAL REPORT 11 (2014), http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf. Note that this task force also ended up recommending a state-level monitoring agency modeled on, for instance, that of North Carolina. *Id.* at 13.

19. *See, e.g.*, Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L.J. 1364 (2012); Gillette, *supra* note 2; Clayton P. Gillette & David A. Skeel, Jr., *Governance Reform and the Judicial Role in Municipal Bankruptcy*, 125 YALE L.J. 1150 (2016) (proposing governance reform, but only for municipalities that are already bankrupt).

20. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008) (describing a now-classic argument for *ex ante* credit regulation, as with other consumer goods).

21. The Consumer Financial Protection Bureau (CFPB) is of course also under threat from the Trump Administration. It would be ironic if local governments were to receive more protection just as their citizens were to lose protections. However, just as states should protect their local governments, states should also protect their citizens by absorbing as much of the CFPB in state law as possible should it be abolished. Local governments can, and should, also act to protect their citizens. *See, e.g.*, Kathleen S. Morris, *Expanding Local Enforcement of State and Federal Consumer Protection Laws*, 40 FORDHAM URB. L.J. 1903 (2013) (advocating for Congress and state legislatures to grant large cities and counties standing to enforce the Federal Trade Commission Act and its state statutory counterparts).

22. Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1059 (1980) (arguing that granting cities real power and rights comparable to those enjoyed by private corporations best secures people's individual freedom).

power.[24] There is a huge literature advocating regionalism—or not.[25] New sub-local districts are advocated for—or critiqued.[26] All of these discussions are very valuable. Jurisdictional lines matter because of socioeconomic stratification, racial segregation, and concentration of environmental harms. But regardless of whether a district is rich or poor, we want it to make sound financial decisions. Suppose that we had a new set of socioeconomically and racially diverse local jurisdictions—surely we would not want a jurisdiction in this new more equitable landscape to issue debt that it cannot afford. To address this challenge, I argue, we do not need to think about jurisdictional lines but rather about levels of government.

We must think about levels of government because expertise is what is needed. To see this more clearly, suppose we manage to protect local governments from making the worst financial decisions. What then? On an individual level, is it enough just to protect individuals from hustlers, or do we want individuals to save enough for retirement (if that is what the individuals want for themselves)? Saving adequately for retirement is actually quite a complex enterprise.[27] For instance, knowing how much to save requires, among other things, projecting how much you are likely to earn and for how long. Choos-

23. *See* Richard Briffault, *Our Localism: Part II—Localism and Legal Theory*, 90 COLUM. L. REV. 346 (1990) (arguing that cities enjoy greater autonomy than is generally recognized in academic literature).

24. Michelle Wilde Anderson, *Mapped Out of Local Democracy*, 62 STAN. L. REV. 931 (2010).

25. *See* Richard Briffault, *The Local Government Boundary Problem in Metropolitan Areas*, 48 STAN. L. Rev. 1115 (1996); *see also* Richard Thompson Ford, *Beyond Borders: A Partial Response to Richard Briffault*, 48 STAN. L. REV. 1173 (1996).

26. Christopher K. Odinet, *Super-Liens to the Rescue? A Case Against Special Districts in Real Estate Finance*, 72 WASH. & LEE L. REV. 707 (2015); Nadav Shoked, *The New Local*, 100 VA. L. REV. 1323 (2014); Kenneth A. Stahl, *Neighborhood Empowerment and the Future of the City*, 161 U. PA. L. REV. 939, 941–46 (2013).

27. *See, e.g.*, JEFFREY KLING ET AL., PROJECT MUSE, POLICY AND CHOICE: PUBLIC FINANCE THROUGH THE LENS OF BEHAVIORAL FINANCE 73 (2011); *see also* David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19 (2011). Steven Schwarcz similarly distills the behavioral finance literature and also argues that it indicates the needs for additional—and smarter—regulation, but Schwarcz's recommendations are focused on disclosure and the possible actions of external regulators on firms. Steven L. Schwarcz, *Regulating Complacency: Human Limitations and Legal Efficacy*, 93 NOTRE DAME L. REV. (forthcoming Jan. 2018) (see "Compendium Of Potential Regulatory Improvements"). These recommendations are all sensible, but do not look to affect the actual structure of decisionmaking through the creation of a new intermediate institution. This might make sense as to improving the performance of private financial firms, which seems to be Schwarcz's focus, but, as argued *infra* Section II.B., is not sufficient as to local governments.

ing what to invest in requires understanding the nature of different financial instruments.

Making long-term financial decisions involves difficult calculations, but it also requires overcoming all three categories of cognitive bias that psychologists have identified as impeding optimal decision-making: limited attention, limited computational capacity, and biased reasoning.[28] The notions of limited attention and limited computational capacity are presumably self-evident, but biased reasoning may not be. The term refers to certain distorting shortcuts the human brain seems hardwired to make. For instance, we are prone to overconfidence,[29] which is another reason that it is so alarming that only thirty-eight percent of local government officials consider themselves "very knowledgeable" financially.[30]

It seems reasonable to assume that making financial decisions for a local government is at least as challenging as making a financial decision for oneself; indeed, it is likely more challenging, given that the sums and timeframes involved are generally larger and longer than those involved in personal finances. While there are theories about how modern local governments might end up acting *as if* they were financially sophisticated, these theories are ultimately unconvincing.[31] Thus, for instance, one might believe that market forces, in effect, inform local governments of bad decisions. That is, a government that makes poor financial choices will face higher borrowing costs, and this feedback could move the government to make better decisions. Credit markets, however, are a very crude check, replete with distortions. The bondholders who buy a particular municipality's bonds can diversify their portfolios and thus have limited incentive to make sure that a particular municipality borrows wisely. In any event, bondholders also have little interest in whether a transaction is the best one or even a decent one for the municipality, so long as the transaction does not threaten the municipality's solvency. Furthermore, financial intermediaries, such as investment bankers, are often conflicted—they earn money based upon the number and size of transactions.[32] As

28. KLING ET AL., *supra* note 27, at 21.

29. *Id.* at 27.

30. *See supra* note 7.

31. *See generally* Darien Shanske, *Local Fiscal Autonomy Requires Constraints: The Case for Fiscal Menus*, 25 STAN. L. & POL'Y REV. 9, 13–19 (2014). For a more detailed evaluation of these arguments, see *infra* Sections II.B–E.

32. *Cf.* Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573 (2015). Considering only the role of financial intermediaries in the private marketplace, Judge comes to a similar conclusion: "Focusing on the source of the challenge—the differential between the expertise of intermediaries and those who would benefit from a

such, the profit motive diminishes their incentives to push for greater fiscal prudence within municipalities. This, of course, also assumes that the intermediaries understand all the details of the financial instruments they sell.[33] In short, financial markets are at best a limited check on the borrowing activities of local governments, as the poor decisions revealed by the Great Recession demonstrated.

But how is it that one can provide financial expertise to local governments without undermining the autonomy that justifies having a multiplicity of local governments to begin with? Theorists looking to improve the functioning of our democracy typically try to separate the "how" from the "what."[34] That is, they seek to separate the application of expert knowledge (the "knowhow") from the democratic ideal of having the citizenry determine a political community's substantive policy goals (the "what"). In this vein, as to local financial decisions, this Article is an attempt to sketch out an intermediate institution that will allow local democracies to meet *their* goals as effectively as possible.[35]

The institutional intervention we are looking for would need to guide local governments in making decisions at the outset—ex ante—because, in many cases, living with the consequences of poor financial decisions when they unfold is unacceptable, especially if those consequences are preventable. The ex ante approach is preferable for two reasons. First, as already explained, we do not want local government finance to simply be non-disastrous; we want it to be on solid footing. Second, the alternative to the ex ante approach—imposing future negative consequences—will not work. As one commentator has aptly explained: "Politicians who shift too much wealth from the future to the present, whether by borrowing from investors or by promising pension payouts, have already demonstrated their myopia, their rela-

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more efficient institutional arrangement—suggests an alternative approach: create one or more bodies that have the information, expertise, and incentives needed to produce a more balanced debate." *Id.* at 640 (citing other related proposals).

33. They do not. *See, e.g.*, MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010).

34. *See, e.g.*, JAMES S. FISHKIN, WHEN THE PEOPLE SPEAK: DELIBERATIVE DEMOCRACY AND PUBLIC CONSULTATION 119 (2009) ("[I]t is worth distinguishing questions of collective political will from purely expert or technical questions. The public should be consulted about its priorities in answer to the question 'what should be done?' ").

35. *See, e.g.*, Josiah Ober, *Democracy's Wisdom: An Aristotelian Middle Way for Collective Judgment*, 107 AM. POL. SCI. REV. 104 (2013); *see also* Elizabeth Anderson, *The Epistemology of Democracy*, 3 EPISTEME: J. SOC. EPISTEMOLOGY 8, 21 (2006) ("[D]emocratic reform is the application of experimental social epistemology to improve collective inquiry into the definition and solution of public problems.").

tive insensitivity to future consequences. Threatening these same actors with bad future consequences thus seems an unpromising route."[36]

An innovation that can guide local governments ex ante without undermining local autonomy seems like a very tall order, and, indeed, most states do not even try to monitor local government finances. For those who do try, effective monitoring is difficult,[37] but there are contemporary success stories of intermediate institutions that both protect and guide local governments ex ante.[38] North Carolina is the leading model of a state with a powerful regulator.[39] Its Local Government Commission (LGC) is commonly held up as a model by the market.[40] California provides another example where county-level education agencies exercise significant fiscal oversight of school districts' activities.[41] Its results have also been promising.[42] My goal in this Article is to extract from these successes a viable framework for reforming the status quo.

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36. Brian Galle, *In Praise of Ex Ante Regulation*, 68 VAND. L. REV. 1715, 1757 (2015).

37. Philip Kloha et al., *Someone to Watch Over Me: State Monitoring of Local Fiscal Conditions*, 35 AM. REV. PUB. ADMIN. 236, 252 (2005) ("Even though oversight of local fiscal behavior is a primary responsibility for states, it is not being carried out diligently and effectively in most states. Our 50-state survey found that only 15 states indicated some use of indicators to evaluate their local governments' fiscal positions. Of that small number, only 7 states used both early warning and ex post declaration of fiscal distress.").

38. There are also related reform proposals. For instance, in connection with borrowing, see ANDREW ANG & RICHARD C. GREEN, THE HAMILTON PROJECT, LOWERING BORROWING COSTS FOR STATES AND LOCALITIES THROUGH COMMONMUNI (2011).

39. The commission has received some attention in the law review literature, usually as a possible reform mentioned at the end of an article. *See, e.g.*, Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 637 (2008). Recently, the overall functioning and history of the commission was discussed thoroughly in Adam C. Parker, *Positive Liberty in Public Finance: State Oversight of Local-Government Debt and the North Carolina Model*, 37 CAMPBELL L. REV. 107, 140–52 (2015). Note that Parker argues that the role of the commission should not be extended, a position with which I disagree.

40. *See* Charles K. Coe, *Preventing Local Government Fiscal Crises: The North Carolina Approach*, 27 PUB. BUDGETING & FIN. 39, 48 (2007); Parker, *supra* note 39; *see also* Stephen C. Fehr, *North Carolina Agency Is Local Government Lifeline*, PEW CHARITABLE TRUSTS (June 6, 2012), http://www.pewstates.org/projects/stateline/headlines/north-carolina-agency-is-local-government-lifeline-85899396242 ("The three national agencies that evaluate municipal bonds think so highly of the commission that they have rewarded North Carolina communities with bond ratings higher than those in most of the United States.").

41. *See, e.g.*, CAL. EDUC. CODE § 42127 (WEST 2017).

42. *See* MAC TAYLOR, LEGISLATIVE ANALYST'S OFFICE, SCHOOL DISTRICT FISCAL OVERSIGHT AND INTERVENTION 16–17 (2012) (assessing the current system and finding it effective).

The basic reform proposal is this: Local governments should be provided with menus of financial options, such as a limited set of possible debt instruments or possible taxes. The plausibility of such menus is crucial because it is their existence that permits local governments to retain meaningful fiscal autonomy, by ensuring they retain the freedom to choose among options, even as they are brought under additional state guidance. Furthermore, local government should be subject to regular expert oversight in order to permit exceptions from the default rules, prevent coordination problems, and head off budgeting crises. The organization of the expert coordinating entity should be guided by politics at a higher (state) level of government, though the resulting entity should also be partially shielded from ordinary politics.[43] If ordinary politics were producing good results, then this intervention would be unnecessary. There are successful models of balancing expertise and democracy within such an institution. Thus, as with North Carolina's LGC, the board level of our new coordinating entity *could* be drawn from several politically responsive sources, while the core of the staff, as in California's monitoring entity, could be drawn from retired, or near-retired, local business officials, chosen based on their years of experience and good judgment. I wish to further emphasize the "could" here. There is no guarantee that an entity organized in this way will succeed, and I am certainly not intimating that other models such as direct state oversight could not be successful. This Article's argument is simply that there is a need for such an entity, and the institutional design problems are soluble.

One final introductory point: My argument also has important *negative* implications for the current structure of local government finance. We should not only *add* an intermediate monitoring institution but also *subtract* some local fiscal rules. Above all, supermajority voting requirements that constrain local governments' ability to tax or to borrow are superfluous. Other quantitative rules are similarly contraindicated. The reason for shedding these tools can be stated succinctly: They are inconsistent with democratic norms and obstruct the functioning of the local-government quasi-market, and they do so without accessibly aggregating the expert knowledge that local governments need.

Thus, the argument of this Article should not be understood as prioritizing expertise over local democracy. This is primarily because expertise is meant to inform the exercise of local democracy. Further,

43. *Cf.* Jon Elster, Ulysses Unbound 150–53 (2000) (arguing for central banks as a type of precommitment device in a related context).

if a new intermediate institution is embraced and existing fiscal rules eliminated, this could result in a net increase in democratic options.

The argument of this Article is also not an argument against the possible benefits of interjurisdictional competition. After all, markets only work if there is good information. There is not likely to be a positive payoff from interjurisdictional competition if localities are competing by means of poorly planned and poorly executed debt financings. Moreover, if the reform proposed here were to lead to the reduction of fiscal rules, this would lead to a net increase in jurisdictional competition because these fiscal rules severely limit the means by which localities can compete.

This Article proceeds in five parts. Part I develops the prima facie case for a new state-level entity with the responsibility of monitoring local finances. Part II develops a version of the classical economic model for how local governments are supposed to make economically rational decisions. I demonstrate that, even working at its best, the model will tolerate a great deal of fiscal mismanagement and, as such, requires an institutional supplement to facilitate better systemic outcomes. Part III introduces an institution that I call the Local Government Finance Commission (LGFC) that can fill the gaps identified in the standard model discussed in Part II. Part IV offers greater specificity as to what the LGFC ought to do and how it can succeed. Part V explains why certain common fiscal rules such as supermajority requirements for debt issuance should be abandoned in favor of regulating local governments through the LGFC. This is because these rules are not responsive to the shortcomings in local government decision-making identified in Part II and, in fact, often exacerbate these shortcomings.

I.
The Simple Case for Additional State-Level Monitoring of Local Governments

This Part will proceed in two steps. First, I will identify the key problems. Second, I will explain how a new institution could solve those problems.

A. *The Problem*

Even small local governments are relatively complicated financial enterprises; they are certainly more complicated than most households or even most businesses. For instance, even a small school district has multiple revenue streams (e.g., local property tax receipts, state and federal funds), multiple capital assets (e.g., schools, buses), and multiple employees governed by complicated state laws and contracts. A school business official will need to be competent in putting together the annual budget, but this is quite another matter from having the requisite expertise to assess financing structures on the rare occasions when a debt financing is required. The governing board of a locality, made up of ordinary citizens, is even less likely to have the expertise to assess the implications of different financing structures.[44] Larger governments will likely have greater in-house expertise but also face more complicated problems, such as evaluating plans to finance multiple pieces of infrastructure, which may include proposals to grant private parties long-term stakes in the management of public infrastructure.

The lack of expertise of the key decisionmakers in financial matters is compounded by the various reasons why people tend to have a difficult time making financial decisions over long time horizons: limited attention, limited computational capacity, and biased reasoning.[45] Concerning biased reasoning, there is more widespread acceptance that such biases exist than there is consensus as to what they are and how they specifically influence people's thinking. For example, there is a large body of literature documenting that individuals have present bias; that is, they favor what is immediate over what is in the future.[46] Most people value having money in hand today far more than the effects of inflation and interest rates suggest that they should.[47] There could be many reasons why people overvalue the present, each with somewhat different implications. For instance, individuals may always use a higher discount rate because the future is uncertain or because individuals simply impose a fixed surcharge on any future outcome.[48]

For our purposes, the exact contours of the bias are less important than its existence. If most local politicians and officials have present bias along with limited computational capacity, then making optimal long-term financial decisions is going to be difficult. This, of course,

44. For some studies of the performance of local governments, see *infra* notes 72–78 and accompanying text.

45. KLING ET AL., *supra* note 27, at 21.

46. *See* Jess Benhabib et al., *Present-Bias, Quasi-Hyperbolic Discounting, and Fixed Costs*, 69 GAMES & ECON. BEHAV. 205, 209–13 (2010) (surveying experimental literature and offering a new theory based on a new experiment: that people apply a fixed cost to future payments).

47. *Id.*

48. *Id.*; *see also* Shane Frederick et al., *Time Discounting and Time Preference: A Critical Review*, 40 J. ECON. LIT. 351 (2002) (surveying wide variety of explanations for this behavior).

is before we even account for the incentives current politicians and officials may have to defer present costs to the future.[49]

Note that overvaluing the present can also prevent corrective action in many cases. Suppose a transaction has been shown to be a bad but not terrible deal. Suppose further that, over the long term, it will be better for the local government to exit the losing transaction now, even if it means bearing an immediate financial (and possibly a political) cost.[50]

These hypotheses and theoretical observations would seem to indicate that local governments would struggle with certain long-term, occasional, financial decisions. This, in fact, is exactly the case. For instance, consider the auction rate securities debacle. In many instances, auction rate securities allow one to borrow money that could, in many instances, offer government borrowers a lower rate of interest.[51] In order to secure this lower rate, however, issuers must take on greater risks; indeed, the risks were so great that they were completely out of balance relative to the modest interest rate savings they offered.[52] The potential dangers represented by these poorly considered risks became full liabilities in 2008, unnecessarily costing local governments a lot of money when they could least afford it.

There are other headline-grabbing examples of local fiscal mismanagement, such as the ongoing pension crisis, but there is also a large body of evidence detailing smaller problems. For instance, many local governments continue to sell even their conventional bonds at negotiated sales when the academic literature overwhelmingly indicates that a competitive sale would yield a better rate.[53] A competitive sale is when one sells the bonds to the bank that offers the issuer the lowest interest rate. A negotiated sale is when an issuer negotiates the interest rate with one bank. Local governments seem inclined to hold

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49. *See, e.g.*, Michael K. MacKenzie, *Institutional Design and Sources of Short-Termism*, *in* INSTITUTIONS FOR FUTURE GENERATIONS 27 (Iñigo González-Ricoy & Axel Gosseries eds., 2016) (discussing the difficulties politicians face when making claims about long-term benefits and the reasons why politicians "have strong incentives to adopt policies that will have noticeable net benefits over the course of a small number of electoral cycles, and they have equally strong incentives to avoid policies that have near-term costs and longer-term benefits").

50. *See* Eric Johnson et al., *Time Preferences, Mortgage Choice and Strategic Default*, 39 ADVANCES CONSUMER RES. 178, 179 (2011) (finding this issue in connection with underwater mortgages).

51. *See* Raineri & Shanske, *supra* note 4, at 68–72.

52. Such a skewed risk/reward tradeoff is called "asymmetric risk." *See id.* at 77–79

53. *See, e.g.*, U.S. SEC. & EXCH. COMM'N, *supra* note 11, at 17 ("Negotiated offerings appear to be more expensive for issuers than competitive offerings both in terms of bond yields and underwriter gross spreads.").

on to negotiated sales as a method of bond issuance despite empirical evidence of poorer outcomes, and do so even in the face of adverse publicity and state pressure.[54] In other words, fiscal mismanagement that could be easily corrected is leading to a slow drip of taxpayer dollars down the drain.

B. The Solution

One solution to the kinds of problems canvassed above is to create an intervening institution whose job is to inject financial expertise into local government decisionmaking. Examples of useful expert rules of thumb regarding financings include: avoiding excessively risky debt instruments, selling most debt competitively, and using conservative assumptions regarding revenue growth. There are similar rules of thumb available for general budgeting, pensions, tax structure, and public-private partnerships.

Examples of such rules being implemented by a higher-level government entity are plentiful. For instance, the North Carolina Local Government Commission (LGC) has very significant oversight authority over the financial affairs of local governments generally,[55] and the LGC sells its bonds competitively.[56]

California has also assigned significant fiscal oversight activities of school districts to county-level offices of education.[57] Further, California has assembled "SWAT" teams of retired school business offi-

54. Mark D. Robbins & Bill Simonsen, *Competition and Selection in Municipal Bond Sales: Evidence from Missouri*, 27 PUB. BUDGETING & FIN. 88, 102 (2007); *see also* Mark D. Robbins & Bill Simonsen, *Missouri Municipal Bonds: The Cost of No Reforms*, 36 MUN. FIN. J. 27, 45 (2015). One might plausibly label this an issue of corruption, perhaps even institutional corruption. Alexander W. Butler et al., *Corruption, Political Connections, and Municipal Finance*, 22 REV. FIN. STUD. 2873 (2009). But it would seem to be corruption of a peculiar sort, namely not so much aimed at putting money in the pockets of politicians, but at keeping politicians in office by allowing them to offer something for nothing (or less). *See* Christophe Pérignon & Boris Valée, *The Political Economy of Financial Innovation: Evidence From Local Governments*, 30 REV. FIN. STUD. 1903, 1922–23 (2017).

55. *See, e.g.*, N.C. GEN. STAT. ANN. §§ 159–181(c) (West 2017) ("The Local Government Commission shall have authority to impound the books and records of any unit of local government or public authority and assume full control of all its financial affairs (i) when the unit or authority defaults on any debt service payment or, in the opinion of the Commission, will default on a future debt service payment if the financial policies and practices of the unit or authority are not improved . . . .").

56. Coe, *supra* note 40, at 41 ("The LGC sells all GO bonds competitively. . . . In deciding whether a local government can sell a GO bond, the LGC evaluates the adequacy of the bond amount, the bond's effect on the property tax rate, and whether the bond can be marketed at a reasonable interest rate.").

57. *See, e.g.*, CAL. EDUC. CODE § 42127 (West 2017).

cials[58]—the Fiscal Crisis Management Assistant Team (FCMAT)—to go into troubled school districts and set their financial houses in order.[59] FCMAT must also monitor school districts in connection with the "[fifteen] most common predictors of a school district needing intervention," as established by FCMAT itself.[60] As with North Carolina, the results have been promising.[61]

In sum, the prima facie case for an additional institutional intervention is simple: Local governments lack some key financial expertise, but the expertise exists, and there are successful models which match localities with those experts. Matters are not so simple, of course; we will need to counter objections and deepen the analysis, but, after the dust settles, the prima facie case will remain standing.

II.
Counter-argument: We Have a Local Government Quasi-Market

In Part I, I outlined a simple case for an additional institutional intervention. Here, I will consider objections to it. The primary objection is that an additional intervention is simply not needed. According to these critics,[62] when local governments are working well, they operate in a kind of jurisdictional marketplace. Competition with other local governments for residents, businesses, and capital should keep local government finances in line. Thus, a government that taxes too much relative to its competitors will lose residents or the residents will vote out that government; governments that borrow too recklessly would suffer the same fate. In the latter case, the cost of reckless bor-

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58. *Id.* § 42127.8 ("[FCMAT] shall consist of persons having extensive experience in school district budgeting, accounting, data processing, telecommunications, risk management, food services, pupil transportation, purchasing and warehousing, facilities maintenance and operation, and personnel administration, organization, and staffing.").

59. *See generally id.* (statute establishing the "Fiscal Crisis Management Assistance Team"); *see also* Mary C. Barlow, A Study of the Predictive Factors for School District Fiscal Insolvency 54–55 (Jan. 2014) (unpublished Ed.D. dissertation, University of La Verne), https://search.proquest.com/docview/1553455637?pq-origsite=Gscholar.

60. Cal. Educ. Code § 42127.6.

61. *See* Taylor, *supra* note 42, at 16–17 (assessing the current system and finding it effective).

62. As this is a new proposal, there are, as yet, no specific critics of it, though I am responding to insightful criticisms of those who reviewed earlier versions of this Article. There are many leading scholars who subscribe to some version of the quasi-market view, at least as better than central control. *See, e.g.*, Clayton P. Gillette, *Fiscal Home Rule*, 86 Denv. L. Rev. 1241 (2009); *see also infra* note 66.

rowing will eventually lead to negative outcomes like higher taxes to fund higher interest payments.

An easy counterargument to this first objection is that interjurisdictional competition is clearly not preventing a whole host of fiscal problems at the local level. We can point to the use of auction rate securities as one telling example of how markets are doing a very poor job of monitoring local governments. A proponent of local jurisdictional competition has (at least) two answers to the many specific examples of poor monitoring by the credit markets. First, it could be that there is not enough competition or some other problem, like information asymmetries in the marketplace. For instance, there might be a problem with local government disclosures to the marketplace when borrowing. Second, it might be that the cure is worse than the disease. Sophisticated backers of the market-based solution do not claim that markets are perfect; they say only that the alternatives to markets are often worse.[63] Thus, one should not regulate further whenever there is a problem in the marketplace; rather, one should only regulate when the additional regulation's benefits outweigh its costs.

So where are we? Proponents of a market-based approach to local government finance can plausibly explain away the same problematic empirical data with which we began and also have a plausible argument that the kind of intervention I am proposing will make things worse. One way to proceed is to dive deeper into the empirics. For instance, it is superficially plausible to argue that the markets just need to be improved, but that argument seems non-responsive to many of the issues we have already identified, such as the ability of local government officials to choose affordable but unnecessarily expensive borrowing structures. Proceeding through each potential issue in this way is not likely to result in a very clear answer, as there are many studies out there that do indicate problems with the marketplace. I am willing to stipulate for the sake of argument that current empirical studies of local government finance do not clearly indicate that a new regulatory entity would lead to better outcomes than a refined marketplace.[64]

Rather than argue over the limited data, I will argue instead that, even in theory, the marketplace model would be improved by an expert regulator of the type our simple case indicated was the right approach. In the next section, I will elaborate upon the "elegant marketplace" model that animates proponents of jurisdictional compe-

63. *See* Gillette, *supra* note 62, at 1261.

64. That is not, in fact, how I read the evidence.

tition and demonstrate that this model is not merely consistent with but also *requires* an additional regulator to work optimally. This conclusion should not come as a surprise. The larger securities market is a market, but it operates better with some regulations and regulators to enforce those regulations. To be sure, the devil is in the details, but the notion that municipal finance is already over-regulated is prima facie implausible, given that the municipal market is far less regulated than the private market.[65]

A. *The Model of Interjurisdictional Competition*

The model that follows is an idealized economic model[66] that both justifies and describes a decentralized system of local governments. I am focusing on demonstrating that even this kind of model requires supplementation because it represents the biggest challenge to my reform arguments. Note that if one is skeptical of decentralization in general, then, presumably, there will be even less objection to additional regulation of local fiscal matters. I will discuss the reform argument, in case one rejects this stylized model, in Section II.E. *infra*.

In designing a system of local government finance within a larger federal system, the touchstone from an economic perspective is the benefit principle. In general, the benefit principle states that taxation should be proportional to the benefits conferred.[67] Applied to designing a federal system, the principle indicates that we should try to align benefit with burden at each level of government.

The principle is appealing from both a positive and negative vantage point. Speaking positively, if there is a clear connection between

65. *See* Darien Shanske, *The Federal Role in Regulating Municipal Debt Finance*, 33 REV. BANKING & FIN. L. 795, 800–02 (2014).

66. The model is a rough updated amalgam of the classic Tiebout model, taking into account subsequent seminal contributions by Oates (and others) and the literature now known as "Second Generation Fiscal Federalism." This account also builds on the classic tax assignment literature as first stated by Musgrave. As my main goal here is to lay out my intellectual priors, I think no harm is done through not trying to disentangle each thread. For some key sources, see Richard Bird, *Tax Assignment Revisited*, *in* TAX REFORM IN THE 21ST CENTURY: A VOLUME IN MEMORY OF RICHARD MUSGRAVE 441, 441–42 (John G. Head & Richard Krever eds., 2009), Richard A. Musgrave, *Who to Tax, Where, and What?*, *in* TAX ASSIGNMENT IN FEDERAL COUNTRIES 2 (Charles E. McLure Jr. ed., 1983), Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LITERATURE 1120 (1999). *See also* Charles E. McLure Jr., *The Nuttiness of State and Local Taxes—And the Nuttiness of the Response Thereto*, 25 ST. TAX NOTES 841 (2002); Barry R. Weingast, *Second Generation Fiscal Federalism: The Implications of Fiscal Incentives*, 65 J. URB. ECON. 279 (2009).

67. JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 231 (3d ed. 2010); RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 195 (1973).

the public services one cares about and how one's tax levies are spent, then people are more likely to participate in selecting and monitoring projects, either through voice (voting) or exit (moving out of the jurisdiction).

Speaking negatively, a federal system, by definition, has multiple competing jurisdictions. Since all levels of jurisdiction are within one nation-state, there are typically no appreciable trade or other such barriers between them. Thus, if a jurisdiction is taxing and spending in a manner inconsistent with the benefit principle, then there may be a (possibly very costly) correction. If City *A* is charging high taxes for low-quality services, then citizens may move to City *B*, which charges low taxes for low-quality services, or to City *C*, which charges high taxes for high-quality services. They may even move to City *A*'s nearby, low-cost Suburb *D* to take advantage of the city's amenities without paying its taxes. Some competition is generally seen as positive, but too much of the "wrong" kind is generally seen as destructive. "Destructive" here means, for instance, that government services are being provided at a level lower than most would want because of a race to the bottom.[68] Thus, by hypothesis, because City *A* can only charge its own residents for what are essentially regional amenities, it will eventually stop providing regional amenities even though that is not actually reflective of the desires (or economic self-interest) of the region.[69]

Applying the benefit principle provides recommendations for the *vertical* division of responsibilities in a federal system. Thus, for instance, national defense provides broad benefits to all citizens and should be funded by the national government using a national tax. So, too, with interstate transportation systems—they need national support, though there clearly seems to be a role for regional participation. As this analysis proceeds all the way down to repaving the road outside a given house, a benefit that is largely localized, the means are also very specific: the special benefit assessment.

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68. *See, e.g.*, Joseph Bankman, *State Tax Shelters and State Taxation of Capital*, 26 VA. TAX REV. 769, 786 (2007) (discussing destructive competition in connection with state corporate income tax).

69. It should be noted that individuals are not nearly as mobile as this thumbnail sketch of the Tiebout model might suggest. *See, e.g.*, John R. Brooks II, *Fiscal Federalism as Risk-Sharing: The Insurance Role of Redistributive Taxation*, 68 TAX L. REV. 89 (2014). Yet this does not mean that there is not a negative case for the benefit principle, certainly over time and as to capital. Furthermore, there are other arguments for fiscal federalism, including its greater ability to align costs and preferences (the decentralization theorem). *See, e.g.*, Oates, *supra* note 66, at 1124.

The benefit principle also indicates a *horizontal* distribution of powers and responsibilities as to local public goods such as schools, parks, police, and fire protection. Local public goods are, by definition, those goods whose benefits are separable in space.[70] They are also degraded as they are subject to congestion, which means that they are also impure public goods.[71] For example, consider a fire station. One of a certain size can only house a certain number of trucks and firefighters and can only serve a certain-sized area before diminishing returns reach a tipping point such that certain structures are no longer effectively protected. There should therefore be one such fire station within an optimally sized zone. If one owns a piece of land within the zone, then the benefit principle indicates that that person should pay a tax to fund the station. The presence of fire protection will increase the value of the land, though the tax will also decrease its value. If the system is working well, then the benefit should more than offset the burden. Recall that people will move away if the burden is too high (and vice versa). If this jurisdiction is providing great value for its constituents' money, this will encourage people to move in; this, in turn, will increase home prices, demonstrating the special incentive local landowners have to make shrewd investments in local public goods.

The benefit principle even has an *intertemporal* dimension. A local government diligently pursuing the benefit principle will need to purchase many long-lived goods, such as fire trucks and fire stations. The government will likely be unable to purchase these expensive capital goods with its regular cash flow (nor should it), since these long-lived goods will be providing benefits to future taxpayers as well. Thus, if local governments are to be effective at providing local services in the present—e.g., fire protection—then they must also have the power to borrow in order to align the costs of a benefit with the future cohorts of taxpayers who will also enjoy that benefit. Note that the borrowing power presupposes that the government has revenue instruments available that match benefit and burden in the present such as the benefit assessment and the property tax.

We should observe right away that proper matching also requires a hard budget constraint.[72] That is, the penalties of a poor borrowing

70. Jonathan Gruber, Public Finance and Public Policy 269–70 (4th ed. 2013).

71. *Id.* at 184.

72. *See generally* Jonathan Rodden et al., *Introduction and Overview*, *in* Fiscal Decentralization and the Challenge of Hard Budget Constraints 3 (Jonathan A. Rodden et al. eds., 2003).

decision must be borne by the jurisdiction that made the poor decision. If the cost(s) can be shifted even in part to outsiders, such as the uninvolved residents within the same state, then there will have been no matching. This, in turn, will produce a moral hazard amongst jurisdictions who know they will be bailed out, if necessary.

B. Limitations of the Model

1. Externalities

A negative externality occurs when the costs of the action of one entity are not fully borne by that entity.[73] The classic example would be that of a polluting factory—or city—that sends its pollution downstream. Externalities are, by definition, those costs that actual markets—or quasi-markets—do not impose on the actor who creates the cost.[74] There are many types of externalities that plague the jurisdictional quasi-market just described.

First, hard budget constraints cannot be perfect, as the larger polity (such as the state) will not and cannot actually allow a failed jurisdiction to operate without police, schools, and other basic services. Thus, there will always be some moral hazard—an externality—because higher-level governments cannot let local governments cease functioning.

Second, politicians have incentives to shift the costs of popular projects onto future voters.[75] It should be added that business leaders are also often driven by short-term results at the expense of the long-term,[76] so simply urging local politicians to behave more like business people as they compete with one another is hardly a panacea. Furthermore, even if a government bears a near-contemporaneous cost for any decision, like a large termination fee in connection with interest rate swaps, it is not clear that the cost will be perceived as such by

73. GRUBER, *supra* note 70, at 121–48.

74. *Id.*

75. *See, e.g.*, Christophe Pérignon & Boris Valée, *The Political Economy of Financial Innovation: Evidence from Local Governments*, 30 REV. FIN. STUD. 1903, 1932 (2017). Note that this paper also seemed to find that, contrary to one line of argument I am making, the officials who entered into complex transactions *did* know what they were getting into because such officials tended to be more educated and education is correlated with financial literacy. This is a weak point in their paper; the authors cite only one paper for the proposition connecting education to financial literacy and that paper emphasizes that "even at the highest level of schooling, financial literacy tends to be low." Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy Around the World: An Overview*, 10 J. PENSION ECON. & FIN. 497, 504 (2011).

76. *See* Dominic Barton, *Capitalism for the Long Term*, HARV. BUS. REV., Mar. 2011, at 86.

those who made the decision. Whether the penalty fee is viewed as such will be a complex matter of local politics.[77]

Third, in a landscape with overlapping jurisdictions, there are common pools that are likely to be overfished—that is, there is a classic tragedy of the commons. In many borrowings and taxes, local governments share common pools such as an area's maximum property tax-secured debt limit and the maximum amount of property tax that property holders can collectively bear. There is considerable research that confirms that local governments are more likely to raise taxes[78] and issue debt[79] against a shared tax base.[80] This means, somewhat ironically, that the severity of common pool problem is exacerbated when there are more governments in competition with one another if those additional competitors share a base.

Fourth, there are also externalities caused by interjurisdictional mismatch. In optimal fiscal federalism, there is an attempt to match benefit with burden where possible; it is understood, however, that that this will not be possible in practice. For example, imagine a city that provides fire protection, public education, and police protection. It is very unlikely that each of these services has the same economies of scale. Even if a city is just the right size to efficiently provide fire protection, it may be too small to efficiently provide public education or police protection. If it is too small to achieve adequate economies for public education and police protection, and, assuming it cannot

77. *See generally* Daryl J. Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. CHI. L. REV. 345, 347 (2000) (examining how to adjust incentives for political entities to avoid constitutional violations).

78. *See* CHRISTOPHER R. BERRY, IMPERFECT UNION: REPRESENTATION AND TAXATION IN MULTILEVEL GOVERNMENTS 98–101 (2009) (finding correlation between degree of jurisdictional overlap and aggregate tax burden and arguing that the overlap was the cause); *see also* Jocelyn M. Johnston et al., *The Impact of Local School Property Tax Reductions on City and County Revenue Decisions: A Natural Experiment in Kansas*, 11 PUB. FIN. & MGMT. 180, 192 (2011) (finding that cities and counties increased their property tax rates after school districts were compelled to lower theirs).

79. Robert A. Greer, *Overlapping Local Government Debt and the Fiscal Common*, 43 PUB. FIN. REV. 762, 782–83 (2014) (laying out a theory of debt competition between governments with a shared tax base).

80. Indeed, the unwillingness to reduce tax rates against a common pool is one explanation for why local governments in California did not act to prevent the passage of Proposition 13. *See* Robert P. Inman, *Financing Cities*, *in* A COMPANION TO URBAN ECONOMICS 323 (Richard J. Arnott & Daniel P. McMillen eds., 2006). With surging property values, all local governments had to do was reduce their rates in order to keep the overall tax burden in place, but each local government was concerned that if they reduced their rates, then some other overlapping entity would increase theirs. *Id.*

raise taxes much higher than its neighbors because of interjurisdictional competition, then our sample city is going to have suboptimal outcomes in public education and police protection, which may create negative externalities for its neighbors. Consider another version of the same problem. Suppose a small city is part of a larger, independent school district. Now, problems with school district management or another community within the district but outside the city will nevertheless affect the city.

Fifth, interjurisdictional competition can devolve into a race to the bottom. As already outlined in the initial model, local governments are *supposed* to compete fiscally. A benefit of having a multiplicity of jurisdictions is that a locality that imposes too high a tax burden upon its citizens relative to other localities can be sent a signal through the jurisdictional marketplace (i.e. people leaving) or local politics (i.e. voting the current elected officials out). Yet competing to reduce taxes for only one taxpayer in order to encourage relocation is very different from competing on the basis of an overall package of taxes and services. For one, providing locational incentives to a single business requires that local governments choose the right businesses, a task they are ill suited to do.[81] Furthermore, the mobile taxpayer that is the object of local blandishments can play different jurisdictions against one another until the eventual winning incentive is so large that even a successful venture will impose a net cost on a locality. The overwhelming critical consensus is that such breaks are thus not very effective.[82]

Sixth, a multiplicity of jurisdictions imposes significant transaction costs on the national economy as a whole. To be sure, in the stylized model, these costs are "worth it" because the whole system is operating better, but the model does not answer whether the national economy is getting the best deal possible. Right now, for instance, local governments employ a wide variety of local business taxes.[83] These taxes are generally not very well-designed and their multiplicity

81. *See* Richard C. Schragger, *Rethinking the Theory and Practice of Local Economic Development*, 77 U. CHI. L. REV. 311, 331–33 (2010) (explicating some of the problems involved with offering location subsidies).

82. "The [e]conomic [e]vidence [s]hows that [s]tate [t]ax [i]ncentives, at [b]est, [p]roduce a [z]ero-sum [c]ompetition and, at [w[orst, [r]esult in a [n]ational [e]conomic [l]oss." Brief for Economics and Public Policy Professors Randy Albelda et al. as Amici Curiae Supporting Respondents at 8, DaimlerChrysler Corp. v. Cuno, 547 U.S. 332 (2006) (Nos. 04-1704, 04-1724), 2006 WL 189794 at *8 [hereinafter "Professors' Amicus Brief"].

83. *See* Charles Swenson, *Empirical Evidence on Municipal Tax Policy and Firm Growth*, 3 INT'L J. PUB. POL'Y & ADMIN. RES. 1, 3 (2016) (examining the effectiveness of municipal tax structures on business growth).

imposes a drag on businesses.[84] Would jurisdictional competition really become much less efficient if all of these local governments were forced to use the same business activity tax? Each locality could still compete on tax, but the base would be the same. The scholarly consensus here is also that permitting competition on the base is not worth it.[85]

There is a straightforward solution to the inevitable problem of interjurisdictional externalities: higher level governments should intervene. They should try to: 1) create properly-sized and configured jurisdictions in order to maximize the degree to which they internalize their externalities; 2) regulate the externality; or 3) subsidize or tax the externality. To stick to classic examples, a region-sized special district could be created for affording fire protection, regulating polluting plants, taxing pollutant emissions, or subsidizing cleaner technology. It is uncontroversial in the fiscal federalism literature that these are the proper and rightful tools of a central government.

Now that we have identified fiscal externalities, our task is to determine the appropriate central government intervention. Before moving on to this task, there are several other broad considerations that indicate the need for central government intervention as to local fiscal affairs, even assuming a highly functional local government marketplace.

2. *Behavioral Finance and Blind Spots*

The classical model of interjurisdictional competition relies upon the assumption that the model's actors act rationally. At this point, there is significant literature critiquing the efficiency of markets from the general perspective of behavioral finance.[86] I deepen the explica-

84. *See id.*; *see also* Robert M. Bird, *A Better Local Business Tax: The BVT*, IMFG Papers on Muni. Fin. & Governance, no. 18, 2014, at 2.

85. *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 Mich. L. Rev. 895, 900–01 (1992) (arguing that locational tax neutrality eliminates undue substitution effects in taxpayer behavior that would otherwise result in a "deadweight social loss [in] the amount of the reduced pretax benefit to the taxpayer by reason of the substitution").

86. For a still excellent survey of these issues, see Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 Calif. L. Rev. 1051 (2000). It must also be noted that markets misfire for reasons other than behavioral reasons. For instance, one recent important paper has argued that, in fact, major financial players have incentives to make riskier investments once those investments become a trend (however foolish) among unsophisticated investors. *See* Emmanuel Farhi & Jean Tirole, *Collective Moral Hazard, Maturity Mismatch, and Systemic Bailouts*, 102 Am. Econ. Rev. 60 (2012).

tion of this literature here, given its implications for the functioning of the classical model.

The key insight of the behavioral finance literature is that market participants are not wholly rational decisionmakers. Mistakes in reasoning can result in all manners of market inefficiencies, perhaps most notably in asset bubbles. If investors in actual markets succumb to their all-too-human cognitive limitations, we should hardly be surprised that local government officials also do so when operating in the local government quasi-market.

The literature on markets misfiring covers not just markets in general but also the municipal market in particular. In addition to the evidence adduced in the prima facie case above, there is evidence that appointed and relatively more expert county treasurers borrow more cheaply than elected treasurers.[87] There is evidence that smaller borrowers do worse in borrowing than they ought to, presumably because of reduced expertise.[88] There is evidence that counties with greater expertise are somewhat more likely to use developer fees, a targeted instrument more consistent with the benefit principle, rather than using a general revenue instrument.[89] There is also evidence of signs of mispricing such as higher borrowing costs because of relationships formed between intermediaries and local governments.[90] One recent study has found that more diverse communities face higher borrowing costs than they should, given market fundamentals.[91] A related study has found that communities with residents with lower social capital pay more in the bond market.[92] All of these studies indicate that there are limitations, cognitive or otherwise, that thwart efficient market outcomes.

87. Alexander Whalley, *Elected Versus Appointed Policymakers: Evidence from City Treasurers* 24–25 (Nat'l Bureau of Econ. Research, Working Paper No. 15643, 2012), http://www.nber.org/papers/w15643.pdf.

88. Bill Simonsen et al., *The Influence of Jurisdiction Size and Sale Type on Municipal Bond Interest Rates: An Empirical Analysis*, 61 PUB. ADMIN. REV. 709, 715 (2001).

89. Moon-Gi Jeong, *Local Political Structure, Administrative Capacity, and Revenue Policy Choice*, 39 ST. & LOCAL GOV'T REV. 84, 90 (2007).

90. Gao Liu, *Relationships Between Financial Advisors, Issuers, and Underwriters and the Pricing of Municipal Bonds*, 36 MUN. FIN. J. 1, 18–19 (2015). On corruption and higher borrowing costs, see generally Butler et al., *supra* note 54.

91. Daniel Bergstresser et al., *Demographic Fractionalization and the Municipal Bond Market*, 34 MUN. FIN. J. 1, 3 (2013).

92. Pei Li et al., *Social Capital and the Municipal Bond Market*, J. BUS. ETHICS, Oct. 2016, at 2.

To be sure, the behavioral finance critique has not gone unanswered, particularly as to policy interventions.[93] Thus, a committed proponent of interjurisdictional competition might not find this subsection's argument as compelling as the previous one's argument. In particular, it is so far unexplained how these observed outcomes can be improved upon through superior institutional design. Most municipal finance professionals were and are committed to helping their clients. And, in the end, the municipal marketplace remains relatively stable and successful.[94] If not even all of this intelligence and goodwill lead to better results, then perhaps such results are simply unattainable.

There is also a large and growing literature analyzing how even well-meaning and well-informed people can go astray.[95] For instance, in the aftermath of financial scandals such as Enron, there was considerable discussion of how professional auditors could get things so wrong.[96] While there were some actively corrupt actors, many more actors were simply swept along with the corruption on account of unconscious bias.[97] The literature indicates, not surprisingly, that the problem of unconscious bias is not simply caused by the perceived benefits of acting in a certain way. That is, professional auditors did not overlook wrongdoing because they expected an ill-gotten payout; also crucial was the presence and interpretation of ambiguity.[98] These studies indicate that if the question being evaluated were truly straightforward, then even large material (and social) blandishments would not generally skew professional judgment. Yet, if the question under consideration is ambiguous, then unconscious bias has gained a subversive space to work. Choosing the right tool to finance a long-

93. *See, e.g.*, RICCARDO REBONATO, TAKING LIBERTIES: A CRITICAL EXAMINATION OF LIBERTARIAN PATERNALISM 5–6 (2012).

94. Isabel Rodriguez-Tejedo & John Joseph Wallis, *Fiscal Institutions and Fiscal Crises*, *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 10 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

95. *See generally* Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Governmental Design*, 87 CORNELL L. REV. 549, 558–61 (2002).

96. *See, e.g.*, Max Bazerman et al., *Why Good Accountants Do Bad Audits*, HARV. BUS. REV., Nov. 2002, at 96 (summarizing research on sources of unconscious bias among auditors); Don A. Moore et al., *Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling*, 31 ACAD. MGMT. REV. 10 (2006) (noting structural pressures on auditors to present favorable reports).

97. *See supra* note 96.

98. *See* Maurice E. Schweitzer & Christopher K. Hsee, *Stretching the Truth: Elastic Justification and Motivated Communication of Uncertain Information*, 25 J. RISK & UNCERTAINTY 185 (2002) (noting the importance of ambiguity in controlled experiments concerning corporate valuation).

term infrastructure project is a complicated question. Riskier securities do offer lower payments, at least initially—in short, this is just the kind of ambiguous question that we might have predicted could lead experts astray.

The analysis of how good intentions can go awry does not foreclose the possibility of designing institutions that better use expert knowledge.[99] One simple design choice post-Enron was to try to separate auditing from other lines of work.[100] An expedient in our context would be the creation of an expert regulatory entity exclusively concerned with the long-term fiscal probity of local governments. It should be noted that, despite all the experts involved in local government debt issuance, no expert currently has a high-level understanding of finance *and* a professional commitment to the long-term financial health of his or her local government, much less a procedure for studying new issues and institutionalizing that knowledge.[101] As already explained in the prima facie case, there are extant examples of institutions doing a better job of marshaling and applying expert financial information.[102] Thus, while it is surely the case that municipal finances can never be made to work optimally (whatever "optimally" may entail), there is little reason to believe that there are no plausible means of making them work better.

99. Rachlinski & Farina, *supra* note 95, at 560–61.

100. *See, e.g.*, Bazerman et al., *supra* note 96, at 102 (discussing the Sarbanes-Oxley Act's prohibition on accounting firms serving as both auditor and consultant to a single client).

101. As one leading scholar has summarized the literature on whether organizations can make a difference:

> Organizational structures can improve the decisionmaking process. Within an organization, people need only make parts of decisions. Information gathering can be separated from judgment, and judgment from decisionmaking. Problems such as overconfidence can be remedied by forcing people to submit their decisions to organizational review processes. The process can remove those personally invested in some outcome from the decisionmaking loop or curtail their influence. Frequentist representations become more accessible through the accumulation of actuarial data on similar choices. "Outsider" perspectives are also easily accessible as people within organizations review the choices made by others. Finally, simply making a choice in a group setting alone can lead to a deliberation process that will involve several different representational structures.

Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 Nw. U. L. Rev. 1165, 1214 (2003).

102. *See supra* Section I.B.

3. The Positive Science of Fiscal Federalism

The first limitation of the simple model is that there are numerous externalities that the central government must address. The second limitation of the model is that it does not take into account the cognitive limitations of the decisionmakers. These limitations can be mitigated through the judicious use of expertise, but the model does not include any particular mechanism for the introduction of expertise. The third limitation builds on the first two. Suppose that all local decisionmakers could be counted on to avoid mistakes, such as by using auction rate securities. Suppose as well that all jurisdictions were just the right size so as to avoid interjurisdictional externalities. Nevertheless, the simple model would still require the wise application of expertise.

The benefit principle aggregates some knowledge through a market-like mechanism, but it also presupposes knowledge that is not so readily produced by the market alone. Two examples illustrate the point. The first concerns public-private partnerships (P3). When P3 is trotted out as the solution to infrastructure needs, the general idea is that a government entity enters into a long-term lease (on the scale of seventy-five years) with a private party for a piece of existing infrastructure, such as a toll road.[103] Proponents suggest that such transactions are a no-brainer. The government receives a huge payout for the long-term lease of the piece of infrastructure, and the private party will then maintain it better and more cheaply than the government could have done.[104]

Note from the start that evaluating P3 properly requires mitigating many externalities and cognitive limitations. For instance, these long-term leases implicate our cognitive difficulty in accounting for the future; they also implicate our institutional difficulty in competently designing democratic institutions that are responsive to present-day voters and also consider the future. Thus, P3 already indicates the need for additional guidance to navigate the classical model's aforementioned limitations.

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103. Examples and analysis drawn from Darien Shanske, *Clearing Away Roadblocks to Funding California's Infrastructure*, 54 ST. TAX NOTES 567, 577 (2009); *s*ee also Public-Private Partnerships (P3), GOV'T FIN. OFFICERS ASS'N (Jan. 2015), http://www.gfoa.org/public-private-partnerships-p3 (listing twelve key considerations regarding P3 and warning "P3 agreements can leave the public entity exposed to fiscal and/or political fallout if proper due diligence does not occur, the private partner fails to perform, or if expected project outcomes do not happen").

104. *See, e.g.*, Mary E. Peters & Samara Barend, *The Benefits of Private Financing for Public Works*, N.Y. TIMES, July 17, 2017, at A19.

The challenges posed by P3 have another dimension: extraordinary complexity. At the heart of a P3 arrangement is a contract. The contract must, among other things, set the parameters for how the piece of public infrastructure will be maintained over generations and by whom. Another feature of these contracts is provisions for changes in and protections for investors. For instance, what obligations might the owners of a privatized roadway have to invest in charging stations for electric cars? Can the contracting government subsidize public transportation even if this will cut down on toll paying drivers of the toll road that is being privatized? What happens if the contracting private party defaults on its obligations? How might the contracting government adequately account for such liabilities? After all, if a key highway collapses because of inadequate maintenance by an insolvent private party, the government will likely have to fix the problem.

To be clear, I believe that the value of P3 to local governments in the United States will almost always be negative, once risks are fully taken into account,[105] though I cannot be certain of this for every project, a priori. This is why expertise is needed and why intermediary institutions should be created to specifically assess whether individual P3 projects are prudent. Trump's infrastructure proposal, inchoate as it is,[106] has always emphasized an increase in public-private partnerships.[107] If the proposal were enacted, then local governments will be bombarded with P3 proposals, making it more important than ever that a mediating institution operate as a P3 filter and gatekeeper. Not surprisingly, other countries with more extensive P3 experience often

105. This is not just an intuition, but seems to be a widely held view. *See, e.g.*, Graeme A. Hodge & Carsten Greve, *PPPs: The Passage of Time Permits a Sober Reflection*, 29 ECON. AFF. 33, 35–36 (2009) (summarizing mixed evaluations of public-private partnerships).

106. Despite a lengthy incubation period, Trump's plan remains thinly sketched:

> Trump has actually been promising a full and detailed infrastructure plan in the near future since August 2016; as of April, we were supposed to see it by sometime in May. This January, he got the GOP to include infrastructure in their 200-day legislative agenda. But we didn't see any detail about what Trump had in mind until late May, when he slipped a six-page info sheet on infrastructure in his budget proposal for 2018 with no fanfare. This fact sheet remains the most concrete sense of Trump's plans we have.

Mark Hay, *Trump's Infrastructure Plan Is a Trainwreck*, VICE (Aug. 18, 2017, 5:30 PM), https://www.vice.com/en_us/article/mbb7b3/trumps-infrastructure-plan-is-a-trainwreck.

107. For the most recent example of the administration's emphasis on P3, see *Fact Sheet, 2018 Budget: Infrastructure Initiative*, OFF. OF MGMT. & BUDGET, https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/budget/fy2018/fact_sheets/2018%20Budget%20Fact%20Sheet_Infrastructure%20Initiative.pdf (last visited Sept. 25, 2017).

have such a body. These organizations always provide expertise and sometimes serve as a gatekeeper.[108] In all of the press coverage of the Trump infrastructure plan, I have not seen any mention of a plan to create a similar institution to guide and protect local governments.

For another example of the need for expertise, suppose the jurisdictional marketplace is operating so as to indicate when a locality's taxes are too high relative to other jurisdictions; how refined is this signal? Consider a large road project where, ideally, multiple revenue instruments should be used: regular special assessments for local roads, perhaps a regional assessment for a large overpass, perhaps toll revenue for general usage, perhaps grants from a higher level government agency, and, finally, general tax revenue from property tax levies. This is a lot of instruments to coordinate. It is easy to see how some projects might not get done at all because of lack of knowledge as to how to organize these sources of revenue. Alternatively, one can see how a government determined to complete the project might be inclined to unwisely rely largely on one source, such as general tax revenues, rather than coordinating the use of other tools better indicated by the benefit principle.

The importance of multiple revenue instruments is not a new insight,[109] but the hydraulic interactions here need to be emphasized. Again, it is not that localities should levy user charges and property taxes willy-nilly but rather that they should only use taxes when it is inefficient or undesirable to charge.[110] Now, if the fees and assessment component of local government finance are working well, then this relieves the pressure on general property taxes. Also, if the local government finance system as a whole is working well, then this fiscal harmony further relieves the pressure on higher-level governments.

The argument for the dynamic relationship between the various classic tools of local government finance can be made with a quick negative example. In 1978, California voters permanently cut their property tax by sixty percent through Proposition 13,[111] doing so in a

108. *See* ORG. FOR ECON. CO-OPERATION & DEV., DEDICATED PUBLIC-PRIVATE PARTNERSHIP UNITS: A SURVEY OF INSTITUTIONAL AND GOVERNANCE STRUCTURES 32 (2010) (presenting an overview of dedicated public-private partnership units).

109. *See, e.g.*, Robert P. Inman, *Financing Cities*, *in* A COMPANION TO URBAN ECONOMICS 323 (Richard J. Arnott & Daniel P. McMillen eds., 2006).

110. *See generally* Richard M. Bird & Thomas Tsiopoulos, *User Charges for Public Services: Potentials and Problems*, 45 CAN. TAX J. 25, 71 (1997).

111. *See* Darien Shanske, *What the Original Property Tax Revolutionaries Wanted (It Is Not What You Think)*, 1 CAL. J. POL. & POL'Y, no. 1, 2009 (reviewing ISAAC WILLIAM MARTIN, THE PERMANENT TAX REVOLT: HOW THE PROPERTY TAX TRANSFORMED AMERICAN POLITICS (2008)).

manner that effectively deprived local governments of even the power to set their own future property tax rates. Of course, local governments were still expected to provide (more or less) the same services with the remaining revenue tools, which they used. In particular, local governments turned to assessments, fees, and tax increment financing to try to close the gap opened by Proposition 13. Each method, in turn, was perceived (and with some justification) to have been abused, and each had its possible scope sharply curtailed by additional voter initiatives or higher-level government action.[112] At this point, local governments in California have no tools for raising revenue that have not been sharply curtailed since 1978.

Though it likely cannot be quantified, this dynamic relationship between local government instruments suggests a kind of political economy multiplier effect. If the right tools are available and being used properly, then the relationship permits the existence of a manageable general tax burden and ensures that those general tax dollars are being used at least somewhat efficiently. The reverse, as California demonstrates, is also true. Without one instrument, the others become more difficult to use as well. Yet the knowledge of the different instruments available and how they might be counterbalanced must come from somewhere. In larger governments, it is possible that there is a director of public works or some other source of institutional knowledge, though it is not always so. In many cases, a local government official might be primarily interested in "getting the job done" and may actually know relatively little about different financing tools. Furthermore, many projects are discrete affairs, done by smaller local government entities that tend not to have staff familiar with the finer points of assessments and taxes.[113]

But this knowledge exists and it matters. It matters most obviously if the local government marketplace is to operate efficiently and also if the local government marketplace is to operate at all in the long run. As California demonstrates, repeated poor use of revenue instruments could well result in very few revenue instruments left to use.

112. *See* Right to Vote on Taxes Act, Proposition 218 (Cal. 1996) (enacted as CAL. CONST. arts. XIII-C–D) (requiring local governments to submit local tax increases to referenda); *see also* Supermajority Vote to Pass New Taxes and Fees Act, Proposition 26 (Cal. 2010) (enacted as CAL. CONST. arts. XIII-A, § 3, XIII-C, § 1) (requiring tax increases to be approved by a two-thirds majority of each house of the state legislature).

113. *See* Simonsen et al., *supra* note 88, at 710; *see also* Jeong, *supra* note 89, at 92 (noting relationship between local governmental capacity and sophistication in designing funding streams).

4. *The Model is Wrong*

The local government model we began with has (many) critics. If they are right, then we must rely upon another model to understand and correct the decisionmaking problems identified before.

One prominent critique of the model is normative. The heart of this critique is that there are going to be serious social equity concerns if governments mimic market actors.[114] Poor people, by definition, will not yield much tax revenue and will require the same, if not higher, level of local services. It is unacceptable to have a model of local government where each municipality is encouraged to zone out the poor and seduce the rich. Note that if we are going to tamp down intergovernmental competition on ethical grounds, then competition becomes less capable of policing poor fiscal decisions. For instance, if we create larger localities in order to combat economic and racial segregation, there will be fewer localities for consumer-voters to flee to with their feet. Thus, the ethical critique of the quasi-market model underscores the need for additional regulation.

A more recent critique of the market model is descriptive.[115] Our best theories of urban life do not indicate that private firms are the best analogues for cities. Citizens do not move to or remain in a locality because they have carefully scrutinized its value proposition. Cities are better analogized to living things, with their rise and fall relying on innumerable factors beyond dollars and cents. The recent revival of many cities has been a stark illustration of this. No one had predicted the recent revival of cities, and no one can fully explain why some cities have revived to a greater degree than others.[116]

If the success of local governments is not tied to their outcompeting their peers but to other factors (few of which are under control of the local government), then the model of jurisdictional competition ought not constrain local governments. This should be so not only because such competition leads to inequitable results but also because

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114. *See, e.g.*, Richard Briffault, *supra* note 23, at 415–16 (presenting an overview of the legal powers of contemporary American local governments and the practical impacts of local legal power given wide divergences in localities' fiscal capabilities, needs, and the ideological commitment to local autonomy).

115. *See generally* RICHARD SCHRAGGER, CITY POWER: URBAN GOVERNANCE IN A GLOBAL AGE 35 (2016) (likening a city to a "developing embryo" rather than a "widget that is produced and sold in the marketplace"); *see also* David Schleicher, *Local Government Law's "Law and ____" Problem*, 40 FORDHAM URB. L.J. 1951 (2013) (discussing various theoretical shortcomings of the current model of local government law in failing to integrate modern social science research).

116. *See* SCHRAGGER, *supra* note 115, at 192.

it is ineffective. A city is unlikely to succeed just by cutting its taxes; this might actually be the losing strategy.

I happen to be broadly sympathetic to both critiques of the traditional model, and so it is worth remembering why we started with this model. First, as I indicated in introducing the model, the successful operation of jurisdictional competition is the strongest argument that additional central regulatory intervention is not needed. Second, I believe this model is successful as a description in at least some instances. William Fischel, one of the key proponents of a form of this model, is clear that he is describing a certain set of primarily suburban places.[117] These suburbs are very different in their local politics than the great cities studied by Richard Schragger, a critic of the Fischel model.[118] I think it would be useful to explain the need for supplementation even when the model is working at least somewhat economically well, as in the suburbs.

In any event, these critiques of the classic model of competing jurisdictions do not make the need for an additional intervention any less important. This is because these competing models of local government are even less able to explain how local government officials are going to make sound financial decisions. Common pools and myopia remain without the argument that, somehow, market forces are constraining governments for the better. To be sure, somewhat like proponents of a market-based solution, pro-city theorists such as Richard Schragger are suspicious of higher-level interventions precisely because the history of such interventions points to an erosion of local autonomy and the imposition of worse decisions by others.

This is a serious critique, which must be kept in mind as I further develop the reform proposal below. To foreshadow, the new intermediary institution is to be designed to focus on fiscal means rather than ends, thus minimizing its impact on local political and policy decisions.[119]

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117. WILLIAM FISCHEL, THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES 15 (2001).

118. *See* SCHRAGGER, *supra* note 115; *see also* J. ERIC OLIVER WITH SHANG E. HA & ZACHARY CALLEN, LOCAL ELECTIONS AND THE POLITICS OF SMALL-SCALE DEMOCRACY 33 (2012) (finding most smaller local governments are more of a managerial nature).

119. Although the distinction between ends and means is not fixed, the overlap can often be salutary. For instance, insisting that localities use vanilla financings will make certain projects impossible, but the inability to finance a project using traditional structures is some evidence that this was not an affordable project. Or, as for big cities, some pressure from central regulators might be a good thing if it counteracts logrolling that otherwise would lead cities to borrow too much. Jacob S. Rugh &

III.
The Reform Proposal

In the prima facie case, I outlined the need for a new intermediary entity, roughly modeled on North Carolina's LGC or California's FCMAT. Here, I will explore how such an institution might operate. Before doing so, we must remember the problem: expertise is not adequately shaping local government financial decisions. We must also remember a key constraint: The reform ought to enable, rather than stifle, local democracy. Put another way, one simple (but undesirable) reform aimed at solving the knowledge problem would be to simply centralize all decisionmaking and then focus our energy on how to make sure that the centralized experts do not err.

Such a centralizing reform not only ignores the reality that local governments are not going away but also the additional benefits that local governments may provide. On the theoretical side, local governments make political participation possible, and exercising deliberation in such a context is arguably a fundamental human capacity. More pragmatically, and as roughly summarized already, fiscal federalism has much to be said as an efficient—and normatively desirable—way to allocate resources. Thus, we are looking for a reform proposal that provides expertise to local governments with as light a touch as possible. This, I will argue, can be achieved by means of an expert entity providing local governments with menus of options from which to choose. Local governments can retain and even increase their autonomy, but their exercise of that autonomy will be much more financially sound. Much, therefore, depends on whether such menus are plausible. Thus, after sketching out the composition of the new expert entity, I will proceed to canvass what it might do in the areas of taxation, debt, pensions, and budgeting. In all these areas, I conclude that sensible menus and rules are an option.

A. A New Entity

States should establish an expert local government finance entity (conveniently named the "Local Government Finance Commission" or "LGFC"), which should/must have substantial powers over local government finances. I will further specify the powers in the sections that

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Jessica Trounstine, *The Provision of Local Public Goods in Diverse Communities: Analyzing Municipal Bond Elections*, 73 J. Pol. 1038, 1039 (2011) (finding that more diverse cities issue bonds more rarely, but the bond issuances are larger and appeal to more constituencies).

follow. It should be noted that nothing in my LGFC model hangs on the details sketched below if a better way exists.

The LGFC should be given both democratic legitimacy and some independence. A promising way of doing this is to have the LGFC governed by board members who are themselves elected officials or who are selected by elected officials to represent the interests of specific groups. For instance, the state treasurer might sit on the board, along with three gubernatorial appointees, each of whom is required to have experience with a particular type of local government entity such as cities, counties, and schools. The legislature might get to make three appointments of its own from the same classes.[120] The board members should have staggered multi-year terms to maintain some continuity. Further, the LGFC should have sound governance woven into its DNA to the greatest extent possible. This can be done in several ways.

First, where desirable default rules are known to exist, they should be set by statute. The LGFC itself might be permitted to grant exceptions or to petition the legislature for reform, but if we believe in expertise—as we sometimes should—then the wheel should not need to be constantly reinvented.[121]

Second, excellent professional staff should be hired. Naturally, one way to do this is to offer competitive salaries. Another way is to organize the LGFC so that a significant percentage of its staff is drawn from local government business officials with significant experience. There are many reasons for this. First, to the extent that we seek knowledge aggregation, these experienced officials are the holders of important information, such as about the right mix of financing tools, and this is not being disseminated in many cases. Second, insofar as these long-term officials have good judgment, exercising such judgment is *not* a skill that can simply be disseminated by workshops or handbooks; good judgment can only be applied by holders themselves. Third, it seems more likely that current local government officials will be less resistant when oversight is administered by senior peers.[122]

120. This is just an example; there should presumably be representation for special districts in a state where they are important.

121. I can envision that a legislature may have an easier time agreeing on the need for the LGFC versus any specifics. In such a case, the LGFC should promptly issue regulations about recurring issues that admit of a clear solution, such as involving auction rate securities.

122. These first three reasons point to the sensible rule that, in general, experienced officials should be assigned to monitor the entities they are most familiar with—e.g., county officials should monitor counties. Of course, this rule should not be too rigidly applied lest groupthink take hold of one particular type of entity.

Fourth, because these senior officials have already made careers in the public sector, they are less likely to be captured by private industry.[123] This is not to say that the entity should not hire more broadly, as hiring narrowly would also defeat the end of creating a node of aggregated knowledge. On the contrary, there should be entry- and senior-level public policy experts, accountants, senior state officials, public finance professionals from private industry, and even visiting academics. The LGFC's various decisions should be subjected to horizontal review by peers of different specialties (e.g., a career accountant reviews the work of a former official) and vertical review so as to mitigate the likelihood of "groupthink," a particular danger for experts in a similar field.[124]

IV.
Tasks for the LGFC

At this point, it is time to move to specifics. The LGFC is intended neither to micromanage local governments nor to herald the "One and Only, True Set of Rules". Instead, we will examine particular areas where an LGFC could help set up and enforce menus of rules that lead to greater fiscal strength, including the power to change the menu and even authorize activities that are not on the usual menu.[125]

A. *Debt Issuance*[126]

In our traditional picture, we observed that borrowing is a necessary power, though it is one fraught with difficulties. As already indicated, it is likely that local government boards and officials, as individuals, are not well-equipped to make complicated financial decisions. Worse, a politician seeking reelection will often have an incentive to accept flawed proposals that promise a project now and payments later.[127] It has been suggested that the municipal markets

123. Unlike, for instance, the analysts at credit rating firms. *See* Jess Cornaggia et al., *Revolving Doors on Wall Street*, 120 J. Fin. Econ. 400, 401 (2016) (examining empirically the existence of a "revolving door" between credit rating agencies and the companies they rate).

124. Rachlinski & Farina, *supra* note 95, at 579–80.

125. That said, though I believe that it is crucial that I offer more specifics as to what an LGFC might do, the specifics are ultimately only meant as illustrations. Objecting to one of the hypothetical tasks that I outline below should not, I hope, prevent a reader from seeing the larger argument for the type of institutional intervention that the LGFC represents.

126. Some of the arguments in this section first appeared in David Gamage & Darien Shanske, *The Case for a State-Level Debt-Financing Authority*, 67 St. Tax Notes 188, 190 (2013).

127. *See supra* note 49.

constrain local governments to borrow wisely, and there is certainly something to this, but, as already discussed, the power of market monitoring is limited.

Fortunately, there are numerous bright-line rules and rules of thumb that can be of enormous help in structuring local financing. It is well-established that competitive sales are preferable to negotiated sales, so this practice should be the statutory default;[128] there may be exceptions, and the LGFC should be empowered to permit them. There should be a similar default rule governing interest rate structure; borrowings should be at a fixed rate for a term roughly as long as the useful life of the project that is being financed. Again, exceptions (if warranted) should be permitted by the LGFC.

This last rule can be explained and justified as followed: because local governments are ill-equipped to cope with asymmetric risk,[129] they should not take it on in the first place. Remember, local governments are properly subjected to hard budget constraints. At moments of crisis, local governments cannot simply borrow for operating expenses, nor should they count on support from higher levels of government. In truly difficult economic times, such a constraint can be hard to enforce, but there is certainly no good ex ante reason to allow local governments to court disaster. An auction rate security or, to a lesser extent, any variable rate security, should often offer *some* net savings to a borrower because the borrower is borrowing at shorter term rates, which are typically lower than long-term rates. But interest rates shift, and, if there is a big enough change, then the transaction is a liability and can be (very) expensive to terminate. Leaving aside the question of expertise in selecting such an instrument's details, local governments are not designed to sustain the asymmetric risk of loss, even for a likely and regular gain.

Put still another way, we might wonder about the value of a project if it can only be made to pencil out through taking on asymmetric risk. If the project is worthwhile without taking on the risk, then the price reflected by using ordinary financing (already subsidized by the federal and likely state tax exemptions) should allocate the cost evenly across cohorts. Saving money, at least upfront, through placing risk on later cohorts, is a way of shifting the true cost of a financing. At its most extreme, this is done though undertaking a project that would not have penciled out but for the creative financing. In such a case, a later cohort can get stuck paying for the asymmetric risk and then overpay-

128. *See, e.g.*, U.S. SEC. & EXCH. COMM'N, *supra* note 11.

129. This argument is drawn from Raineri & Shanske, *supra* note 4.

ing for the improvement when it needs to be refinanced using a traditional level financing structure.

It goes without saying that there are exceptions to this rule about borrowing structure. Should a sophisticated borrower with a lot of outstanding long-term debt hedge by exposing itself to short-term rates? Quite possibly. Should a big municipal power supplier purchase derivatives of various kinds relating to energy? Probably. This is why we are creating an expert commission and establishing bright-line *default* rules.

There are many other examples of rules of thumb that can be applied directly by the LGFC.[130] One such rule would be to always assume a low growth rate for a tax base. It is appropriate to assume that a tax base will grow in many circumstances, but the assumption should not be so aggressive that a prolonged but foreseeable slump will render a financing unaffordable. Relatedly, assumptions about new development should be scrutinized lest infrastructure is built for residents who never come. Both rules of thumb are essentially applications of the principle of avoiding asymmetric risk. To be sure, it may be better to plan future expenditures based on current actual revenue raised, but the potential benefits of doing so are outweighed by harms of projecting incorrectly and having relied upon misplaced optimism.

The LGFC can and should also inquire if a proposed project is being financed properly. It might be that general taxes *can* fund a project, but this does not mean that they *should* (at least not exclusively). The LGFC can ask local governments potentially uncomfortable questions if the government is not using user fees or assessments to control utilization of a scarce resource.

In applying these default rules and pragmatic rules of thumb, the LGFC will be dispensing and dispersing expert knowledge to local decisionmakers; it will also be affecting the decisionmakers in other, less concrete ways. Consider a semi-stylized example of the current regime, as modified by the addition of LGFC. An assistant business official is promoted to chief business officer of a school district and is charged with completing the first financing the district has done for five years. The official, the superintendent, and the school board do not have any experience in public finance. The most experienced participants will be the financial intermediaries such as the bond lawyer

130. *See* Robert W. Doty, *The Readily Identifiable Riskiest Municipal Securities: Due Diligence* Does *Make a Difference*, 32 MUN. FIN. J. 63, 71–72 (2011) (noting the importance that governance and disclosure reforms made in shielding California land-secured financings from default during the fiscal crisis even as many similar Florida financings defaulted).

and investment banker, as well as any additional consultants that might be needed (e.g., an absorption consultant to estimate the size of new development). It is easy to see why the absorption consultant might provide aggressive assumptions so as to justify a larger financing and why none of the other participants might object: The intermediaries are likely paid only if there is a financing, and are likely paid by commission based on the size of the financing. Leaving aside any rules an LGFC official might apply when reviewing the proposal, knowledge of the fact that such a review will be conducted and be conducted by an experienced and disinterested retired school business official might change people's behavior ex ante. For intermediaries who aspire to be repeat players, there are even greater incentives to avoid a reputation with the LGFC as being the actor whose aggressive analyses landed a locality in hot water.

1. The Non-Special Case of Employee Pensions and Benefits

Long-term employee pensions and benefits, particularly those that involve retirement or health care benefits, are long-term debts of local governments.[131] Though the scale of the problem is fiercely debated, there is a broad consensus that state and local governments have not budgeted properly for these obligations.[132] There are also many pension funds—almost 4000 as of 2013.[133] Leaving aside what to do about the current funding gap, the question we address now is what should be done going forward. The short answer is that these contracts, as a form of debt, should be treated like other forms of debt.

131. The exact legal nature of this debt is largely a matter of state law, but could also raise federal statutory and constitutional issues. *See* Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617, 618–21 (2010).

132. Current estimates of the funding gap for retirement benefits start at about $1 trillion and go up from there. *See, e.g.*, Craig Foltin et al., *State and Local Government Pensions at the Crossroads: Updating Accounting Standards Highlight the Challenges*, CPA J. (May 2017), https://www.cpajournal.com/2017/05/08/state-local-government-pensions-crossroads/. For a summary of some of theoretical issues involved in estimating the gap, see Siona Listokin-Smith, *Public Employee Pensions and Investments*, *in* OXFORD HANDBOOK OF STATE AND LOCAL GOVERNMENT FINANCES 853–54 (Robert D. Ebel & John E. Petersen eds. 2012).

133. PHILIP VIDAL, U.S. CENSUS BUREAU, ANNUAL SURVEY OF PUBLIC PENSIONS: STATE- AND LOCALLY-ADMINISTERED DEFINED BENEFIT DATA SUMMARY REPORT: 2013: ECONOMY-WIDE STATISTICS DIVISION BRIEFS: PUBLIC SECTOR (2015), http://www2.census.gov/govs/retire/g13-aspp-sl.pdf. Indeed, this is no accident, as "many local governments want to have pension benefit programs that are tailored to their employees" and "therefore, more local governments choose to manage their own pension plans and assets than they do their idle cash." Jun Peng, *Cash, Investments, and Pensions*, *in* MANAGEMENT POLICIES IN LOCAL GOVERNMENT FINANCE 309 (John R. Bartle et al. eds., 6th ed. 2013).

In particular, the kinds and scale of compensation needs to be restricted to a menu of options that is to be reviewed regularly.

The pension problem illustrates many of the concerns that motivate creating an LGFC. Well-known cognitive limitations and biases make it very difficult for individuals to save for retirement, which is one of the reasons why defined benefit plans are so attractive.[134] Those same limitations that affect individuals in planning for retirement are only more pronounced when those same individuals must make decisions as government officials about pension benefits. Not only is the budgeting problem here inherently difficult, but local government officials at any one moment in time also have incentives to accept optimistic projections. Indeed, to the extent that local government officials are prevented by revenue constraints from offering increased compensation, these restrictions channel them into offering more generous deferred compensation. An asymmetry in local government powers (such as how the power to contract for future benefits is greater than the power to tax for current salaries) incentivizes poor decisions that, as a matter of individual psychology, individuals are already primed to make.

Leaving to one side the behavioral finance arguments, it seems clear that there is a good reason to permit local governments to adjust current salaries funded by current tax dollars. Such autonomy encourages local differentiating and monitoring, with some assurance that, if a local government gets too far out of line, it can expect a correction either through voice, exit, or both. By contrast, and again with the case of debt generally, this argument for autonomy is much attenuated when the borrowing and spending will happen over many years (as is the case with pensions) and beyond what current politicians, officials, and even voters could reasonably expect to impact them.

There is a simple solution to this problem, namely, mandating that local governments cannot offer defined benefit pensions on the reasonable theory that their complexity is analogous to other complex financial instruments I am arguing should be limited. There is something to this argument, but it omits the fact that even complex instruments ought to be permitted by our new LGFC in certain circumstances, and perhaps this is such a circumstance. After all, the rationale for defined benefits is to combat the same kinds of myopia (on the individual level) that makes these plans hard to administer. Furthermore, though government officials may indeed have additional

134. KLING ET AL., *supra* note 27, at 73–74; *see also* Robert Novy-Marx & Joshua D. Rauh, *Linking Benefits to Investment Performance in US Public Pension Systems*, 116 J. PUB. ECON. 47, 47 (2014).

perverse incentives to get pension programs wrong, governments also have additional resources relative to individuals to get the calculations right (at least in the long run). The LGFC should be a mechanism for bringing these resources to bear.

To be sure, there are sensible compromises worth an expert's time to explore. For instance, there are clever proposals for hybrid plans that split the investment risk between individuals and governments.[135] And perhaps entirely new programs are not required so long as the assumptions made by governments are sufficiently conservative; monitoring assumptions is clearly a role a LGFC can perform. There are also best practices that can be mandated, such as ensuring the best possible relationship between the projected pool of retirees and the community financing the pension. In general, any particular part of a state is at greater risk of downturn than the state as a whole. Thus, if a particular county hits a rough patch, then it is going to have a tough time paying benefits it promised in better times. It would be much better if the county retirees were part of an overall state pool and better still if many states shared pools.[136] To enable smoother integration, it would be important for all of the different entities to offer similar plans. Each of these plans should itself be the product of significant expert analysis, not only of growth rates but also of integration into larger federal regulatory programs, such as Social Security, the Affordable Care Act,[137] and Medicare. The current number of plans (4000) may well be about 3950 too many.

The LGFC proposal might also enable better public contracting outcomes. To be sure, as to pension benefits, the LGFC proposal would limit options. At the same time, however, the LGFC proposal would also increase the options for localities to raise more revenue for current or future salaries, though again within constraints, and, thus, a more generous financial arrangement could be reached. This more generous financial arrangement could, in theory, prevent negotiations from being channeled into issues of workplace conditions that arguably intrude upon matters of policy (e.g., school class size).[138]

135. *See, e.g.*, Novy-Marx & Rauh, *supra* note 134, at 50.

136. *See* Brooks II, *supra* note 69.

137. Or its replacement.

138. *Cf.* Martin H. Malin, *The Paradox of Public Sector Labor Law*, 84 IND. L.J. 1369, 1391 (2009) ("The paradox of public sector labor law is that to avoid antidemocratic aspects of public sector collective bargaining, the law has channeled public employee unions away from investing in the risks of the public enterprise and toward insulating their members from those risks. Unions have done such an effective job in their channeled role that their collective bargaining agreements can impede effective government.").

To sum up, long-term employee contracts are a form of debt. If localities are to be given the power to provide pensions and other retirement benefits, then these powers should be channeled in a manner analogous to how borrowing is otherwise treated. Furthermore, to the extent that pension promises have been too extravagant, this is at least in part a product of how local government officials often have so few other fiscal levers to manipulate. As part of a larger set of reforms that fiscally empower local governments, therefore, an LGFC may encourage better pension practices because local governments will have to subject their decisions to a more exacting review in assessing liabilities and revenue streams. This, of course, brings us to taxes.

B. Local Revenue Instruments

In the traditional model, the property tax is *primus inter pares* among revenue instruments for local governments. To be sure, we should limit the use of the property tax through ensuring that, where possible, user charges are paid.[139] Despite its primacy, there is, in fact, a strong argument that a variety of other general taxes should be made available to localities. Put technically, the argument is that different taxes spur evasion behavior along different margins.[140] Because the cost of evasion increases exponentially with an increase in the tax rate, imposing more taxes that are each set at a lower rate is the better choice, all else being equal.[141] Having such a diverse basket of taxes also helps keep property tax rates lower, which helps to sustain the central pillar of local government finance by not overburdening it.

It is also the case that these other levies can be applied (at least roughly) consistently with the benefit principle, which is another reason that local government entities could raise more revenue from a variety of instruments without creating more deadweight loss. For instance, a local sales tax levied at the site of sale reflects that a locality provided some additional increment of government service to provide a market. Similarly, a local business activity tax designed to operate on the source principle reflects that a government might provide services to businesses over and above what they provide to individual residents.[142]

139. *See* notes 109–112 and accompanying text.

140. *See* David Gamage, *How Should Governments Promote Distributive Justice?: A Framework for Analyzing the Optimal Choice of Tax Instruments*, 68 TAX L. REV. 1, 24 (2014).

141. *See* David Gamage, *The Case for Taxing (All of) Labor Income, Consumption, Capital Income, and Wealth*, 68 TAX L. REV. 355, 381 (2014).

142. Bird, *supra* note 84, at 2.

To put the argument more concretely, consider the following hypothetical cities. City *A* is located right by a beautiful beach. City *B* is located at the confluence of several freeways. City *C* is the heart of a major metropolitan area. City *A*, because of its proximity to an attractive amenity (the beach), is going to be blessed by high property values. Residents and businesses cannot move out without losing the amenity. City *B* might not be blessed with such high property values, but it is well-located to host a number of big box stores that could generate substantial sales taxes, though, among other things, it needs to invest in adequate traffic control. City *C*, as an urban center, certainly generates some substantial revenue from its property and/or sales taxes. Yet, in competition with its suburbs for sales and residents, it is likely not going to generate enough revenue because of the typical scenario where the central city is, in essence, being asked to finance regional public goods. Thus, there are many businesses located downtown, with workers commuting to those businesses from the suburbs. City *C* can generate substantial revenue by imposing an income tax—or business activity tax—on those who commute to downtown.

As this not-so-hypothetical illustrates, local governments respond in ways consistent with the insight about multiple tax instruments—when they can.[143] Many states, however, limit the kinds of taxes that localities can impose, and there is at least one very good reason for this: states do not want local governments imposing a large variety of different taxes and creating a significant burden for individuals and businesses. Fortunately, we do not have to give up on this policy expedient for this reason. The transaction costs and common pool problems can be addressed through the combination of smart legislation and the work of our new Local Government Finance Commission.

States should diversify and standardize their tax bases. Not only should every state impose an income tax, sales tax, and property tax, but states should also impose estate taxes and business entity taxes. Once the state has established a wide variety of bases, all localities should be required to levy each tax at a low level (though perhaps not

143. HOWARD CHERNICK ET AL., INST. ON MUN. FIN. & GOVERNANCE & MUNK SCH. OF GLOB. AFFAIRS, UNIV. OF TORONTO, REVENUE DIVERSIFICATION IN LARGE U.S. CITIES 1 (2011), https://munkschool.utoronto.ca/imfg/uploads/176/chernick_imfg_no._5_online.pdf ("Our empirical results provide strong support for the hypothesis that a more diversified revenue structure generates more revenues than one that relies primarily on the property tax."); *see also* Bo Zhao, *The Fiscal Impact of Local-Option Taxes on Municipalities: The Case of Massachusetts*, 31 MUN. FIN. J. 63, 72, 80 (2011) (finding large differences in local revenue capacity relative to different local option taxes, though the poorest localities were the least helped).

the estate tax). Of course, should a state follow this advice, then all of these new taxes represent a common pool and, as we already have seen, there is evidence of overgrazing even of just the property tax.[144] Thus, there is a need for the coordinating entity to monitor local tax rates to ensure that the different entities do not create "tax holes." The LGFC is thus, again, a missing piece in our search for better state and local tax systems.

A combination of coordinating entity plus minimum rates would mitigate concerns about vertical and horizontal tax competition. Too much vertical competition over the same tax base produces overtaxation, which a coordinating entity can counter. Too much horizontal competition could lead to too little taxation and a race to the near-bottom; since every entity must collect at least some of each tax, there are enough systemic incentives to stop at some point before rock-bottom. Furthermore, the efficient operation of the tax system will hopefully be built on a base of efficiently levied user charges and vice versa; that is, sufficient general taxation should take the burden off of user charges, and adequate use of user charges and assessments should take some of the burden off of general taxation.

In addition, because there is a multiplicity of tax instruments, simply moving is not actually a panacea for would-be tax evaders, and this, too, militates against a race to the bottom. At the local level, moving seems like the single response that would lead to evading several different financial levies, e.g., assessments, property tax, source-based business activity tax, etc. This is misleading. First, in our ideal scenario, all these taxes would be levied by every government to some extent, along with benefit levies. Second, moving to a new home just outside a city might evade a city's relatively high property tax, but that action does not evade the sales tax one pays when one uses a city's stores or the incidence of any business activity tax that the city imposes on one's place of work (assuming it is in the city). We want residents to be responsive to tax rates but not needlessly so because the tax base or bases are poorly chosen. To take a silly example, suppose local governments could only fund themselves with estate taxes; estate taxes would be high and the elderly would move to jurisdictions

144. Or suppose a state does not act to create more state-level taxes, but instead liberalizes the ability of localities to impose a range of taxes. This is certainly a reasonable choice, but one that will make it more important still that the state regulates the taxes that a locality chooses to impose. For an argument for more local taxation, see Erin Adele Scharff, *Powerful Cities?: Limits on Municipal Taxing Authority and What to Do About Them*, 91 N.Y.U. L. REV. 292 (2016) (arguing that state law should grant municipal governments taxing authority that parallels municipal regulatory authority and would be subject to state preemption).

with little or no estate tax. In sum, providing localities with a wide variety of well-designed tax bases along with the traditional tools of public finance could go some way to preventing destructive horizontal competition.

But what are the rules the LGFC is to apply so to avoid creating "tax holes" and setting off destructive vertical tax competition? Here, it seems we have already hit a wall, as there is surely not a one-size-fits-all rule for how much of a common tax pool a service should consume.[145] For instance, a water or fire district in rural California might require many more resources than a suburban town elsewhere in California. Lacking precise knowledge, however, does not mean having no knowledge. There is good reason to believe that the proportion of common tax bases going to fire protection might vary, and our expert LGFC expert administrators, chosen in part for their experience and judgment, must surely be able to come to an adequate arrangement.[146] Indeed, with the weight of time, evolving scholarship, and precedent, one would expect that an LGFC could generate rules of thumb to guide such decisions in the future. After all, private developers and local governments, sometimes jointly and sometimes adversarially, need to assess the likely impact of a new development: How many new schools, police stations, etc., are needed for *X* number of new houses? Accordingly, there is already a literature that provides some reasonable baselines.[147]

There is another—and more direct—way for the LGFC to control tax externalities at the local level. Here, the issue is horizontal externalities. As explained above, local governments often fall over each other to offer tax breaks in order to encourage a business to locate

145. The Lincoln Institute's Fiscally Standard Cities project demonstrates the difficulty of the undertaking, but also its feasibility. *See*, *e.g.*, Howard Chernick et al., *Comparing Central City Finances Using Fiscally Standardized Cities*, 17 J. COMP. POL'Y ANALYSIS: RES. & PRAC. 430, 437 (2015). The LGFC of a given state could try to imitate this methodology for urban school districts, rural counties, etc.

146. In at least some cases, and perhaps the most important one, what the LGFC will need to monitor will be more open-and-shut. Remember that some studies of local government behavior demonstrate that one entity will raise its tax rate to take advantage of another entity having chosen to reduce rates. In such situations, there is at least a clear trigger for more searching LGFC review—e.g., if a city has just cut property taxes and the overlapping school district has increased its tax rate. *See supra* notes 78–80.

147. *See, e.g.*, Zenia Kotval & John Mullin, *Fiscal Impact Analysis: Methods, Cases, and Intellectual Debate* 5–6 (Lincoln Inst. of Land Policy, Working Paper No. WP06ZK2, 2006), https://www.lincolninst.edu/publications/working-papers/fiscal-impact-analysis; *see also* ADAM FOUND, INST. ON MUN. FIN. & GOVERNANCE & MUNK SCH. OF GLOB. AFFAIRS, UNIV. OF TORONTO, ECONOMIES OF SCALE IN FIRE AND POLICE SERVICES IN ONTARIO 17–20 (2012).

within their jurisdiction. It is doubtful that the individual winning locality is made whole in many cases, but, more fundamentally, the wider region may likely suffer losses, thereby creating an externality for the region.[148] To be more concrete, suppose a big box store chain is deciding where to open a new location, and suppose that Jurisdiction *A* wins the competition by offering a very generous property tax abatement. Even if the store is still a net benefit to Jurisdiction *A*, offering a tax break costs the entire region, because surely the big box store was going to locate somewhere within the area in order to be close to its customers.

The response to this problem is a simple rule forbidding locational subsidies. A model could be the one Congress considered in The Distorting Subsidies Limitation Act of 1999.[149] That act defined a "targeted subsidy" as a subsidy "designed to encourage any trade or business operation of such person to locate in a particular governmental jurisdiction or to remain in a particular governmental jurisdiction."[150] Such subsidies can be banned.

But the situation is not so simple. Just as there is a case for more complex financial instruments in some cases, there can be a place for locational subsidies, especially given that there is little restriction on the national level as to what governments can do in competition with one another.[151] Suppose that, instead of competing for a big box store that needs to locate in a certain economic area, the competition is for a manufacturing plant that might be located in another state. No state commission can police what another state (and its jurisdictions) might be doing, and, therefore, there is a fair argument that an entire region should be permitted to compete. Furthermore, we want localities to be able to modulate their tax and spending packages so long as the com-

148. *See, e.g.*, Professors' Amicus Brief, *supra* note 82; *see also* Alan O. Sykes, *The Questionable Case for Subsidies Regulation: A Comparative Perspective*, 2 J. LEGAL ANALYSIS 473, 476–77 (2010) (examining the efficacy and outcomes of subsidies).

149. Distorting Subsidies Limitation Act of 1999, H.R. 1060, 106th Cong. § 4986(c)(1)(A)(i) (1999).

150. *Id.*; *see also* Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 433–440 (1996) (making an extended argument for using the Commerce Clause to invalidate such subsidies).

151. *See generally* Sykes, *supra* note 148, at 479 ("Pending new developments in the doctrine, therefore, the dormant commerce clause places little constraint on state subsidies unless they can be characterized as a tax that discriminates against interstate commerce.").

petition does not cannibalize revenue from economic activity that would have happened anyway.[152]

Of course, recognizing some legitimate role for subsidies creates a line-drawing problem and a coordination problem. Both are problems the LGFC is well-suited to address. The LGFC can help decide when competition is inter- or intraregional, and the LGFC can coordinate superior and fairer competitive responses. Suppose that many intraregional localities are competing with one another and with other regions as well to attract a new business. The LGFC can cajole some of the neighboring localities to drop their bids and also to help win the business by promising to help provide needed regional infrastructure. The LGFC could do this cajoling of neighboring localities because it can condition the ability of the bidding locality to offer tax breaks at all on its willingness to share its new tax revenue regionally.

C. Regular Monitoring

We have already given the coordinating entity a number of assignments in connection with tax rates and debt, but it should also be charged with regular monitoring and given the power to make significant interventions beyond vetoing a tax rate or borrowing proposal. The possible issues with budgeting are similar to those that motivated reforms to taxing and borrowing. On the one hand, budgeting is complex and easy to get wrong. On the other hand, there are sensible budgeting rules of thumb, such as FCMAT's "Indicators of Risk or Potential Insolvency"[153] that can allow an expert monitoring entity to spot trouble earlier, in at least some situations.[154] Furthermore, just as there are rules of thumb for taxing, borrowing, and budgeting, there are also rules of thumb for dealing with various fiscal crises. Yet, despite the existence of this expertise, the particular officials at the local

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152. *See id.*; *see also* David E. Wildasin, *Fiscal Competition for Imperfectly-Mobile Labor and Capital: A Comparative Dynamic Analysis*, 95 J. PUB. ECON. 1312, 1316–17 (2011) (analyzing effects of taxation on long-run equilibrium levels of capital and labor).

153. Among the many factors that FCMAT looks for as "Indicators of Risk or Potential Insolvency" include: inadequate reserves, inadequate account of enrollment, inability to accurately estimate the ending fund balance and lack of control and monitoring of total compensation as a percentage of total expenses. FISCAL CRISIS & MGMT. ASSISTANCE TEAM, FISCAL OVERSIGHT GUIDE: FOR AB 1200, AB 2756 AND SUBSEQUENT RELATED LEGISLATION 81–82 (2015), http://fcmat.org/wp-content/uploads/sites/4/2015/12/Fiscal-Oversight-Guide-final-12-2015.pdf.

154. *Cf.* Richard M. Bird, *Reflections on Measuring Urban Fiscal Health*, 35 MUN. FIN. J. 47, 74 (2014) ("Even the best benchmarks can never replace the educated eye of an expert in providing a diagnosis of a given situation, although they may help by directing that eye to problematic areas.").

government at the moment of crisis have likely never seen such an event.

Returning to our original model of local government finance, we should note that what needs to be monitored is not simply the budget but rather whether the right fiscal tool for a given task is being used. This is crucial because, as we saw, there is a dynamic relationship between these different elements.[155] LGFC review may not guarantee results that perfectly balance the use of every fiscal tool in every situation, even if we could conceive of what such perfection entails. Indeed, the LGFC might even be comfortable with significant deviations from the benefit principle.[156] Nonetheless, the LGFC would be required to ask the right questions, which can itself be a powerful act. For instance, it might ask: Why should a planning department not be substantially financed by the fees from those who submit plans? Or, why should road projects not, as a matter of course, be financed through a combination of special assessments and local property taxes?[157]

V.
Extant Elements of Local Government Finance that Should Be Discarded

Special fiscal rules have long been part of the local government landscape, and they often responded to the same types of issues identified above. For instance, there are requirements for special elections before a locality can issue debt, rules governing the maximum amount of debt and maximum tax rates, etc. As a general matter, the argument of this Article is that these rules are unnecessary and generally deleterious. There are so many of these rules, and they take many different forms, but they are capable of being treated generally and critiqued broadly. Elsewhere, I have critiqued these rules as broadly ineffective at achieving the goal of limiting the size of government.[158] Here, I

155. *See* notes 105–109 and accompanying text.
156. The LGFC could not bless deviations from the benefit principle that overburdened a particular class of taxpayers, as doing so would violate benefit assessment law.
157. This is another opportunity to emphasize the limits of monitoring by the credit markets. If a bond to repave both regional and purely local roads is secured by a general obligation bond, which is ultimately a promise to raise the property tax, then bondholders are actually more—rather than less—secure than if a road maintenance bond were secured by some more appropriate combination of special assessments and the general property tax.
158. *See generally* David Gamage & Darien Shanske, *The Trouble with Tax Increase Limitations*, 6 Alb. Gov't L. Rev. 50 (2012) (exploring the theoretical implications of tax increase limitation rules on state legislatures).

focus on the fact that these rules do not address the issues with local government decisionmaking that one might think these rules were meant to address. It should be remembered that these fiscal rules directly reduce the autonomy of local governments. Thus, trading these fiscal rules for the guidance of the LGFC in the vein of this proposal should lead to a *net increase* in local government autonomy.

The main problem with the special fiscal rules at the local level is that they do not aid with knowledge aggregation. Take the inherently undemocratic supermajority rule: it prevents wise and foolish financings alike.[159] Or take various tax rate caps, which can hardly be conceived of as resulting from expert analysis. Even if the caps were appropriate at a given moment in time, the caps have now calcified, preventing modifications resulting from further expert or democratic input.[160] The caps do not at all respond to the common pool problem; in fact, they can make it worse by reducing the pool. Often, these two kinds of rules are combined: a largely arbitrary tax rate or debt cap along with an arbitrary supermajority threshold to override the cap.[161]

One might that this critique of special fiscal rules is too facile, that I have demolished a strawman because all I have shown is that these rules largely fail at a task they never set for themselves: namely, they fail to enhance—and, indeed, frustrate—local fiscal probity.[162]

159. And this is part of the general problem with supermajority rules; they calcify the system, but do not necessarily do so when the "right" or optimal settings and rules are in place. *See, e.g.*, MELISSA SCHWARTZBERG, COUNTING THE MANY: THE ORIGINS AND LIMITS OF SUPERMAJORITY RULE 128–29 (2014). This problem is arguably not that severe in the civil rights context because we might be sure we have identified the right rules, but this is surely a much more serious objection as to fiscal matters when so much can change about an economy (e.g., the shift to a service economy). Schwartzberg's central argument is that complex majoritarianism (e.g., requiring multiple votes over constitutional amendments over time) can be at least as effective at protecting minority rights and with much less of an impact on democratic norms. *Id.* at 182–204. The proposals here cannot be construed as complex majoritarian, but they do reflect a similar attempt to try to solve a governance problem through institutional design rather than through supermajority rules.

160. For a similar critique, see Gillette, *supra* note 60, at 1258 ("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.").

161. *See, e.g.*, CAL. CONST. art. XIII-A, § 1 (setting a one percent property tax rate limit and allowing that limit to be overridden by two-thirds or fifty-five percent supermajorities of voters under certain conditions).

162. I should note that, as of now, I am agnostic about special rules that require an election on tax or borrowing measures and require a mere majority. On the one hand, these are still special rules and so unwarranted to the extent that local governments are being properly channeled by the LGFC. Zoning decisions are not similarly constrained, for instance. Yet, especially given our concerns about the multi-generational nature of debt, there might be an argument that it would be salutary for politicians to

As a matter of history, these rules had lots of different objectives. Many rules governing local debt seem to have originated from an experience with poor financings,[163] and thus, the weakness of this rationale is relevant on its own terms. However, it is also the case that many rules governing local taxes seem to have emerged from concerns about overtaxing a wealthier minority. This is a reductive formulation, given that the many of the earliest supermajority rules were born in the American South during the Civil Rights Era and seem to have been put in place so as to continue to *oppress* a racial and economic minority.[164] Whatever their genealogy, these rules are now commonly justified as protecting the economic rights of the wealthy minority[165] or as deliberately making it harder for governments to act because of a belief that, on balance, governments are not likely to act well.[166]

This is not the place to engage in a debate about which minority rights should be enshrined in a constitution or present a global assessment of the efficacy of government. Nevertheless, the argument of this Article illustrates the weakness of these other arguments for local fiscal rules.

First and most fundamentally, suppose one accepts the argument that, as a matter of constitutional law, there should be a supermajority rule governing taxation in order to protect the (relatively) wealthy. Even if wealthy people need protection at the national or even state levels, what sort of local level injuries do they need to be protected from? The wealthy are particularly likely to be mobile and able to exit a jurisdiction that seeks to engage in excessive taxation. Furthermore,

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bring their proposals to voters. *Cf.* Richard Briffault, *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 952–55 (2003) (discussing voter approval requirements in debt limitations); Clayton P. Gillette, *Direct Democracy and Debt*, 13 J. CONTEMP. LEGAL ISSUES 365, 372–75 (2004) (exploring whether direct democracy has the efficiency-enhancing effects regarding debt issuance).

163. Rodriguez-Tejedo & Wallis, *supra* note 94, at 31–32.

164. KATHERINE S. NEWMAN & ROURKE L. O'BRIEN, TAXING THE POOR: DOING DAMAGE TO THE TRULY DISADVANTAGED 31–33 (2011).

165. GEOFFREY BRENNAN & JAMES M. BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION 196–98, 202 (1980).

166. John O. McGinnis & Michael B. Rappaport, *Majority and Supermajority Rules: Three Views of the Capitol*, 85 TEX. L. REV. 1115, 1160 (2007) ("While majority rule is better than supermajority rule when legislators' accuracy rates are over 50 percent, it is worse when the accuracy rates are under 50 percent. Citizens may be uncertain of legislative accuracy rates. Even if they believe it is more likely than not that accuracy rates are over 50 percent, they may also believe that there is a substantial possibility that these accuracy rates may be under 50 percent. Under those circumstances, supermajority rule may be better than majority rule because it reduces the risk of really bad results.").

the LGFC, through its monitoring function, can serve as at least a partial check on the improbable jurisdiction inclined to overtax its wealthiest residents. The LGFC is certainly a check on local governments looking to saddle costs on their neighbors or future generations.

Second, if the motivation behind these rules is suspicion of government expertise, then there is an odd tension present. From whence do these constitutional rules come if not government expertise?[167] To be sure, these constitutional rules are broader in scope (and less flexible) than the rules we would hope an LGFC would develop, but surely this means that even more expertise is required to get these constitutional rules correct.[168]

Third, the special fiscal rules being targeted here are those that often work at cross-purposes. They are not a quick and simple supplement to the type of regulation provided by an LGFC. To see the problem, consider one typical fiscal rule and one new rule likely to be implemented by an LGFC.

A typical fiscal rule requires a local two-thirds majority before debt can be issued.[169] The LGFC rule limits the riskiness and possibly even the expense of the debt structure that a locality can use. If a locality has to run the gauntlet of achieving a two-thirds majority every time it wishes to issue debt, it will have an extraordinary incentive to squeeze every penny it can out of that debt authorization, even using a riskier debt structure that promises more money upfront.[170] The situation is made difficult by the fact that the locality might not be able to muster another supermajority for years. Thus in a world where the LGFC is layered on tops of supermajority rules, well-designed

167. And this question is not just rhetorical. If these rules have a goal—say, to protect the wealthy minority—then, for example, the tax cap must not be set too high or the wealthy minority might be overtaxed.

168. Perhaps the argument is that there is indeed constitutional expertise, but not bureaucratic expertise. There is a literature that argues as much, but these arguments are implausible. Consider the details of the institutions canvassed by this Article; is it really plausible to argue that a default rule for selling bonds competitively is a license for a retired school business official to build a fiefdom? *Cf.* Daryl J. Levinson, *Empire Building in Constitutional Law*, 118 HARV. L. REV. 915, 920 (2005) ("In sum, rampant government empire-building would seem to require government officials who care about the interests of the institutions in which they are situated more than their own self-interest or the interests of the citizens they represent. Democratic governments are unlikely to generate such officials.").

169. *See, e.g.*, CAL. CONST. art. XVI, sec. 8.

170. This is not just a hypothetical. School districts in California likely issued more expensive debt obligations at least in part to remain within the confines of a tax levy cap. *See, e.g.*, L.A. CTY. CIVIL GRAND JURY, CAPITAL APPRECIATION BONDS AND OTHER SCHOOL BOND DEBT: CONSEQUENCES OF POOR FINANCIAL PRACTICES 103 (2016), http://www.calboc.org/docs/LACGJ_CAB_Final2015-2016.pdf.

financings desired by a majority of local voters are thwarted, which creates pressure on the LGFC to permit riskier structures when debt authorization is available. If the LGFC accedes to the pressure, then it is not doing its job. If the LGFC holds firm, good projects are not done.

In sum, I have made an argument for why a system of fiscal federalism augmented by an LGFC ought to make better financial decisions and have collected some evidence suggesting that this analysis is correct. On the other side, we know that supermajority rules do not contribute to knowledge aggregation and did not prevent localities from issuing auction rate securities, taking on onerous pensions, relying on poorly designed taxes, and offering dubious tax incentives. Furthermore, I have presented arguments as to *how* the LGFC might be designed to help local decisionmaking rather than just dictate to local governments. I have also explained how these kinds of fiscal rules would make the work of the LGFC more difficult. At the very least, these arguments would seem to shift the burden of proof to the supporters of these rules.

Conclusion

As we enter the second year of the Trump era, it is likely that suboptimal local government financing will not even be on most people's list of things to worry about. Yet, it should be a concern, and states should act to protect their local governments for at least three reasons.

First, there are ultimately billions of dollars at stake, with or without the Trump infrastructure plan. We will need to pay for our failing infrastructure somehow, even if that means continuing to bear the shared cost of having substandard infrastructure. Certainly, if the Trump plan were to make billions in additional funding available, the states should act to make sure that it is used as wisely as possible.

Second, the approach underlying the Trump plan poses a great danger for those who believe in local democracy. If, as is likely,[171] the Trump plan results in manifestly poor outcomes for (unmonitored) local governments, then, superficially, this failure confirms a narrative that governments are not the answer.[172]

171. Again, so-called P3 projects do not have a great track record in this country. *See, e.g.*, Matthew Goldstein & Patricia Cohen, *Public-Private Projects Where the Public Pays and Pays*, N.Y. Times, June 7, 2017, at B1.

172. Note that this is something of a Catch-22 because, if the financings envisioned by the Trump plan work more or less as intended, then they will succeed in privatizing more of the most valuable pieces of public infrastructure, which will also confirm the

Third and most important, the reason to pursue this reform is that states should pursue it anyway. None of the arguments for an LGFC relies on the advent of a particularly misguided federal initiative. Rather, they derive from the nature of local government itself. Local democracies are an excellent means of having communities decide for themselves what kind of places they wish to be, but they are not an excellent means of deciding on all the financial details required to achieve their vision.

narrative about the ineffectiveness of government. Of course, just because a public-private partnership functions reasonably does not demonstrate that it was the better option. In any event, the evidence seems clear that a widespread use of P3 will only succeed if governments use it wisely from the start and thus the success of P3, should it occur, would actually be a (subtle) demonstration of the power of governmental expertise.