DO MARKETS WORK BETTER THAN LEGAL RESTRAINTS? A RESPONSE TO CLAYTON GILLETTE'S "FISCAL HOME RULE"

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Professor Clayton Gillette takes a dim view of state-imposed limitations on municipal taxing and borrowing authority. While recognizing their poor performance of late,[1] Gillette concludes that "markets," however imperfect, are likely to work better than "artificial" legal restraints at ensuring the fiscal health of local governments.[2] Gillette's preference for markets over legal restrictions may strike the reader as a curious one given recent economic events. With the bust of the housing bubble, the subprime mortgage meltdown, and the collapse of once-venerable Wall Street firms, the American public and its elected leaders have increasingly embraced government intervention in the marketplace.[3] Why, then, does Professor Gillette maintain his faith in markets as the best tool for preventing the abuse of municipal fiscal authority?

Part of the reason Professor Gillette prefers "markets" is because he uses that term broadly to include the Tieboutian market for residents and business owners. Gillette believes that this market, which bears little resemblance to the financial markets that have foundered in recent months, more effectively prevents local officials from imposing excessive taxes than constitutional limitations on municipal taxation.[4] Gillette's reliance on the Tiebout theory in criticizing hard limits on municipal taxation authority seems reasonable, although as Gillette recognizes, the theory's value as a descriptor of urban dynamics is significantly limited by its heroic assumptions.[5]

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1. Clayton P. Gillette, *Fiscal Home Rule*, 86 DENV. U. L. REV. 1241, 1259 (2009). *See also* Aaron Unterman, *Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era*, 5 HASTINGS BUS. L.J. 53 (2009); Jon Meacham & Evan Thomas, *We Are All Socialists Now*, NEWSWEEK, Feb. 16, 2009, at 23.

2. Gillette, *supra* note 1, at 1248, 1259.

3. *See* Meacham & Thomas *supra* note 1, at 23; David E. Sanger, *Selling a New Deal, but Promising it Will be Brief*, N.Y. TIMES, Feb. 24, 2009, *available at* http://www.nytimes.com/2009/02/25/us/politics/24web-sanger.html.

4. Gillette, *supra* note 1, at 1255.

5. *Id.* at 1243; *see also* Gerald E. Frug, *City Services*, 73 N.Y.U. L. REV. 23, 26 n.8 (1998) (citing Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956); Wallace E. Oates, *On Local Finance and the Tiebout Momdel*, 71 AM. ECON. REV. PAPERS & PROC. 93, 93 (1981); Lyke Thompson, *Citizen Attitudes About Service Delivery Models*, 19 J. URB. AFF. 291 (1997)).

Not all cities are restrained by taxation limits that are as "blunt and inflexible" as those on which Gillette focuses his criticism.[6] In some states, limits on revenue-raising authority may be circumvented by popular vote while in other states, the state constitution limits only certain types of taxation. By allowing voters and municipal officials some flexibility in determining revenue, these softer restraints may offer an alternative to the hard limits that Gillette dislikes and the crudely functioning Tieboutian "market" that he prefers. Rather than leaving elected officials to guess what level of taxation is likely to be so excessive as to spur an exodus of residents and business owners, soft restrictions allow voters to register their preferences for taxation levels through democratic means. As I will explain, however, these evadable revenue-raising restrictions have proved surprisingly sticky. This stickiness suggests that even limitations less rigid than those criticized by Gillette may have an appreciable impact on voters' preferences for taxation and, therefore, the ability of local governments to raise revenue.

In arguing against municipal debt limitations, Professor Gillette relies more on conventional market mechanisms like the financial institutions—including banks and rating agencies—that have performed so poorly of late. Gillette believes that these institutions will better restrain municipalities from excessive risk-taking than legal debt restrictions. Although there are salient differences between the market for municipal debt and the markets for mortgages and mortgage-backed securities that have recently imploded, one hesitates to share Gillette's faith in the very ratings agencies and bond trading houses that have contributed to the nation's economic pain of late.[7] On the other hand, Gillette rightly identifies these actors as potential providers of information useful to voters seeking to monitor elected officials' behavior. To that end, in the context of debt limitations, particularly when they—like tax limitations—can be circumvented by public vote, market forces can work in conjunction with the plebiscite to restrain excessive borrowing by public officials.

I. LIMITATIONS ON TAXATION

Gillette assesses the constitutional restrictions many states have imposed on property tax rates as "blunt" instruments, and in some states they are, severely constraining local governments' ability to raise revenue.[8] In other states, however, constitutional provisions impose softer limitations on local taxing authority. In California, for instance, Proposition 13 has severely constrained cities' ability to raise revenue through

6. Gillette, *supra* note 1, at 1261.

7. Gretchen Morgenson, *Debt Watchdogs: Tamed or Caught Napping?*, N.Y. TIMES, Dec. 7, 2008, at A1.

8. Gillette, *supra* note 1, at 1253.

taxes on real property.[9] California cities, however, are free, with voter approval, to raise the sales tax beyond the state level and keep the incremental amount collected to fund local services.[10] In Oregon, a series of state constitutional amendments adopted by popular vote in the 1990s limited the ability of local governments to raise revenue through property taxes.[11] The voters in Oregon cities and counties can approve the circumvention of these limits, however, by passing a "local option levy" to raise additional funds for local services.[12] Moreover, Oregon cities remain free to impose income and sales taxes within their jurisdictions.[13]

Softer state constitutional restraints like Oregon's and California's represent something of a hybrid between the hard limits imposed by state constitutions, which Gillette dislikes, and a system that relies solely on market-based constraints, which Gillette prefers. In contrast to market-based restrictions, soft limitations rely to some degree on residents expressing their preference for taxes and services by voting with their ballots rather than only with their feet. Because "consumer-voters," particularly residents, are not as mobile as the Tiebout theory assumes, softer limitations may better elicit voter preferences than the functioning of the Tieboutian market envisioned by Gillette.[14] Soft limitations also may reflect a judgment that the expression of residents' preferences through "voice" rather than "exit" has its own value.[15]

But just how soft are soft limitations on local revenue-raising authority? In states like California, allowing cities to adopt incremental sales taxes clearly does not fully compensate for cities' constricted ability to tax real property in a post-Proposition 13 regime. Voters in California cities can opt for a higher municipal revenue stream, but only in a manner they might consider less favorable than increased property taxes. Moreover, voters who might otherwise prefer a higher-tax, more-services mix may nonetheless vote against a sales tax increase because they fear, with some good reason, that the increase will drive away businesses

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9. CAL. CONST. art. XIII.A; *see generally* ARTHUR O'SULLIVAN ET AL., PROPERTY TAXES AND TAX REVOLTS: THE LEGACY OF PROPOSITION 13 (1995).

10. Coleman v. County of Santa Clara, 75 Cal. Rptr. 2d 516 (Cal. Ct. App. 1998); Neecke v. City of Mill Valley, 46 Cal. Rptr. 2d 266 (Cal. Ct. App. 1995). In those cities or counties that do not adopt a higher sales tax, state law already allocates a one-percent increment out of the state-imposed sales tax of approximately seven or eight percent to local governments. *See* PAUL GEORGE LEWIS & ELISA BARBOUR, CALIFORNIA CITIES AND THE LOCAL SALES TAX 5 (1999).

11. In particular, Ballot Measures 5, 47, and 50, passed in 1990, 1996, and 1997, respectively, limited the ability of local governments to raise revenue through the property tax. *See* Paul Diller, *The Partly Fulfilled Promise of Home Rule in Oregon*, 87 OR. L. REV. 939, 970-71 (2009); David H. Angeli, *The Oregon Legislature's Constitutional Obligation to Provide an Adequate System of Public Education: Moving from Bold Rhetoric to Effective Action*, 42 WILLAMETTE. L. REV. 489, 493 (2006).

12. OR. REV. STAT. § 280.060 (2007).

13. Diller, *supra* note 11, at 971.

14. *E.g.*, Frug, *supra* note 5, at 26.

15. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY (1970).

(who are more likely to vote with their feet than residents).[16] Voters who prefer higher taxes and more services might also vote against a sales tax increase because they fear, with some justification, that it will distort the city's approach to land use: the more reliant the city becomes on sales taxes, the more likely it will adopt a zoning code that favors retail sales, accelerating strip mall development and suburban sprawl.[17] California's soft limitation, therefore, has hard consequences on the menu of choices available to voters.

In states like Oregon that have property tax limitations that can be circumvented to some degree by popular vote,[18] the soft limitations imposed by state law have proved surprisingly sticky. On the surface, the availability of the "local option levy" to communities preferring a higher-tax, more-services mix allows residents a democratic vehicle through which to express their preferences. In practice, however, cities and counties have found it difficult to pass local option levies, with the success rate of those placed on the ballot only about thirty-three percent.[19] Moreover, this thirty-three percent "success" rate relies on a denominator that excludes many revenue-raising proposals floated publicly by local officials but ultimately not placed on the ballot because public opinion polls indicated that they were likely to fail.[20] The reluctance of Oregon voters to adopt local option levies may accurately represent local voter preferences. On the other hand, the requirement of voter approval for a local option levy and the establishment of a state-imposed default taxation baseline likely have an effect on resident preferences for taxes and services. In other words, voters' preferences for tax-service packages are not necessarily stable and are not determined independent of the manner in which the preferences are expressed.

In Oregon, for instance, prior to the state's soft constitutional limitations, local officials could increase the property tax rate without voter approval.[21] The subsequent statewide adoption of a constitutional limita-

16. Richard Briffault, *Our Localism: Part II-Localism and Legal Theory*, 90 COLUM. L. REV. 346, 421 (1990).

17. *See generally* LEWIS & BARBOUR, *supra* note 10; Jonathan Schwartz, Note, *Prisoners of Proposition 13: Sales Taxes, Property Taxes, and the Fiscalization of Municipal Land Use Decisions*, 71 S. CAL. L. REV. 183 (1997).

18. Oregon voters may not circumvent the constitution's limitations on the valuation of real property for taxation, OREGON CONST. art. XI § 11(2), but they may vote to increase the tax rate on assessed property in the taxing district for up to five years or ten years for capital projects. *Id.* § 11(4)(a)(A).

19. *See* Oregon State Univ. Media Release, OSU Study: County Budget Crisis to Have Impact on Roads, Law Enforcement, July 9, 2008, http://oregonstate.edu/dept/ncs/newsarch/2008/Jul08/Roads.html.

20. *E.g.*, Mark Larabee, *Portland Voters Won't See Road-Repair Fee Hike on Ballot*, OREGONIAN, July 25, 2008, at B2 (explaining how Portland council member decided not to refer gas-tax hike to voters because polling indicated the increase would not pass).

21. *E.g.*, Fran Gardner, *School Board Approves $310 Million Budget*, OREGONIAN, Apr. 27, 1989, at C2 (discussing Portland School Board vote increasing "tax rate for the district [from $16.08] to $16.71 per $1,000 assessed valuation").

tion on property taxes, even if soft, however, may have framed voters' views as to what is the appropriate level of taxation by establishing a baseline that voters privilege.[22] When city officials seek to raise revenue beyond the baseline, an "endowment effect" may cause voters to see this increased taxation as a loss they would not feel had state law not established a baseline.[23] Moreover, subjecting property tax increases to a local plebiscite may cause voters to focus on the loss of the extra property tax more than if it were simply enacted by a majority vote of the city council or board of education. By making property tax increases the subject of an up-or-down plebiscite, a local option levy increases the justificatory burden on local officials who support the measure. As a result, in states like Oregon, local officials must engage in extensive campaigns to "sell" voters on why the increased property tax is meritorious.[24] In sum, although they might seem like a way in which community preferences for taxation can be elicited, even soft revenue-raising limitations prove somewhat hard by changing those preferences themselves.

II. DEBT LIMITATIONS

In the context of debt limitations, Professor Gillette's reliance on financial markets and institutions as a restraining force is somewhat questionable in light of their recent performance. On the other hand, Professor Gillette acknowledges that he does not expect these markets to be the only force restraining excessive borrowing by municipal officials even in the absence of hard constitutional limitations. Rather, Gillette sees the financial markets as providing information for voters to use in monitoring the actions of their local officials. Nonetheless, Gillette argues that financial markets and the interest rates they produce will likely provide the main check on excessive borrowing by local authorities.

Gillette acknowledges that constitutional municipal debt restrictions are not always "hard." Rather, many of the limits can be evaded if debt can legally be classified as a certain type. Gillette frowns on some of the more recent "[m]achinations for circumventing debt limits," such as "moral obligation" bonds,[25] the combined use of which can make it

22. *See* Edward J. McCaffery & Jonathan Baron, *Thinking About Tax*, 12 PSYCHOL. PUB. POL'Y & L. 106, 108 (2006) [hereinafter McCaffery & Barron, PSYCHOL.] (citing I.P. Levin et al., *All Frames Are Not Created Equal, A Typology and Critical Analysis of Framing Effects*, 76 ORG. BEHAV. & HUM. DECISION PROCESSES 149 (1998); A. Tversky & D. Kahneman, *The Framing of Decisions and the Psychology of Choice*, 185 SCIENCE 453, 453-58 (1981); A. Tversky & D. Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. 151, 151-78 (1986)); *see also* Edward J. McCaffery & Jonathan Baron, *The Political Psychology of Redistribution*, 52 UCLA L. REV. 1745, 1774 (2005) [hereinafter McCaffery & Baron, UCLA].

23. *See* McCaffery & Baron, PSYCHOL., *supra* note 22, at 108-09; *see generally* Rossell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227 (2003).

24. *E.g.*, Jennifer Anderson, *Portland Public Schools Parents Mobilize Levy Campaign*, PORTLAND TRIB., Sept. 15, 2006 (describing campaign to convince voters to approve local option levy for Portland schools), *available at* http://www.portlandtribune.com/news/story.php?story_id=115828679645386300.

25. Gillette, *supra* note 1, at 1256.

harder for voters to know the locality's "true debt position."[26] Gillette briefly acknowledges another major way in which debt limitations are soft: in many states, they may be overridden by a majority—or sometimes supermajority—vote of residents.[27]

As in the case of tax limitations, soft debt limitations may affect voters' preferences rather than simply provide a vehicle through which those preferences can be expressed. By setting a particular level of indebtedness as a ceiling beyond which the city needs a majority vote to exceed, these systems may cause voters to privilege the preset ceiling more than they would if the city's debt level were being established anew, or if the city's level of indebtedness were determined by an elected council.[28] Because the costs of increased indebtedness are not immediately felt by voting residents in the same way that tax increases are, however, any "endowment effect" created by the state-imposed soft limits may be smaller than in the tax context.[29] Regardless, similar to soft tax limitations, soft debt limitations likely increase the justificatory burden on local officials seeking to increase municipal debt.[30]

Soft debt limits also present an ostensible alternative to the Tieboutian model by allowing voters to express their preferences through the ballot box rather than only via exit. Given that voters are likely to have very little conception of what a good level of indebtedness is for the city, they are likely to approve or not approve circumvention of a soft debt limit more on the basis of the perceived merits of the particular projects for which the extra debt will pay, rather than on some detached assessment of the city's credit position. In this sense, soft debt limitations can serve as a vehicle through which voters express their opinion of city leadership and its preferred projects, a signal which may be useful to local officials concerned about voter preferences.[31]

CONCLUSION

Overall, Gillette is right to doubt the utility of constitutional taxation and debt limitations. While in their softer forms these restraints seemingly allow more democratic input from voters, in doing so, as I have attempted to illustrate here, the limitations may affect the preferences of the voters. Exactly what the voters' "true" preferences for taxation and debt levels are is an issue that cannot be determined independent of the manner in which those preferences are elicited. Hence, while Gil-

26. *Id.* at 1257.

27. *Id.* at 1258.

28. McCaffery & Baron, UCLA, *supra* note 22, at 1774.

29. *Id.* at 1774-75 (observing that people are likely to discount the future costs of current deficits).

30. *E.g.*, Kimberly Melton, *Maintenance To-do List Requires Bonds—Mt. Hood Community College Bond Issue*, OREGONIAN, Oct. 19, 2006, at Metro East Neighbors 1.

31. *Cf.* McCaffery & Baron, PSYCHOL, *supra* note 22, at 118.

lette is right that state-imposed hard limitations on local revenue-raising and debt-incurring authority "artificially" constrain voters' ability to select the level of taxation and debt that they consider optimal, even softer limits likely affect voters' preferences. Whether this phenomenon is salutary depends on considerations beyond the scope of this paper, such as the importance of the programs a city may not be able to afford once its residents' taxation preferences have been framed by soft limits, and, on the other hand, the value of allowing residents to participate directly in municipal fiscal decisions.