

FISCAL FEDERALISM AS A CONSTRAINT ON STATES

CLAYTON P. GILLETTE*

Federalism—by which I mean more than federal-state relationships, and in particular mean all relationships between relatively centralized governments and their relatively decentralized subdivisions—allows different jurisdictions to compete for residents, both firms and individuals. Those who embrace federalism point to the benefits it confers by allowing jurisdictions to vary the bundle of goods and services they offer when the contents of that bundle generate only intrajurisdictional effects. The underlying assumption is that federalism induces subnational jurisdictions to attract residents by offering a preferred public good at a particular tax price.¹ The resulting competition, in theory, has many benefits. It maximizes preference satisfaction, as individuals migrate to jurisdictions that offer the public goods that they desire. It allows efficient delivery of local public goods as competitive markets for residents both drive down monopoly tax prices that public entities might otherwise be able to demand and provide public officials signals of desired services. It reduces the size of government because the resulting homogeneity (1) reduces the costs of monitoring officials who are charged with providing public goods consistent with residents' preferences and (2) represses logrolling among groups with diverse interests that might otherwise divert public resources to private use. And it diminishes corruption within government because that same homogeneity causes expenditures for illicit activity—which almost by definition deviates from majoritarian preferences—to be more salient.

* Max E. Greenberg Professor of Contract Law, NYU School of Law. My thanks to the University of Virginia School of Law Chapter of the Federalist Society for inviting me to participate as a panelist in the Thirtieth Annual Federalist Society National Student Symposium.

1. See Steven G. Calabresi, "A Government of Enumerated Powers": In Defense of *United States v. Lopez*, 94 MICH. L. REV. 752, 775–76 (1995).

A corollary of these characteristics of federalism, and perhaps the primary objective of federalism itself, is that inter-jurisdictional competition simultaneously acts as a bulwark against strong centralized governments.² Allowing potential residents to migrate to jurisdictions that offer desired goods and services and that are motivated to limit expenditures on rent-seeking activities obviously serves liberty interests that otherwise could be quashed by centralized governments that dictated expenditures over a broader jurisdictional scope.³

Apart from pure liberty interests, federalism with these characteristics solves the puzzle that arises once one recognizes that any government strong enough to protect the contract and property rights essential to the functioning of well-ordered markets also can interfere in the operation of those markets. Federalism, in Weingast's useful terminology, becomes "market-preserving" where decentralized governments retain substantial autonomy over the economy within their sphere.⁴ Meanwhile, the national government ensures the flow of goods across jurisdictions through centralized doctrines such as a negative commerce clause.⁵

The conditions under which we would be fully able to achieve these objectives are highly stylized, as has been well-rehearsed since Charles Tiebout first articulated them.⁶ Perfect sorting of the type ideal federalism requires entails the presence of individuals who possess substantial mobility and minimal attachments to their residences for reasons other than the provision of public goods.⁷ Potential residents must have

2. *Id.* at 779.

3. I mean to exclude from this criticism both expenditures for national public goods and certain redistributive mandates that central governments might properly impose because they compensate for inefficient resource allocations that would otherwise interfere with allowing all residents to seek their preferred decentralized jurisdiction.

4. See, e.g., Barry R. Weingast, *The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 3 (1995); Yingyi Qian & Barry R. Weingast, *Federalism as a Commitment to Preserving Market Incentives*, 11 J. ECON. PERSP., Fall 1997, at 83.

5. See Weingast, *supra* note 4, at 4 (noting that the national government plays an important role in ensuring a common market by "preventing the lower governments from . . . erect[ing] trade barriers . . .").

6. See generally Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

7. See *id.* at 419.

substantial choice among a wide array of jurisdictions whose proffered bundle of goods and services is relatively well recognized and imposes no external effects on other jurisdictions.⁸ Thus, if we posit a population of omniscient automatons who live on dividend income and have no interpersonal relationships, the theory could work pretty well.

But even with imperfect satisfaction of the conditions, competition among relatively centralized governments in a federal system promises certain benefits. There is at least some empirical evidence that lower taxes and superior services in some jurisdictions produce efficiency-generating responses in the tax rates and services of neighboring jurisdictions and that the presence of multiple jurisdictions in a metropolitan area constrains the size of government.⁹ Thus, the inability to realize perfectly the assumptions that underlie federalism does not mean that its objectives remain unattainable.

Even if the highly stylized conditions for interjurisdictional competition were fully satisfied, however, the ideal allocation of decisionmaking between centralized and decentralized governments would not necessarily materialize. A frequently unspoken condition of these benefits is the presence of fiscal federalism.¹⁰ That is, the benefits of federalism assume autonomous decisionmaking about revenue raising and expenditures by decentralized states and localities. To the extent that centralized governments exercise plenary power over the budgetary capacity of decentralized units and use that power to deny revenue-raising authority to their subdivisions, the latter may either forgo public goods that their residents prefer or shift to less-preferred revenue-raising mechanisms that might be inefficient or that cause discrimination in the provision of services that local residents would otherwise resist. For in-

8. *See id.*

9. *See, e.g.,* Timothy Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting and Yardstick Competition*, 85 AM. ECON. REV., Mar. 1995, at 24, 41; Jan Brueckner, *A Test for Allocative Efficiency in the Local Public Sector*, 19 J. PUB. ECON. 311 (1982); Wallace E. Oates, *The Effects of Property Taxes and Local Public Spending on Property Values: An Empirical Study of Tax Capitalization and the Tiebout Hypothesis*, 77 J. POL. ECON. 957, 967–68 (1969); Mark Schneider, *Intermunicipal Competition, Budget-Maximizing Bureaucrats, and the Level of Suburban Competition*, 33 AM. J. POL. SCI. 612, 613–14 (1989).

10. *See generally* Wallace E. Oates, *An Essay on Fiscal Federalism*, 37 J. ECON. LIT. 1120 (1999).

stance, state restrictions on local revenue raising frequently take the form of restrictions on taxes, but not on fees and user charges.¹¹ As a result, municipalities that otherwise would finance goods and services through the tax system might be relegated to financing through fees and service charges, notwithstanding that those mechanisms can be regressive or cause distortions that financing the same goods and services through taxes would not generate.¹² Centralized restrictions on decentralized revenue raising can sometimes be justified by demonstrating that granting more complete fiscal authority would generate negative externalities, perhaps by denying the centralized government of needed revenue, because vertical tax competition constrains the taxing capacity of each level of government.¹³ Even if that showing can be made, however, it is worth recognizing that even acceptable constraints on local revenue authority come at the cost of deviating from local preferences and thus somewhat dilute the benefits of federalism.

The possibility that centralized governments will too narrowly confine the fiscal authority of their subdivisions has been the subject of a substantial literature.¹⁴ A more overlooked feature of fiscal federalism is the converse problem. Fiscal federalism implies not only that subnational jurisdictions have the capacity to raise revenue for the projects that residents prefer, but also that those jurisdictions will use only that revenue-raising authority to bear the costs of favored intrajurisdictional projects.¹⁵ Federalism implicitly assumes that decentralized jurisdictions will internalize the full costs of the local objectives they pursue. The rosy theory of fiscal federalism entails that these jurisdictions neither seek subsidies from the central government to pursue their objectives nor impose the costs of those objectives on either other governments or on future residents who will not receive benefits from the financed projects commensurate with the costs those

11. See, e.g., *Martin v. City of Tigard*, 72 P.3d 619, 621 (Or. 2003); Gary M. Galles & Robert L. Sexton, *A Tale of Two Tax Jurisdictions: The Surprising Effects of California's Proposition 13 and Massachusetts' Proposition 2 ½*, 57 AM. J. ECON. & SOC. 123, 123–24 (1998).

12. See Clayton P. Gillette, *Fiscal Home Rule*, 86 DENV. U. L. REV. 1241, 1244–45, 1248–53 (2009).

13. See, e.g., John Douglas Wilson, *Theories of Tax Competition*, 52 NAT'L TAX J. 269, 289–90 (1999).

14. See, e.g., GERALD E. FRUG & DAVID J. BARRON, *CITY BOUND* (2008).

15. See Weingast, *supra* note 4, at 4.

residents will bear.¹⁶ In short, fiscal federalism requires the imposition of hard budget constraints so that subnational governments cannot print money, borrow without limit, or overgraze on the national fiscal commons either by making claims on the federal treasury or by engaging in activities that carry the implicit backing of the centralized government.¹⁷ Without these characteristics, some decentralized units subsidize others, and all decentralized units face incentives to direct centralized expenditures to local projects.¹⁸ The subsequent cross-subsidies necessarily interfere with the sorting and efficient delivery of subnational public goods that underlie the competitive advantages of fiscal federalism.¹⁹ If fiscal resources are taken from one decentralized jurisdiction and dedicated to another, the result is both to deplete the capacity of the subsidizing jurisdiction to promote its own preferences and to dilute the constraints on officials of the subsidized jurisdiction, because they have less accountability with respect to funds received from non-residents.²⁰ In effect, the benefits of federalism (preference satisfaction, efficient service delivery, and transparency in government) depend on the exercise of fiscal discipline, and that discipline exists only when there is jurisdictional congruence of revenues (taxes) and expenditures.

Of course, some subsidies might be appropriate. Central governmental programs that induce subnational jurisdictions to act in a manner that serves national purposes—a common market, a common currency, a common defense, and desirable redistribution—recognize that some decentralized activity can have extramural effects and seek to ensure that those effects are either realized (when decentralized activity can generate positive externalities) or constrained (when decentralized activity can generate negative externalities). Federal grants that induce localities to control more pollution than they would fund out of their own resources seem noncontroversial if the spillover

16. See Erik Wibbels, *Bailouts, Budget Constraints, and Leviathans: Comparative Federalism and Lessons from the Early United States*, 36 COMP. POL. STUD. 475, 479 (2003).

17. See *id.* at 477.

18. See *id.* at 479.

19. See *id.*

20. See *id.* at 477–79.

benefits are proportionate to those federal costs.²¹ Conversely, federal payments that compensate states and cities for the adverse effects of federal policies are perfectly appropriate. The reach of centralized taxation, centralized expenditures, and limitations on decentralized exercise of the same functions, in short, is an attempt in the fiscal realm to implement Madison's distinction between those interests that are "great and aggregate," and thus appropriate for national attention, and those that are "local and particular" and thus best addressed at the subnational level.²²

These points might seem too obvious to raise but for revelations in the recent fiscal crisis of the myriad ways fiscal federalism creates risks different from those on which the legal literature concentrates. As the contributions to this Symposium attest, theories of federalism typically focus on the security that decentralization confers against an onerous centralized government.²³ The Tenth Amendment literature tends to view the constitutionally secured independence of states not only as a formal requirement, but also as serving a functional purpose of limiting the reach of federal power that would otherwise overwhelm the preferences of decentralized units.²⁴

But the manifestations of the recent fiscal crisis in the public sector reveal an alternative possibility: the prospect that subnational governments can exploit the financial strength of central governments, with the anomalous result that the latter requires protection from the former. To understand this difficulty, consider the consequences of the incentives that state and local officials face to externalize the costs of programs that return only intrajurisdictional benefits.²⁵ Externalization can occur both

21. See, e.g., Thomas W. Merrill, *Golden Rules for Transboundary Pollution*, 46 DUKE L.J. 931 (1997).

22. THE FEDERALIST NO. 10, at 83 (James Madison) (Clinton Rossiter ed., 1961) ("The federal Constitution forms a happy combination in this respect; the great and aggregate interests being referred to the national, the local and particular to the State legislatures.").

23. See, e.g., Jonathan H. Adler, *Interstate Competition and the Race to the Top*, 35 HARV. J.L. & PUB. POL'Y 89 (2012); John O. McGinnis, *Federalism as a Discovery Process and a Catalyst for Humility*, 35 HARV. J.L. & PUB. POL'Y 115 (2012).

24. See, e.g., Erin Ryan, *Federalism at the Cathedral: Property Rules, Liability Rules, and Inalienability Rules in Tenth Amendment Infrastructure*, 81 U. COLO. L. REV. 1, 13 (2010).

25. See Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, in FISCAL DECENTRALIZATION AND THE CHAL-

geographically and temporally.²⁶ The geographic externalization of costs is most evident in the literature of state and local government law, where various doctrines have evolved to prevent decentralized jurisdictions from pursuing strategies that allow the imposition of spillovers.²⁷ These include restrictions on large-lot zoning regulations that frustrate migration of the relatively poor²⁸ or pre-emption principles that negate ostensibly environmentally friendly regulations that have the effect of directing locally undesirable land uses to distant jurisdictions.²⁹

In the fiscal arena, the capacity of government officials to impose temporal externalities has received the most attention. It has become a common observation that state and local officials seek both advantage in the interlocal competition for firms and residents and electoral success by pursuing programs that deliver short-term benefits and impose the related costs on the distant future.³⁰ Officials sponsor capital projects that are financed with debt and that can immediately deliver jobs and civic pride, notwithstanding that those projects may turn out to be the white elephants of tomorrow.³¹ Similarly, local officials may garner electoral support by structuring compensation for public employees in a manner that provides supracompetitive benefits—such as substantial pensions for members of unions that can offer political backing—the costs of which materialize only once the officials are out of office. If electoral markets worked perfectly, current residents would properly discount the risks that current proposals for capital projects create, and future taxes necessary to support spending would be perfectly

LENGE OF HARD BUDGET CONSTRAINTS 35, 36–38 (Jonathan A. Rodden, Gunnar S. Eskeland, & Jennie Litvack eds., 2003).

26. *See id.* at 36–37.

27. *See id.* at 36.

28. *See, e.g., In re Adoption of N.J.A.C. 5:96 AND 5:97*, 6 A.3d 445, 461–62 (N.J. Super. Ct. App. Div. 2010).

29. *See, e.g., EnviroSAFE Servs. of Idaho, Inc. v. County of Owyhee*, 735 P.2d 998, 999 (Idaho 1987).

30. *See, e.g., Richard Briffault, Foreword, The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUT. L.J. 907, 909–11 (2003); Clayton P. Gillette, *Direct Democracy and Debt*, 13 J. CONTEMP. LEGAL ISSUES 365, 366–67 (2004); Christopher Serkin, *Entrenching Environmentalism: Private Conservation Easements Over Public Land*, 77 U. CHI. L. REV. 341, 357–58 (2010).

31. *See Gillette, supra* note 30, at 368.

capitalized into current property values.³² As a result, the electorate would fully internalize the future consequences of current policies. But no such mathematical Nirvana exists.

Although the temporal mismatch of costs and benefits might be an intramural problem for the residents of the jurisdiction who must ultimately pay previously incurred obligations, it does not pose a problem for fiscal federalism if the disadvantages of these practices are limited to the jurisdictions that employ them. But that is not necessarily the case. Just as the indebtedness of Greece can adversely affect the European Union, so can the financial distress of cities and states within the United States have contagion effects on other subnational entities and the national government itself. This might initially seem surprising. As a formal matter, states and their political subdivisions appear to suffer hard budget constraints. They are typically obligated to have balanced annual budgets and cannot print money to dilute the value of their debts.³³ Nevertheless, those hard budget constraints appear to falter in the face of legal and accounting machinations that permit the issuance of debt for operating expenses;³⁴ incurring obligations, such as future pension obligations for public employees that are not funded on a current basis;³⁵ and tax and debt limitations that are sufficiently porous as to be nonexistent.³⁶

As a consequence, decentralized governments have the capacity to incur fiscal distress that ultimately creates risks for the centralized jurisdiction of which they are a subdivision. Contagion can result from fear that if one government faces fiscal distress, similar governments will face similar problems. It is this form of contagion that ideal markets would prevent because investors would be able to distinguish qualitatively among debtor juris-

32. Cf. JONATHAN RODDEN, HAMILTON'S PARADOX: THE PROMISE AND PERIL OF FISCAL FEDERALISM 21 (2006).

33. See Robert F. Williams, *Why State Constitutions Matter*, 45 NEW ENG. L. REV. 901, 903 (2011).

34. See, e.g., *Lance v. Codey*, No. MER-L-2087-05, 2005 WL 1924191, at *2 (N.J. Super. Ct. Law Div. Aug. 11, 2005).

35. An April, 2011 report from the Pew Center on the States estimated that thirty-one states fell below the funding level for public pensions recommended by the Government Accountability Office. See PEW CTR. ON THE STATES, THE WIDENING GAP: THE GREAT RECESSION'S IMPACT ON STATE PENSION AND RETIREE HEALTH COSTS 3 (2011).

36. See, e.g., Briffault, *supra* note 30, at 908–09.

dictions. There is at least some evidence, however, that markets are imperfect in this regard: Fiscal distress suffered by some jurisdictions causes investors to demand higher interest rates from other jurisdictions deemed to be similarly at risk.³⁷

But the more important form of contagion that might cause centralized governments to intervene when decentralized jurisdictions face distress can emerge from the interconnected nature of fiscal risk. That is, given that large decentralized governments are substantial employers, that their debt is frequently held by large institutions whose financial stability has been deemed central to the nation's fiscal health, and that their operations provide basic services to constituents, credit markets are unlikely to anticipate that a centralized government would allow the demise of major subdivisions.³⁸ With respect to the federal-state relationship around which most federalism scholarship revolves, this means that the federal government is likely to be implicated if a state—at least a populous state of relative national importance—faces fiscal disaster.³⁹ If Citicorp is too big to fail from the perspective of the federal government, what can we say about California? The consequences of those systemic risks essentially mean that bailouts at centralized levels of government might be appropriate, notwithstanding the moral hazard or legal difficulties that they present.

The risks centralized governments face from decentralized fiscal activity are evident in recent work that investigates the interconnected nature of fiscal risk in federal systems. Jonathan Rodden notes that centralized taxing power, combined with centralized funding of decentralized governments, frustrates efforts by the federal government to commit credibly against bailing out profligate decentralized governments.⁴⁰ As a conse-

37. See, e.g., Edward M. Gramlich, *The New York City Fiscal Crisis: What Happened and What is to be Done?*, 66 AM. ECON. REV. 415, 424 (1976); John M. Halstead, Shantaram Hegde, & Linda Schmid Klein, *Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets*, 39 FIN. REV. 293, 294 (2004); Kristin Stowe & M.T. Mahoney, *The Response of the Debt Market to Municipal Financial Distress* 8, available at <http://myweb.clemson.edu/~maloney/papers/muni-financial-distress.pdf>.

38. See *Can pay, won't pay*, THE ECONOMIST, June 17, 2010, www.economist.com/node/16379740.

39. See, e.g., Kevin Hessett, *California Leads Nation to Bond Default Abyss*, BLOOMBERG, June 1, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ayC51TwbH6_8.

40. RODDEN, *supra* note 32, at 270–71.

quence, “subnational officials face weak incentives *ex ante* for fiscal discipline.”⁴¹ Moreover, these conditions exacerbate the risk of bailout because creditors and intermediaries ignore formal separation between centralized commitments and decentralized debt and treat the latter as enjoying an implicit guarantee from the former. The power of those perceptions is evident from the positive value that credit markets placed on the probability of a federal bailout of Fannie Mae and Freddie Mac, notwithstanding the absence of any legal obligation.⁴² Although the fact that states in the United States have the capacity to raise revenue—if not to print currency—reduces the perception that the central government is obligated to bail out its decentralized units, Rodden points to the countervailing logic that large, wealthy jurisdictions may exploit their position as “too big to fail” to borrow aggressively. Such jurisdictions know that they are more likely to be rescued than weaker co-members of the federation because their failure would generate the greatest fiscal contagion for the federation as a whole.⁴³ It is perhaps not a coincidence that the states that face fiscal distress linked to heavy borrowing include California, Illinois, and New York rather than states with smaller populations or less revenue-generating capacity.⁴⁴

Even in the face of fiscal distress, politics might preclude a federal bailout of profligate states and localities, especially if more frugal jurisdictions believe that credit markets will effectively distinguish them and impose few punishments for the sins of the spendthrifts. Erik Wibbels suggests that the inability of high-debt states to establish a coalition in favor of bailout prevented a second federal assumption of state debts after the fiscal crisis in the 1840s.⁴⁵ But it is unclear whether the same phenomenon would prevail today. The states in the mid nineteenth century exhibited a bimodal distribution, with some states bearing virtually no debt and other states bearing very

42. *Id.* at 271.

43. See J.W. Verret, *Separation of Bank and State: Consolidating Bailed-Out Companies into the U.S. Debt Ceiling and Government Financial Statements*, 2011 BYU L. REV. 391, 422 (2011).

44. RODDEN, *supra* note 32, at 273–74.

45. See Neil Weinberg, *Blue State Blues*, FORBES, Mar. 29, 2010, at 34.

46. See, e.g., Wibbels, *supra* note 16, at 497.

high amounts of debt.⁴⁶ In addition, federal debt at the time was quite low, such that the spillover effects on borrowing costs for the federal government of a state default would not have been substantial.⁴⁷ Under those circumstances, it is perhaps not surprising that the heavily indebted states could not command a congressional majority for federal assumption. Whether this is the case in the more contemporary environment of widespread indebtedness and jurisdictional interdependence remains to be seen. In any event, if politics, rather than legal doctrine, dictate the availability of a federal bailout, then the federal government cannot and probably should not commit not to bail out states or political subdivisions. This stance means credit markets will continue to attribute a positive value to the probability of a federal bailout of at least some states and political subdivisions. In short, distressed states and some localities carry an implicit federal guarantee. The affected jurisdictions can use that guarantee to borrow more and riskier debt, below market rates, and to externalize some of the cost to the federal government.

If these risks are substantial, then maybe our one-way attention to federalism as a bulwark against centralized governments requires revision. Keep in mind that borrowing at the state and local levels is not restricted at all by the federal government.⁴⁸ Notwithstanding the risks that the federal government faces from subnational fiscal activity, there is no federal counterpart to the debt limitations that virtually all states impose on their political subdivisions.⁴⁹ To the contrary, the federal government encourages state and local debt by providing a tax exemption on interest payments made with respect to state and municipal debt, so long as the proceeds of the debts are not intended for certain private activities.⁵⁰ Moreover, most commentators conclude that the tax exemption costs the federal government more than the exemption saves the subnational borrowers, making it an inefficient subsidy yet one that nevertheless induces them to increase both the amount and riskiness

46. *See id.* at 497–98.

47. *See id.* at 498.

48. U.S. CONST. art. I, § 8, cl. 1 (enumerated powers of Congress include taxation but not the ability to constrain state taxation or borrowing).

49. *See id.*

50. *See* 26 U.S.C. § 103 (2006).

of their debt and to subsidize projects that return little benefit outside the immediate jurisdiction.⁵¹ It is one thing to use federal subsidies to ensure that subnational governments provide essential public services through capital financing of schools or a courthouse. It is another to employ subsidies that support local private goods. I am somewhat reluctant to conclude that taxpayers in South Dakota are happy to have provided a subsidy for the new Yankee Stadium.⁵² And it is perhaps most peculiar to use federal subsidies to attract firms to what is considered to be their most productive location in the name of interlocal competition. Given the difficulties of identifying the ideal location for any firm, one might think that objective is best served by requiring the attracting locality to bear the full costs of the move.

As suggested above, more substantial negative consequences arise when subnational governments face financial distress because they incurred too many obligations. In light of both the adverse consequences that states can inflict on the federal government and the implausibility of credible commitments against bailout, perhaps more federal authority over the fiscal situation of states than is typically recognized is appropriate. One might think that federal intervention in the name of federal interests could take any of a variety of forms that have too readily been dismissed as inconsistent with concepts of federalism rooted solely in the need to protect subdivisions against the central government. Consider, for instance, the current regime of municipal debt adjustment, commonly called municipal bankruptcy. One statutory constraint in such proceedings is that bankruptcy judges may not interfere with the political or governmental powers of the debtor municipality, any of its property or revenues, or its use or enjoyment of any income-producing properties.⁵³ For many, this restriction is justified by invoking the shibboleth of federalism.⁵⁴ But if the state and federal governments are funding interjurisdictional competition at

51. See, e.g., Andrew H. Goodman, *The Public Financing of Professional Sports Stadiums: Policies and Practices*, 9 SPORTS LAW. J. 173, 176–82 (2002) (discussing the role of tax-exempt local bonds in building costly local sports arenas and stadiums).

52. See, e.g., I.R.S. Priv. Ltr. Rul. 200641002 (Oct. 13, 2006), 2006 WL 2925866; I.R.S. Priv. Ltr. Rul. 200640001 (Oct. 6, 2006), 2006 WL 2848788.

53. 11 U.S.C. § 904 (2006).

54. See *In re New York City Off-Track Betting Corp.*, 427 B.R. 256, 264 (Bankr. S.D.N.Y. 2010).

federal expense, and if fiscal overextension by states and localities places the federal treasury at risk, then it seems unclear that the federal government should be restricted from engaging in any ex ante regulation of states in order to avoid the need for ex post bailouts. One might, therefore, imagine circumstances in which the practice or threat of tax increases or service cuts imposed by a federal bankruptcy court would be an appropriate protection against the incentives of decentralized jurisdictions to overgraze on the fiscal commons.

Perhaps even more heretically, note that states that are likely to suffer contagion effects from their fiscally distressed municipalities might exercise substantial control over the budgetary authority of those municipalities in return for assistance in avoiding defaults on debts.⁵⁵ That control might take any of a variety of forms, ranging from advisory or financial control boards to dissolution of the locality. It is certainly the case that the constitutional relationships between states and their cities differ dramatically from the relationship between the federal government and the States. But if there is a risk of contagion from fiscal distress, such that states or localities seek federal assistance, it seems rigidly doctrinal to suggest that principles of federalism prohibit federal intervention in a form that reduces the moral hazard related to providing that assistance. If state financial control boards seem an appropriate price to demand in order to facilitate a state rescue of its profligate municipalities, should the federal government be deemed to suffer a constitutional disability from exacting the same price in order to assist the recovery of a jurisdiction that could otherwise threaten the fiscal health of the remainder of the nation?

Federalism describes a set of institutional arrangements that promise both an optimal amount of liberty and an efficient delivery of desired public goods. It achieves that objective largely by forcing each level of government to internalize the costs of its activities. No single level of government, however, has a monopoly on the capacity to intrude on the benefits that can be derived from those arrangements. The standard federalist objective of protecting decentralized governments from an overpowering centralized government makes perfect sense where the threat

55. Cf. Note, *Missed Opportunity: Urban Fiscal Crises and Financial Control Boards*, 110 HARV. L. REV. 733, 734–35 (1997).

from the latter against the former looms large. But where decentralized governments have both the incentive and capacity to derail the fiscal stability of the centralized government, the same principles of federalism should be considered to require—or at least permit—centralized action that forces the problematic subdivision to bear the costs of the harms it imposes on others. Rodden’s felicitous phrase that fiscal federalism presents both promise and peril⁵⁶ reminds us that the legal principles that govern the relationship between centralized and decentralized governments must be attentive to both.

56. RODDEN, *supra* note 32.