Chapter 1

Introduction

This book is about urban government as borrower and investor. Whether building infrastructure or supporting economic development, city officials historically have borrowed money and invested it. In fact, "the vital services at the heart of urban rule" depend on such capital investment.[1] Public power has mobilized private money for public purposes. Over time, such investment has become disconnected from the normal political and administrative processes of local policy making. A great deal of local government investment now takes place in an institutional world that differs significantly from the picture of urban politics and government presented in textbooks. This book addresses the question of why local government as borrower and investor differs from local government as we traditionally think of it.

The historical evolution of the American federal system provides an important explanation for the distinctiveness of those governmental institutions charged with local investment. This book consequently explores how local government's role as investor has been shaped both by the actions of higher levels of government and by local responses to such actions. It argues that intergovernmental politics have produced the distinctive institutional world within which much local public investment takes place.

A discussion of the politics of public investment must begin by recognizing the shrunken role of cities in the American system of government. As the federal system became institutionalized over two centuries, city government lost much of its formal autonomy. Major (and many minor) policy initiatives needed the approval of state legislatures. Cities also became limited informally. They began to compete for residents, employment, and tax revenue with the suburbs that provided an escape for citizens unhappy with the city. Although city officials themselves have long been aware of the limits within which they worked, scholars writing about urban politics in the 1960s and 1970s usually ignored these limits. Scholars regarded the policies of cities as originating in the political life of cities rather than as responses to forces outside. The debate over who governed in cities assumed that even if the "elite" was in fact several elites, urban political life was self-contained.[2]

Recent scholarship has challenged this assumption. Paul Peterson, for example, convincingly argued that cities are vulnerable to external forces and that such vulnerability creates limits on what they can do. In his view, cities are not like independent nation-states:

> Too often cities are treated as if they were nation-states. . . . It is the burden of my argument that local politics is not like national politics. On the contrary, by comparison with national politics local politics is most limited. There are crucial kinds of public policies that local governments simply cannot execute. They cannot make war or peace; they cannot issue passports or forbid outsiders from entering their territory; they cannot issue currency; and they cannot control imports or erect tariff walls. . . . [C]ity politics is limited politics. . . . The place of the city within the larger political economy of the nation fundamentally affects the policy choices that cities make.

Martin Shefter, for his part, notes that "cities lack autonomy juridically, economically, and politically," while Paul Kantor argues that "the modern city has become politically democratic but economically dependent."[3]

Seen in a historical context, the "limited politics" discussed by Peterson are a phenomenon particularly characteristic of the twentieth century. Although cities have never exercised the powers of national governments, they enjoyed far greater scope of action in the nineteenth century than they do now. Why and how, then, did cities' political and policy options eventually become more limited?

The conventional answer would emphasize "Dillon's rule," which rendered cities legally "creatures of the state." Yet Dillon's rule is often referred to in isolation, without recognition that Judge Dillon was writing in the midst of an important debate about the proper role of local governments in the economy.[4] Dillon's view of local government was shaped by the entrepreneurial role it had been playing for decades, a role that became increasingly controversial when state judges began to view cities' investment activities as moving beyond the proper boundaries of "public purpose." Dillon's rule, set in its own time, had as much to do with the political economy of the United States as with state-local relations.

An alternative answer to the question of why city politics are so limited might stress the limited reach of elected mayors and city councils within their own territorial boundaries. It might note the importance of independent authorities, which often cut across city/suburban boundaries. Peterson, for one, finds that developmental policies (those that benefit the economic position of a community) in cities are not controlled by elected city officials but rather "come under the direction of independent authorities." These authorities are self-financing rather than reliant on taxation, and this gives them enormous leverage and insulates them from normal political channels. (Such authorities differ from so-called special-district governments, which are typically elected, levy property taxes, and must submit their borrowing to the electorate in the form of referenda.) Annmarie Hauck Walsh notes that "the corporate form of public authorities permits jobs to be done and projects to be completed without the clamorous debates, recurring compromises, and delaying checks and counterchecks that characterize the rest of American government."[5]

These authorities or special-purpose governments do indeed weaken the control of elective institutions over capital investment and increase the power of those interest groups that are most closely affected by such investment decisions. The relatively insulated and closed nature of the politics surrounding public authorities allows economic-development activities under their control to proceed without much input from the electorate. This is important, because critics of Peterson's conclusion that "cities, like private firms, compete with one another so as to maximize their economic position," argue that he assumes "there tends to be a consensus in cities to promote 'rational' community economic goals."[6] No such consensus needs to exist, however, to the extent that authorities as opposed to elected officials are making the relevant economic-development decision. Given the closed nature of politics in authorities, they are often able to operate with little concern for the wishes of voters. Herman Leonard, in discussing the "quiet side" of public expenditure, points out that spending by authorities is deliberately insulated from legislative control:

> Spending by public authorities—like water and sewer commissions and port, turnpike, and public power authorities—could also be viewed as quiet

> public spending. Public authorities annually spend billions of dollars raised through "user" fees. . . . [Yet such spending] is not supposed to be authorized through a legislative appropriations process. Public authorities have deliberately been sheltered from the appropriations process—excused from it by duly constituted legislative authority.[7]

Why do such authorities exist? Why did powerful mayors allow such obvious competitors for power to come into being? Why do they exist solely in those policy areas concerned with capital investment, and not in others such as social services? And why are they not elected or subject to legislative control?

The literature on urban politics is strangely silent about these non-elective institutions and the implications that their activities have for urban government and politics. Perhaps the very fact they are not perceived as part of the normal political landscape has shielded them from the scrutiny of political scientists. Whatever the reason, scholars have tended to focus on the governments that provide social welfare services and that levy taxes rather than on the governments that provide capital-intensive and economic-development services and that levy user fees. The literature on public administration, while giving some attention to these bodies, is also lacking.[8]

This book analyzes how city governments as borrowers and investors became subordinate to the state government; how and why they then gradually lost their role as investors to public authorities; and how the borrowing and lending activities of such authorities eventually put local capital investment on Washington's policy agenda. It argues that the use of public authorities represented an important way to circumvent the limitations on investment imposed on city governments by the state government. Given that the state attempted to limit city governments by empowering the electorate in the making of investment decisions, the dilution of state power has also led to the exclusion of the local electorate from the capital investment arena. General-purpose goverments (that is, city governments) created innovatively financed, non-elected, special-purpose governments in order to dilute state power and the power of local electorates. However, they have found that their own power has been diluted as well.

Once special-purpose governments became central to local capital investment, their activities moved far beyond the infrastructure-building typically associated with authorities. Local government capital finance then came under the scrutiny of Washington — of both the Supreme Court and Congress. The "politics of circumvention" that had maximized local governmental power while simultaneously fragmenting it and insulating it from electorates led ironically to an increased role for the federal government.

Governments as Actors

The analysis presented here treats local governments as unitary actors operating within a universe of other governments and governmental institutions such as courts. Its focus is not on those groups or individuals who have tried to influence decisions about which projects to fund. Briefly put, that part of the story is not surprising. Land speculators (eager for a railroad in order to increase their land values) and railroad investors (anxious for help with financing construction) certainly lobbied for the financing provided by local governments.[9] Certainly, too, the relationships between such owners and municipal officials were not always honest, and a substantial amount of corruption accompanied the entrepreneurial activities of state and local governments in the nineteenth century. More recently, firms specializing in the borrowing of funds for municipalities have been key campaign contributors. Candidates running for state and local office turn to such firms for campaign funds as a matter of course and steer business to them when borrowing.[10]

But this book is concerned more with the strategy adopted by governments — as institutions — to increase their power to borrow funds and thereby to invest. It is concerned with how local governments achieved their goal of being allowed to finance capital investment at levels they desired in the face of limits placed on them by state government and the courts. This analysis thus takes seriously the idea that local governments pursue their "institutional self-interest."[11] In the case of investment, such an interest has focused on maximizing local governments' ability to borrow and invest as much as they saw fit for activities of their own choosing.

Intergovernmental Politics

Although this book is concerned with the United States, its argument has been developed by the use of comparison. Both the questions asked and the answers provided by this analysis are rooted in a comparison between the United States and Great Britain. Although not a comparative study, this work has used comparison as a way of identifying those aspects of the American experience that differ enough to deserve extended analysis. In fact, it was a comparative habit of mind that first alerted me to the importance of the politics that take place among governments.

The lack of a "public sector" in the British sense has made American intergovernmental politics both more complicated and less visible than in Britain. Although it is difficult to discuss British urban politics without including central-local politics, for example, many analysts of American urban politics quite comfortably relegate intergovernmental "relations" to a separate subfield and pay it little heed. Many urban scholars ignore federalism except to make a token acknowledgment to Dillon's rule, which is seen as limiting the power of cities. Those political scientists who have analyzed federalism have tended to downplay both the role of judicial action and the behavior of governments acting in their own interest in the evolution of federalism. Instead, they have focused on the party system, social change, or intergovernmental relations as defined administratively, for example, as central variables in the evolution of federalism.[12]

Urban politics are typically not analyzed as intertwined with intergovernmental politics, although John Mollenkopf's *The Contested City* represents an important exception to this statement. Mollenkopf argues:

> The federal government . . . ceded a tremendous amount of discretion and control over its programs to local political actors who, in a sense, completed the construction of the intergovernmental program delivery system. The federal government provided some powerful tools, and designed them to achieve political as well as economic change at the local level, but in the final analysis local actors were the ones who put these tools to use. Their distinctive concerns and interests had considerable impact on the shape and effect of these programs. These local concerns led to outcomes which differed from those which national advocates of federal urban development programs had in mind.[13]

Politics in urban area are usually defined as involving *local* actors, whether these be community and neighborhood organizations, elected officials, corporate interests, those concerned with the development of real estate, or the local electorate. Debates among scholars of urban affairs have focused on the relative influence of economic interests vis-à-vis those of elected officials, community groups, or electoral coalitions.[14] Political activity is assumed to be about the representation of interests defined in societal terms. Elective officials, neighborhood organizations, and real estate owners, for example, pursue their interests in the political arena. In this view, government is the object of pressure from groups rather than an actor in its own right. Along the same lines, politics are defined as groups coming into conflict rather than as governments coming into conflict.

Yet if one examines the landscape of local government in any metropolitan area, one is struck by the number of governments—municipalities, counties, special districts, independent commissions, and public authorities—that exercise overlapping public authority in any given territory. Such governments are as likely to negotiate with other governments (as well as come into conflict with them) as are organized groups, for governments desire policy outputs from other governments just as groups do. In fact, Matthew Holden's notion of governments' conducting "diplomacy" with one another is apt. Samuel Beer too has noted this dynamic: "Government itself—the public sector—has become such a large proportion of the total society that it generates within itself powerful forces leading to further government action."[15] In the case of city governments, they must often negotiate with other units in order to be provided with capital-intensive services. They must do so partly because public authorities have been established and partly because much capital investment crosses territorial boundaries. City governments negotiate about the future with other governmental bodies whose primary function is to invest—and they also are forced to respond to the impacts of past decisions made by those same governmental investors.

Whereas "diplomacy" implies that the units bargaining are formally of equal status, "public-sector politics" often involves local officials' trying to influence governments (federal or state), which wield much greater power and authority. Beer has referred to public-sector politics as involving local governments in lobbying and negotiating in ways similar to those practiced by private organized groups.[16] Yet the participation of local governments in intergovernmental politics is not limited to the role of lobbyist. It is in their other roles that local governments have structurally changed the nature of local governance in the United States.

Politics between governments are central to explaining why capital investment takes place as it does at the local level. I use the term *politics* advisedly, rather than the more bland, conventionally used, term intergovernmental *relations*. Where there is an undoubtedly strong constitutive element to the distribution of power among different governmental units, that distribution is not so overwhelming as to eliminate the kinds of behavior we routinely classify as "political" when exhibited by representatives of societal interests such as interest groups. Governments bargain with each other as well as lobby, confront, ignore, threaten, circumvent, and sue one another. Furthermore, local governments are such important implementers of policy—even in such supposedly centralized countries as France and Italy in the 1960s—that they are able to modify national policy to fit their own objectives.[17]

This book analyzes three types of intergovernmental politics and argues that, in the case of local capital investment, the three are directly linked. The setting of limits, the circumvention of such limits, and intergovernmental lobbying are the three types of politics that have shaped the institutional world of local investment. The first two types are particularly important in explaining why the institutional world of local capital investment differs so significantly from that of municipal government as traditionally understood.

Governments set limits on the activities of subordinate governments. Politics between governments of unequal power often address the question of how much discretion the weaker government can exercise. The setting of such limits represents one of the key ways that governments interact with other governments. Limits, once established, set the parameters for future relations and are therefore of strategic importance.

In the investment arena, such limits have restricted the borrowing of those funds typically used for investment purposes. Borrowed capital is so central to investment that systems of public capital investment are primarily shaped by the locus of control over the opportunity to borrow. In the case of American local investment, the decision to shift the locus of control over borrowing from the local to the state level shaped the institutional world of local capital investment. When local governments were transformed from relatively autonomous borrowers to objects of state regulations on borrowing, the nature of state-local investment politics was profoundly affected.

This book argues that decisions about the locus of control over capital investment have played a key role in shaping the role of the city in both the federal and the metropolitan systems. City government lost the struggle to borrow and therefore invest as it saw fit, and that defeat became enshrined specifically in debt limitations and more generally in the law of municipal corporations. Not only were local investment activities strictly controlled but Dillon's rule ensured that the state became in all fields the city's legal master. City government inevitably played a subordinate role in a range of sectors unrelated to investment. Hendrik Hartog, for example, argues:

> In place of local autonomy and political decentralization, the new law of municipal corporations posed the absolute centrality of state power and the insignificance of local publics in the political order. In place of the distinctive chartered rights of cities and the particular customs of local communities—both of which earlier served to frustrate the designs of central authorities—the new "law" held localities to explicit delegations of legislative power.[18]

If the city in the nineteenth century had been allowed to maintain its autonomy in borrowing and investment, it is possible that the city's powers in the twentieth century would have been more expansive.[19] The defeat over capital investment was thus a strategic defeat and shaped the future role of cities in the federal system in the sense that subordination was to be the city's fate.

In contrast to the argument made here, most political scientists do not view the nineteenth-century experience as critical. Ester Fuchs, for example, notes in her important study that "The starting point for this analysis must be the 1930s, because the onset of the Great Depression was the formative period for modern city governments." That argument is certainly valid if one examines the non-investment-related activities of city government. In the area of capital investment, however, the legal foundations for aggressive public investment had been laid by the time of the Great Depression. Such foundations were critical, for public investment cannot proceed without a supportive legal framework.[20]

The Politics of Circumvention

A type of intergovernmental politics of particular importance to local capital investment involves circumventing limits imposed by higher levels of government. Circumvention can entail manipulating the organization of government itself. Such manipulation helps to circumvent regulations imposed by higher levels of government. Local governments, for example, have established public authorities in order to circumvent restrictions imposed by states.[21] Similarly, new instruments—such as the revenue bond—have been developed for use in the financial markets so as to circumvent state restrictions applicable to older instruments. Finally, public authorities and new financial instruments have been used to test the limits of federal subsidy of local investment. Local officials, then, have revamped or transformed both the institutions and the processes of investment in order to maximize their autonomy from both the state and the federal governments.

Public authorities, for their part, can be viewed as a type of government institution designed in the twentieth century to recapture the freedom localities had enjoyed as investors for much of the nineteenth century. Public authorities, created to ensure that local governments can invest with minimal restriction, are "pure" government investors—and distinctively American. They form a governmental strata largely ignored by scholars and citizens but crucial to understanding the political economy of both federalism and local capital investment in the United States.

The politics of circumvention have evolved incrementally, but the impact has been dramatic. By the early 1990s, the system of American local government had fragmented, with municipal government becoming ever less responsible for capital investment decisions. Non-elected public authorities were the dominant local public investors. Consequently, the link between electoral accountability and capital investment is tenuous. Although borrowing and investment in the 1970s and 1980s became increasingly directed toward economic development rather than toward the provision of capital infrastructure, the role of special-purpose government did not diminish. The definition of capital investment had changed—but the public authority was still one of the key institutions charged with borrowing and spending funds.[22]

Government-Market Relationships

Intergovernmental politics need financial resources—and the resources used in the field of investment are borrowed monies. Such borrowing takes place in the private capital market so that governments use "private" money to pursue their investment objectives—and, we shall argue, their own institutional self-interest. The argument made here is that, in the area of public capital investment, intergovernmental politics involved public authority using private finance capital to circumvent public restrictions. Private capital (in the form of the revenue bond) has been used by local governments to expand their own power vis-à-vis state governments. Private capital has been a tool used by public authority, an essential element of the politics of circumvention, which has helped define American federalism in the arena of capital investment.

Arguing this is not a conventional view. The conventional view is that capital calls the tune, that private interests use or constrain public authority. Capital plays a determinative role in structuring the relationship between public and private power in the United States. In the case of cities, both Marxist and non-Marxist analysts have identified "finance capital" or the "structure of capital markets" as crucial concepts in understanding urban political economy in the United States. In this view, the financial market "generally acts as a de facto 'outer boundary' for political choices made by city officials about service levels, tax rates, and economic development."[23] Local governments borrow funds from private lenders operating in the municipal bond market, which renders local governments vulnerable to the credit assessments made by such lenders. Therefore, local officials, in this view, are forced to be extremely responsive to business, whose locational decisions are critical for the fiscal health — and thus the credit rating — of any locality.

This school points out (rightly) that if business firms do not locate in a municipality, the latter's tax base deteriorates, which incurs a decline in creditworthiness and higher costs for borrowing. Stephen Elkin, for example, sees the reliance of municipalities on private credit markets as a crucial factor in relations between public officials and business. He continues:

> The effects on city politics are substantial and little appreciated by students of city political affairs. The shape of city public policy, the access of certain kinds of business to public officials and the latter's consuming interest in economic growth all are greatly affected by the city's reliance on private credit.

In a more historical vein, Steven Erie writes: "I join others in arguing that urban growth cannot be understood historically apart from the municipal bond market."[24]

Borrowing in the private capital market clearly renders local officials very sensitive to the credit ratings issued by *Moody's* and *Standard and Poor's*, ratings that can raise or lower the cost of borrowing.[25] Furthermore, if loan repayments cannot be made, cities may find their autonomy substantially reduced, as occurred in the case of New York City. Shefter offers an excellent analysis of the changes imposed on New York City in the period after March 1975 (the date when the city was denied access to the capital markets). He writes:

> the most visible and enduring change in 1975 was the creation of a new set of institutions to supervise New York City's finances: the Municipal Assistance Corporation (MAC) and the Emergency Financial Control Board (EFCB), . . . the Office of the Special Deputy Controller for New York City (OSDC), and the Office of New York City Finance in the U.S. Treasury Department. . . . To provide investors with an ironclad assurance that MAC would be able to meet the debt service payments on these bonds, the state legislature converted the city's sales and stock transfer taxes into state taxes. The proceeds from these taxes flowed directly into a special account, inaccessible to city officials, from which MAC could withdraw funds to make interest and principal payments on its bonds.[26]

Given the costs borne by cities that do run afoul of the market, it may not be surprising that the demands of the market for repayment have been usually met. The experience of New York City is very atypical in the post–World War II period. In general, even cities experiencing a fiscal crisis have managed to avoid what Leeds terms the "financing crisis," which led to the state's imposition of fiscal controls on New York City.[27]

Yet if we analyze the role of capital markets from a comparative perspective, we become more cautious about that role.[28] Private lenders clearly do influence local officials a great deal in the United States; but does this demonstrate the determinative force of capital markets or does the explanation lie elsewhere? No system of investment is cost-free from the point of view of local government. But the costs vary in different countries. British local governments, for example, also borrow in the capital market, but the British and American systems of investment differ dramatically. Stephen Elkin points out that English local governments are less worried than American governments about the judgments of the credit markets. In his words, "English local authorities worry more about how central authorities view them than they do about how prime lenders rate their economic prospects. The result is that they have to be less dutiful in seeking out and attending to the desires of local businessmen."[29] Each system imposes its own costs and offers its own benefits to local governments.

American localities are certainly more vulnerable than their British counterparts to market criteria in terms of access to lenders and the cost of borrowing. But they can borrow much more cheaply than either British local authorities or (perhaps most surprisingly) the American federal government itself. This does mean that British localities are insulated from certain market imperatives, but they seem to pay a relatively high price for such insulation. American localities are not insulated from these market imperatives, but they do enjoy important privileges not enjoyed by their British counterparts.

Could the sources of the power of capital markets identified by Elkin lie in the logic of the American federal system itself rather than in the influence of capitalists? Certainly, an explanation arguing that capital markets qua markets are the key variable in explaining the political economy of public investment is suspect. An alternative view (the view taken here) is that the system of public capital finance is driven by government rather than by the capital market. In the area of capital investment, higher levels of government—rather than the capital market—determine the relationship that local governments will have with that market. If such governments allow the market to be influential, then it will be. If they decide the opposite, the market will not be influential. In either case, the key decision maker is not the capital market but the public authority.

The subordination of the market to public authority goes much further, however. American local governments have used the market as a vehicle, or instrument, to circumvent legal restrictions on their borrowing. (British local governments also use the markets to circumvent restrictions on their borrowing, but these are restrictions having to do with the technicalities of borrowing rather than with the aggregate amounts they are allowed to borrow.)[30] Using the market in such a fashion is unexpected, especially since such restrictions were intended to minimize borrowing. Yet the market has created new financial instruments specifically designed to evade restrictions on local government borrowing. Such instruments have allowed American local governments to borrow a lot as opposed to a little. Local governments have been able to use the creativity of the financial market for their own purposes. The municipal bond market therefore is used to further subnational government's own political and economic interests.

If the city can be conceptualized as a firm struggling for wealth, it can also be thought of as struggling against other governments for autonomy. Just as certain business groups use government to gain an advantage over other business groups, subnational governments use markets to circumvent controls and constraints imposed by other political units. Government officials view other governments as more constraining to their autonomy than the imperatives of the private capital market that funds much of their capital investment. It is better to put up with the credit ratings demanded by private lenders—and the pressures for economic growth or fiscal austerity that credit ratings can promote—than it is to put up with the limits placed on capital investment by governments.

In the United States, the relevance of other governments is seen in the very birth of public capital investment. A strong federal role in investment was vetoed largely because of the fear of a too powerful federal government. State governments were more worried about the power of Washington than about the power of financiers. Laissez-faire ideology had little to do with the debate: the states went on to pursue public enterprises and other forms of extensive public economic activity. The relationship between subnational government and the market, therefore, was not determined by ideas about the proper role of the market—it was shaped by ideas about the proper role of the federal government.

The Role of Law

But the market alone cannot provide a mechanism for circumvention. The legal order must support the market's activity. The work of Willard Hurst in the field of legal history has had enormous impact on those studying the relationship between law and markets. Arthur McEvoy summarizes Hurst's overarching argument: "'Law' and 'the market' . . . do not exist independently of one another but rather create each other. The law . . . creates and sustains the life of the market economy."[31]

Without law, the capital market cannot function. Local officials were able to develop a strategy of circumvention because the state courts legitimated the new financial instrument developed by the market. Ironically, it was the courts that allowed local officials to circumvent the laws designed to minimize their borrowing. The courts approved the "escape hatch" designed by the financial market, an approval that was absolutely critical.

The courts exacted a high price for their approval of circumvention, however. They encouraged the creation of a new form of government—the public authority. Authorities have gradually come to dominate the world of capital investment. They have diluted the power of general-purpose governments, have insulated themselves from the electorate, and have transformed taxpayers into ratepayers subject to user fees. The fragmentation of local government has been so great that the world of local government now looks very different from the way it did in the period before World War II. "Local" government is far from synonymous with "municipal" government, and the proliferation of public authorities helps explain that fact. In a sense, the courts both liberated local investment and transformed the structure of government responsible for it.

Local governments used both the market and the courts to evade laws designed to minimize their borrowing. Local governments used the financial market to evade restrictions on their access to that same market and they used the courts to legitimize evading the law. Finally, their pursuit of circumvention led them to create a new type of governmental entity, which over time minimized their own power and autonomy. The construction of the federal system in the area of public investment is thus rooted in a triple irony.

Given the fragmentation of public authority at the subnational level, the availability of the capital market as a provider of funds, and the legacy of history in the oldest domestic-policy sector in the United States, the federal government has faced the problem of how to channel subnational public investment activity in a way compatible with its own aims. Particularly problematic were state and local governments' activism in the area of economic development. Washington responded by using tax policy as an instrument with which to recast its relationship to the entrepreneurial activities of subnational governments. The Tax Reform Act of 1986, therefore, stands as a piece of landmark legislation in the reshaping of American federalism.

Tax policy allowed Washington to constrain both private and public actors in the public investment game, with the Internal Revenue Service acting to enforce the new rules written in Washington. By increasing the costs of borrowing for certain local activities but not others, tax law has allowed Washington to play a more influential role in local investment decisions than it had previously. Federal tax policy, therefore, does not only shape the activity of firms and individuals; it also constrains and limits the policy options open to local governments.

Politics among governments, therefore, involve the use of both law and market. Governments as political actors use resources from both public and private sectors in choosing their political strategies. The mobilization of such resources leads to unanticipated consequences over time. The institutionalization of federalism has not proceeded in a linear, straightforward fashion. The system is consequently full of counterintuitive surprises.

Plan of the Book

Given that nineteenth-century America was a developing country, its subnational governments acted, in Monkkonen's words, "as economic adventurers."[32] In some ways, they resembled the venture capitalists of the late twentieth century. Such activism shaped the way capital investment is undertaken today: it laid the foundation for the costs and benefits transmitted to contemporary local governments by the current system of investment. Furthermore, since most (civilian) public capital investment is undertaken at the local level, such activism has played a crucial role in the national system of capital investment in the United States.

This study argues that local government as investor can only be understood in light of its nineteenth-century interventionist and entrepreneurial role. As such, it differs from interpretations assuming that nineteenth-century America was the land of laissez-faire, and that markets (and the American economy) developed naturally and without extensive public intervention. In the nineteenth century, state and local governments took the risks that private entrepreneurs either could not or would not take. They mobilized financial resources for the building of infrastructure that was crucial for economic development.

The pathologies of such public entrepreneurship set off a chain reaction. Restrictions were imposed by state governments on both state and local investment. Subsequently, however, such restrictions were circumvented in order to provide the capital infrastructure necessary for public health and urbanized life. The "entrepreneurial state" (to use Peter Eisinger's term) reemerged after World War II, followed in the 1980s by restrictions imposed at the federal level.[33] The initial nineteenth-century sequence of activism, limitation, and circumvention was partially replicated when the Tax Reform Act of 1986 restricted the economic development activities of subnational governments.

The pattern of investment entrepreneurship, restriction, and circumvention constitutes a major theme of this analysis. The analysis traces this pattern by examining those investment activities of local government financed by borrowing in the municipal bond market. Activities that fall under this rubric include capital investment as traditionally defined (providing capital infrastructure) as well as those economic development activities funded by borrowed monies. The relationships discussed in this analysis characterize capital investment in all capital-intensive policy sectors in which local government plays a role. The aim is not to discuss the details of any one sector but rather to sketch the general contours of the system within which all American subnational capital investment takes place. Although my focus is primarily on local investment, I discuss "subnational" investment where it is appropriate to include an examination of the capital investment carried out by the states.

Chapters 2 and 3 explore the roots of the state-local relationship in the area of capital investment. The states are discussed in detail in chapter 2 because it was the reaction to their investment adventures that spurred local government to its period of intense entrepreneurial activism. These chapters analyze the roots of the symbiotic relationship that exists between state government and local government in the investment arena. That relationship is so fundamental that one can analyze "local" investment as local only if one is willing to ignore the importance of the structure, imposed by state government, within which local governments invest.

More specifically, chapter 2 examines the role of state governments as entrepreneurs and the legal reaction to such entrepreneurship. Chapter 3 discusses local governments' investment activism and analyzes the reasons behind that activism. Chapter 4 explores the second major function of local government — that of providing capital-intensive services. It discusses how such provision is intimately entangled with both debt and technological change, which in turn requires still more borrowing. The reaction to such active investment by state legislatures, state courts, and the Supreme Court is explored in chapter 5. The limits imposed by the states and the judiciary on the local borrowing that underpinned such entrepreneurialism are sketched.

Chapters 2, 3, 4, and 5 form a unit in the sense of (1) laying out the evolution of the legal and market structure within which twentieth-century local officials had to maneuver in order to borrow and (2) sketching the process whereby the role of local government within the American federal system came to be defined. In particular, these chapters highlight how contingent was the process whereby local government came to occupy the place it does in the governmental hierarchy. That process involved the experience of the states themselves, the consequences of the activities initiated by autonomous local governments, and the conflict between the state and federal courts. Taken as a whole, these chapters argue against the notion that laissez-faire ideology or the emphasis of

American culture on "privatism" adequately explains the division between state and market in the American system. The emphasis here is on the often contentious dialogue *between governments* concerning which government should do what and how much as an economic actor. The history of that dialogue has significantly shaped current relations among governments.

Chapters 6 and 7 form a unit for collectively they describe how local governments managed to avoid some of the most burdensome consequences of the limitations placed upon local borrowing by the states. They analyze the two-pronged strategy used by local officials to circumvent restrictions imposed on public investment, emphasizing the development of both law and the municipal bond market as instruments of circumvention. Chapter 6 examines the use of the market as a mechanism of circumvention, paying particular attention to the development of the revenue bond as the instrument that allowed the municipal bond market to play the role it did. Chapter 7 focuses on the creation of a new governmental unit—the public authority—as a means of circumventing debt limitations. Both chapters examine the role of the New Deal in facilitating the diffusion of instruments of circumvention. Both chapters stress the critical role that the courts played in the survival of the authority and of the revenue bond.

Chapters 8 and 9 examine the postwar period, and they too form a unit. Chapter 8 is concerned with the use of the public authority and the revenue bond in the area of economic development, exploring how the instruments of circumvention—developed and diffused in the period before World War II—came to be used by subnational governments in the 1960s and 1970s to help private firms and residential households. Chapter 9 focuses on the restrictions imposed by the federal government in the 1980s on the economic-development activities of state and local governments, paying particular attention to the impact of the Tax Reform Act of 1986, landmark legislation in the history of federalism.

Chapter 10 concludes by sketching some of the enduring characteristics of the American federal system suggested by this examination of capital investment. In particular, the chapter argues that the dimension of territorial politics—the politics among governments—needs to be recognized as coexisting in the American polity alongside politics as conventionally understood. Political parties and interest groups share the political arena with subnational governments pursuing their own interests as institutions.