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Clayton P. Gillette
clayton.gillette@nyu.edu

CAN PUBLIC DEBT ENHANCE DEMOCRACY?

CLAYTON P. GILLETTE*

ABSTRACT

This Essay draws on historical and current examples to examine the extent to which public creditors can enhance democracy by monitoring public officials in a manner that compensates for the failures of the government debtor's constituents to monitor public officials. Creditors and constituents may share significant interests, depending on the structure of security arrangements for public debt and the identity of the debtors. Where interests overlap, the capacity of creditors to overcome collective action problems suffered by constituents may transform creditors into surrogates for constituents. Whether creditors are willing to play this role, however, may depend on the existence of alternatives to creditor monitoring, such as diversification and market constraints on default. The Essay concludes with an examination of the plausible scope of creditor monitoring in contemporary settings of sovereign and state and local debt.

* Max E. Greenberg Professor of Contract Law, NYU School of Law. An earlier version of this Essay was presented as the annual George Wythe Lecture at the College of William and Mary Marshall-Wythe School of Law in April 2008. Thanks to Alyssa Bell for substantial research support and to Kevin Davis and Katharina Pistor for conversations and comments.

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INTRODUCTION

In the early fifteenth century, the Republic of Genoa was teetering on the brink of financial disaster. Plague, war, and internal dissent had increased Genoa's debt to the point that 90 percent of the Republic's ordinary income was required to service interest obligations.[1] Creditors of the Republic recognized the situation as unsustainable, and acted to protect their interests from what must have seemed like imminent bankruptcy.[2] In 1407, they founded the Casa di San Giorgio ("San Giorgio"), an institution that was nominally a private association, but the function of which was to bring order to the Republic's finances and reduce the risk of debt repudiation.[3] San Giorgio began its operations by exchanging Genoa's massive debt for equity shares in the new association.[4] San Giorgio then made "grants" to fund the Republic's governmental activities. In return, San Giorgio received the right to collect taxes, to operate the Republic's profitable salt monopoly and mint, and to govern some of the Republic's overseas territories.[5] Thus, although San Giorgio's 11,000 shareholders, governed by a corporate structure that involved several councils and an eight-person board of directors called "The Protectors of San Giorgio," were nominally equity holders, they were effectively lenders secured by payments from dedicated revenue streams of the Republic.[6]

San Giorgio was, in some ways, a beneficent creditor. It distributed large sums to Genoan charities,[7] forgave many of the Republic's debts during times of excusable fiscal distress, and

1. STEVEN A. EPSTEIN, GENOA AND THE GENOESE, 958-1528, at 229 (1996).

2. *See id.*

3. *See id.*; Michele Fratianni, *Government Debt, Reputation, and Creditors' Predictions: The Tale of San Giorgio*, 10 REV. FIN. 487, 487 (2006).

4. *See id.*

5. *See* JAMES MACDONALD, A FREE NATION DEEP IN DEBT: THE FINANCIAL ROOTS OF DEMOCRACY 95 (2003).

6. *Id.* at 95-96.

7. *See* Fratianni, *supra* note 3, at 496. As I hope to indicate below, the capacity to distinguish between excusable fiscal distress and inexcusable strategic nonpayment by the debtor is a hallmark of the monitoring capacity of creditors. The fact that San Giorgio shareholders made this distinction indicates their capacity to monitor the conduct of the state.

dedicated substantial contributions to the operation of the state.[8] This beneficence may have been motivated largely by the self-interest of the shareholders, who also tended to be residents of Genoa.[9] Thus, imposing unduly harsh conditions on the Republic would mean imposing such conditions on themselves.[10] But most importantly, San Giorgio regularized access to credit, attracted shareholders by reducing the risk of default, and—by assuring repayment of loans—brought political stability to a state that had previously so abused the financial wherewithal of its constituents[11] through policies such as forced loans that, in 1339, the enraged constituents burned the Republic's tax and debt records in a popular revolt.[12] Machiavelli so highly regarded the subsequent effect of San Giorgio on the finances and governance of Genoa that he referred to the association as "the preserver of the country and the Republic."[13]

It would be inappropriate, however, to think of San Giorgio as a crucible of democracy. Although a "state within a state,"[14] San Giorgio was primarily interested in protecting creditors' rights and reversing Genoa's reputation for debt repudiation.[15] In doing so, San Giorgio arguably enriched its own shareholders by transforming the Republic into a mere pensioner and shifting the obligation to support the state from the merchant beneficiaries of the state's commercial ventures to the general public.[16] Moreover, San Giorgio enforced its contractual rights in ways that might be seen as inconsistent with democratic values. San Giorgio had the right not only to prosecute tax evaders, but to torture them, excommunicate them, and sentence them to death.[17] There is, however, no indication of the use of waterboarding.

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8. *Id.*

9. *See* MACDONALD, *supra* note 5, at 142 (concluding that "the eleven thousand shareholders of San Giorgio represented the large majority of households in the city").

10. *See* Fratianni, *supra* note 3, at 488.

11. I use "constituents" throughout to refer to a group broader than the electorate, which may be limited by voting qualifications.

12. MACDONALD, *supra* note 5, at 80-81.

13. *Id.* at 96 (quoting Machiavelli).

14. Fratianni, *supra* note 3, at 495.

15. *Id.* at 487.

16. *See id.* at 495.

17. *See* MACDONALD, *supra* note 5, at 95.

Even if San Giorgio was undemocratic, its role in creating more widespread wealth, diluting the authority of the few autocratic families that had theretofore ruled Genoa, and constraining the exercise of political power by controlling financial affairs suggests that its policies greatly facilitated the growth of democratic values.[18] San Giorgio certainly did not intend the fomentation of democracy to be one of its objectives, but governance through structures more likely to align the interests of officials and constituents may have been an inevitable byproduct of its activities. It was not simply that San Giorgio involved a complicated governance structure—a General Assembly of 480 shareholders and an elected protectorate of 8 members with financial expertise[19]—that reduced concentrations of power by giving rise to a large pool of prospective public officials. It was also the case that the control that creditors exercised over the Republic's access to credit constrained those who sought political control over Genoa from attaining power through the abuse of constituents' rights.[20]

San Giorgio, then, stands as an exemplar of an interesting but underanalyzed phenomenon of public finance. It has become commonplace to suggest that the institutions that support public credit simultaneously create incentives for democratic governance within constitutional constraints.[21] According to this theory, public

18. *Id.* at 96. Macdonald explains that San Giorgio effectively displaced political feuds by omitting the parties who placed power politics ahead of financial security:

> The Genoese, unable to form a cohesive polity on the basis of one-man-one-vote, had effectively formed [through San Giorgio] a parallel polity based on formalized power-sharing that largely excluded the two most disruptive elements in city life: the ex-feudal aristocracy and the urban poor. The Fieschi and Grimaldi families, so dangerous politically, were almost unrepresented in its administration, whereas the urban mercantile nobility, such as the Spinola family, featured prominently.

Id.

19. Fratianni, *supra* note 3, at 493-94 (reporting that the election was not fully democratic, in that persons eligible for election were limited to a subset of citizens listed in a secret book that was updated annually). Indeed, it is not clear that even this level of democratic election was always available. *Cf.* MACDONALD, *supra* note 5, at 96 (noting that "protectors" were appointed, and they, in turn, appointed their successors at the end of their term.).

20. *See* AVNER GREIF, INSTITUTIONS AND THE PATH TO THE MODERN ECONOMY: LESSONS FROM MEDIEVAL TRADE 250 (2006).

21. *See, e.g.*, MICHAEL SONENSCHER, BEFORE THE DELUGE: PUBLIC DEBT, INEQUALITY, AND THE INTELLECTUAL ORIGINS OF THE FRENCH REVOLUTION 3-8 (2007).

creditors will condition their loans on the sovereign's creation or toleration of institutions that increase the probability of payment by constraining the capacity of the debtor either to use loaned funds for unanticipated objectives (the moral hazard problem) or to repudiate or unilaterally alter the repayment obligation.[22] Frequently, these institutions take the form of representative bodies—at least representative of creditors—that are able to control tax collection and sovereign expenditures.[23] Through these footholds in the political process, creditors arguably set in motion the forces that have emerged into full political participation in advanced democracies. Moreover, commentators now perceive these institutions as precursors to rapid commercialization, economic growth, and the general enforcement of contract and property rights. In short, the presence of public debt is seen as a catalyst for democracy and robust markets rather than simply a means of financing the self-interested objectives of political officials.[24]

In this Essay, I explore an additional mechanism that identifies public credit with democratic governance. I suggest that, notwithstanding some inevitable divergence between the interests of governmental creditors and debtors, public debt can enhance the representative nature of democratic governance to the extent that creditors engage in monitoring that transforms them into surrogates or virtual representatives for the debtor's constituents. To be specific, creditors may have the capacity to monitor government officials in a manner that both complements and improves the institutions that constituents at large utilize to constrain public officials. Indeed, creditors' incentives allow them to overcome collective action problems that frustrate constituent monitoring of their officials. It was just this form of monitoring that presumably allowed the members of San Giorgio to distinguish between threatened defaults generated by benign conditions and those that arose from opportunistic behavior of public officials.[25] Ostensibly, the creditors were willing to waive the former, but not the latter.

22. *See, e.g.*, Fratianni, *supra* note 3, at 494-96.

23. *See, e.g.*, MACDONALD, *supra* note 5, at 95 (referring to San Giorgio as an example of such a body).

24. *See* SONENSCHER, *supra* note 21, at 3 & n.7.

25. *See* Fratianni, *supra* note 3, at 488-89, 496.

Any such strategy, however, required that creditors actively monitor officials to determine the source of the threatened default.[26]

On reflection, the claim that creditor monitoring can enhance democracy should not be surprising. The capacity of creditors to constrain the activities of officials in private firms is the subject of a vast literature.[27] Creditors of firms presumably have interests that, to some extent, coincide with those of shareholders, insofar as profit-maximizing activities increase both the capacity of debtors to repay debts and the value of shares. Thus, although creditors provide financial advice to debtors or monitor fiscal behavior to constrain the firm's officers from misusing corporate assets in a manner that would threaten repayment,[28] they simultaneously confer a benefit on shareholders who lack either the capacity or the willingness to engage in similar monitoring. My objective here is to explore the extent to which a similar relationship exists between creditors of government and the constituents of government debtors.

My reference to democracy in this Essay is somewhat idiosyncratic. It does not necessarily entail direct participation by constituents in political processes. Instead, it entails any political system in which officials face significant institutional constraints to comport themselves in a manner that is consistent with the interests of their constituents. Typically, those constraints come from the constituents themselves in their role as voters, or from designated third parties, such as courts, that are charged with enforcement of constitutionally dictated restrictions on governmental authority. Thus, my use of the term "democracy" necessarily embraces the concept of virtual representation by proxies who are not elected or accountable to constituents, but who, by virtue of sharing the constituents' interests, serve to advance their preferences, which public officials might otherwise ignore.

The alignment of interests between creditors and constituents is important because constituents—even when acting as voters—face numerous obstacles to serving as effective monitors of their officials.

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26. *See id.* at 496.

27. *See* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 757 (1997) (describing some of the existing literature).

28. *See* Frances E. Freund, *Lender Liability: A Survey of Common Law Theories*, 42 VAND. L. REV. 855, 886 (1989).

Thus, the claim that public creditors can enhance democracy assumes that creditors can overcome the limitations on monitoring by noncreditor constituents. It is plausible, of course, that public creditors could serve as effective monitors of officials, but still not serve as an effective substitute for the electorate. This would be the case, for instance, if public creditors are monitoring for behavior that varies from the behavior that concerns the electorate, or if the time horizon of creditors varies from the time horizon of the electorate. Thus, the claim that creditors enhance democracy also assumes that within the range that creditors can monitor and noncreditor constituents cannot, the interests of creditors, and thus the conditions for which they would monitor, coincide with the interests of noncreditor constituents.

I. THE IDENTITY OF CREDITOR AND CONSTITUENT INTERESTS

The possibility that public debt could actually benefit democratic governance is by no means self-evident. Indeed, public debt is frequently considered antithetical to good government.[29] After all, capital to which credible commitment provides easy access can be used for bad reasons as well as good. Much of the early history of public debt, particularly that incurred by hereditary monarchs, is written in the blood of destructive wars financed by foreign capital, the corruption of officials by financiers who advanced sums in return for a subsequently abused right of tax collection, and the reduced productivity created by the use of capital for forced loans rather than for the infrastructure and public goods that one might imagine constituents would have preferred.[30] Because political officials have the capacity to raise taxes, they suffer fewer constraints than officials of firms for whom debt may serve as a bond to pay future cash flows to shareholder recipients of the debt.[31]

The San Giorgio experience illustrates how financial arrangements that mollify creditors are not necessarily embraced by those

29. *See, e.g.*, SONENSCHER, *supra* note 21, at 3.

30. *See, e.g.*, MACDONALD, *supra* note 5, at 138-44; DAVID STASAVAGE, PUBLIC DEBT AND THE BIRTH OF THE DEMOCRATIC STATE: FRANCE AND GREAT BRITAIN, 1688-1789, at 52-53 (2003).

31. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 324 (1986).

who must pay the debt service, even when capital is put to good use. Governments could favor use of limited funds to repay creditors over use of the same funds to fulfill political and social obligations to constituents.[32] The common practice in late and post-medieval England and Europe of granting creditors the right to collect debts directly, rather than to receive payments funneled through the debtor's treasury,[33] suggests distrust of governmental willingness both to collect sufficient revenues from constituents and to pay creditors those funds that were collected. The fact that creditors were from a small, propertied class of nobles and merchants,[34] or worse yet, foreigners who feared debt repudiation more than they feared the hostility of taxpayers,[35] exacerbated the divergent interests between creditors and constituents.

Moreover, there are conditions under which creditors will fail to monitor, so that the mere extension of credit, for good reasons or bad, reveals little reason to believe that creditors and constituents share interests that would make the former group a useful proxy for the latter. Monitoring may be futile where sovereigns suffer little compunction about default or debt repudiation. France, for instance, witnessed five defaults between the mid-sixteenth and mid-seventeenth centuries.[36] Subsequent monarchs avoided repudiation, but unilaterally reduced contracted-for interest rates.[37] Spanish debt was "restructured," after defaults on at least eight occasions between 1557 and 1662.[38] Indeed, monitoring becomes superfluous to the extent that there is no effective way to enforce payments by sovereigns who wish to default, a phenomenon that resurfaced in the 1920s when sovereign borrowers as diverse as Russia, Mexico,

32. *See* SONENSCHER, *supra* note 21, at 11.

33. *See, e.g.*, STASAVAGE, *supra* note 30, at 60 (noting that English kings "often secured loans by giving their creditors the right to directly collect certain Crown revenues").

34. *Id.* at 135 tbl.6.1 (reporting that in France, nobles and merchants made 77 percent of the loans to the State from 1682 to 1700, and 81 percent of the loans from 1730 to 1788).

35. *Id.* at 135 tbl.6.2 (reporting that in France, foreign creditors made 12 percent of loans to the State from 1730 to 1749, and 18 percent of the loans from 1770 to 1789).

36. *See* MACDONALD, *supra* note 5, at 143 (noting that there were "five major bankruptcies ... the last four of which were accompanied by massive repudiations of debt").

37. *See* STASAVAGE, *supra* note 30, at 89.

38. MACDONALD, *supra* note 5, at 129-30.

and Turkey defaulted notwithstanding the apparent absence of any fiscal distress that warranted nonpayment.[39]

The ineffectiveness of monitoring is, of course, a relative matter. Creditors will still be willing to extend credit to risky debtors if there exists a reasonable substitute for monitoring. Traditionally, creditors have demanded risk premiums in the form of higher interest rates from sovereigns whose history indicated a higher likelihood of default to compensate for the higher risk of nonpayment.[40] Although this tactic has been economically rational for creditors, it necessarily imposes a more significant financial burden on the debtors' constituents. After French sovereigns in the late seventeenth and early eighteenth centuries defaulted on outstanding debts and unilaterally reduced interest rates, subsequent French sovereign borrowing occurred only at interest rates significantly higher than those charged for English sovereign borrowing,[41] a fact that ostensibly contributed to the fiscal crises underlying the French Revolution.[42] Alternatively, potential creditors may refuse to extend credit at all to sovereigns that have reneged on existing debts without justification.[43] Assuming that the sovereign has the need for capital infusions and would use the proceeds to advance constituent interests, one can hardly consider creditor refusals to lend based on the defaults of former governments to be evidence of unity of interests with constituents.

These concerns about public credit found voice in David Hume's reaction to the vast debts incurred by England to fight the Seven Years War. In floating the prospect of the state's declaration of voluntary bankruptcy, Hume famously wrote "[E]ither the nation must destroy public credit or public credit will destroy the nation."[44] Hume's objections, however, were not simply economic. Instead, they were based largely on the political implications of debt. In particular, his concerns implied a necessary contradiction between

39. MICHAEL TOMZ, REPUTATION AND INTERNATIONAL COOPERATION: SOVEREIGN DEBT ACROSS THREE CENTURIES 86-87 (2007).

40. *See* STASAVAGE, *supra* note 30, at 89.

41. *See id.* at 69.

42. *See id.* at 95.

43. *See* TOMZ, *supra* note 39, at 86-89.

44. DAVID HUME, ON PUBLIC CREDIT (1752), *reprinted in* HUME: POLITICAL ESSAYS 166, 174 (Knud Haakonssen ed., 1994).

public debt and the conditions for democracy.[45] Public debt exacerbated divergent interests within the nation, insofar as it facilitated concentration of capital among an urban merchant class that was supported by taxation on the "provinces."[46] Debt inflated prices and taxes; it placed too much authority in the hands of foreign creditors whose allegiance was inconsistent with the interests of Englishmen; and, in a reminder of the biblical admonition to live by the sweat of our labor,[47] it would encourage a "useless and unactive life" by allowing creditors to live idly off the interest of their investments.[48] The state's voluntary declaration of bankruptcy might sacrifice the welfare of the thousands of people who held state obligations, but the alternative was to sacrifice millions "for ever to the temporary safety of thousands."[49] That would be the case if servicing debt were to consume so much of the sovereign's assets as to render the state defenseless against its enemies. The sovereign debt would be extinguished, but it would be a "violent death," as compared with the "natural death" of bankruptcy.[50]

More recent literature is kinder to the relationship between public debt and democratic governance.[51] In the most obvious connection, creditors who impose strict requirements on debtors that increase the probability of payment necessarily constrain the use of cash and reduce borrowing costs for the debtor's constituents. San Giorgio's tough tactics for debt collection revealed that relationship: long-term interest rates in Genoa were lower than those in virtually every other European financial center.[52]

More to the point, however, the terms that creditors demand from sovereign debtors induce the creation of democratic institutions.[53] Those requirements result from the puzzle of public debt: although its extension could make a government economically secure enough to collect revenues necessary for repayment, any sovereign suffi-

45. *See id.* at 169-70.
46. *See id.*
47. *See Genesis* 3:19 ("In the sweat of thy face shalt thou eat bread.").
48. HUME, *supra* note 44, at 170.
49. *Id.* at 177.
50. *Id.* at 176.
51. *See, e.g.*, SONENSCHER, *supra* note 21, at 3 n.7.
52. Fratianni, *supra* note 3, at 502.
53. *See, e.g.*, SONENSCHER, *supra* note 21, at 3 n.7.

ciently powerful to enforce a regime of taxation necessary to service its debt might also be secure enough to repudiate its obligations; any government with the resources necessary to attract public credit could also have the capability of defaulting with relative impunity. Thus, creditors should prefer not only financial covenants to ensure repayment, such as negative pledge clauses and promises to maintain revenues (taxes) sufficient to service the debt, but also institutional changes that reduce the moral hazard of using borrowed funds for high risk endeavors or that frustrate incentives to default. It may not be completely off the mark to think of those who loaned funds to rulers as the medieval equivalent of today's venture capitalists, who, in return for funding, demand a seat on the board of directors and guide decisions that are consistent with the interests of shareholders generally. In effect, the adoption of institutional structures that restrict discretion constitutes credible commitments from sovereigns to repay their debts.

Historically, these credible commitments have consisted of private and public institutions that ensured the collection of funds sufficient to repay debts and the imposition of constraints on executives who might otherwise divert funds that were collected.[54] As demonstrated by the work of Douglass North and Barry Weingast, these institutions of credible commitment have included the removal of authority from the executive (in England's case, the King), such as occurred with the creation of the Bank of England to handle the government's loan accounts or the assignment to Parliament of the right to approve loans.[55] The consequence was that public credit expanded, generating economic growth even as interest rates fell, and constitutional constraints initially instituted to ensure creditors' rights evolved into constitutional and political constraints on the capacity of rulers to interfere with property and

54. *See* STASAVAGE, *supra* note 30, at 66-67. The relationship between political representation and credible commitment to repay is such that their coexistence may depend on underlying economic and political conditions, rather than a purely causal relationship. *See* DAVID STASAVAGE, THE RISE OF POLITICAL REPRESENTATION AND THE PROBLEM OF PUBLIC CREDIT IN EUROPE, 1250-1750 (forthcoming 2009) (manuscript at 5, 7-8).

55. *See* DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 139 (1990); Douglass C. North & Barry R. Weingast, *Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England*, 49 J. ECON. HIST. 803, 820-21 (1989).

contract rights generally.[56] The expanded powers of Parliament, the inclusion of the Contracts Clause into the American Constitution, and the evolution of an independent judiciary in both societies are all related in large part to demands imposed on sovereigns by creditors to restrict the discretion of debtors.[57] Indeed, the development of a rich jurisprudence that injected significant substance into the Contracts Clause emerged in the late nineteenth century, after states and cities, through irrational exuberance or corruption, borrowed to finance poorly capitalized railroads and then sought to repudiate their debt obligations when the promised commercial benefits failed to materialize.[58]

More recent and more nuanced analyses suggest that the mere presence of representative assemblies and democratic governance does not establish the ability of sovereigns to make credible commitments.[59] That is, democratic institutions are neither a necessary nor a sufficient condition to forestall default or to create an environment of trust that translates into a financial environment that makes economic growth more plausible.[60] Nevertheless, democratic institutions may be more conducive to the circumstances that permit the creation of credible commitments.[61] Political parties that allow logrolling among various interests can provide creditors with assurances that they can build coalitions to resist default, and administrative bureaucracies can shield default decisions from the demands of an autonomous executive.[62] In short, political institutions can reduce the risk of financial distress that might discourage creditors from lending to sovereigns.[63]

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56. *See* North & Weingast, *supra* note 55, at 824-28.

57. *See* NORTH, *supra* note 55, at 138-39; Lino A. Graglia, *The Burger Court and Economic Rights*, 33 TULSA L.J. 41, 46-47 (1997).

58. *See* 6 CHARLES FAIRMAN, HISTORY OF THE SUPREME COURT: RECONSTRUCTION AND REUNION, 1864-88, PART ONE 918 (1971). The most important decisions about the reach of the Contracts Clause continue to involve constraints on governments that seek to repudiate their debts. *See, e.g.*, U.S. Trust Co. v. New Jersey, 431 U.S. 1, 30-32 (1977).

59. David Stasavage, *Credible Commitment in Early Modern Europe: North and Weingast Revisited*, 18 J.L. ECON. & ORG. 155, 155-56 (2002).

60. *See* STASAVAGE, *supra* note 30, at 45-47.

61. *See* Stasavage, *supra* note 59, at 183-84 (describing the structure of partisan interests and political coalitions important for the creation of credible commitment).

62. *See* STASAVAGE, *supra* note 30, at 2-3.

63. *See id.*

These analyses suggest that, although the efforts of creditors to ensure repayment may be motivated by self-interest, they can generate as a byproduct a series of constraints on the anti-democratic tendencies of officials that is consistent with the interests of constituents who would otherwise have less capacity to monitor their officials.[64] Moreover, economic historians attribute the presence of institutions that emerge from—or that are consistent with—the desire to facilitate public debt to the developmental divide between rich and poor countries, while political scientists attribute the same phenomenon to the degree of freedom enjoyed by a nation's citizens.[65]

But I want to explore a stronger claim: that public credit can enhance democracy not simply because the desire to attract credit generates institutions that check the exercise of executive discretion, but also because creditors have incentives to monitor the exercise of that discretion in ways that overcome limits on the capacity of constituents to deploy those democratic institutions. In short, the institutions that simultaneously attract credit, support democracy, and encourage economic development are not self-enforcing. These institutions provide avenues of opportunity that constituents can exploit to monitor their officials.

II. PUBLIC CREDITORS AS PUBLIC MONITORS

A. The Limits of Monitoring: Shareholders and Constituents

If constituents fail to take advantage of institutions that facilitate monitoring, then there is little reason to believe that the presence of these institutions will enhance democracy. Unless, of course, some substitute group can compensate for the shortcomings in constituent monitoring. Can creditors play that role? That is, can creditors improve democratic governance, not simply by demanding institutional arrangements that make commitments to repay credible, but also by direct supervision of the governing process?

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64. *See id.*

65. *See generally* DEMOCRACY, GOVERNANCE, AND GROWTH (Stephen Knack ed., 2003) (containing articles describing these institutions as necessary for the relative poverty and development of nations).

And if they do so, can they exercise that supervision in a manner that aligns with the interests of constituents at large? In this section, I suggest that there is at least a theoretical basis for concluding that creditors have the capacity to engage in monitoring that constituents of the state will otherwise avoid. "Monitoring" in this context means monitoring for *fiscal propriety*. The interests of creditors lie in obtaining repayment of the funds they have loaned. There is little reason to believe that creditors would fill any gap in monitoring for official conduct that exhibits moral turpitude or lax government skills, but does not have budgetary implications. Yet so much of what governments do, and—as I will suggest below—so much of what escapes the notice of constituents,[66] is directly tied to budgetary issues that creditor interventions with respect to financial conditions would appear to have significant implications for democratic governance.

Here, a corporate analogy may be appropriate. One underlying assumption of corporate governance is that capital structure affects the performance of firms, largely because different capital structures influence the mechanisms of corporate governance and impose different forms of discipline on managers.[67] Adding debt to the firm's capital structure has the positive effect of inducing creditors to scrutinize managers in a manner that may be unavailable at the same cost to shareholders.[68] Different creditors of firms have different capacities to monitor their debtors, although there is debate about which creditors enjoy which advantage.[69] Much of the debate about the efficiency of secured credit, for instance, assumes that unsecured creditors or creditors who have wraparound security interests in all the firm's assets may monitor the entire firm, while creditors who lend against specific assets of the firm may closely monitor only those assets.[70]

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66. *See infra* notes 86-97 and accompanying text.

67. *See* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 653-54 (1984).

68. *See* Jensen, *supra* note 31, at 324 (noting that "debt ... reduces the cash flow available for spending at the discretion of managers"); George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 CAL. L. REV. 1073, 1078 (1995).

69. *See* Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 909-11 (1986) (discussing contradictory positions in context of secured credit).

70. For a summary of the debate as it has played out in literature, see *id.* at 904-11.

Credit facilities for firms may also include covenants against actions that serve as observable proxies for imprudent debtor behavior.[71] For example, covenants may mandate certain levels of performance, proscribe activities suggestive of managerial self-dealing, and constitute barometers of financial difficulties within the firm.[72] Indeed, the very existence of fixed payment obligations is assumed to impose significant discipline on managers, because missed payments provide a readily detectable indication of mismanagement and trigger consequences more salient than those that attend other characteristics of managerial slack.[73]

Finally, debt issuance may reduce agency costs by retarding the capacity of managers to use corporate assets for projects that cannot be readily detected, but that deviate from the firm's mission.[74] Debt covenants, for instance, may obligate managers to pay out "free cash flows," that is, cash that cannot profitably be reinvested by the corporation, but that officers and managers might otherwise use to purchase perquisites or invest in projects with negative net present value.[75]

These positive aspects of debt are, in theory at least, enhanced when debt is issued on a secured basis.[76] The effects of granting security interests are twofold. First, they create a bond between the debtor and creditor that encourages the latter to become significantly involved in the operations of the former.[77] Interactions that increase the debtor's likelihood of success not only ensure repayment of outstanding debt, but also increase the likelihood of future profitable interactions between the parties.[78] These same interactions facilitate monitoring by giving the creditor significant information about the debtor's operations. Simultaneously, security interests encourage monitoring by providing the creditor with a

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71. *See* Clifford W. Smith, Jr., *A Perspective on Accounting-Based Debt Covenant Violations*, 68 ACCT. REV. 289, 289-90 (1993).

72. *See* Triantis & Daniels, *supra* note 68, at 1093.

73. *See id.*

74. Easterbrook, *supra* note 67, at 653-54; Scott, *supra* note 69, at 909.

75. *See* RICHARD A. BREALEY & STEWART MYERS, PRINCIPLES OF CORPORATE FINANCE 528 (6th ed. 2000); Easterbrook, *supra* note 67, at 653-54; Jensen, *supra* note 31, at 323-24.

76. *See* Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 56 (1982).

77. *See id.* at 55-56; Scott, *supra* note 69, at 926.

78. *See* Scott, *supra* note 69, at 937.

significant payoff for reviewing the firm's financial activity.[79] Should the firm detect fiscal distress, the security interest provides a relatively inexpensive mechanism by which the creditor can exercise leverage, since the assets subject to the security interest are likely to be essential to the continued operation of the firm and the threat to foreclose is both credible and relatively inexpensive.[80] Should that threat go unheeded, the existence of the security interest permits the creditor to extricate itself from the relationship at a lower loss than might be realized by unsecured creditors.[81] By taking security interests, creditors can elevate their status in bankruptcy proceedings and preclude the firm from liquidating useful assets or from incurring additional debt that might be used to engage in low-expected-return activities.[82]

Perhaps most importantly, creditors hold both an ex ante and an ex post threat against managers who might otherwise be able to shirk in recognition of the limits of the monitoring capacity of shareholders. Creditors can effectively foreclose access to capital markets either by demanding negative pledge clauses or by tying up sufficient assets to leave little for subsequent creditors.[83] The incentives for creditors to act in this way may simply be the *in terrorem* effect that presumably deters debtor misbehavior in the first instance. But more to the immediate point, the capacity of creditors to detect misbehavior is derivative of the claim that they monitor the firm. Indeed, Henry Hansmann and Reinier Kraakman have suggested that the limited liability of corporations can best be explained as an inducement for creditors to monitor the corporation, because the assets of shareholders are unavailable in the event of default.[84] Creditors, they contend, may have access to information unavailable to other stakeholders, such as shareholders who suffer from collective action problems. Additionally, the fact that recover-

79. Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 425 (2000).

80. *See* Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 645-47 (1997).

81. *Id.* at 648-49.

82. *See* George G. Triantis, *A Free-Cash-Flow Theory of Secured Debt and Creditor Priorities*, 80 VA. L. REV. 2155, 2158-61 (1994); Triantis & Daniels, *supra* note 68, at 1078.

83. *See* Mann, *supra* note 80, at 641-45.

84. Hansmann & Kraakman, *supra* note 79, at 425.

ies can be had only against the firm's assets induces creditors to seize that advantage by monitoring the firm's financial condition.[85]

Many of these aspects of debt have some, if imperfect, analogy to the market for public credit. If debtholders and constituents are analogous to public creditors and residents respectively, then the capacity of private creditors of firms to compensate for any slack in shareholder monitoring may apply with equal force to the capacity of creditors of public entities to substitute for passive constituents.

Consider in this regard the need for creditor monitoring. Although it may occur only out of creditors' own self-interests, it confers a public benefit if constituents fail to monitor their officials and creditor monitoring serves as a substitute. There is significant support for the proposition that constituent monitoring is seriously limited.[86] Typically, the imperfections that characterize constituent monitoring emanate from agency costs in the government-citizen relationship.[87] If government officials were faithful servants of their constituents, then monitoring would be superfluous. If, on the other hand, government officials were self-interested, then they have no independent reason to pursue the public good when it deviates from their own self-interest.

There is no shortage of claims that public officials deviate from the public interest model that underlies the most optimistic view of democratic governance.[88] Examples of self-interested objectives that might induce public officials to act in a manner inconsistent with the interests of their constituents include maximization of governmental budgets, maximization of leisure time, or maximization of post-public service private sector employment opportunities.[89] Even the assumed desire that public officials seek reelection or higher office, which might be thought to require performance of one's current task in a manner reflective of the public interest, does not dilute the need for substantial monitoring of official performance.

85. *Id.*

86. *E.g.*, Joseph P. Kalt & Mark A. Zupan, *The Apparent Ideological Behavior of Legislators: Testing for Principal-Agent Slack in Political Institutions*, 33 J.L. & ECON. 103, 107-08 (1990).

87. *See id.*

88. *See, e.g., id.* at 103-04.

89. *See* Clayton P. Gillette, *Local Redistribution, Living Wage Ordinances and Judicial Intervention*, 101 NW. U. L. REV. 1057, 1067-68, 1102-03 (2007).

Continuation in office or elevation to higher office may depend on the support of discrete groups who may seek a disproportionate share of public resources or reciprocal support for programs that either return social benefits less than their costs or are inconsistent with principles of optimal redistribution.[90] Monitoring, therefore, can detect and deter conduct that is aligned with the interests of particular groups that might serve the limited objectives of public officials, but is inconsistent with the interests of constituents at large.

Stated in these terms, the imperfections of constituent monitoring follow from standard models of collective action.[91] Monitoring itself constitutes the quintessential public good; an individual act of monitoring confers benefits on all constituents, none of whom can be excluded from enjoying the rewards of others' efforts and each of whom could monitor without foreclosing others' similar conduct. Thus, no potential beneficiary has an incentive to undertake the costs of monitoring, as he or she can enjoy identical benefits from monitoring by others. On this theory, free riding among constituents on matters of public finance should be prevalent, because the small consequences that befall any one constituent when an official misuses public funds is unlikely to justify any individual's expenditure necessary to detect and publicize the misconduct.[92] This remains true even when the aggregate costs of misconduct outweigh the social benefits of the expenditure.

In this sense, constituents may be perceived as the functional equivalent of shareholders. According to what one commentator has called the "passivity story," shareholders similarly face collective action problems in monitoring corporate officers.[93] The analogy to shareholders offers both good news and bad news for constituents concerned about monitoring public officials. The first piece of bad news is that, in the absence of monitoring, public officials are more likely to impose agency costs on their constituents than unmonitored corporate officers. When monitoring is implausible, firms can

90. *Id.* at 1085-86.

91. *See id.* For the paradigmatic discussion on Collective Action Theory, see MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1965).

92. *See* RUSSELL HARDIN, COLLECTIVE ACTION 17-18 (1982).

93. Benard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 526-29 (1990).

adopt alternative strategies to counteract the tendencies of officers to pursue personal interests.[94] Firms, for instance, can bond officers to shareholder interests, through means such as including in compensation packages stock options and incentive pay schemes that are tied to firm performance. Additionally, firms are sufficiently flexible to adopt organizational structures that separate agents who initiate and implement decisions from those who ratify and monitor decisions. A board of directors may thus explicitly disapprove proposed officer actions that conflict with shareholder interests.[95]

Constituents of public entities have fewer available mechanisms to bond public officials.[96] As often noticed in the literature on privatization of governmental functions, the operations that public officials supervise do not generate residual profits in which officials can be granted an interest.[97] Governments may use external monitors, but any such review is likely to be haphazard, rather than a systematic review as conducted by a board of directors.[98] For example, the prospect of judicial review should constrain officials' willingness to deviate from the interests of constituents. But even when official defalcations diverge sufficiently from expectations to create a reviewable claim, judicial intervention requires that interested litigants initiate legal action. This requirement simply replicates the collective action problem of finding a party with a sufficient stake in the outcome to justify the litigation costs. Even when fiscal programs are challenged, judicial deference to political decisions that concern public expenditures may be appropriate, given the relative institutional competence of political and judicial decision makers.[99] There is little reason to believe that courts have

94. Easterbrook, *supra* note 67, at 653-54.

95. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 307-08, 311 (1983).

96. *See generally* Einer R. Elhauge, *Does Incentive Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31, 70-80 (1991) (describing the shortcomings of using judicial review to curb interest group influence over public officials).

97. *See, e.g.*, Clayton P. Gillette, *Opting Out of Public Provisions*, 73 DENV. U. L. REV. 1185, 1189-90 (1996); Michael H. Schill, *Privatizing Federal Low Income Housing Assistance: The Case of Public Housing*, 75 CORNELL L. REV. 878, 883-84 (1990).

98. *See* Fama & Jensen, *supra* note 95, at 311.

99. *See* Elhauge, *supra* note 96, at 78 (describing problems related to judicial review of legislation).

any advantage over even flawed political processes in applying the potentially broad scope that might legitimately be given to "public purpose" expenditures or to financial arrangements that might plausibly comply with the objectives of "debt" limitations.[100] Courts are also likely to be highly imperfect monitors because they have limited ability to reverse engineer political decisions and distinguish benign political deals from malign rent-seeking.[101] Judges, after all, have little capacity to replicate or second-guess the kinds of budgetary tradeoffs and investment strategies that affect decisions about capital expenditures on local public goods.[102] In theory, courts can effectively limit the capacity of discrete, well-organized interests to override constituents' preferences. In practice, however, courts will have difficulty distinguishing between financial decisions that respond to interest group entreaties and those that respond to well-intentioned constituent desires, but that nevertheless impose diffuse costs and confer concentrated benefits—the hallmark of interest group dominance.[103] Indeed, fiscal decisions will systematically share those characteristics, insofar as taxes used to construct or operate a facility will be widely imposed, while the facility's benefits may be enjoyed differentially.[104] Without some relatively clear indication of fiscal impropriety, it is therefore unsurprising that courts tend to refrain from the kind of financial risk assessment for which the doctrines of public purpose, debt, and lending of credit serve as proxies.[105] Moreover, governments could

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100. Gillette, *supra* note 89, at 1117-18.

101. *See id.* at 1096-97.

102. *See* Elhauge, *supra* note 96, at 84.

103. *Id.* at 78.

104. *See* Gillette, *supra* note 89, at 1117-18 (describing a scenario in which public funding is used to construct a golf course used predominately by the rich).

105. *See* Richard Briffault, *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 956 (2003). I have argued that there may be some satisfactory metrics, predicated on the issue of who bears the risk of project failure, for whether a particular financing scheme violates constitutional debt limits. *See* Clayton P. Gillette, *Direct Democracy and Debt*, 13 J. CONTEMP. LEGAL ISSUES 365, 381-83 (2004). Although such a test is more readily administrable by a court, it admittedly does not eliminate the need for a more difficult inquiry in some cases. At the same time, even if courts could adopt an easily administrable test, the very existence of debt limits must be judged against alternative measures for constraining fiscal overextension. The vast array of debt limitations reveals that even drafters of such provisions in deliberative constitutional conventions could not develop a single metric that can properly be used to determine the

not easily adopt more rigorous private sector models that provide oversight or division of decision making authority. Constitutional structures and legal doctrines preclude local governments from delegating responsibilities in a manner that would provide disinterested nonresidents significant authority over local decision making.[106]

At the same time, shirking of duties by public officials may be less detectable than shirking by officers of firms. The willingness of constituents or shareholders to monitor will be inversely proportional to costs, and the costs of monitoring increase when information about officials' performance is not readily available in a digestible form. Even when financial information about governmental performance exists, it is rarely transparent. Governmental budgets are long, complex, and difficult to decipher, such that it is not in the interest of the average constituent to take the time to discover defalcations. Even at the local level, where free riding on the monitoring efforts of others might be diminished by lower populations than at the state or federal level, systematic review of fiscal programs is likely to be rare. Just as an example, I would venture that few residents of the City of Williamsburg, Virginia have perused either the 280-page Fiscal Year 2008 Adopted Budget[107] or the 91-page Comprehensive Annual Financial Report for Fiscal Year 2007,[108] even though both are readily available on the city's website.

In firms, information about performance can be garnered from comparing the performances of competitors; however, since govern-

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conditions under which financial obligations threaten the financial viability of states and their political subdivisions. Courts deciding whether a particular project fails to satisfy a public purpose, or threatens the objectives of a constitutional limitation, are not likely to have a significantly easier job.

106. For instance, the nondelegation doctrine and constitutional grants of home rule would arguably preclude localities from creating the functional equivalent of an outside board of directors to review the intramural decisions of local officials. *See* William N. Eskridge, Jr., *Vetogates,* Chevron, *Preemption,* 83 NOTRE DAME L. REV. 1441, 1461 (2008) (defining the nondelegation doctrine as prohibiting Congress from delegating "law-elaborating authority" to agencies without guidelines sufficient to permit robust judicial review).

107. *See* 2008 CITY OF WILLIAMSBURG, VA., ADOPTED BUDGET, *available at* http://www.ci.williamsburg.va.us/Index.aspx?page=300.

108. *See* 2007 CITY OF WILLIAMSBURG, VA., COMPREHENSIVE ANN. FIN. REP. [hereinafter ANN. FIN. REP.], *available at* http://www.ci.williamsburg.va.us/modules/ShowDocument.aspx?documentid=237.

ment-provided services tend to be monopolies, similar comparisons cannot readily be found.[109] Even when multiple localities offer the same service (for example, mass transportation), intercity comparisons are of limited utility. Comparisons of subway fares per mile in New York and San Francisco, for instance, cannot easily be made without considering relative costs of living, construction costs, number of riders, and age of the system. Even property tax rates are not easily comparable, because the utility of the information that they generate will depend on the more mysterious metric of the proportion of market value used to derive the actual taxes that property holders pay.[110]

From the perspective of constituents, the second piece of bad news in the shareholder-resident analogy is that shareholders can solve collective action problems in ways that residents cannot. Shareholders vary significantly in the extent of their interests in the firm; some may have invested little of their wealth in the firm, while others may be substantially invested in the same firm. But the public goods nature of monitoring suggests that not all principals have to monitor to deter agent misconduct. Since deterrence of officer misconduct by some confers benefits on all, it is sufficient if there exist groups with a large enough stake in corporate performance to warrant intervention. Thus, institutional investors are frequently seen as surrogates for smaller investors.[111]

Of course, constituents also have disparate interests. Some will have disproportionately high stakes in their locality, by virtue of property ownership, job, or other relatively immobile investment.[112] As in the case of institutional investors with significant stakes in

109. The real distinction may be between entities that face competition and those that do not. *See* JOHN DONAHUE, THE PRIVATIZATION DECISION 64, 67, 147 (1989). Still there is a greater tendency for firms to face competition for a particular service than for municipalities to do so.

110. *See* John A. Miller, *Rationalizing Injustice: The Supreme Court and the Property Tax*, 22 HOFSTRA L. REV. 79, 85 (1993) (asserting that assessments often fail to keep pace with property appreciation, resulting in fractional assessments; and that these assessments serve to cap property "tax bills in an inflationary economy").

111. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 66-67 (1991); Black, *supra* note 93, at 523-25, 587; John C. Coffee, *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1284-85 (1991) (pointing out that institutional investors may have interests that deviate from those of other shareholders).

112. WILLIAM A. FISCHEL, THE HOMEVOTER HYPOTHESIS 5, 74-75 (2001).

firms, these constituents may find it worthwhile to monitor against official misconduct. Landowners who pay large sums in property taxes or individuals who benefit from government programs that will be underfunded if the government is operated inefficiently all have incentives to overcome collective action obstacles that are typically attributed to political constituents.[113] In addition, to the extent that those with high stakes are willing to underwrite the costs of discovering and disseminating information about the misconduct of local officials, they—like institutional shareholders of firms—can reduce search costs for other constituents who are interested in detecting misconduct. Thus, one might initially believe that those with low stakes will be able to free ride on those to whom monitoring is worthwhile in the public as well as the private sector.

But the analogy between institutional investors and constituents with significant local stakes collapses once we consider the extent to which those who do monitor serve as proxies for the interests of those who do not. In the corporate context we fairly assume that all shareholders, regardless of the size of their stake in the firm, share a monolithic objective of maximizing the values of their shares.[114] There may be variations among shareholders, so that those who anticipate short shareholding periods may prefer corporate strategies that differ from those preferred by shareholders who anticipate longer shareholding periods.[115] But the fact that all shareholders seek some form of profit maximization, and that both large and small shareholders could have either long- or short-term interests, ensures that the objectives of shareholders with high stakes, for whom monitoring is cost effective, will largely coincide with those with low stakes.[116] Thus, the latter can free ride on the former with relative impunity.

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113. *See id.* at 75 (arguing that homeowners' reduced mobility makes them eager to organize to protect home values).

114. EASTERBROOK & FISCHEL, *supra* note 111, at 6 (1991).

115. However, some believe that even institutional investors are overly concerned with the short-term performance of public firms and therefore are less likely to play a role in monitoring the corporation. *See, e.g.*, Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205-06 (1991).

116. *See id.* at 208 (presenting the efficient capital markets hypothesis as a result of a blend of the long- and short-term).

The market for managers and takeover markets further facilitates these efforts. Even if monitoring does not occur on a very wide scale, market mechanisms may provide substitute constraints on self-interested officers of firms. Officials who do not pursue the profit-maximizing interests of shareholders are likely to lose employees who can obtain better terms of employment at more financially successful competitors.[117] The possibility of takeovers provides potential acquirers with an incentive to monitor the firm's performance and to disseminate negative information at low cost to other shareholders, simultaneously providing them with opportunities to support those who promise more significant returns for all shareholders.[118]

The situation is different in the public sector. Consider first the conflicting interests that emerge from different residents' expected period of residency. These periods may be analogous to shareholders' expected periods of shareholding. Constituents who rent rather than own their homes and who anticipate leaving the jurisdiction within a relatively short period of time may prefer local officials to incur significant capital burdens in order to provide substantial public goods and services in the near term. Those constituents will receive the current benefit of the projects, but may not bear the full share of their costs through either tax or rent payments, some of which will be deferred to future residents. Thus, assuming imperfect capitalization of future payments into current property values, current short-term constituents may systematically prefer that the government incur more debt than residents who anticipate long periods of residency.[119] If the latter group is more likely to monitor officials, they would not necessarily serve as good proxies for the former group. It is less clear, however, that this divergence would problematically distort monitoring. If residents who are expecting

117. *See id.* at 214-15.

118. *See id.* at 197-98.

119. Residents who anticipate emigrating soon may also have less reason to incur the costs associated with voting, because they will not be able to enjoy the benefits of their votes, or may belong to the group of relatively poor who do not vote with the same frequency as wealthier residents. *See, e.g.*, Mark Thomas Quinlivan, Comment, *One Person, One Vote Revisited: The Impending Necessity of Judicial Intervention in the Realm of Voter Registration*, 137 U. PENN. L. REV. 2361, 2368 (1989) (noting that "[v]oter participation has always been strongly related with socioeconomic factors," and that as a result, the poor experience lower rates of voter participation).

to exit the jurisdiction in a relatively short period of time (especially tenants who are unconcerned about the capitalization of new projects into higher property taxes) would otherwise be urging a supraoptimal amount of debt, then the omission of their interests from the process is unlikely to skew local officials to act irresponsibly.

There is, moreover, an alternative source of friction that complicates monitoring in the public sector. Even the most well-meaning (publicly interested) resident may fail to represent residents generally, because the objective function that governments legitimately pursue varies more widely than is the case with firms.[120] As I noted above, all shareholders will be concerned with profit maximization in the firm. But governments, at least multifunction governments, have no such single objective.[121] Governments provide some services, such as paving roads, police or defense services, and environmental cleanup, to solve market failures. But governments also offer some services, or modify the market allocation of collective goods, to engage in redistribution (for instance, municipal day care centers or other welfare services); and offer still other services that implicate both efficiency and distributional concerns (education may be an example). Moreover, the absence of a readily verifiable metric of success, such as profits, complicates the problem of determining whether public services and the officials who run them are performing in the public interest.[122] Even if we were to disagree over whether long-term or short-term profitability were the proper measure of corporate success, it is still more complex to determine, for instance, whether a school system is doing "its job." We could analyze standardized test scores, graduation rates, college acceptance rates, or any of a number of other variables that presumably serve as proxies for the quality of education. Thus, both the objective function of governments and the determination of whether that function has been satisfied may be subject to disputes far more contentious than in the case of firms.

120. *See* Clayton P. Gillette, *Constraining Misuse of Funds from Intergovernmental Grants*, *in* FISCAL FEDERALISM IN UNITARY STATES 101, 102 n.1 (Per Molander ed., 2004) (stating that local officials may think about the public welfare differently than other constituents).

121. Jean Tirole, *The Internal Organization of Government*, 46 OXFORD ECON. PAPERS 1, 3 (1994).

122. *Id.* at 3-4.

This multiplicity of functions and ambiguity in measurement has several consequences. First, it frustrates efforts of potential monitors to determine whether local officials are doing a "good job." Conduct that satisfies such a standard is less observable by principals and less verifiable to third parties when agents must simultaneously perform potentially conflicting tasks (for example, efficient waste disposal may conflict with offering all residents equal access to waste disposal) than when agents can be evaluated against a single observable metric, such as profit maximization.[123] This phenomenon means that officials themselves cannot easily determine which financial strategy is consistent with constituent preferences. The binary nature of voting in public elections requires that votes be cast based on an assessment of the overall performance of candidates. An official who wins an election will be unable to determine whether constituents were pleased with all of his or her policies, a majority of those policies, or only a minimum of those policies. The multiplicity of government objectives that I referred to above makes discerning any message from electoral results still more difficult to interpret.

Second, to the extent that officials pursue multiple objectives, even those constituents who have high enough stakes to justify monitoring are unlikely to represent the interests of all constituents, at least outside of small jurisdictions that offer limited services and attract a largely homogeneous population.[124] Even if we assume publicly interested actors, constituents with interests sufficiently intense to warrant monitoring are likely to equate the public's interest with their own. If, for instance, I live next door to a public park, I will care with great intensity of purpose that it be maintained in a manner that ensures its cleanliness and safety. I am likely to identify my own interest in the adequacy of the park with that of the public generally. I may then feel perfectly righteous in lobbying for and monitoring the use of maximum expenditures for the park, even though funding for that purpose may require reduced expenditures for other services like school nurses or paved

123. *See id.*

124. These jurisdictions form the basis for William Fischel's "Homevoter Hypothesis" that local taxpayers constrain the capacity of local officials to provide local public goods other than those preferred by residents. *See* FISCHEL, *supra* note 112, at 4, 19, 73-76.

sidewalks—services in which I have a lesser interest. My desire for maximum spending on my objective, in short, is likely to vary from the median constituent's view of optimal spending on the same objective. But the median constituent, by virtue of having no special interest in any subject, is unlikely to monitor for the sale of his or her competing objectives, simply because those with only average interest in expenditures suffer from the inducement to free ride on others with similar preferences.

Thus, with respect to those who have high enough stakes in the public entity to monitor, the problem is not failure to constrain public officials; rather, it is that if these constituents have such an idiosyncratic stake in the conduct of public officials to justify incurring monitoring costs, then one might wonder what they are monitoring *for*. Think, for instance, of the media, which qualifies as one of the standard theoretical substitutes for lax constituent monitoring.[125] By discovering and reporting on official scandals, the media may be able to increase circulation and individual reporters may enhance their reputations, so one might think that their self-interested objectives would transform them into effective proxies for free riding constituents. But, short of criminal activity that affects budgetary outlays, the media tends to scandalize low value defalcations in lieu of making more costly investigations into misappropriation of public funds. Recent events in New York provide a revealing illustration: In a two-week span, New York government suffered two substantial setbacks. One was related to the failure of the New York Metropolitan Transit Authority to make the capital improvements that it promised to deliver in return for fare hikes that it had received.[126] The other involved former Governor Elliot Spitzer's personal expenditures.[127] I will leave to the reader's speculation the issue of which story consumed more ink and newsprint.

Public unions that have a stake in the public budget may also monitor to ensure their financial security. But the objectives for which they monitor will not necessarily coincide with those of

125. *See* Timothy Besley, Robin Burgess & Andrea Prat, *Mass Media and Political Accountability*, *in* THE RIGHT TO TELL 45, 45 (Roumeen Islam et al. eds., 2002).

126. William Neuman, *M.T.A. Delays Improvements, Citing Drop in Real Estate Sales Taxes*, N.Y. TIMES, Mar. 25, 2008, at B1.

127. *See* Danny Hakim & William K. Rashbaum, *Spitzer, Linked to a Sex Ring as a Client, Gives an Apology*, N.Y. TIMES, Mar. 11, 2008, at A1.

constituents whose concern is for the overall health of the municipality. For example, teachers' unions may, in the name of educational quality, monitor the school budget to ensure that salaries are consistent with those of other school districts, but be less concerned with total educational expenditures or with whether taxes, which are used to pay their salaries, are set at optimal rates.

This is not to say that there are no public analogues to the market mechanisms that constrain officers of firms in the absence of monitoring. Take, for instance, the constraint on officers of a firm that is created by the takeover market, which suggests that officers will seek to maximize returns for shareholders.[128] Local officials likewise face a robust takeover market in the form of political opposition. Potential political opponents have significant incentives both to monitor behavior of incumbent officials and to disseminate information about shirking to the electorate. The problem with relying on electoral monitoring, therefore, is not limited to the high costs of discovering information (political opponents should be willing to subsidize those costs), the infrequency of elections, or small turnouts. The various objectives of constituents and the preference of voters for low value, but salient, indicia of success provide political challengers little incentive to scrutinize fiscal data with more than cursory attention. If the streets are clean and property taxes have remained stable, a decrease in bond rating will be of less concern, even though it may foretell a more difficult financial future.

In some respects, one might anticipate more monitoring by constituents than by shareholders. Costly monitoring becomes unnecessary if one can exit an investment at relatively low cost after one discovers misconduct.[129] Those who hold shares in firms—at least in publicly held firms—typically face thick markets for shares, and thus can exit easily once their tolerance for misconduct is exceeded.[130] Selling shares may entail some financial loss, but a well-diversified shareholder should be able to absorb that loss with

128. *See* EASTERBROOK & FISCHEL, *supra* note 111, at 96-97 (observing that takeover markets increase future costs of poor performance, thus helping to assure contractual performance).

129. *See* FISCHEL, *supra* note 112, at 74.

130. *Id.*

minimal dislocation. Investments in homes, jobs, and communities are more costly to exit and less easily diversified.[131] As a result, we might anticipate that constituents would invest more in monitoring to forestall or detect value-reducing misconduct at an early stage. In light of all the disincentives to monitor that constituents face, however, it is difficult to believe that high exit costs alone are sufficient to overcome the collective action problem.

The result may be that the sum total of public monitoring is not undersupplied, as classic collective action theory suggests.[132] Instead, monitoring may be maldistributed. That is, it is oversupplied for discrete functions that affect an intensely interested group, and undersupplied for functions that have diffuse effects. As a result, public officials may not face optimal monitoring for any functions. Members of an intensely interested group may effectively lobby for services and expenditures that provide them with significant benefits. If that group's preferences fail to coincide with the preferences of constituents generally, there is little reason to predict that the group serves as a representative proxy for those who would prefer to free ride.

B. Creditors to the Rescue?

Can creditors enter this void and solve these collective action problems? The tentative answer I want to give is,"it depends." Let me begin with reasons for optimism. There are a variety of ways in which the interests of creditors compensate for the collective action failures that dilute the monitoring capacity of constituents. The first is simply one of numbers. There will tend to be fewer creditors than there are constituents. Since numbers have some, if imperfect, relationship to free riding,[133] the relative inability of a small number of creditors to free ride on the efforts of others suggests that any given creditor will be more willing to play a role in monitoring

131. *See id.* at 74-75.

132. *See* OLSON, *supra* note 91, at 31. *But cf.* Eric Biber, *The Importance of Resource Allocation in Administrative Law*, 60 ADMIN. L. REV. 1, 45 (2008) (attributing the undersupply of monitoring to inaction); John O. McGinnis & Ilya Somin, *Federalism vs. States' Rights: A Defense of Judicial Review in a Federal System*, 99 NW. U. L. REV. 89, 98 (2004) (attributing undersupply of monitoring to rational ignorance and multiple principals).

133. *See* HARDIN, *supra* note 92, at 182.

officials than any given noncreditor constituent. To return to Williamsburg, Virginia, the financial statements reveal that public credit tends to be extended by bank loans or through the issuance of bonds.[134] A bank that is the sole lender will obviously have a significant incentive to monitor the source of repayment. Even in the event of bonded debt, in which the ultimate bondholders may be numerous, the collective action problem may be at least partially solved by the presence of a trustee, who is appointed to receive funds for repayment and who can at least provide early warning signals of impending financial distress.[135]

Second, creditors, at least those within the same class, have a common interest. They want to be *paid*; they care about the overall fiscal health of the debtor in ways that divided interests within the jurisdiction are willing to ignore.[136] Thus, creditors can overcome the problems related to the multiplicity of objectives that preclude one set of constituents from serving as proxies for others. At least to the extent that creditors are secured by the general revenues of the debtor, they are less interested in the provision of any particular service than in the overall fiscal health of the jurisdiction.

Here, the analogy to corporate creditors threatens to break down. I noted above that monitoring by corporate creditors is likely to be enhanced by secured credit, which provides both a bond between the creditor and debtor and allows the exercise of leverage in the event of threatened fiscal distress.[137] Sovereign debtors, however, are less likely to be able to grant security interests to private creditors. In the event of default, creditors will not be able to seize the city's fire trucks or the state's military equipment. Even when creditors lend against a dedicated revenue stream, such as tolls from a toll bridge erected with loan proceeds, creditors may benefit from a rate covenant that assures that minimum tolls are charged. But

134. *See, e.g.*, ANN. FIN. REP., *supra* note 108, at 6 ("At June 30, 2007, outstanding liabilities were $17.3 Million, with $14.4 Million in bonds and notes payable.").

135. *See* Levmore, *supra* note 76, at 73-74 (discussing the trustee as a provider of a warning system that aids in monitoring).

136. *See* Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633, 664 (2008) (remarking that creditor monitoring plays an important role in maintaining fiscal health).

137. *See supra* text accompanying notes 76-84.

creditors will not be able to foreclose on the toll bridge in the event that collections are insufficient to service the debt.

The unavailability of security interests, however, does not mean that creditors will fail to monitor. It may instead mean that creditors will find a substitute for pledged physical assets. For instance, creditors may develop benchmarks that are observable and that serve as indicia of financial success or failure, and monitor to see whether those benchmarks have been achieved. If creditors are able to withhold additional funding or accelerate repayments in the event of failure to maintain benchmarks, then the effect may be the same as if the creditor could make a credible threat to foreclose on collateral essential for the firm's success.

Indeed, let me go further and claim that creditors will exercise their monitoring capacity in a manner that actually improves decision making over what would occur even if constituents *could* overcome the obstacles to collective action. Creditors may be absorbed in the financial wherewithal of the debtor to avoid default. But that interest requires a commitment to stability, overall welfare, and tradeoffs among different governmental functions that decision making by a more participatory process, dominated by interest groups that divide an expanded budget pie rather than by pluralistic compromise, will endanger.

Thus, even Hume, with all his antipathy to public debt, acknowledged the mollifying influence that creditors could impose on a public driven by internal strife to be "factious, mutinous, seditious, and even perhaps rebellious."[138] In a rare moment of praise for debt, he responds:

> But to this evil the national debts themselves tend to provide a remedy. The first visible eruption, or even immediate danger, of public disorders must alarm all the stock-holders [by which he meant creditors], whose property is the most precarious of any; and will make them fly to the support of government, whether menaced by Jacobitish violence or democratical frenzy.[139]

138. HUME, *supra* note 44, at 170.
139. *Id.*

Here, we face the next assumption about the democratizing effects of public debt: that creditors who monitor will do so in a manner that reflects the interests of constituents. Of course, the alignment of interests between creditors and constituents will be closer when the two classes are composed of the same individuals. Certainly, public creditors who are also stakeholders in other aspects of the debtor's activities, by virtue of their roles as taxpayers, tenants, or business operators, are likely to balance their various roles and subordinate their interests as creditors when doing so generates net benefits to them in their other roles.[140] I have previously indicated that the large overlap between San Giorgio shareholders and Genoa residents may have facilitated the latter's willingness to forgo technical defaults motivated by true financial distress.[141] The same phenomenon may explain the success of the Dutch financing system. Dutch creditors were, to a large extent, Dutch citizens.[142] Macdonald cites estimates that at a time when there were approximately 100,000 Dutch households, 65,000 were creditors of the state.[143] These included public officials who, albeit not popularly elected, provided comfort to citizens that their financial interests would be served because failure to do so would adversely affect the decision makers as well as the populace.[144]

To some extent, this alignment of interests between creditors and constituents seemed to underlie Alexander Hamilton's views about public credit.[145] His argument for national assumption of state debts and of embracing a policy of national debt generally was based in part on the capacity of debt to create affinities between an important property-holding class and the national government.[146] In his January 1790 Report to Congress on Public Debt, Hamilton famously wrote:

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140. *See supra* note 6 and accompanying text.

141. MACDONALD, *supra* note 5, at 142; Fratianni, *supra* note 3, at 188; *see also supra* notes 8-12 and accompanying text.

142. MACDONALD, *supra* note 5, at 154-55.

143. *Id.* at 156.

144. *See id.* ("Because the officers of the state themselves held large portions of their fortunes in government debt, every public creditor could be sure that his investment was safe.").

145. *See* ALEXANDER HAMILTON, REPORT OF THE SECRETARY OF THE TREASURY ON PUBLIC CREDIT (1790), *reprinted in* THE WORKS OF ALEXANDER HAMILTON 1 (N.Y., Williams & Whiting 1810).

146. *See id.*

> If all the public creditors receive their dues from one source, distributed with an equal hand, their interest will be the same. And having the same interests, they will unite in the support of the fiscal arrangements of the Government—as these, too, can be made with more convenience when there is no competition .... If, on the contrary, there are distinct provisions, there will be distinct interests, drawing different ways. That union and concert of views, among the creditors, which in every government is of great importance to their security, and to that of public credit, will not only not exist, but will be likely to give place to mutual jealousy and opposition.[147]

When Hamilton then pronounced a properly funded national debt to be "a national blessing,"[148] did he have in mind that creditors would confer on the United States a class of monitors who would demand more democratic processes than constituents alone would require? Was he simply saying that national creditors would be more drawn to identify with the United States and thus assist in strengthening a federal government? Or was he also saying that they would constitute a propertied class that would improve the quality of decision making otherwise made by an electorate that, although narrow by today's standard, could be driven by sensitivities inconsistent with Hamilton's mercantile vision? I am not certain. One thing that does seem clear, though, is that Hamilton viewed creditors as having interests that could reduce the risks of factionalism that might otherwise endanger collective welfare.[149]

But what are the implications of this phenomenon for the situation in which creditors are not constituents of the debtor? Does it necessarily follow that these creditors will be poor representatives? At least in one respect, Hamilton's concerns reflect a possibility that creditors may actually make better financial decisions than would be made by the constituents of debtors.[150] Hamilton's comments reflect a difficult inquiry posed by any democratic theory based on government accountability to constituent preferences:

147. *Id.*
148. *Id.* at 52.
149. *See id.* at 19.
150. *See id.* at 19-20.

whose preferences count?[151] The question of long-term fiscal planning implicates that issue to the extent that it deals with intertemporal externalities. Current financial decisions that require long-term payments can impose significant costs on future generations who have little to say about the desirability of the long-term obligation at the time it is incurred. Optimal financial decisions, one would think, would reflect the interests of those who pay long-term costs as well as those who enjoy the short-term benefits. Who, as between creditors who fund long-term projects and current constituents, are better positioned to represent those future constituents? Because public credit necessarily requires attention to the risk of future payments, perhaps public creditors better internalize the benefits and burdens that financial decisions impose on both current and future generations than the more traditional delegation of those issues to the present generation of constituents alone.

Decisions to fund capital improvements with a payment stream that extends for several decades necessarily commit creditors to a time horizon that exceeds the notoriously short attention span of public officials concerned primarily about the next election,[152] or the high discount rate of constituents concerned about the level of taxes that they must pay today.[153] Current constituents, for instance, may favor projects that generate immediate benefits, imposing the costs on future generations who may find the projects superfluous. Or, current constituents may favor default, especially when the creditors are nonresidents and those who would bear the burdens of taxation necessary to service the current debt are residents. Those current constituents may be either oblivious or indifferent to the default premium that future generations of residents will be required to pay.

This is precisely the situation that arose in the late nineteenth century when cities and states incurred substantial debts to attract railroads that promised to confer commercial benefits sufficient to offset any tax burden necessary to service the government's financial obligations. When those successful railroads failed to material-

151. *See id.* at 20.

152. *See* Sungjoon Cho, *Doha's Development*, 25 BERKELEY J. INT'L L. 165, 201 (2007).

153. *See* Peter H. Aranson & Kenneth A. Shepsle, *The Compensation of Public Officials as a Campaign Issue: An Economic Analysis of* Brown v. Hartilage, 2 SUPREME CT. ECON. REV. 213, 249 (1983).

ize, taxpayers were left with the legal obligation to pay debt service, but none of the promised benefits. Throughout the South and Midwest, cities and states did what any debtor with a brief time horizon would do—they repudiated their debts.[154] Did they have to? That is, were they facing such financial distress if they complied with their obligations that repudiation was the only way to avoid dissolution? In that case, repudiation may not have been a manifestation of a brief time horizon, but only of an exogenous shock that makes repayment impracticable, all things considered. Nevertheless, urban historian Eric Monkkonen's study of the phenomenon suggests that many of the defaults on railroad bonds were less the result of the kinds of fiscal distress that might have generated sympathy and waiver from the shareholders of San Giorgio[155] than the consequence of class, ethnic, and political interests that ignored consequences for future generations.[156] If we include within "constituents" of the debtor those future residents who pay for the fiscal errors of prior generations, then creditor demands may better reflect the interests of at least that class of constituents than current taxpayers alone.[157]

Creditors may also vary from constituents in that they are likely to have a different preference for risk.[158] Although this may suggest a lack of alignment in the interests of the two groups, we might favor creditor monitoring for risk if creditors exhibit a more rational strategy of dealing with the long-term health of the debtor. Let us return again to the potentially analogous corporate sector. In the corporate setting, the divergence of interests between creditors and debtors is largely related to the role of each in setting the proper level of risk taking by the firm. Equity holders may favor a high degree of risk taking because they are essentially gambling with

154. *See* ERIC MONKKONEN, THE LOCAL STATE: PUBLIC MONEY AND AMERICAN CITIES 24, 27-30 (1995) ("[T]he city of Duluth and the Minnesota state legislature used legal maneuvers to cheat the city's bondholders of the early 1870s out of any hope of full debt recovery.").

155. *See supra* notes 8-10 and accompanying text.

156. *See* MONKKONEN, *supra* note 154, at 24.

157. *See id.* at 22-23. Monkkonen discussed Memphis, Tennessee and Watertown, Wisconsin as examples in which future residents suffered as a result of decisions by current taxpayers. *Id.*

158. For example, William A. Fischel argues that homeowners are unique in that they are particularly sensitive to "the vulnerability of their largest asset," which is their home. FISCHEL, *supra* note 112, at 12. Fischel also notes that homeowners may attach a sentimental value to their homes. *Id.*

creditors' money. If the firm borrows money with a promise of engaging in relatively low risk activities, and subsequently engages in relatively high risk activities, the firm gets all the upside of its gamble—the creditors, though, receive only repayment of principal and interest.[159] If the venture fails, the creditors who supplied the funds bear the loss. As a result, creditors have incentives to monitor the firm who proposes to borrow funds for one purpose, but then deploys the funds for a riskier endeavor.

Governmental entities are more constrained in the activities in which they can engage, and thus the level of risk they can take with borrowed funds may be less variable. It is, for example, difficult to hide a risky sports stadium in the guise of the municipal power plant that the locality indicated was the objective for which it was borrowing funds. But money is fungible, and governments can use funds from one source to free up funds from an alternative source and gamble with the latter in ways that expose the government as a whole to greater risk. A creditor who has both the capacity and the incentive to examine revenues and expenditures can serve much of the same risk-reducing function that is attributed to the general lender of private firms. Thus, creditor monitoring may also limit governmental risk taking to a level more consistent with constituent preferences.

I am not, of course, positing a perfect identity of interests between creditors and constituents. The complicated issue of who the "constituents" are means that at least some within that group—perhaps tenants with short-term interests in residence—will find little similarity of interests with long-term creditors. Additionally, even if creditor monitoring forestalls government insolvency should bankruptcy occur, the interests of constituents in continuing governmental services will diverge greatly from the interests of creditors in raising taxes and liquidating governmental assets to assure payment. Should the municipal borrower prove able to pay only school teachers or creditors, local residents may opt for the former, while bondholders would obviously desire the latter. Alternatively, once doubts are raised about the locality's future ability to make debt service payments, creditors are likely to want the locality to increase fees, while residents will want to shift the

159. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 111, at 68.

risk of nonpayment to creditors.[160] These disputes about remedies indicate divergent interests of creditors and residents; they do not, however, indicate differences in the desire to detect fiscal impropriety before the events that would create such disputes arise.

What I *am* positing is that, at least from a theoretical perspective, it is plausible that the interests of creditors and constituents will overlap sufficiently to allow the former to compensate for some of the monitoring lapses of the latter. Whether creditors will do so depends on a variety of factors, such as the extent to which creditors and constituents overlap and the structure of the transaction. Obviously, when creditors can be repaid without regard to the overall health of the borrower, such as when their payments come from only a single resource, creditors have little incentive to monitor more than that resource. Historically, creditor monitoring would have been diluted by allowing creditors to seek repayment directly from taxpayers rather than from the state.[161] Seventeenth- and eighteenth-century French debts were incurred largely by the selling of offices to creditors who were willing to advance cash in return for subsequent payments from the state or the value of future tax revenues that could be collected through the offices.[162] Venal office holders had a claim to the first taxes collected, so that once they collected the sums due to them, they had weakened incentives to collect the remaining sums that would be paid to the state.[163] I will say only that this mechanism does not inspire confident predictions either that an optimal level of taxes will be collected or that, once collected, state funds will be expended in pursuit of social welfare.

Our thicker understanding of sovereignty suggests that we are less likely to delegate tax collection than were city-states and

160. For example, in *Patterson v. Carey*, 363 N.E.2d 1146 (N.Y. 1977), New York State had granted Jones Beach State Parkway Authority the power to increase the toll on the parkway, but subsequently passed a law rescinding an increase that the Jones Beach State Parkway Authority authorized. *Id.* at 1151-53. Much of the jurisprudence of the Contracts Clause has been written in terms of conflicts between the interests of municipal creditors and residents when fiscal distress precludes simultaneous satisfaction of each group's preference. *See, e.g.*, U.S. Trust Co. v. New Jersey, 431 U.S. 1, 32 (1977); Mobile v. Watson, 116 U.S. 289, 305 (1886); Van Hoffman v. City of Quincy, 71 U.S. (4 Wall.) 535, 555 (1866).

161. *See* STASAVAGE, *supra* note 30, at 86.

162. *Id.*

163. MACDONALD, *supra* note 5, at 141.

capital-hungry monarchs. But transactional structures still matter. The extent to which creditors can credibly substitute for constituents depends on the extent to which the creditors' repayment rights are linked to the overall fiscal health of the debtor. Some transactional structures (such as bonds secured by a locality's general revenues) align those interests, but others, which limit creditor's rights to particular assets, may not. A lender secured solely by waterworks revenues, for example, has little incentive to monitor the debtor's receipt of property taxes, although the latter may be a better indicator of officials' performance. Legal doctrines may further frustrate monitoring by denying creditors the ability to take security interests in assets that might be easily monitored and that might serve as proxies for overall fiscal health. Potential lenders might also find monitoring worthwhile if they believed that the default risk was sufficiently high and had no lower cost way of dealing with such risk. In the next section, I suggest that significant obstacles to creditor monitoring arise from the availability of low cost alternatives to risk management that may reduce the scope of monitoring. But, as I will conclude, it may also focus monitoring on those situations where constituents are also most in need of external support to create democratic governance.

III. WILLINGNESS TO MONITOR

My argument to this point has been that historical lessons and corporate analogies tell us a great deal about the extent to which the theoretical capacity of creditors to compensate for suboptimal constituent monitoring can actually be implemented. But there is also reason to believe that creditors may fail to take advantage of these opportunities. Monitoring is costly, and potential monitors, if rational, will only undertake that task when (1) the costs of monitoring are less than expected benefits, such as by reducing the probability of default; and (2) no less costly alternative for loss avoidance exists.[164] The second condition is perhaps more difficult to satisfy under current circumstances than has been true in the past.

164. *See* Douglas W. Diamond, *Monitoring and Reputation: The Choice Between Bank Loans and Directly Placed Debt*, 99 J. POL. ECON. 689, 697 (1991).

Monitoring and reputation may be substitutes, in that creditors will avoid monitoring costs when borrowers have developed a solid reputation for repayment.[165] When governments have sufficiently invested in reputation that the perceived expected loss from default is less than the costs of monitoring, it is unlikely that creditors will engage in monitoring at all. The development of financial models and the longer history of repayment for sovereign borrowers during both good times and bad have allowed markets to distinguish between more and less reliable debtors and to adjust interest rates to reflect risk rather than to engage in monitoring.[166] At least in the United States, default risk for governmental debt is remarkably low, typically below 2 percent when all municipal bonds are included, and significantly lower when the bonds are issued for general municipal purposes rather than when issued to provide low interest finance for a private firm.[167] For instance, one study found that sixteen to twenty-three year cumulative default rates for tax-backed and traditional revenue bonds were less than 0.25 percent.[168] Joel Seligman reports that the default rate on municipal bonds between 1983 and 1988 was 0.7 percent, while the default rate for corporate debt was 1.1 percent.[169] Given these statistics, rational creditors are likely to forgo costly monitoring.

Next, consider losses, or the risk that municipal creditors face in the event of default. Creditors are unlikely to monitor if they believe that default, should it occur, will be cured with little expense or loss on their part. Municipal defaults, especially in the case of sizeable cities, are likely to generate external costs that deprive surrounding areas of easy access to capital or that generate concerns about residents' access to basic municipal services.[170] As a result, defaults trigger significant calls for bailouts by more centralized levels of

165. *Id.* at 690.

166. *See* TOMZ, *supra* note 39, at 86-113.

167. *See, e.g.*, Good Jobs First, Municipal Bonds and Defaults, http://www.publicbonds.org/public_fin/default.htm (last visited Nov. 25, 2008).

168. *Id.*

169. Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 699 (1995).

170. *See* Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, *in* FISCAL DECENTRALIZATION AND THE CHALLENGE OF HARD BUDGET CONSTRAINTS 35, 42-43 (Jonathan Rodden, Gunnar S. Eskeland & Jennie Litvak eds., 2003).

government.[171] Although those bailouts may require that the defaulting city suffer reduction of local fiscal autonomy, and hence more rigorous scrutiny by state agencies,[172] creditors who anticipate bailouts in the event of default will rationally fail to monitor pre-default.

A variety of legal doctrines also reduce creditor losses in the event of default and thus dissuade municipal creditors from monitoring. In some states in the United States, specific constitutional or statutory provisions protect municipal creditors in the event of default. Virginia, for instance, provides that any state funds that would otherwise be appropriated to a local government must be paid directly to creditors if the locality is in default on its general obligation bonds.[173] Additionally, the New York Constitution famously provides that constitutional tax limitations can be exceeded in order to pay debts to which a locality's faith and credit has been pledged.[174] One would anticipate that creditors prefer these bailouts to the extent that they impose default costs on municipal residents while simultaneously reducing the need for costly pre-default scrutiny or requiring creditors to incur the costs associated with municipal debt adjustment under Chapter 9 of the Bankruptcy Code.

When creditors have found monitoring to be useful, they may condition their lending on metrics that are easily monitored or that can serve as low cost proxies for risky activity that would otherwise

171. Notwithstanding the famous "Ford to City: Drop Dead" headline, Congress ultimately provided a modest debt guarantee that assisted New York City in averting fiscal disaster, and the state created a municipal assistance authority that provided payments to bondholders. *See id.* at 59. Additionally, Congress has provided a federal bailout of Washington, D.C., and states provided assistance to the cities of Bridgeport, Philadelphia, Camden, and Miami. *Id.* at 60-61. But note the absence of bailouts in the Washington Public Power Supply System (WPPSS) and Orange County. *See id.* at 59-61; Gerald J. Miller, *Debt Management Networks*, 53 PUB. ADMIN. REV. 50, 50-51 (1993). Robert Inman reports that the Illinois Constitution of 1870 contained a prohibition on local bailouts by the State. *See* Inman, *supra* note 170, at 58 & n.33; Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 442 (1993).

172. For example, New York State maintains quarterly reports on the City of New York, including such information as the city's financial statements and a review by an independent accountant. *See* Municipal Assistance Corporation of the City of New York, http://www.nysl.nysed.gov/scandoclinks/ocm18935828.htm (last visited Nov. 25, 2008).

173. *See* VA. CODE ANN. § 15.2-2659 (2000).

174. *See* Flushing Nat'l Bank v. Mun. Assistance Corp. of N.Y., 358 N.E.2d 848, 852 (N.Y. 1976) (interpreting N.Y. CONST. art. VIII, § 2).

require costly investigations.[175] For instance, when credible information about some government assets can be obtained at low cost, creditors may restrict the use of their loans to the purchase of those relatively transparent assets.[176] When that is the case, the interests of creditors in ensuring that the funded asset generates sufficient revenue to support debt service is less likely to coincide perfectly with the general interest of constituents in the overall financial security of the state. In effect, creditors in such a case provide comfort to constituents that is parallel to the comfort that creditors of firms provide to shareholders when the creditors take security interests in specific assets of the firm rather than a wraparound security interest in all the firm's assets.[177]

Alternatively, creditors may eschew examination of the underlying conditions of debt and consider only the amount of debt that a borrower has incurred, presumably on the theory that sovereigns will be able to service relatively small debts. Tamim Bayoumi, Morris Goldstein, and Geoffrey Woglom tested a market discipline hypothesis for sovereign debt.[178] Their conclusions indicated that yields on debt of states within the United States rise at an increasing rate with the level of borrowing, and that at some level of borrowing, the market stops supporting a sovereign's debt issuance.[179] The result is that borrowers have market incentives to avoid issuing excessive debt.[180] I do not want to make too much of these conclusions. To conclude that borrowers are attentive to market constraints is quite different from saying that borrowers' officials properly respond to market incentives, an issue on which the authors are agnostic.[181] Moreover, market constraints do not necessarily indicate that potential creditors are monitoring borrowers in a manner that compensates for constituent passivity.

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175. *See* Michael D. Bordo, Barry Eichengreen & Douglas A. Irwin, *Is Globalization Today Really Different than Globalization a Hundred Years Ago?* 32-33 (Nat'l Bureau of Econ. Research, Working Paper No. W7195, 1999).

176. *See id.* at 32-34.

177. *See supra* note 70 and accompanying text.

178. *See* Tamim Bayoumi, Morris Goldstein & Geoffrey Woglom, *Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States*, 27 J. MONEY, CREDIT & BANKING 1046, 1046-47 (1995).

179. *See id.* at 1050.

180. *Id.* at 1057.

181. *See id.*

They may suggest only that creditors review the per capita debt burden of the issuer, which may be a very rough surrogate for quality of debt. These studies do, however, suggest that creditors react at least to some degree to the incentive to obtain information about their sovereign borrowers.[182]

Contemporary theories of finance may also reduce incentives to monitor in other ways. Creditors may be able to manage risk by diversifying their portfolios rather than by incurring monitoring costs. Indeed, in a world of securitization, even creditors who wish to specialize in a particular portfolio of loans, such as sovereign debt, can diversify by investing in funds that carry multiple loans rather than by investing in a single loan and monitoring the borrower.[183] Although some have blamed securitization for the absence of monitoring that has allegedly contributed to credit crises, that literature only suggests that substituting securitization for monitoring has social costs, not that it is irrational for investors.[184]

The implication of these developments is that even investors who theoretically have the capacity to enhance democracy by monitoring for misconduct that constituents are otherwise likely to ignore will often fail to seize their comparative advantage and confer the benefits of monitoring on passive constituents. Indeed, the structure of the transactions may further frustrate any efforts to impress public creditors into service as monitors. By allowing credit to be extended against specific assets, debtors dilute the incentives of creditors who might otherwise monitor broadly, instead causing these creditors to direct their efforts only at specific sources of repayment.[185]

Consider in this context recent developments in the esoteric area of state and municipal debt finance. Those of us who play in the fields of state constitutional law—and who understand that the law school curriculum does a great disservice by concentrating only on the musings of a single supreme court when there are fifty state

182. *See id.*

183. For an example of such a fund, see Invesco PowerShares, PowerShares Emerging Markets Sovereign Debt Portfolio, June 30, 2008, http://www.invescopowershares.com/pdf/P-PCY-PC-1.pdf (last visited Nov. 25, 2008).

184. *See, e.g.*, Benjamin J. Keys et al., *Did Securitization Lead to Lax Screening? Evidence from Subprime Loans 2001-2006*, at 26 (Eur. Fin. Ass'n, meeting paper, 2008), *available at* http://faculty.london.edu/vvig/index_files/securitize.pdf.

185. *See supra* text accompanying note 70.

constitutions to analyze—sometimes consider the constraints placed on states and municipalities that seek to incur debt.[186] Those limitations—which typically take the form of election requirements, flat dollar limitations, or percentages of taxable property—generally apply only to what is called general obligation debt, that is, debt secured by all the revenue-generating capacity of the issuer.[187] They therefore do not apply to revenue bonds, that is, debt secured solely by the revenue produced by a single revenue-producing project, such as a toll bridge or a municipal water works.[188] The history of debt limitations, therefore, is dominated by the efforts of highly paid, intelligent attorneys and investment bankers to structure transactions to look more like revenue debt not subject to debt limitations than to general obligation debt.[189]

One perhaps unanticipated consequence of this phenomenon has been to dilute the incentives of creditors to serve as proxies for constituents because the jurisdiction's revenue sources are balkanized and the creditors' interest is limited to a particular revenue source rather than to the general fiscal health of the debtor. If bonds issued to fund street improvements, for example, are secured by parking meter revenues, bondholders need only monitor meter collections and disbursements, notwithstanding that they are well positioned to review a broader array of local fiscal activity.[190]

One recent example of this phenomenon is in some respects eerily reminiscent of fifteenth-century Genoa. The governor of New Jersey, a former chairman of Goldman Sachs, recently advocated a plan to reduce outstanding state debt by establishing a nonprofit public benefit corporation that would collect tolls and manage highways in the state,[191] a procedure that perhaps qualifies the corporation as the type of "state within a state" that characterized San Giorgio.[192] As initially proposed, the corporation would issue approximately

186. Gillette, *supra* note 105, at 370-72.

187. *See id.* at 367-68.

188. *Id.* at 368 n.6.

189. *Id.* at 370-71.

190. Among the other defects of debt limitations, which I will not examine at this time, is they have potentially antidemocratic effects.

191. STATE OF NEW JERSEY OFFICE OF THE GOVERNOR, FINANCIAL RESTRUCTURING AND DEBT REDUCTION [hereinafter FINANCIAL RESTRUCTURING], *available at* http://www.state.nj.us/frdr/pdf/background.pdf.

192. *See supra* note 14 and accompanying text.

$40 billion worth of its own bonds, and use the proceeds both to pay off existing state debt and to finance the next seventy-five years of multi-modal transportation projects in the state.[193] The corporation's own bonds would then be paid by substantial toll hikes on the highways.[194] The initial plan appears to have met its demise in massive resistance from legislative leaders who found the projected 800 percent toll increase over fifteen years politically nonviable.[195]

Apart from whether the public benefit corporation would share San Giorgio's right to torture toll evaders on the Garden State Parkway, this end run around the New Jersey constitutional debt limitation arguably reduces the democratizing effects of credit. Although creditors of existing general obligation debt of the state might monitor for a broad range of fiscal activities, holders of the corporation's bonds would be limited to a single revenue source—toll payments—and thus would have little incentive to monitor beyond those highway payments. To the extent that New Jersey constituents face collective action problems in monitoring their officials, they would find few reliable proxies in the new set of bondholders that would arise out of the proposed highway corporation.

IV. THE PLAUSIBLE SCOPE OF CONTEMPORARY CREDITOR MONITORING

Does the presence of low cost alternatives to monitoring combined with restricted collateral that reduces the incentives of creditors to monitor mean that, notwithstanding the theoretical possibility that creditors could compensate for constituent passivity, they will fail to serve as democracy-enhancing surrogates? I conclude with a suggestion that there remains some range within which creditors can enhance democratic monitoring. Moreover, creditor monitoring is perhaps most likely, and thus its benefits most plausible, in those contemporary situations that are strikingly similar to my historical examples. The successful credit arrangements that arose in fifteenth-century Genoa, seventeenth-century England, and eighteenth-century America all responded to and made possible

193. *See* FINANCIAL RESTRUCTURING, *supra* note 191, at 12-19.

194. *See id.* at 17.

195. *See* Richard G. Jones & David Chen, *Corzine Weighs Options on Toll Increases*, N.Y. TIMES, Apr. 30, 2008, at B5.

demands for commercial expansion and the sharing of political and economic capital. In those situations, the debtor states may have been ambitious about the future, but they lacked the reputations, the thick credit markets, or the effective constituent political cohesion that would have rendered creditor monitoring superfluous. Instead, these situations cried out for some form of institutional constraints on the debtor governments, constraints that neither a small taxpayer base nor a limited electorate could supply. It was in that kind of environment that small numbers of creditors not only could, but *had* to fill the political gap, reduce corruption, and induce the creation of institutions that would both constitute credible commitments against default and lay the groundwork for broad political participation.

The emerging nations of today stand in a similar situation. These potential debtors necessarily pose greater risks than developed nations insofar as their success in creating wealth that will support debt payments remains untested,[196] and they have not generated reputations that can substitute for more costly monitoring.[197] Although the creation of funds pooling multiple emerging nations' debt allows some diversification that reduces the need for monitoring, many of these funds do not include debt of the least developed emerging nations.[198] Rather, nations with limited or no credit

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196. *See* Ruth Bosauer, Note, *Emerging Market Instruments Pay Siren Song for Pension Plans*, 7 MINN. J. GLOBAL TRADE 211, 213-14 (1998) (describing several factors that made it difficult for developing nations to pay their debt).

197. *See supra* notes 165-66 and accompanying text.

198. In reaching this conclusion, I reviewed the top ten holdings of each of the following emerging market bond funds (ticker symbols are provided in parentheses): AllianceBernstein High Income A (AGDAX); PIMCO Emerging Markets Bond A (PAEMX); TCW Galileo Emerging Markets Income I (TGEIX); MFS Emerging Markets Debt A (MEDAX); T. Rowe Price Emerging Markets Bond (PREMX); Fidelity New Markets Income (FNMIX); MainStay Global High Income A (MGHAX); Fidelity Advisor Emerging Markets Inc T (FAEMX). Popular holdings were from Argentina, Brazil, Columbia, Mexico, Russia, Turkey, and Venezuela. None of the funds listed an African or former Soviet bloc debtor among their top holdings. The major holdings of an exchange-traded fund that specializes in investments in the Middle East and Africa—State Street Global Advisors SPDR S&P® Emerging Middle East & Africa ETF—consist of stocks from Middle Eastern and African countries rather than bonds. *See* State Street Global Advisors, SPDR S&P Emerging Middle East & Africa ETF (GAF), http://www.ssgafunds.com/etf/fund/etf_detail_GAF.jsp (last visited Sept. 17, 2008). The Invesco PowerShares Sovereign debt fund mentioned earlier appears to be more diversified, and includes sovereign debt from Bulgaria, Hungary, Poland, South Africa, and Vietnam. *See* Invesco PowerShares, *supra* note 183.

history are likely to obtain capital through individual lenders who have informational advantages over the broader capital markets and are thus willing to lend at rates that more closely reflect the actual risks of payment. For similar reasons, relatively new firms will seek capital through bank loans rather than through sales of equity or the debt markets. Thus, lenders may find free riding implausible and monitoring financially worthwhile, given the absence of alternatives. Just as banks that make loans to new firms will want to monitor those firms to reduce moral hazard and to capitalize on their informational advantage about the firm, so may individual lenders to developing nations desire to take advantage of the informational advantage that they have over capital markets generally.

A potentially happy coincidence that arises from this situation is that these same nations may be in the greatest need of the kind of creditor monitoring that can enhance democracy by substituting for low levels of constituent monitoring. Developing nations, by definition, are unlikely to have either a broad taxpayer base or politically cohesive institutions that can represent the financial interests of all constituents.[199] If the incentive for monitoring arises out of fear that taxpayers' funds will be misused, the absence of a significant taxpayer class necessarily undermines constituent monitoring.[200]

The essential question is whether creditors who participate in monitoring do so in a manner that is consistent with the interests of the constituents of developing nations. Clearly, the creditors of contemporary emerging nations are not, like the shareholders of San Giorgio or Dutch citizens, constituents of the debtors.[201] Thus, the natural alignment of interests that arises from serving as both creditor and constituent does not exist in these cases. But given that

199. *See generally* EDMUND JAN OSMAŃCZYK, ENCYCLOPEDIA OF THE UNITED NATIONS AND INTERNATIONAL AGREEMENTS 527 (Anthony Mango ed., 2003).

200. This phenomenon, of course, can reduce constituent monitoring in extremely wealthy nations as well as extremely poor ones. For instance, renter nations that can fund their activities from sales of resources, such as oil, do not have to tax their citizens. *See Between Fitna, Fawda and the Deep Blue Sea*, THE ECONOMIST, Jan. 12, 2008, at 40-41 ("No taxation without representation, said America's revolutionaries. Arab governments have inverted this refrain: by appropriating national energy resources and other rents, they neatly absolve themselves of the need to levy heavy taxes and therefore to win the consent of the governed.").

201. *See supra* notes 11-12, 142-44 and accompanying text.

creditors' interests in repayment may require monitoring of the same conditions that constituents would prefer, the availability of monitoring may still serve as a proxy for weaker domestic politics. In short, as democracy comes to the developing world, it is just as likely to come through the back door of financial monitoring as it is to come through the front door of political participation. International credit markets provide at least as much opportunity to generate political reforms today as credit markets provided several centuries ago.

It is in this context that policymakers should evaluate the conditions of lending for potential monitors such as the World Bank, the International Monetary Fund (IMF), or other international financial institutions (IFIs). Loans made through the World Bank or the IMF typically are governed by loan documents that contain specific provisions that exploit the lender's capacity to dictate repayment terms.[202] As one might expect, these terms tend to address payment provisions that protect the interest of the creditor in repayment.[203] There is significant criticism of these institutions, and of IFIs generally, for imposing Western values on resistant cultures, for measuring success only by reference to narrow economic objectives and thus failing to remedy social issues that have only indirect economic implications, or for sponsoring globalization that adversely disrupts domestic labor markets.[204] Nevertheless, the stated objectives and mandates of IFIs, including the World Bank and the regional development banks involve not profit maximization, but rather the promotion of economic or social development or the reduction of poverty.[205] This is not to say that the IFIs are indifferent to repayment or that, in practice, efforts to obtain repayment do not trump the stated objectives. Of course, one

202. *See* International Bank for Reconstruction and Development, Article IV: Operations, Feb. 16, 1989, *available at* http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,,contentMDK:20049603~pagePK:43912~menuPK:58863~piPK:36602,00.html.

203. *See id.* (allowing the Bank, for example, to set the terms and conditions of payments and to modify the terms of an amortization).

204. *See, e.g.*, INTERHEMISPHERE RESOURCE CENTER & INST. FOR POL'Y STUDIES, FOREIGN POLICY IN FOCUS: INTERNATIONAL FINANCIAL INSTITUTIONS 2 (1996), *available at* http://www.fpif.org/pdf/vol1/08ififi.pdf.

205. The World Bank, Multilateral Development Banks, http://go.worldbank.org/F3REECOMB1 (last visited Nov. 25, 2008). The regional development banks are the Inter-American Development Bank, the European Bank for Reconstruction and Development, the Asian Development Bank, and the African Development Bank. *Id.*

effect of those conditions could be the creation of institutions that, as a happy byproduct of serving creditor interests, also obligate or induce debtor governments to enact reforms consistent with democratizing institutions. Indeed, it would be difficult to claim that the creation of incentives to subordinate other domestic objectives to repayment is necessarily at odds with constituent preferences, because repayment of IFI loans assists in the creation of a reputation that permits subsequent access to capital markets at low interest rates.[206]

But my claims in this Article relate to the possibility that creditor monitoring can not only enhance democracy directly, but also indirectly by demanding the creation of institutions or reputations that, as a happy byproduct of monitoring, create greater consistency between official conduct and constituent preferences. The conditions of IFI lending have the possibility of conferring far more specific benefits than the creation of reputation that will have long-term benefits to the constituents of borrowers. IFI monitoring is likely to focus on benchmarks and the creation of institutions that can be monitored at a relatively low cost. But if those benchmarks and institutions reflect the objectives for which constituents would lobby if they were politically cohesive, then creditor monitoring serves as virtual representation of constituent interests.

The controversial conditions offered by IFIs provide a basis for determining whether creditors actually play this role. In theory at least, conditions of lending can improve the quality and effect of aid. In practice however, interest group pressures within both the IFI[207] and recipient countries may significantly distort the effects of aid.[208] Thus, developing nations may not realize the theoretical benefits of conditionality that are consistent with the monitoring capabilities of creditors. Indeed, to some extent, IFIs appear, at least superficially, to be reluctant to seize opportunities to use their monitoring capacities in ways that might distort decisions that recipient

206. *See* TOMZ, *supra* note 39, at 86-88; Douglas W. Diamond, *Reputation Acquisition in Debt Markets*, 97 J. POL. ECON. 828, 830-31 (1989).

207. *See, e.g.*, JOSEPH STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS (2002); Roland Vaubel, *Bureaucracy at the IMF and the World Bank: A Comparison of the Evidence*, 19 WORLD ECON. 195, 209 (1996).

208. *See* Wolfgang Mayer & Alexandros Mourmouras, *The Political Economy of IMF Conditionality: A Common Agency Model*, 9 REV. DEV. ECON. 449, 453-56 (2005).

governments might otherwise render. The World Bank pledges in its documents not to interfere in the political affairs of members and to be guided only by economic considerations.[209] Nevertheless, again in practice, the World Bank has utilized its role as lender to "recommend" structural reforms that seem to transcend financial concerns. For instance, although a recent report by World Bank staff with respect to Botswana suggested that authorities implement long-term plans to solve budget deficits, that same report recommended that avenues toward that goal include HIV/AIDS programs, deregulation of the labor market, stronger measures to enforce tax compliance, and trade liberalization.[210]

The same possibility seems to be inherent in the recent movement to reform conditionality to respond to criticisms of external intervention in domestic affairs. The IMF has advertised the requirement of conditionality through a relatively narrow lens that appears consistent with constituent preferences: "a way for the IMF to monitor that its loan is being used effectively in resolving the borrower's economic difficulties, so that the country will be able to repay promptly."[211] The imposition of these conditions has, at least on occasion, ignored the preferences of officials in developing nations, as evidenced by their refusal to accept IMF loans even during periods of financial distress. Where democratic regimes are not in place, of course, that refusal does not necessarily mean that the conditions are inconsistent with the preferences of constituents.[212] Even in the case of democratic borrowers, it is plausible that loans that depend on conditions such as those imposed by the IMF would be refused because meeting the conditions are deemed too costly.

The World Bank has recently reduced its conditions and taken steps to make them more consistent with presumed internal preferences of borrowers, although it has accomplished the latter

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209. *See* International Bank for Reconstruction and Development, *supra* note 202, at art. IV, § 10.

210. *See* WORLD BANK, AN ASSESSMENT OF THE INVESTMENT CLIMATE IN BOTSWANA 3-5 (2007), *available at* http://siteresources.worldbank.org/INTAFRSUMAFTPS/Resources/BWA_ICA_Volume_1_FINAL.pdf.

211. International Monetary Fund, IMF Conditionality, http://www.imf.org/external/np/exr/facts/conditio.htm (last visited Nov. 25, 2008).

212. *See* Silvia Marchesi & Jonathan P. Thomas, *IMF Conditionality as a Screening Device*, 109 ECON. J. C111, C114 (1999).

through reference to standards that are inherently ambiguous, such as "ownership" of the policy by the borrower and "customization" of policy.[213] But the number of conditions should matter less than their substance. The key is to create conditions that are both vulnerable to monitoring and reflective of constituent preferences for which constituents themselves have limited monitoring capacity. Wolfgang Mayer and Alexandros Mourmouras, for instance, suggest that conditions should be tailored to weaken interest groups that frustrate domestic institutional reforms necessary to broader national welfare.[214]

CONCLUSION

Little of the reasoning provided throughout this Essay would be lost on the Protectors of San Giorgio. They certainly understood the relationship between reducing payment risks and reducing political distortions between officials and constituents.[215] The historical institutional changes wrought by creditors of developing nations, motivated largely by self-interest, have similarly sought to induce political officials to conduct themselves in a manner consistent with the interests of constituents.[216]

So my claims boil down to the following: creditors have the capacity to solve some collective action problems that compensate for defects in monitoring by constituents. Whether or not creditors have incentives to seize those opportunities depends on the structure of the debt transaction; the value of creditor monitoring increases as the probability that constituents will monitor decreases, and all these characteristics converge when credit is being extended to a jurisdiction in the birth pangs of democracy. If these claims have any resonance, then the primary implications for current public debt are to apply greater scrutiny to the transactional structures used by those who lend to developing nations; to celebrate their efforts to create institutions of credible commitment;

213. *See* WORLD BANK, CONDITIONALITY IN DEVELOPMENT POLICY LENDING, at i-iii (2007), *available at* http://siteresources.worldbank.org/PROJECTS/Resources/40940-1114615847489/Conditionalityfinalreport120407.pdf.

214. *See* Mayer & Mourmouras, *supra* note 208, at 463.

215. *See supra* notes 22-23 and accompanying text.

216. *See supra* note 25 and accompanying text.

but even more so, to recognize how their self-interested pursuit of repayment—the conditions that sometimes earn these institutions substantial scorn—may be as crucial as their financial capital in contributing to the stability and accountability that historically is the precursor of both economic and political success.