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Local public finance and municipal governance: an another role of fiscal federalism

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This paper aims to interpret Charles Tiebout’s model of local public expenditures based on the theory of the so-called corporate governance. In this interpretation, communities and jurisdictions are viewed as “municipal corporations”, whose shareholders are owners of property and local governments are the administrators. Beyond that, proposes itself that the rights of the local governments defined in the Fiscal Federalism can serve of guide for good practice of governance.

Este artículo pretende interpretar el modelo de Charles Tiebout de gastos públicos locales a partir del referencial teórico de lo que se acordó llamar de gobernanza corporativa. En esta interpretación, las localidades, jurisdicciones, son vistas como “corporaciones municipales” cuyos accionistas son los propietarios de los inmuebles y los administradores son los gobiernos locales. Además de eso, se propone que las atribuciones de los gobiernos locales definidas en el Federalismo Fiscal pueden servir de guía para buenas prácticas de gobernanza.

Key words: urban economy, residential choice, corporate governance, municipal governance, fiscal federalism
JEL classification: H31, H41, H72, H73, H75, H76, H77, R2

1. Introduction
Within in the theoretical structure of the so-called New Urban Economy, when a family moves to determined city and has to choose a residency, a complex set of decisions has to be faced by the family. According to Fujita (1989), the families are confronted with a trade-off between the following factors: accessibility, space, amenity. Accessibility includes both pecuniary costs and the time to get to work, to visit friends, to get

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groceries and other activities. In relation to space we consider the size and quality of the property itself. Finally, the amenities include characteristics of nature, as well as characteristics of the vicinity, meaning quality of schools, public safety, and racial composition among others.

In such case of choosing a residency a family may consider all of the three factors appropriately, but, furthermore, may be confronted with both budget and time limits. For example, normally a good accessible location comes along with high land prices. Consequently, a family should sacrifice space for accessibility. Yet, accessibly locations typically lack environmental quality. Therefore, consider for a moment the case of a resident thinking about moving or not moving to the suburbs. What variables will influence the choice of location? If he has children, good schools (high level of expenditures on schooling) may be of great importance. Another person may simply prefer a community with parks or a neighbourhood with more public safety. The utility and quality of public goods and services, according to the preferences of the individual, will influence the decision-making process.

In one of Tiebout's (1956) seminal works he suggests a partial solution for the problem of efficient provision of public goods, raised by Samuelson (1954). Knowing that production and consumption are geographically located, he proposes a solution that involves a system of various local governments. The idea is basically that families can deliberately migrate to the community that has the best bundle of goods in relation to their preferences. That being so, Tiebout (1956, p. 418) argues that the “consumer-voter may be viewed as picking that community which best satisfies his preference pattern for public goods”

Tiebout suggests that it is of great importance to look at the provision of local public goods in a system with numerous jurisdictions as they are analogous to a competitive market for private goods. The competition to live in those jurisdictions causes an output variability of bundles of public goods. Consumer-voters will reveal their preferences through public goods, moving to the jurisdiction that provides them. Therefore,  

1 This occurs as consumer-voters are normally aware of the fact that they are not the only one interested in the consumption of a determined public good. Knowing that the public good would probably be offered anyway the individuals can show less interest than they really have. In other words, the consumers are encouraged to underestimate their preferences, benefiting from the “hitch-hike effect” (enjoy the goods while avoiding the tax).
Tiebout’s argument is based on the idea that individuals “vote with their feet”.

Despite his ground-breaking ideas Tiebout (1956) is vague about various points. The following questions are not answered adequately: Are the governments autarkic? What type of local governments do the individuals face? What are the motivations of such governments? Bewley (1981) distinguishes between two types of motivations: motivations of democratic governments and “enterprising governments”. Democratic governments aim to maximize welfare of their inhabitants, consequently the idea of migration between jurisdictions loses significance. Enterprise governments, on the other side, set their goals independently from the welfare of its population. They can both repel and attract new inhabitants.

Due to the existing disagreement on the relations dominating the interaction between local governments and residents this paper aims to interpret Tiebout’s (1956) model based on the theory of the so-called corporative governance. According to Fischel (2001), communities and jurisdictions are viewed as “municipal corporations”, whose shareholders are owners of property and local governments are the administrators. Beyond that, proposes itself that the rights of the local governments defined in the Fiscal Federalism can serve of guide for good practice of governance.

In the following section I will present Tiebout’s model. I will discuss the principles that guide the structures of governance and how the concept of corporative governance fits into the structures in the third section of this paper. In the subsequent section will be the reinterpretation of Tiebout’s model. The fifth section includes the questions related to the idea of fiscal federalism and how they can serve as guidelines for a good structure of municipal governance. In the end I will draw some conclusions.

2. Tiebout’s model
Tiebout makes the following assumptions to postulate his model:
1. Consumer-voters are fully mobile and will move to that community where their preference patterns are best satisfied.
2. Consumer-voters have full knowledge of differences among revenue and expenditure patterns and react to these differences.
3. There are a large number of communities in which consumer-voters may choose to live.
4. Restrictions due to employment opportunities are not considered.
5. The public services supplied exhibit external economies or diseconomies between communities.
6. For every pattern of community services, set by a city manager who follows the preferences of the older residents, there is an optimal community size.²
7. Communities below the optimum size seek to attract new residents to lower average cost. Populations above optimum size do just the opposite. Communities at an optimum try to keep their population constant.

As a consequence of these extremely strong hypotheses Tiebout suggests that the result of the process of consumer-voters choosing a jurisdiction (community) would be Pareto efficient. This optimum emerges due to the fact that public goods are provided at the lowest average cost and each consumer-voter lives in a community where his preferences are best satisfied.

The last hypothesis assumes that big cities try to get rid of their residents, which surely is hard to imagine since no mayor would ever admit that his city is too big. Yet, Tiebout (1956, p. 420) argues that “every

² The optimal community size is defined in terms of the number of residents for which a determined basket of services can be produced to an average minimum cost. Moreover, a fixed factor is assumed as it is necessary to determine the number of communities. The factor could be, for example “the limited land area of a suburban community, combined with a set of zoning laws against apartment buildings.”

³ Rubinfeld (1983) stresses the importance of differentiating between optimum and efficiency, normally used indistinctly, that have two different meanings in the public economy. Commonly the term applies to the provision of public services within a jurisdiction. An optimum provision that generates intra-jurisdictional efficiency is the one that maximizes the supply for all the individuals of a jurisdiction due to costs and the intentions to pay for public goods. An optimum within a system of jurisdictions, inter-jurisdictional efficiency, occurs in terms of provision of public goods between jurisdictions when migration is possible. Efficiency is achieved if there is a number of jurisdictions in the provision at a level of public goods that is sufficient to satisfy the individual demands, produced at a minimum cost. The notion of inter-jurisdictional efficiency may not really matter for the discussion about the public good supply on the federal level, but it is essential for local public economy.

⁴ We could think of a central administrator, who tries to develop decentralization projects.
resident who moves to the suburbs to find better schools, more parks and so forth, is reacting, in part, against the pattern the city has to offer.” The case of a small community at optimum size, trying to remain so, is not so hard to visualize. Proper zoning laws, for example, are such attempts to keep the population stable.

The hypothesis of mobility allows individuals that are not happy with their community pattern to move to a community that will satisfy their preferences. The “act” of moving is crucial as it substitutes the usual market test of willingness to buy a good and reveals the preferences of the consumer-voters. Consequently, each locality has its pattern of expenditures and revenues that reflects the desires of its residents.

Based on McGuire’s (1974) work we can formalize Tiebout’s model in the following way. Suppose that an economy consists of \( N \) identical individuals and only two types of goods: private good, \( y \), and local public good \( x \). Each individual is characterized by a well-behaved utility function \( U_i(x^i, y^i); i = 1...N; N = \text{size of the population} \). Assuming that a certain function cost for a given jurisdiction, \( C = C(x,n) \) adapts to all of the possible jurisdictions independent of its composition, where \( C = \text{total cost measured in units} \) and \( x = \text{level of the public goods, offered by each member of the jurisdiction and } n = \text{population of the jurisdiction} \).

Individuals have an income that could be allocated between public goods and private goods. Assuming that local public goods are defrayed by local taxes and defined by \( c_i \) as the personal tax of the \( i \) individual, the final consumption of private goods by a certain individual, his income will be (initial endowment), \( y^i \), minus his taxes or rather \( y^i = \bar{y}^i - c^i \). Moreover, we assume that all individuals have the same level of income.

Considering that the optimization of the supply of public goods is an important question in relation to the objective of welfare, individual utilities have all the same impact on the overall welfare. This formulation is implicated in a symmetric solution for the problem of maximization, which would be level of utility and consumption of the same public goods for everybody. This symmetry is used to simplify conditions related to the optimization of welfare through the observation what happens when the personal charges remain the same \( c^i = C(x,n)/n \) and if the maximization of the social welfare becomes equivalent to maximize the utility of a representative individual:

\[
\max_{x,n} U \left( x, \bar{y} - \frac{C(x,n)}{n} \right) \quad [1]
\]
First-order conditions:

\[
\frac{C(x,n)}{n} = C_n \tag{2}
\]

\[
n \frac{U_x}{U_y} = C_x \tag{3}
\]

An allocation in Pareto-efficient manner occurs when the conditions are satisfied simultaneously. The third equation is a condition for an efficient public good supply, stated by Samuelson. According to this condition, the public goods provision should rise until it reaches the sum of Marginal Rate of Substitution between public and private goods, equal to the marginal cost of the public good, Marginal Rate of Transformation respectively. The second equation is what we would call the condition of society and shows that each jurisdiction may admit individuals until the cost per-capita is minimized. This happens when the average cost per individual is equalized to the marginal cost of admitting one more individual to live in the community. With decreasing average costs for all levels of \( x \) (or rather pure public goods) the optimum community will include the whole population, while the decreasing average costs result in an optimal size of zero. In case of constant average and marginal costs the optimal size of the community is indeterminate. The size of the jurisdictions will be \( n^* \), therefore, the optimal number of jurisdictions is \( N/n^* \).

Bewley (1981) shows that only enterprising governments manage to generate an efficient equilibrium. But what exactly are the objectives of these governments? As in the preceding formalisation we can assume that local governments are profit maximizer. They get their revenues from taxes and their expenditures from embedded costs in public goods. This

\(^{5}\) Bewley (1981, p. 715) observes that the relationship between costs of public goods and the size of the population of the community change the result of the model considerably. He assumes two extreme cases. One in which costs are independent from the population and one that assumes proportional cost to the population size. He calls the first one case of pure public goods and the second case of pure public services. A third case that appears a lot in the literature is the one in which the cost per capita of public goods is function of the population in form of a U-shape, which is the case Tiebout (1956) considered as well.
is certainly a conspiratorial hypothesis as it would be more appropriate for a model of a feudal society, where governments remain in the hands of a few individuals. Nevertheless, the idea relates exactly to Tiebout’s attempt to formulate a local goods theory that is analogous to the general equilibrium theory.

3. Corporate governance

Governance is a widely known term used in various disciplines; yet, its popularization did not come along with an elaborated explanation of its meaning. Although it is commonly used it still deserves some theoretical and empirical research.

While it is a multiply interpreted term we find a predomination of approaches suggesting discussions and political proposals to manage conflicts between administrators and shareholders. In this point of view, corporate governance occurs as a system that channels and monitors society, involving mainly the relationships between shareholders, board of directors and managers. Thus, in the literature corporate governance aims to overcome the so-called principal agent problem, generated by the separation of property and business control. In this case, economic well-being of one part (shareholders) depends on the decision-making of the other part (managers). Although the administrator should reach decisions from which the shareholder could benefit, interest clashes frequently cause an opportune behavior of the manager.

We encounter the principal agent problem of distinct interests of managers and owners in corporations with property structures that are pulverized or rather “diluted” among various small shareholders. This perception of big corporations with dispersed property, first described by Berle and Means in 1932, dominated the debate over corporate governance for many decades. Yet, recent studies have revealed (La Porta & Lopez-De-Silanes & Shleifer, 1998) that the established paradigm of Berle and Means is an exception mostly to be seen in the United States and Great Britain. In most parts of the world the predominant society structure is one with a concentration of a few major shareholders. This particular situation can lead to a problem of one or many proprietress exerting influence on the controlling of corporations for personal benefit. That way, it causes a new agency problem that consists of a conflict between majority shareholders and minority shareholders.

There are cases in which controlling should solely protect interests of the shareholders and the ones in which other group’s interests should
be considered as well. Nevertheless, we can differentiate between two models of corporate governance: the Anglo-Saxon model that prevails in the United States and Great Britain and the German-Japanese model, predominating in Germany and Japan. The first model constitutes that shareholder participations are relatively pulverized. The second determines a more concentrated property. This, however, is not the only difference between the two models. The primary object of corporations using the Anglo-Saxon model is value creation for shareholders, whereas corporations with the German-Japanese model aim to interconnect shareholder interests with the interests of other groups, known as stakeholders, also affected by decisions of the administrators. Thus, the two models distinguish between two extreme types of corporate controlling: shareholder, in which administrators are obligated to act on behalf of shareholders interests; and stakeholder, where, apart from shareholders a vast conjunction of interests need to be contemplated through the corporations actions and results.

The understanding of controlling structures and property is indispensable for corporate governance, as these variables influence the market efficiency controlled by corporations, showing the degree of diversity in relation to the shareholders risks and indicating a potential agency problem.

The shareholder model is more attractive to us as for the purpose of this paper we will look exclusively at the relationship between administrators (local governments) and shareholders (property owners) and leave out other groups representatives, such as associates of the public administration. In the following section we will present Tiebout’s model from the perspective of corporate governance.

4. Municipal Governance
Corporation shareholders elect a board of directors, whose members vote for executives that will administrate the company. In municipal corporations shareholders are individuals that own a property, the assets in the city. That way a variation of asset values would be a consequence of the individual’s actions, administrating the municipality. And these assets are negotiated in a competitive market, or rather in a real estate market. The risk is, yet, the wide difference between municipal corporations and enterprising corporations due to the fact that shareholders of municipal corporations cannot diversify their assets, decreasing the risk by transposing their corporation to different jurisdictions. According to Fischel (2001,
property owners “can insure the physical capital of their homes but not its location value”. On the other hand, asset owners in corporations can alter their portfolio by participating in different companies.

Normally property practically stands for all the physical wealth of the shareholders, which is another factor of risk in municipal corporations. That being so, bad decisions by the city manager are dangerous for owners as it may cause a drop in property prices, which is irreversible in most cases. As mentioned before, it is possible to assert the physical value of property, but normally public policies affect the location’s value. Furthermore, since they hold an office elected directors of municipal corporations cannot be punished immediately for bad decision-making.

Studies show that public policies are potentially affected by the relationship between government subsidies and house price capitalization. Consider an intergovernmental transfer by state or federal governments for communities with low-quality schools or a great number of poor residents. Many authors have argued that such assistance, based on the location, (in opposition to direct assistance to the poor) may have contrary consequences, because poor residents are typically tenants that would be forced to pay more rent, if transfers were capitalized causing higher property prices (Hamilton, 1976; Wyckoff, 1995). Wyckoff (1995) suggests that the dislocation of the constituents would cause an equalization of intergovernmental assistance, capitalized by housing prices. Assuming a fixed supply of housings, he shows that in most cases intergovernmental assistance has no effect on the welfare of poor citizens and in some cases it even deteriorates the situation. At this point it is important, however, to state that the supply of land is not completely inelastic and fiscal differences are not fully capitalized into housing values. Therefore, Wyckoff’s conclusions are not necessarily valid for this case.

The idea and causes of the capitalization within models like Tiebout’s have caused a lot of disagreement on the interpretation, yet, I will base my work on the following interpretation. The classic model of Tiebout (1956) assumes that individuals are fully mobile and that they will move to the jurisdiction that best satisfies their preferences. Moreover, the model assumes a large number of jurisdictions, as well as the possibility to create them (high elasticity in terms of land supply). The reality proves that such hypotheses cannot be realized in practice. That way the capitalization is the result of rigidity in terms of mobility of the individuals, or rather, an impossibility to move to another community, due to change in offered public services, that has an impact on property prices.
Various other works concentrate more on understanding and amplifying the capitalization of property taxes within housing prices\(^7\). A few authors suggest that in terms of public goods the level of local expenditures depends, in a way, on the extension to which fiscal variables and amenities are capitalized into property values. Wildasin (1979) and Sosntelie & Portney (1980) suggest that property owners have an incentive to vote for local public goods that will maximize the values of their housings. They move to the community where they encounter ideal public expenditures, hoping to “collect some proceeds”. Brueckner & Joo (1991) prove that in a world where consumer-voters face restricted mobility and capitalization into property value, the ideal level of expenditures on durable local public goods is a combination of own preferences and the preferences of the purchaser, to whom he or she would like to sell the property in the future. This pattern of choice may explain why the average voter would accept additional expenditures on good schools even if he or she did not have children that go to school\(^8\).

Although as a matter of principle, central governments can retort each allocation made by local governments, the literature normally argues that (taking political and informational reasons into account) the central government is constrained to provide a uniform level of public services for its population, independent from the residence’s location. We find that in some countries it is unconstitutional to provide different levels of public services for different areas. The idea behind the establishment of local governments, e.g. municipal corporations, is that they have better information in relation to local preferences and are, consequently, able to provide public goods based on local “needs”. Referring to the discussion about the size of the governments, Oates (1999) argues that between local governments small units adjust themselves better to the variation of preferences of big local governments. Reciprocally, due to transaction and information costs big local governments face way more problems providing public products for various groups within a jurisdiction.

Despite the fact that local governments adjust themselves better to preferences of their population, they are restricted in terms of public goods supply due to problems of scale. The bigger a jurisdiction, the hig-


\(^8\) Further details in Hilbert & Mayer (2004)
her are the revenues of the public goods production. Therefore, the chances for a trade-off between adjusting preferences and scale-economies are relatively high. Tullock (1969), nevertheless, argues that small local governments can hire private companies\(^9\) or other governments to provide services. Consequently, small communities would not have to be founded to explore economies of scale. Fischer (1996) cites reports, which reveal that in 1982 almost fifty percent of the city and county\(^{10}\) governments in the United States stipulated provisions of goods and services provided by other governments.

Tullock’s argument is not fully convincing, since not all services can be easily contracted due to the fact that it is highly difficult to elaborate and monitor them properly. These difficulties can lead to problems like adverse selection, moral risk and the deterioration of services. Under such circumstances it may be better for local governments to produce the services instead of buying them, and the trade-off emerges again.

Due to the problems in relation to municipal governments, property owners may be more interested in the governance of their municipal corporation than corporation shareholders. Therefore, elections and local political happenings are highly important to owners that thus need a more strict system of institutional monitoring than companies. In this paper we came to understand that the governance rules of municipal corporations could be linked the fiscal attribution of municipal governments within fiscal federalism.

5. Fiscal federalism and rules of municipal corporations

Tiebout’s model assumes mere fiscal decentralization, in which local governments have all the fiscal competence (allocative function, stabilization function and distributive function). Yet, according to Silva (2005, p. 118):

*In the analysis of the more adequate fiscal function of the government it is not convenient to think in terms of a dichotomy between plain centralization versus extreme decentralization, but rather in terms of a diverse federative structure at the level of decentralization.*

In a system with various jurisdictions, where there is no regulating central government, the mobility of producing factors may nullify the

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\(^9\) Such companies could achieve great scales producing for various governments.

\(^{10}\) A county in the United States is a local government smaller than a state, but most of the times bigger than a city.
governments distributing and establishing policies. In a federative system, centralized and decentralized competences are mixed forming a structure, in which fiscal responsibilities are distributed at different levels of government with its federative units. That way, distributive policies “are identified as functions that the central government of a federative state has to carry out, demanding procedure on a national scale, degree and uniformity, in order to prevent possible spatial dislocations of producing factors”. (Silva, 2005, p. 124)

In countries with a federal system, federal units divide responsibilities by administrating allocation, stabilization and distribution functions. Therefore, a fiscal system should precisely define the competences that are to be distributed at every level of the government. The objective is to create a Pareto efficient situation.

For Silva (2005) the best federal arrangement of welfare or property prices in municipal corporations may be the one whose provision and financing of public goods derive from resorting constituted jurisdictions in number and space. This should happen proportionally to population groups with identical fiscal preferences. “The financing may be arranged according to the benefit principle which constitutes that every individual contributes to the welfare by the bundle of offered goods (ibidem, p. 12).

This is basically Tiebout’s (1956) argument. Oates’ argument for this case can be taken from his theorem of decentralization which shows that when a local public service is consumed by one part of the population (granted that producing costs are the same) the localized provision

11 In Tiebout’s model the local public services are financed with benefit taxes, or rather, residents pay taxes according to received benefits. As Musgrave (1973, p. 90-91) observes “to rely solely on benefit cannot solve the issues of distribution and stabilization. Yet, to deal with the division of allocations, this approach has the merit of linking the choice-making of public services to the preferences of the consumer-voter of a community”.

12 In the case of Brazil, we can see that the process of decentralization consolidated by the constitution of 1988 generated a series of disequilibrium issues. The demands of the decentralization of the public revenues of states and municipalities were not accompanied by a concomitant decentralization of public responsibilities, mostly within political structures. Further details in Resende (1995 & 1998)

13 Oates (1972) develops two important terms related to fiscal federalism, the so-called “perfect correspondence” and the “theorem of decentralization”. 
based on the preferences of the residents is always more efficient than the decentralized uniformed provision.

The federal model, initially presented by Oates (1972), is based on the idea of perfect correspondence; or rather, it assumes a perfect correlation between preferences, tax base and financing capacity. Nevertheless, such hypothesis stretches reality. Oates, aware of this issue, develops in the same work a model of imperfect correspondence, in which he assumes various imperfections within the relations between preferences, mobility factors, tax base etc. He corrects the “flaws” by adopting fiscal intergovernmental mechanisms of transfer.

Hillbrecht (1997) argues, if the idea of fiscal decentralization aims to reach the highest allocative efficiency, local governments should have budget constraints. This should be done since a harder budget constraint for inferior units of the government prevents them from systematically receiving assistance from the central government in case of financial difficulties. That way it assures a better allocative efficiency of public expenditure. According to McKinnon (1995, p. 467) the following factors guarantee a hard budget constraint:

1. Inexistence of grants to finance running expenses. The deficit of running expenses is limited either by law, by rationing in the equity market or by a combination of both.
2. Fiscal separation. Revenue sharing and intergovernmental transfers should either not exist, or be limited.
3. Inexistence of restrictions on employment movement and capital among the jurisdictions.
4. Open fiscal competition between local governments to attract profitable capital.

Tiebout’s model yields the 3rd and the 4th condition and implicitly the 1st and the 2nd which are not to be seen in practice. Yet, condition 1 and 2 are necessary to guarantee that condition 4 increases welfare due to a better allocation of resources. In other words, to create a benignant instead of a destructive “fiscal war”, government budget constraints should be severe.

The fiscal separation is highly important for the budget constraint as revenue sharing and intergovernmental transfers may induce the “syndrome of soft budget constraints”:

*If the transfers were not linked to one another local governments could spend the revenue as they want. The level of expenditures becomes independent from its tax base. Local governments would not have any
more incentives to expand it and the local political activity would proceed to aim for higher transfers, configuring a rent-seeking behaviour (Hillbrecht, 1997, p. 59).

Local governments should therefore have a tax base that is equal to their expenditures so that the competition between the governments generates benefits. Taking this into account, Hillbrecht sees regional equalization as a hindrance to economic development. Such an affirmation should be considered with two exceptions. Firstly, in federative systems the union carries out the function of reducing regional dissimilitude. Secondly, interregional inequalities cause inequalities in terms of opportunity and choice as well as the manifestation of preferences between individuals, regions and productive sectors.

6. Conclusions
Even after fifty years of interpretation and empirical relevance of Tiebout’s arguments, still remain controversies that leave much room for debate. This paper tried to interpret Tiebout’s classic model in terms of corporate governance. If we understand corporate governance as rules and procedures for a good administration of conflicts between elected administrators and property owners of a certain location, the definition of rights and responsibilities that arise from discussions concerning fiscal federalism could serve as a guideline for good governmental practices.

Within the interpretation of Tiebout’s model in the corporate environment the difficulty of assigning administrative and fiscal competences in relation to fiscal federalism is that the idea of imperfect correspondence and the resulting adoption of transfer mechanisms are not incorporated in the model. In other words, there is an exogenous component, the federal government, interfering with the model’s “market” equilibrium.

The interpretation of Tiebout’s model as a system of municipal corporations, despite all the mentioned exceptions, can be considered an important instrument, not only for a comprehension of the relationship between local governments and the residents of its jurisdictions but also for an understanding of the rules that should determine these relations.
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