CHRONICLE OF A LOCAL CRISIS FORETOLD—LESSONS FROM ISRAEL

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INTRODUCTION

The financial crisis in 2008 stirred a debate about the state's role in the monitoring of the financial markets. The once-dominant neoliberal approach weakened, and various reforms in the state's financial regulation were suggested. Many of the reforms called for more intense state involvement, others called for a more cautious approach. Much less attention, however, was paid to the state's role in monitoring local finances. Although the crisis no doubt affected localities, and despite predictions of massive local defaults, there was little discussion about the state's supervision of local fiscal policies. What difficulties does the state face in monitoring these issues and how can we mitigate these difficulties? This Article aims to explore these issues, in light of the Israeli experience. It demonstrates the pitfalls in the state's monitoring, and suggests partial solutions.

My main argument is that political interests frustrate efficient state monitoring. State politicians do not always internalize the costs of a local crisis, and they may even benefit from local economic weakness. They prefer to maintain the local dependency on the central government's funds, thereby strengthening their own position vis-à-vis the local leadership. An interesting metaphor for the state-local relationship in Israel can be found in the famous fable about the frog and the scorpion. The scorpion asks the frog to carry it across the river. In the middle of the way, the scorpion stings the frog and they both drown. The stunned frog asks the scorpion why it did that, and the scorpion replies, "It is my nature." The same is true with regard to the policies of Israel's central government toward the local sector. Although the local crisis was detrimental to both localities and the central government, the state politicians were largely responsible for it. The nature of Israel's political system incentivized them to shift costs and to underfund the local sector until it was on the verge of financial collapse.

In 2004–2005, localities in Israel underwent a severe fiscal crisis. About three quarters of the local governments suffered from deficits—most of them had deficits of over 30% of their annual budgets.[1] Defaults were prevalent, employees worked for months without compensation, and basic services were not provided.[2] A large portion of the local sector was unable to finance the public goods for which localities were legally responsible.[3] This Article shows that much of the responsibility for this local crisis lies with the state. Since the 1980s, various socioeconomic and political processes joined together and created an environment that facilitated the creation of huge local deficits. The central government shifted more and more responsibilities to the slim shoulders of the local sector,[4] but it failed to finance these additional obligations.[5] On the contrary, the state significantly decreased independent revenues.[6] In addition, although the state had ample authorities to supervise local expenditures,[7] it failed to do so.[8] The state did not force localities to be fiscally disciplined, and it did not sanction localities for violating regulatory duties, even when these violations were readily known and could be corrected cheaply.[9] State

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1. ISRAEL CENTRAL BUREAU OF STATISTICS, LOCAL GOVERNMENTS IN ISRAEL 2006, 4 (2007).

2. *See infra* notes 16–20 and accompanying text.

3. *See infra* notes 21–24 and accompanying text.

4. *See infra* notes 28–30 and accompanying text.

5. *See infra* note 38 and accompanying text.

6. *See infra* notes 38–42 and accompanying text.

7. *See infra* note 69 and accompanying text.

8. *See id.*

9. *See infra* notes 91–92, 99 and accompanying text.

politicians preferred to ignore the local plight rather than take actions to correct it.[10]

After examining the state's responsibility for the local crisis, I explore the motives behind the state's behavior. I argue that Israel's political structure incentivized state politicians to neglect the municipal sector and to create a lax supervision system over local finance. Within the Israeli national political system, local issues are not considered an important factor. State politicians are not rewarded for investing resources in distressed localities, and they are not punished for the creation of local deficits. They are better off, therefore, under-financing municipalities, and spending the state's funds on other purposes from which they enjoy political dividends. Underfunding the local sector has an additional benefit: it forces municipalities to beg constantly for assistance, thereby giving state officials the power to decide who will receive additional funding and who will not. Moreover, due to the mayors' power in the national parties, state politicians are reluctant to confront them. Mayors are allowed to overspend and violate state regulations because the minister of interior, who is in charge of the state's monitoring system, needs the mayors' support for his political career. Using Israeli cases, I illustrate the inherent conflict between the interests of the individual politician and the state's monitoring duties.

Drawing on the Israeli experience, I then identify two mechanisms that can decrease the weight of the political interests. One is an efficient municipal credit market, and the other is an established statutory procedure for the state's intervention. The credit market compels the central government to internalize some of the costs of the local crisis and incentivizes state officials to take action. Evidence from the United States shows that states assist local governments to recover from fiscal crises because they are apprehensive of crises' contagion effects on the municipal bond markets. The Israeli experience, on the other hand, suggests that the lack of an efficient credit market aggravates the local plight and holds back local reforms. A statutory procedure for the state's response in the face of local distress can also decrease political pressures. Especially when implemented by an insulated state agency, such a procedure can serve as a commitment device and constrain state politicians in their actions. While these mechanisms cannot guarantee that the state will monitor effectively, evidence shows that they may have positive effects on the local fiscal health.

10. *See infra* notes 108–14 and accompanying text.

Although this Article focuses on Israel as a case study, the political dynamics it describes are not unique to a particular country. Similar problems also surface in the United States, where political interests get in the way of efficient state supervision on local finance. Bridgeport's crisis, for example, was partly the result of state-local relations,[11] and the roots of the Orange County bankruptcy were also connected to the state.[12] A study of the difficulties in the state's monitoring can help improve local finances by helping us understand the motives behind the state's local policies, so that we can structure the state's monitoring system accordingly.

I. THE DEVELOPMENT OF THE ISRAELI LOCAL CRISIS

In 2004–2005, local governments in Israel were in a severe fiscal crisis.[13] The crisis was not experienced by just a few localities with problematic financial practices, but rather it encompassed a significant portion of the municipal sector. In 2004, no fewer than 75% of the local governments (190 out of 255 municipalities) suffered from a budget deficit and had difficulties paying their debts when due.[14] In 2005, the percentage of the localities in deficit declined a bit to 56%, but over 75% of those municipalities (107 municipalities) suffered from a deficit that reached over 30% of their yearly budget.[15]

Many municipalities in those days did not have enough funds even to pay salaries. In May 2004, 35% of the localities were unable to pay their employees, and many municipalities kept workers without compensation for months.[16] In a private workplace employees might sue their employer

11. Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANK. DEV. J. 625, 663 (1995). Brown describes Bridgeport's municipal bankruptcy as a political power struggle between the state and the city. She argues that Connecticut's officials were motivated by their own political interests and not by the best interests of Bridgeport's residents. *Id.*

12. MARK BALDSSARE, WHEN GOVERNMENTS FAIL, THE ORANGE COUNTY BANKRUPTCY 25–29 (1997). Although the bankruptcy was the result of bad investments made by the county's treasurer, California shares much of the responsibility. California shifted costs to its local governments, but at the same time limited, through Proposition 13, their ability to generate revenues. *Id.*

13. ISRAEL CENTRAL BUREAU OF STATISTICS, *supra* note 1, at 4. Israel's local government sector consists of about 255 localities. These localities can be divided into three categories: municipalities (usually cities with 20,000 residents or more), local councils (with usually fewer than 20,000 residents), and regional councils (which are federations of several rural villages). All three types of local authorities experienced the crisis. *Id.*

14. *Id.*

15. See *id.*

16. THE KNESSET RESEARCH CENTER, WITHHOLDING SALARIES TO LOCAL GOVERNMENTS' EMPLOYEES (2004) (Isr.), http://www.knesset.gov.il/mmm/data/pdf/m01389.pdf.

for the payment they deserve, but it was pointless to sue Israeli local governments. All potentially sizeable local assets were already repossessed by banks or by other creditors,[17] and there was no way to enforce the judgment.[18] Thousands of employees, therefore, worked in the local government sector for nothing.[19]

Some municipalities failed to provide even the most basic and essential public services.[20] There were shortages or shutdowns of water and electricity supply because municipalities could not pay electricity and water bills.[21] Garbage was not collected frequently enough and posed health hazards.[22] Infrastructure was not maintained properly, and even school houses were kept in poor physical condition.[23] Although some municipalities did better than others, the local sector in general, and especially Arab localities,[24] did not perform even basic functions.

The development of such a severe local crisis begs the question, how could Israel, now a member of the OECD, allow the local sector to deteriorate to this level? What caused so many localities to practically go bankrupt? In the following sections, I examine these questions, focusing mainly on the role the state played. I show that the state had a crucial role in the local deterioration and that it neglected its duties to monitor local

17. See the explanatory comments to the Budget Foundations Act (Amend. No. 31), 2004, SH No. 1943 (Isr.).

18. Unlike commercial corporations in such conditions, municipalities cannot be liquidated, because the Companies Ordinance, the Israeli equivalent of Chapter 7 of the United States Bankruptcy Code, does not apply to municipalities. *See* Companies Ordinance, 1999, SH No. 1105 164 (Isr.); *cf.* 17 MCQUILLIN MUN. CORP. § 49:44 (3d ed. 2011).

19. Haim Biur, *16,500 Local Governments' Employees Did Not Receive Salaries for Two Months; Local Governments Say That the Payments Are Delayed Because of Severe Deficits*, THE MARKER (Dec. 11, 2003), http://www.themarker.com/career/1.178210. *See also Reverse Unemployment: Thousands Work but Do Not Get Compensated*, YNET (Dec. 10, 2003), http://www.ynet.co.il/articles/1,7340,L-2836537,00.html.

20. *See, e.g.*, HCJ Appeal No. 4815/05, Israel vs. Local Council of Arabea (May 20, 2006) Nevo Legal Database (by subscription) (Isr.); DC Bankruptcy (TA) 2419/07 *In re The Municipality of Taibe, A Special Report of the Trustee* (Nov. 18, 2007) (Isr.) (on file with author).

21. HCJ Appeal No. 4815/05, Israel vs. Local Council of Arabea, at 4; *see also* ISRAEL COMPTROLLER, ANNUAL REPORT ON LOCAL GOVERNMENTS 2008, 285 (2009) [hereinafter ISRAEL COMPTROLLER, ANNUAL REPORT 2008], *available at* http://www.mevaker.gov.il/serve/contentTree.asp?bookid=541&id=96&contentid=&parentcid=undefined&sw=1024&hw=698.

22. *Id.*

23. *Id.*

24. *Id.* For a general overview of the poor financial condition of Arab local governments, see Yousef T. Jabareen, *Arab-Palestinian Local Governance in Israel at a Glance: Challenges and Opportunities*, BOELL.ORG (June 12, 2011), http://www.boell.org.il/web/97-383.html.

finance. I do not mean to negate other important causes of the crisis by focusing on the state. The causes are varied, and certainly there were cases of mismanagement and corruption not connected to the state. The scope of the crisis shows, however, that in addition to the specific reasons of each local distress, something was wrong structurally. There were common processes, many of them connected to state policies, that led to the decline of the entire local sector, and it is those processes I wish to explore.

A. Socioeconomic Processes

Although the crisis erupted in the new millennium, its roots can be traced back decades, to the 1980s or even earlier.[25] During the 1980s Israel faced great economic and social challenges. From an economic perspective, Israel suffered from a national economic crisis. In the mid-80s, inflation reached a yearly rate of almost 500%, and there was a growing problem of national deficit and payment imbalance.[26] From a social perspective, Israel increasingly turned into a fragmented society. It was no longer the small, unified country it had been in the 1950s and 60s, and due to large waves of immigration it became torn between different cultural and political segments and views.[27]

The combination of these social and economic challenges created a process of decentralization.[28] The decentralization was not the fruit of an organized and systematic thinking, but rather it was, as Nahum Ben Elia phrases it, "decentralization by default."[29] The central government could no longer cope with the growing needs of the different communities, and local authorities filled the vacuum.[30] Thus, since the 1980s, often without a proper statutory basis, the local government sector started to broaden its

25. Nahum Ben-Elia, *The Municipal Crisis in Israel: The Management Failure and the Challenge of Recovery* (Floersheimer Inst. For Pol'y Stud., Working Paper No. 1/23, 1998) (Isr.) [hereinafter Ben-Elia, *Municipal Crisis*].

26. Michael Bruno, *Sharp Disinflation Strategy: Israel 1985*, 1 ECON. POL'Y 379, 380 (1986); Linda Sharaby, *Israel's Economic Growth: Success Without Security*, 6 MIDDLE E. REV. INT'L AFF. 25, 30 (2002).

27. Eliezer David Jaffe, *Ethnic and Minority Groups in Israel: Challenges for Social Work Theory and Practice*, 22 J. SOC. & SOC. WELFARE 149, 150 (1995); Nahum Ben-Elia, *The Fourth Generation: A New Local Government For Israel* 19 (Floersheimer Inst. For Pol'y Stud., Working Paper No. 1/52, 2004) (Isr.) [hereinafter Ben-Elia, *The Fourth Generation*].

28. Ben-Elia, *The Fourth Generation*, *supra* note 27, at 22–26; Ben-Elia, *Municipal Crisis*, *supra* note 25, at 8.

29. Nahum Ben-Elia, *Policymaking and Management in Israeli Local Government: Evolving Trends and Strategic Challenges*, 21 POL'Y STUD. J. 115, 117 (1993) [hereinafter Ben-Elia, *Policymaking*].

30. Ben-Elia, *The Fourth Generation*, *supra* note 27, at 22–23; Ben-Elia, *Municipal Crisis*, *supra* note 25, at 8.

scope of authority.[31] Localities branched out from the provision of the "purely local" goods and services, and they entered into areas that were traditionally under the central government's realm of authority.[32] Localities started to deal with areas such as education, welfare policies, economic development, and even some aspects of national security.[33] They increasingly developed a perception of an over-arching responsibility to the welfare of their residents, partly as a result of over-ambitious mayors and partly as result of the weakness of the central government.[34]

The growing responsibilities of the local sector, however, did not come without a cost. To provide the additional services, municipalities had to increase their workforce and spend more.[35] Thus, whereas in the beginning of the 1980s, the local governments' current expenditures amounted to less than fifteen billion shekels per year, in 2001 current expenditures reached 33.5 billion shekels (both in 2002 prices)—an increase of 125%.[36] According to Ben-Elia, population growth can account for approximately 60% of this expenditure increase, but the rest of the growth is attributed to the broadening scope of local services.[37]

The problem was that this increase in expenditures was not accompanied by a corresponding increase in revenues. To the contrary, the state tightened the local revenue sources, so that revenues were insufficient to cover the growing costs.[38] The state, in this respect, acted in two

31. Ben-Elia, *Municipal Crisis*, *supra* note 25, at 8.

32. *Id.*

33. *Id.*

34. *Id.*

35. Ben-Elia, *The Fourth Generation*, *supra* note 27, at 23.

36. *Id.* at 24; Ben-Elia, *Municipal Crisis*, *supra* note 25, at 12–14. The amounts include current expenses such as salaries, operational activities and loan repayments. They do not include irregular budget expenditures, such as high cost infrastructure, transportation, lighting, and drainage, which are typically financed by specific governmental grants, donations, and special loans.

37. Ben-Elia, *The Fourth Generation*, *supra* note 27, at 23.

38. *See id*. Municipal revenues can be divided into two major sources: independent revenues and intergovernmental grants. Independent revenues are revenues collected directly from the local residents (businesses and individuals). *See* Guy Navon, *Budgeting Dynamics in Local Authorities in Israel*, 4 ISR. ECON. REV. 19, 22 (2006). They are levied by the local government, and typically include municipal taxes, fees for municipal services, fees for use of municipal property and more. *Id.* Intergovernmental transfers are funds transferred from one level of government to another, usually from central to local authorities. *Id.* In Israel the intergovernmental transfers can be divided into three major sources: specific grants, general grants, and transferred revenues. *See* Eran Razin, *The Impact of Decentralization on Fiscal Disparities Among Local Authorities in Israel*, 2 SPACE & POLITY 49, 53 (1998) [hereinafter Razin, *Impact of Decentralization*]. Specific grants are grants provided by the central government to finance specific services, such as education, welfare and sometimes infrastructure. *See id*. General grants, also called

directions: it significantly decreased the intergovernmental grants, but at the same time it also limited local fiscal autonomy, constraining localities' ability to raise taxes.[39]

The reduction of intergovernmental transfers was particularly severe. In light of the national economic crisis—the recession and hyper-inflation[40]—the Ministry of Finance cut two major sources of intergovernmental transfers: transferred revenues and general grants.[41] Transferred revenues were portions of certain state taxes that were transferred to localities according to a specific formula.[42] Since the mid-1980s the Ministry gradually decreased the transfer of these tax revenues, until in the mid-1990s the transfer was eliminated altogether.[43] Localities lost a significant source of income—about a billion shekels a year, and have not been compensated for this loss ever since.[44] In addition, the central government cut the amount of general grants by 80%, from a level of 3.5 billion shekels in 1980 to 700 million in 1986.[45] General grants are distributed to fill the gap between local needs and resources, and so weak municipalities—those that could not finance their expenses in good times—suffered the most from this decrease.[46] Although from 1987 onwards there was a gradual increase in the amount of grants, it took about a decade for general grants to return to their original levels.[47] In the beginning of the new millennium, however, the central government again severely cut general grants. In 2003, the government reduced the grants by 25% and in 2004, by an

equalization grants, are grants distributed to fill the general gap between local needs and resources. *See id.* These grants have a substantial redistributive element. Transferred revenues are a portion of certain state taxes that were transferred to localities according to a specific formula. *Id.*

39. *See* Razin, *Impact of Decentralization*, *supra* note 38, at 53.

40. Bruno, *supra* note 26, at 380–84.

41. *See* Razin, *Impact of Decentralization*, *supra* note 38, at 53.

42. *See id.*

43. *Nahum Ben-Elia, Government Finance and the Fiscal Crisis in Israeli Local Authorities* 19 (Floersheimer Inst. For Pol'y Stud., Working Paper No. 1/37, 1999) (Isr.) [hereinafter Ben-Elia, *Government Finance*]. The State's Comptroller criticized the central government for this reduction, but to no avail. *See* ISRAEL COMPTROLLER, ANNUAL REPORT ON LOCAL GOVERNMENTS NO. 43 FOR YEAR 1992, 512–18 (1993), http://www.mevaker.gov.il/serve/folderAdmin.asp?id=151&opentree=,11,2.

44. The ministry of finance argued that local governments were compensated for this loss through increases in general intergovernmental grants, but there is no evidence of such compensation. *See* Ben-Elia, *The Fourth Generation*, *supra* note 27, at 43.

45. Ben-Elia, *Government Finance, supra* note 43, at 19.

46. Ben-Elia, *The Fourth Generation*, *supra* note 27, at 44.

47. Only in 1997 did the grants return to their level in the 1980s in real terms, but even then the amounts did not compensate for the massive population growth in the local sector. *See id.*

additional 7.5%.[48] Many see these reductions as the trigger for the pervasive local crisis—the straw that broke the camel's back.[49]

In addition, the state also put limits on the ability of local governments to levy taxes.[50] In 1985, in an effort to combat inflation, the central government implemented a national stabilization program, freezing all prices and wages in the market.[51] Initially local property taxes were exempt from the general freeze,[52] but since many localities abused their authority, raising taxes to unprecedented levels, the central government decided to include them in the stabilization program.[53] In 1992, the Knesset rendered the temporary limitations on fiscal autonomy permanent, and curtailed, by statute, localities' ability to tax their residents.[54] According to the state's legislation, the minister of finance together with the minister of interior set minimum and maximum property tax rates.[55] If a locality wishes to exceed the maximum tax rate allowed by the ministers or if it wishes to give discounts on the rates it usually charges, then it must ask for the ministers' permission.[56] The ministers do not always give the requested permissions,[57] and tax increases are not always sufficient to cover the local expenses.[58]

It follows, therefore, that since the 1980s, three vectors, all pointing toward the direction of a local crisis, have acted simultaneously: first, the significant increase in local expenditures, second the decrease in

48. THE KNESSET RESEARCH CENTER, ANALYSIS OF GENERAL GRANTS TO LOCAL GOVERNMENTS 1 (2010) (Isr.), http://www.knesset.gov.il/mmm/data/pdf/m02620.pdf.

49. *See, e.g.*, Eran Razin & Nir Brender, *Local Government Reform: Decentralization to the Fit and Assistance to the Weak* (Working Paper Caesarea Forum 2004), http://www1.idc.ac.il:549/2004/37674.pdf.

50. The Financial Arrangements Law, 1992, SH No. 1406 §§ 7–20 (Isr.).

51. *See* Bruno, *supra* note 26, at 388–89.

52. Razin, *Impact of Decentralization*, *supra* note 38, at 53.

53. *See id.*

54. The Financial Arrangements Law, 1992, SH No. 1406 §§ 7–20 (Isr.).

55. The property in each municipality is divided into several categories, such as residential buildings, agricultural areas, commercial areas, banks, insurance companies, and so on. The minimum and maximum tax rates are set separately for each category. *See* The Regulation for the Financial Arrangements Law (Local Property Tax), 2007, KT 6549, p. 429 (Isr.).

56. The Financial Arrangements Law, 1992, SH No. 1406 §§ 7–20 (Isr.) (Statutory Amendments to Achieve Budgetary Goals).

57. *See* Raz Smollansky, *145 Local Governments Submitted a Request to Increase Property Tax Rates*, MARKER (Aug. 11, 2011), http://www.themarker.com/realestate/1.681287.

58. Meirav Arlozorov, *Who Is to Blame for the Local Poverty?*, THE MARKER (Jan. 11, 2012), http://www.themarker.com/misc/article-print-page/1.1614303 (quoting a source in the Ministry of Interior saying that even if localities exhausted all their property tax base, they still would reach a balanced budget).

intergovernmental transfers, and third the limitations on local taxation. As a result of these changes, localities were unable to generate sufficient income to cover their expenses, and deficits were created.[59] In the twenty years from 1985 until 2005 municipal deficits grew larger and larger. Every year the municipal sector suffered deficits, which gradually accumulated to billions of shekels.[60] The central government did little to change this situation, and so the deficit reached uncontrollable proportions.[61]

Arab municipalities particularly suffered.[62] Arab localities in Israel are typically poor communities and have difficulty attracting large and profitable businesses.[63] They also have difficulties collecting local taxes and rely on intergovernmental transfers to finance their expenses.[64] Consequently, when the state decreased the amount of general grants, these localities found themselves in an extremely difficult situation.[65] In addition, even within the amounts the state does distribute, Arab localities do not get their fair share.[66] Although the gap significantly decreased over the years, even today, the amounts an Arab locality receives from the central government are often smaller than the amounts received by a Jewish municipality with similar characteristics.[67] It is, therefore, not surprising that they were the most affected by the local crisis. Some Arab localities, like Taibe or Arabea, reached a point where they literally stopped providing local services.[68]

59. Ben-Elia, *Municipal Crisis*, *supra* note 25, at 12; Dovrat Zilberstein, *Local Governments' Deficits* 2 (2007) (unpublished manuscript), *available at* http://public-policy.huji.ac.il/upload/taksiv.pdf.

60. Ben-Elia, *Municipal Crisis*, *supra* note 25, at 12; Zilberstein, *supra* note 59, at 2.

61. Ben-Elia, *Municipal Crisis*, *supra* note 25, at 12; Zilberstein, *supra* note 59, at 2.

62. *See* Jabareen, *supra* note 24.

63. *Id.*

64. *Id.*

65. *See id.*

66. *See id.*

67. Eran Razin, *Fiscal Disparities Between Arab and Jewish Local Authorities—Is the Gap Narrowing?* (Floersheimer Inst. For Pol'y Stud., Working Paper No. 1/38, 1999) [hereinafter Razin, *Fiscal Disparities*]; Dan Ben David & Yuval Erez, *Inequality in the Equalization Grants* 2–7 (2007) (unpublished manuscript), *available at* http://www.tau.ac.il/~danib/israel/izun.pdf; Razin, *Impact of Decentralization, supra* note 38, at 66.

68. HCJ Appeal No. 4815/05, Israel vs. Local Council of Arabea (May 20, 2006) Nevo Legal Database (by subscription) (Isr.); DC Bankruptcy (TA) 2419/07 *In re The Municipality of Taibe, A Special Report of the Trustee* (Nov. 18, 2007) (Isr.) (on file with author).

B. The Local Political Structure and Lack of State Monitoring

Theoretically, the shrinkage in local revenues just described did not have to result in such huge deficits. Local officials could have adapted the local expenditures to the actual income level and avoided excessive spending. Most localities, though, did not conduct themselves in a fiscally responsible manner. Although local officials understood the gravity of the situation, they maintained a high level of spending and chose to ignore the economic problems.[69]

The reasons for the local officials' fiscal irresponsibility were varied. In some cases the increased spending was the result of bad management skills,[70] in some cases corruption,[71] and yet in others it resulted from an assumption that the state would eventually cover the local costs.[72] In most cases, however, political circumstances within the locality drove the local officials to overspend.[73]

Economic research shows that one of the most important causes for the creation of deficits, both in the national and sub-national levels, is political fragmentation.[74] The more fragmented a government is, the more likely it is to enter a fiscal crisis.[75] The extent of political fragmentation is largely determined by the size of the local coalition, and by the number of social groups (constituencies) this coalition represents.[76] The larger and the more

69. Ben-Elia, *Municipal Crisis*, *supra* note 25, at 12–14.

70. *See infra* notes 204–23 and accompanying text.

71. *Id.*

72. *See* David Dery, *Fuzzy Control*, 12 J. PUB. ADMIN. RES. & THEORY 191, 203 (2002) [hereinafter Dery, *Fuzzy Control*].

73. AVI BEN BASSAT & MOMI DAHAN, THE POLITICAL ECONOMY OF LOCAL GOVERNMENT 60 (2009) [hereinafter BEN BASSAT & DAHAN, POLITICAL ECONOMY].

74. John Ashworth et al., *Government Weakness and Local Public Debt Development in Flemish Municipalities*, 12 INT'L TAX & PUB. FIN. 395, 395–96 (2005); Reza Baqir, *Districting and Government Overspending*, 110 J. POL. ECON. 1318, 1347 (2002); Terje P. Hagen & Signy Irene Vabo, *Political Characteristics, Institutional Procedures and Fiscal Performance: Panel Data Analysis of Norwegian Local Governments 1991–1998*, 44 EUR. J. POL. RES. 43, 43–44 (2005); Guntram B. Wolff, *Fiscal Crisis in U.S. Cities: Structural and Non-Structural Causes*, 6 ICFAI J. PUB. FIN. 7 (2008). *See also* Mark Hallerberg & Jürgen von Hagen, *Electoral Institutions, Cabinet Negotiations, and Budget Deficits in the European Union* 3 (Nat'l Bureau of Econ. Res. Working Paper No. 6341, 1997); Roberto Perotti & Yianos Kontopoulos, *Fragmented Fiscal Policy*, 86 J. PUB. ECON. 191, 194 (2002); Roberto Ricciuti, *Political Fragmentation and Fiscal Outcomes*, 118 PUB. CHOICE 365, 368–69 (2004); Nouriel Roubini & Jeffrey D. Sachs, *Political and Economic Determinants of Budget Deficits in the Industrial Democracies*, 33 EUR. ECON. REV. 903, 922 (1989); Andres Velasco, *Debt and Deficits with Fragmented Fiscal Policymaking*, 76 J. PUB. ECON. 105, 106–07 (2000).

75. *See* Perotti & Kontopoulos, *supra* note 74~~74~~, at 193.

76. *See id.*

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politically diverse a coalition is, the more likely a deficit is to develop.[77] The local crisis in Israel illustrates this point. Especially since 1978, when direct elections to the mayor's position were implemented,[78] local politics became increasingly fragmented.[79] The number of parties in local coalitions considerably increased,[80] and this in turn contributed to their irresponsible spending.[81]

According to research conducted by Avi Ben Bassat and Momi Dahan,[82] in 1978 there was an average of five parties competing for votes in every locality. In contrast, in 2003, there was an average of ten parties.[83] City councils have on average ten seats, and these seats are populated by no less than seven different parties.[84] And just as the economic theory suggests, the fragmentation contributes to the creation of deficits.[85] Each alderman seeks to maximize the budgetary benefits for his constituency, giving little attention to the general damage of overspending the municipal resources.[86] The mayor, who needs the support of the city council to approve the budget, is forced to comply with the different interest groups' demands, and deficits are created.[87] Ben Bassat and Dahan demonstrate this point by examining the correlation between the size of the mayor's party in the coalition and the locality's accumulative deficit.[88] They find that the ratio

77. The intuition behind this observation derives from the well-known common pool problem. *See* Hallerberg & von Hagen, *supra* note 74, at 6; Wolff, *supra* note 74, at 10. The city's budget can be viewed as a common resource controlled by the different groups that comprise the city's coalition. Due to the shared control of this common resource (the budget), each group within the coalition has an interest in increasing its budgetary demands, because the group fully enjoys the utility of the demands it imposes, but the costs of those demands (and in particular the costs of a possible budgetary deficit) are shared with all other groups in the city. Since the various groups do not fully internalize the costs of their financial claims, as the number of groups increase, so do the budgetary pressures. In addition, in fragmented political environments interest groups play a dominant role. Interest group support is essential for both forming and sustaining the local coalition, and so politicians are more susceptible to the groups' financial demands. *See* Wolff, *supra* note 74, at 9–17. For a more general account of interest group influence in politics, see DENNIS C. MUELLER, PUBLIC CHOICE III 475–97 (2003).

78. For an analysis of the change in the election system and its consequences, see generally David Dery, *Elected Mayors and* De Facto *Decentralization Israeli Style*, 24 LOC. GOV'T STUD. 45 (1998) [hereinafter Dery, *Elected Mayors*].

79. BEN BASSAT & DAHAN, POLITICAL ECONOMY, *supra* note 73, at 59–60.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.* at 43.

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id*,

of a locality's cumulative deficit and its income negatively correlates to the relative power of the mayor's party in the city's coalition.[89] The smaller the mayor's party is, the larger the deficit (in relation to the income).[90]

These results are not unique to the Israeli political environment. Ample empirical evidence shows that when coalitions are comprised from representatives of multiple parties, politicians are driven to overspend.[91] This, however, is where the state should come in. The state should monitor the local fiscal affairs and prevent the local politicians from succumbing to local political pressures. The state is not part of the local political arena, and as an outside supervisor it is able to force localities to behave in a fiscally responsible manner.[92] Indeed, the Israeli legal system vested in the Ministry of Interior various authorities to do exactly that.[93] These authorities significantly improved in 2004, but even before 2004, the Ministry had considerable powers. It could review localities' financial statements,[94] approve (or disapprove) local budgets,[95] authorize (or nullify) financial activities (such as taking loans, selling real estate, giving guarantees, et cetera),[96] examine the function of certain local officials,[97] and more.[98] In theory, these authorities could have enabled the Ministry to efficiently supervise and limit local spending, but in practice the Ministry's supervision was lacking. Although the state had meaningful monitoring authorities, it did not take advantage of its statutory capabilities.

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89. *Id.*

90. According to the research, when members from the mayor's party comprise 6 to 15% of the council, the deficit to income ratio is 71%. *See* BEN BASSAT & DAHAN, POLITICAL ECONOMY, *supra* note 73, at 60. When members from the mayor's party comprise 31 to 42% of the city council, the deficit to income ratio is 55%. *Id.* This negative correlation continues to hold even when controlling for other local characteristics (such as size, socio-economic level and more). *See id.*

91. *See* Ashworth et al., *supra* note 74, at 395–96; Baqir, *supra* note 74, at 1347; Hagen & Vabo, *supra* note 74, at 43–44; Hallerberg & von Hagen, *supra* note 74, at 9; Perotti & Kontopoulos, *supra* note 74, at 192, 194; Ricciuti, *supra* note 74, at 369; Roubini & Sachs, *supra* note 74, at 922; Velasco, *supra* note 74, at 105.

92. For the advantages of state monitoring of local fiscal affairs, see generally Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises,* 88 B.U. L. REV. 633 (2008) [hereinafter Kimhi, *Reviving Cities*].

93. Zilberstein, *supra* note 59, at 5; SHALOM ZINGER, A PROPOSAL FOR LOCAL GOVERNMENT REFORM 267–93 (2003); BARAK CALEV, SUPERVISION AND AUDITING MECHANISMS ON LOCAL GOVERNMENTS IN ISRAEL (2009), *available at* http://spirit.tau.ac.il/government/downloads/BarakCalev.PDF.

94. Municipalities Ordinance, 1964, M.Y. 8, § 216 (Isr.).

95. Municipalities Ordinance, 1964, M.Y. 8, § 206 (Isr.).

96. Municipalities Ordinance, 1964, M.Y. 8, §§ 201, 202A, 212, 222 (Isr.).

97. Municipalities Ordinance, 1964, M.Y. 8, § 171 (Isr.).

98. *See, e.g.*, Municipalities Ordinance, 1964, M.Y. 8, § 207 (Isr.) (discussing the minister's ability to alter the local budget).

According to the state's Comptroller report prepared in 2006, the Ministry of Interior failed to monitor local finances.[99] The report examined localities' financial practices from 2003 to 2005, and it shows that during this period, localities did not comply with the ministry's regulations, and the Ministry did not discipline disobedient localities.[100] A good example is the approval of local budgets. According to the Municipalities Ordinance, all localities need to submit their proposed budgets for the Ministry's approval.[101] The Ministry should approve the budget before January 1, the beginning of the fiscal year, and without such approval the municipality cannot work with the new budget.[102] According to the Comptroller's Annual Report of 2006, however, from 2003 to 2005 the Ministry of Interior did not approve even a single local budget by the statutory deadline of January 1.[103] Less than 20% of the local budgets were approved by September 30, and the majority of local governments operated without an approved budget for the entire year.[104] Forty municipalities—16% of the total number—operated without an approved budget during all three years that the Comptroller examined.[105] Moreover, according to the report, more than half of the municipalities whose budget was approved overspent their budget.[106] The Ministry of Interior rarely sanctioned the defiant localities and in most cases, just approved the deviation retroactively.[107] This of course raises doubts about whether the approval procedure was needed in the first place.

One of the main reasons for the state's feeble monitoring was simply a lack of personnel. There was no correlation between the number of staff overseeing the local finances, and the scope of their tasks, and the shortage in human resources inevitably decreased the level of supervision.[108]

99. *See also* ISRAEL COMPTROLLER, ANNUAL REPORT ON LOCAL GOVERNMENTS 2006: THE RELATIONSHIP BETWEEN THE LOCAL AUTHORITIES AND THE MINISTRY OF INTERIOR 38 (2007), *available at* http://www.mevaker.gov.il/serve/contentTree.asp?bookid=481&id=188&contentid=&parentcid=undefined&sw=1024&hw=698 [hereinafter ISRAEL COMPTROLLER, ANNUAL REPORT 2006].

100. *Id.*

101. Municipalities Ordinance, 1964, M.Y. 8, § 206 (Isr.).

102. Without an approved budget, the locality can spend one-twelfth of the previous year's budget each month. *See* Municipalities Ordinance, 1964, M.Y. 8, § 206(e) (Isr.).

103. ISRAEL COMPTROLLER, ANNUAL REPORT 2006, *supra* note 99, at 49.

104. *Id.*

105. *Id.*

106. *Id.* at 40, 59.

107. *Id.*

108. *Id.* at 60; *see also* Zilberstein, *supra* note 59, at 4–5. According to the report, it took an average of 160 days for the Ministry of Interior to review a local budget, after the budget

Although the central government knew its monitoring staff was insufficient, it preferred to ignore the situation.[109] It chose to invest state resources elsewhere, and the level of local monitoring remained unsatisfactory.[110]

But the lack in personnel was not the only reason for the state's omissions. Often the Ministry of Interior was reluctant to use its monitoring tools, even when forcing compliance could have been done relatively cheaply. A good example is the external auditors' reports. As part of its supervisory duties, the Ministry of Interior appoints external auditors to localities.[111] The auditors study the way the locality is managed and write a detailed report to the Ministry scrutinizing the local governance.[112] Examining the auditors' reports reveals an interesting phenomenon. In most municipalities the same critiques reappeared year after year.[113] Even if the auditors' comments could have been easily corrected, the Ministry often chose to ignore them.[114] It preferred to let sleeping dogs lie, and not to create a conflict with the locality unless a catastrophe occurred.[115]

had been already submitted. *See* ISRAEL COMPTROLLER, ANNUAL REPORT 2006, *supra* note 99, at 53.

109. The 2006 Comptroller report specifically states that the problem with the state's supervision was known for many years, and that it was discussed in various reports submitted to the government as early as 1981. *See* ISRAEL COMPTROLLER, ANNUAL REPORT 2006, *supra* note 99, at 53.

110. The Comptroller report quotes a letter written by the head of one of the counties in the ministry of interior, emphasizing the need to hire more people to supervise the localities' budgets. The quoted letter maintains that the money the state saves by not hiring a sufficient number of people actually costs dearly when local deficits are created. *See id.* at 60.

111. Municipalities Ordinance, 1964, M.Y. 8, § 214 (Isr.).

112. *See Fundamental Principles and Guidelines in the Work of the Local Government Audit Department of The Ministry of Interior*, http://www.moin.gov.il/Subjects/LocalGovermentCriticism/Pages/About.aspx (last visited Mar. 18, 2012).

113. CALEV, *supra* note 93, at 33–36. Calev writes that the auditors put a small asterisk in their reports whenever a certain finding was also mentioned in the previous year's report and was not corrected. He points out that the reports are filled with such asterisks.

114. *Id.*

115. *Id.* at 35–36. A good example is the submission of local budgets for the Ministry's approval. According to the Comptroller's report, local governments submitted the budgets an average of 148 days after the statutory deadline. *See* ISRAEL COMPTROLLER, ANNUAL REPORT 2006, *supra* note 99, at 50–52. The Ministry did not insist on early submission, and did not sanction localities for the delay. On the contrary, although strictly prohibited by the Municipalities Ordinance, localities often worked with their non-approved proposed budget. *See* Municipalities Ordinance, 1964, M.Y. 8, § 206. (Isr.).

II. THE PROBLEMS WITH STATE MONITORING

From the foregoing description it appears as though Israel's central government did not do much to prevent the local fiscal crisis. It can even be said that the central government's policies contributed to the creation of the crisis. The state neglected the local sector, and allowed localities to reach a point where they could not efficiently provide public services.

Such behavior by the state may seem puzzling. Although the state delegates the responsibility for the provision of local public goods to localities, it is still ultimately responsible for its residents. It is the state's duty to assure that its residents will continue to receive essential services (such as waste disposal, welfare, education, or proper infrastructure), and it cannot shirk its duties by allowing municipalities to go bankrupt. So why did the Israeli government, particularly the Ministries of Interior and Finance, allow such a massive local crisis to develop?

The state's conduct in this respect is particularly puzzling when we consider the efficiency with which Israel monitors its banking system and securities markets. Israel has managed to create a relatively successful supervision mechanism on its commercial banks.[116] In face of the world's credit crisis, the Israeli banking system remained relatively stable.[117] The International Institute of Management Development (IMD) at Lausanne, Switzerland ranked Israel first among fifty-eight states in economic soundness, and attributed much of the success to the tight supervision of the central bank.[118] So if the state, through the Bank of Israel or the Securities Authority, can make sure that banks and insurance companies remain stable, shouldn't it be able to do the same with local governments?

In this Part, I argue that the reasons for the state's failure in the monitoring of local finance are mainly political. The nature of Israel's political system did not provide the state's politicians sufficient incentives to invest state resources in the local sector or to effectively supervise localities. To the contrary, in some respects, state politicians benefited from the local sector's weakness. Localities were forced to come to the state for assistance, and the state politicians were empowered by the localities' dependency on the state.

116. *See* Avital Lahav, *S&P Upgrades Israel's Credit Rating*, YNET NEWS (Sept. 9, 2011), http://www.ynetnews.com/articles/0,7340,L-4120069,00.html (noting that the rating agency cites Israel's "strong institutions" among the reasons for the recent upgrade); Adi Ben-Israel, *Israel Tackled Global Crisis Best—Survey*, GLOBES (May 20, 2010), http://www.globes.co.il/serveen/globes/docview.asp?did=1000560890&fid=1725.

117. *See* Lahav, *supra* note 116.

118. *See* Ben-Israel, *supra* note 116.

A. The Costs (or Lack Thereof) of a Local Crisis to the State Politician

In the end of the 1970s, in a series of papers, Geoffrey Brennan and James Buchanan posited a theory often referred to as the "Leviathan Hypothesis."[119] This hypothesis draws an analogy between a monolithic government and a private monopoly.[120] Just as a private monopoly seeks to maximize profits, the hypothesis maintains, a central government aims to maximize tax revenues.[121] The government aims to grow and spend, and it exploits its residents by increasing its tax rates.[122] To constrain the central government's behavior, Brennan and Buchanan suggested a decentralization policy.[123] Since individuals and firms in the sub-national level are mobile, they argued, decentralization will force local governments to engage in tax competition.[124] Local governments will be compelled to be smaller and more efficient, because they wish to lure tax-paying residents to their territory.[125]

The Leviathan Hypothesis was empirically tested with inconclusive results.[126] Several economists, therefore, questioned the hypothesis, and showed that decentralization can also produce negative consequences.[127]

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119. *See generally* GEOFFREY BRENNAN & JAMES BUCHANAN, THE POWER TO TAX: ANALYTICAL FOUNDATIONS OF A FISCAL CONSTITUTION (1980) [hereinafter BRENNAN & BUCHANAN, THE POWER TO TAX]; Geoffrey Brennan & James Buchanan, *Tax Instruments as Constraints on Disposition of Public Revenues*, 9 J. PUB. ECON. 301 (1978); Geoffrey Brennan & James Buchanan, *Towards a Tax Constitution for Leviathan*, 8 J. PUB. ECON. 255 (1977) [hereinafter Brennan & Buchanan, *Towards a Tax Constitution for Leviathan*].

120. BRENNAN & BUCHANAN, THE POWER TO TAX, *supra* note 119, at 15.

121. *See* Brennan & Buchanan, *Towards a Tax Constitution for Leviathan*, *supra* note 119, at 258 & n.6.

122. *See id.*

123. *See* BRENNAN & BUCHANAN, THE POWER TO TAX, *supra* note 119, at 185 ("Total government intrusion into the economy should be smaller, *ceteris paribus*, the greater the extent to which taxes and expenditures are decentralized.").

124. *See id.*

125. *Id.* at 171–73.

126. Some studies approved the theory. S*ee, e.g.*, Silika Prohl & Friedrich Schneider, *Does Decentralization Reduce Government Size? A Quantitative Study of The Decentralization Hypothesis*, 37 PUB. FIN. REV. 639, 659 (2009). While others found zero or even a negative connection between decentralization and government size. *See, e.g.*, Wallace E. Oates, *Searching for Leviathan: An Empirical Study*, 75 AM. ECON. REV. 748, 756 (1985); Ernesto Stein, *Fiscal Decentralization and Government Size in Latin American Countries*, 2 J. APPLIED ECON. 357, 365 (1999).

127. Luiz R. De Mello Jr., *Fiscal Decentralization and Intergovernmental Fiscal Relations: A Cross Country Analysis*, 28 WORLD DEV. 365, 373–74 (2000); Jonathan Rodden, *Reviving Leviathan: Fiscal Federalism and the Growth of Government*, 57 INT'L ORG. 695, 724 (2003); Stanley L. Winer & Walter Hettich, *Vertical Imbalance in the Canadian Federation* 8 (July 2, 2010) (unpublished manuscript), *available at* http://http-server.carleton.ca/~winers/papers/VFI-Revised-July2-10.pdf.

This strand of literature focuses on the common pool problem created if intergovernmental grants finance decentralization.[128] When the central government's funds are shared among the different localities, then each locality attempts to maximize the central financing.[129] Localities have an incentive to overspend their revenues, in expectation that the central government will come to their rescue and pay their debts.[130] Decentralization, therefore, can lead to growing governmental expenditures, rather than efficiency or downsizing.[131] In support of these claims, studies show that in certain cases, such as in Norway or in Latin American countries, decentralization led to an increase in total governmental spending.[132]

Israel's decentralization, however, fits neither the Leviathan hypothesis nor the common pool paradigm. On the one hand, contrary to the Leviathan hypothesis, the decentralization resulted in the growth of local expenditures.[133] Localities were assigned with more and more responsibilities, and there was little competition for efficiency among them.[134] On the other hand, intergovernmental transfers decreased.[135] The state's politicians were unwilling to overuse the state's budget, and they dried the local revenue sources—both transferred and independent.[136] Thus, although decentralization inflated public spending, contrary to the predictions of the common pool paradigm, the central government did not bear the increased costs. Localities had to carry much of the extra burden themselves, and with insufficient resources a local crisis was bound to develop.

The reason for Israel's behavior lies in its political system. In countries that invest significant central resources in the local sector, like Norway, state politicians are usually rewarded for their support.[137] State politicians have an interest in transferring state funds to localities because they gain political benefits as a result.[138] In Israel, however, this assumption does not

128. De Mello Jr., *supra* note 127, at 367; Rodden, *supra* note 127, at 695–99.

129. *See* De Mello Jr., *supra* note 127, at 368; Rodden, *supra* note 127, at 704–05.

130. De Mello Jr., *supra* note 127, at 367.

131. Lars-Erik Borge & John Rattso, *Spending Growth With Vertical Fiscal Imbalance: Decentralized Government Spending in Norway 1880–1990*, 14 ECON. & POL. 351, 351 (2002); Stein, *supra* note 126, at 363–66.

132. *See, e.g.*, Borge & Rattso, *supra* note 131, at 6.

133. *See supra* notes 25–68 and accompanying text.

134. *See id.*

135. *See id.*

136. *See id.*

137. *See* Borge & Rattso, *supra* note 131, at 6.

138. Rodden, *supra* note 127, at 707; Torsten Persson & Guido Tabellini, *Does Centralization Increase the Size of Government?*, 38 EURO. ECON. REV. 765, 770–73 (1994).

hold true. Investing in the local sector in Israel does not seem to be politically worthwhile, because residents do not inflict retribution on state politicians for their local policies.

First, Israel's national electoral system is based exclusively on nation-wide proportional representation.[139] There are no electoral districts, and the number of seats each party receives in the Knesset is proportional to the number of voters who voted for it all over the country.[140] Consequently, regional constituencies do not play a significant role in national politics. State politicians do not feel obligated to a narrow geographical constituency, and the different constituencies are usually divided by ethnic or religious affiliations. Politicians feel committed to their national sector (ultra-orthodox, ethnic minorities, agriculture, et cetera), but not to a certain locality or county.[141]

Second, due to ever-urgent security issues, local issues play a small role in the national elections.[142] Voters will usually vote for the party that best represents their views with regard to national security (as in the Israeli-Palestinian conflict), and local affairs do not receive considerable attention.[143] As Razin points out, voters in Israel are not particularly interested in the local government system.[144] They do not consider local policies to be very important, and so the state's actions in this area often go unrewarded or unpunished.[145]

Third, and perhaps most importantly, the fiscal relations between the state and local spheres are so complex that residents do not always understand the state's fiscal policies toward the municipal sector.[146] There

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139. *See The Electoral System in Israel*, THE KNESSET, http://www.knesset.gov.il/description/eng/eng_mimshal_beh.htm (last visited Feb. 25, 2012).

140. *Id.*

141. *Cf.* Eran Razin, *Needs and Impediments for Local Government Reform: Lessons from Israel*, 26 J. URB. AFFS. 623, 635 (2004) [hereinafter Razin, *Needs and Impediments*] (arguing that "lack of ethno-religious homogeneity hampered the implementation of territorial reform, particularly when the suggested reforms are interpreted as influencing inter-ethnic relations.").

142. *Id.*

143. *Id.*

144. *Id.*

145. *See id.* at 634.

146. Edward Zelinsky used the same line of reasoning to explain the phenomenon of unfunded mandates in the United States. *See* Edward A. Zelinsky, *Unfunded Mandates, Hidden Taxation, and the Tenth Amendment: On Public Choice, Public Interest, and Public Services*, 46 VAND. L. REV. 1355 (1993). Zelinsky argues that unfunded mandates allow federal and state politicians to take political credit for the benefits of regulatory mandates, while shifting the blame for the costs of these mandates to the local level. *Id.* at 1366 n.41. Central to Zelinsky's argument is the assumption that voters are not able to correctly assign

is no code or clear set of rules that defines the scope of responsibility of each level of government,[147] and residents are often not aware of the state's and localities' respective responsibilities, even in areas as important as education, welfare, or infrastructure.[148] The financing of many services is part local and part central, with informal formulas that determine the contribution of each level.[149] Even experts have difficulty understanding how and why funding arrangements are determined, let alone an average resident in a locality.[150] State politicians, therefore, can increase local costs, impose mandates, or cut state funding in ways that the general public usually will be unable to observe.

As a result of these reasons, the central government's accountability towards the municipal sector decreases. State politicians know that their local policies have little effect on the outcome of the national elections, so they pay little attention to localities' financial condition. They prefer to spend the state's funds in places that would bring them electoral benefits (for example, on the ultra-orthodox sector), rather than investing them in local fiscal health.[151]

This is particularly severe in times of national economic difficulty. During a national recession, state politicians confront strict state budget limitations.[152] They are expected to cut costs and might face political

the responsibility for costs of the mandates. They credit the state or federal officials for their benefits, but erroneously blame local officials for the costs. *See id.* at 1386 n.80.

147. The Municipalities Ordinance details local governments' duties and authorities, but the statutory list is by no means exhaustive. The law does not include some of the more important local duties, and does not explain the role of the state. *See* Nahum Ben-Elia, *Core Local Services: Expanding the Public Responsibility of the Ministry of Interior* 12 (Floersheimer Inst. For Pol'y Stud., Working Paper No. 1/58, 2006) (Isr.) [hereinafter Ben-Elia, *Core Local Services*].

148. Many services are provided by local governments merely as sub-contractors of the central government. The central government is statutorily responsible for the services, but it uses localities as the actual providers. *See id*. at 9–10.

149. *See id.* at 10.

150. Arie Hecht, *Restructuring Municipal Finance in Israel* (Floersheimer Inst. For Pol'y Stud., Working Paper No. 1/13, 1997) (Isr.) (describing the intricate funding system between the different central government ministries and the local government).

151. *See* Dery, *Elected Mayors, supra* note 78, at 45–46 (describing the relationship between the local and central governments in Israel as follows: "[t]he relationship between central and local government in Israel is fraught with crises and emergencies. Financial crises in particular have become a matter of routine in the past two decades, often accompanied by strikes, mass demonstrations and other forms of pressure politics . . . . Rather than reform the system, the government of Israel has consistently shown preference for an *ad hoc* coping strategy, retaining the traditional 'agency' model, whereby local authorities are seen as an administrative arm or sub-contractor of central government . . . .").

152. BEN BASSAT & DAHAN, POLITICAL ECONOMY, *supra* note 73, at 67.

consequences if they fail to do so.[153] Under these circumstances, from a state politician's perspective, shifting costs to the local government level is a convenient solution. The costs of the central government are reduced, but with a relatively small political price.[154] The Israeli experience demonstrates this point well. When faced with economic or social difficulties, the Israeli central government shifted the problem to the local level.[155] This was the reason for the massive growth in local expenditure since the 1980s and for the dramatic cuts in intergovernmental transfers in 1986 and 2003.[156]

Moreover, due to the lack of accountability, state politicians were able to use the state's authorities towards the local sector as a political tool. They created local dependency on the state so as to increase their own powers vis-à-vis the local leadership. Dery and Schwartz-Milner, for example, argue that the Ministry of Finance deliberately underfunded the municipal

153. *Id.*

154. *Id.* at 67. This cost shifting phenomenon is not unique to Israel. According to research conducted for the OECD, when faced with hard budgetary constraints central governments often shift costs to lower levels of governments. *See* Isabelle Joumard & Per Mathis Kongsrud, *Fiscal Relations Across Government Levels* 17 (OECD Econ. Dep't, Working Paper No. 375, 2003), *available at* http://www.oecd-ilibrary.org/economics/fiscal-relations-across-government-levels_455513871742 ("While changes in fiscal balances since the early 1990s indicate that central governments have contributed most to fiscal consolidation, cuts have often been effected by devolving spending responsibilities to lower levels of government without providing commensurate financial resources. Central government grants to sub-national governments have also sometimes been reduced."); *see also* Robin Boadway & Jean Francois Tremblay, *A Theory of Vertical Fiscal Imbalance* 1 (Queen's Econ. Dep't, Working Paper No. 1072, 2006) (arguing that there are cases where the central government takes advantage of its lead financial role, and does not transfer sufficient funds to local authorities). Boadway and Tremblay give the Canadian example:

> For example, in Canada, the case with which we are most familiar, there has been much debate about a so-called "vertical fiscal imbalance" that has emerged in recent years. The argument has been that the federal government's fiscal response to its structural deficit and debt problems that built up over the 1980s has been a disproportionate reduction in transfers to the provinces, effectively passing on some of its deficit to the latter.

See id. at 1.

155. See *supra* notes 25–61 and accompanying text.

156. *S*ee BEN BASSAT & DAHAN, POLITICAL ECONOMY, *supra* note 73, at 68. Adi Eldar, the former chairman of the Union of Local Authorities, expressed the same view in a conference held in 2008 about the local crisis. Eldar maintained that the crisis stemmed from budget cuts and unfunded mandates imposed on local governments. He explained that whenever the local leadership attempted to confront the government about this, journalists on behalf of the ministry of finance wrote newspaper articles on how corrupt mayors are. Local governments were not given sufficient resources to fund all the activities mandated by the state, but mayors were still blamed for lack of management skills. *See* Adi Eldar, Address at Caesarea Economic Policy Planning Forum (2008), *available at* http://www.idi.org.il/events1/CaesareaForum/Pages/Forum_2008_B_Rashuyot_1.aspx.

sector to get better control over local affairs.[157] The central government did not give localities the resources it knew they needed to properly finance their responsibilities, and thereby forced them to beg constantly for assistance.[158] Itzhak Yaron, the former mayor of Givatayim, explained this point in a mayors' conference in 1992:

> The ministry of finance and the ministry of interior torture us . . . but they also know how to play with us. Together we can protest and shout: "we won't let you! we won't let you!," but then individually, every one of us tries to get a few shekels for class rooms, or tries to get the minister's signature on a loan he wants to borrow . . . together everybody shouts "we won't let you!," but then each one of us secretly approaches the minister and says—"Look, Deri (Arie Deri—then the minister of interior—O.K), I need to talk with you for a minute." This is our weakness.[159]

State politicians, then, could use their power to give funds to localities whose leadership is more powerful and politically influential. Although generally the local sector was underfunded, specific localities—usually those with strong and connected local leaderships—were able to get more funds. Research conducted by Gershon Alperovich demonstrates the effects of political considerations on the distribution of general intergovernmental grants.[160] Alperovich examined the grant allocations to local governments under two different governments: Labor and Likud, and he evaluated the motivations behind the amounts distributed.[161] His research shows that central governments reward their supporters.[162] Labor governments gave per capita more grants to cities with predominantly labor

157. DAVID DERY & BINAT SCHWARTZ-MILNER, WHO CONTROLS THE LOCAL GOVERNMENT? 63–64 (1994); Eran Razin, *Local Government Reform in Israel, Between Centralization and Decentralization, Between Tradition and Modernity* 68 (Floersheimer Inst. For Pol'y Stud., Working Paper No. 1/48, 2003) (Isr.) [hereinafter Razin, *Local Government*]. Dery and Schwartz-Milner explain that in many cases there was no clear statutory mandate imposed on localities or an obvious reduction in financing. The central government simply failed to take responsibility for various activities, and it left localities to cope on their own. Particularly enlightening is Dery and Schwartz-Miller's discussion of the immigration wave that came to Israel in the 1990s from the former soviet-union. Faced with a massive population growth, the central government adopted no overarching policy. The local governments had to absorb about a million new immigrants in a period of a few years (an increase of about a fifth of the population), and independently faced the educational, welfare, and employment challenges this immigration posed. The Ministry of Finance was reluctant to increase intergovernmental transfers, preferring to keep the funds in the central government's pockets. *See* DERY & SCHWARTZ-MILNER, *supra* at 19–21.

158. DERY & SCHWARTZ-MILNER, *supra* note 157, at 63–64.

159. *Id.* at 57.

160. *See generally* Gershon Alperovich, *The Economics of Choice in the Allocation of Intergovernmental Grants to Local Authorities*, 44 PUB. CHOICE 285 (1984).

161. *Id.* at 286.

162. *Id.*

voters, and Likud governments gave per capita more funds to cities that support the Likud.[163] Naturally, municipalities that are not associated with any of the ruling parties, in particular Arab municipalities, suffer from continuous discrimination.[164]

Another manifestation of the political interests underlying the state's funding is provided by Avi Ben Bassat and Momi Dahan. Ben Bassat and Dahan show that specific grants (grants designed to finance specific state services provided by local governments) are distributed regressively rather than progressively.[165] Affluent localities, that have the ability to raise more local taxes, receive higher specific grants than poor municipalities that need the funds much more.[166] In education, for example, in 2005, the poorest localities got 2455 shekels per student, whereas the richest localities received 4147 shekels.[167] The same is true for welfare. In 2005, municipalities in the top decile (in terms of socio-economic strength) received a state grant of 3522 shekels per welfare patient as compared to only 869 shekels that patients in municipalities in the last decile received.[168] Clearly, if a person is in need of welfare, he should reside in an affluent locality. Affluent localities are more politically powerful and attract more funding.

The state's lax monitoring of local finance can also be seen as a political tool. The state created a situation where multiple financial and regulatory requirements are in place, but there are not enough resources to force compliance.[169] Only a handful of bureaucrats are assigned to monitor local finance, which clearly is not enough to control the behavior of more than 250 localities effectively.[170] Thus, although the local financial practices are formally regulated, their enforcement is selective and discretionary.[171] There is a great tolerance for disobedience, and silent understandings replace the strict and rigid requirements.[172] This type of vague system, which Dery refers to as "fuzzy control," empowers the central

163. *Id.* at 293.

164. *See supra* notes 62–68 and accompanying text.

165. AVI BEN BASSAT & MOMI DAHAN, LOCAL GOVERNMENT CRISIS: EFFICIENCY VS. REPRESENTABILITY 15 (2008), *available at* http://www.idi.org.il/PublicationsCatalog/Documents/BOOK_RASHUIOT/Rashuiot_For%20Press.pdf [hereinafter BEN BASSAT & DAHAN, LOCAL GOVERNMENT CRISIS].

166. *Id.*

167. *Id.* at 16.

168. BEN BASSAT & DAHAN, POLITICAL ECONOMY, *supra* note 73, at 40–41.

169. *See generally* Dery, *Fuzzy Control*, *supra* note 72.

170. *See id.* at 207.

171. *Id.* at 201.

172. *Id.* at 209.

government's officials.[173] The state enjoys a wide range of flexibility in the enforcement of the rules, and the state bureaucrats and politicians decide on whom the rules will be strictly applied and who will enjoy the central government's good graces.[174] State officials are able to engage in informal discriminatory treatment and favor certain localities over others.[175]

The appointment of internal auditors provides a good example. According to the municipal ordinance, all local governments are compelled to appoint an internal auditor.[176] If the locality does not appoint an auditor after a certain period of time, the Ministry of Interior can appoint one for it.[177] The Ministry, however, did not strictly enforce the statutory obligation. In the last decade, eleven localities operated for years without an internal auditor, but the Ministry did nothing.[178] The Ministry knew about the violation, but it preferred to look the other way.[179] Despite severe local corruption, no sanction was taken, and the localities operated as if nothing was wrong.[180] The situation changed only after a petition to the Israeli High Court of Justice was filed.[181]

Such regulatory uncertainty, together with local financial weakness, creates a climate of local dependency. Localities need the state for additional funds and for favorable regulatory treatment, and state officials are the ones deciding whether and who will get such treatment. With relatively small political costs from local financial distress, state politicians have little incentive to change this situation. They are better off preserving the local sector's weakness, thereby maintaining their own strength.

B. The Political Costs of State Intervention

Until now, I have argued that Israeli state politicians are reluctant to invest resources to assist distressed localities. They do not bear the political costs associated with the urban plight, and they benefit from the local dependency. This Section discusses the political costs associated with

173. *See id.* at 207.

174. *Id.* at 211.

175. *See id.* at 210; *see also* Razin, *Needs and Impediments*, *supra* note 141, at 630.

176. Municipalities Ordinance, 1964, M.Y. 8, § 167(b) (Isr.).

177. Municipalities Ordinance, 1964, M.Y. 8, § 167A (Isr.).

178. Calev, *supra* note 93, at 36.

179. *Id.*

180. Ari Sirkin, *A Petition to the High Court of Justice to Enforce the Appointment of Internal Auditors in Local Governments*, NEWS1 (Apr. 12, 2005), http://www.news1.co.il/ArticlePrintVersion.aspx?docID=68342&subjectID=1.

181. HCJ 3582/05 (Jerusalem) Movement for Quality Gov't in Israel v. The Mayor of Ohr Akiva, (July 11, 2010) Nevo Legal Database (by subscription) (Isr.).

the state's monitoring. I show that state officials are reluctant to efficiently monitor local finances, because they do not want to confront the local leadership.

The connections between local and national politics in Israel have significantly changed over the years. Initially, during the 1950s and 1960s, national parties, particularly the Labor party, dominated local politics.[182] The leaders of the Labor party formed lists of nominees for local elections, and mayors could not have been elected without the party's approval.[183] Since the 1970s, however, the dominance of national parties gradually has decreased.[184] This change is the result of two important developments that took place in the late 1970s.[185] First, in 1975, the Knesset reformed the local election system.[186] Mayors are elected directly by the residents, and party lists are less relevant to the mayors' success.[187] Second, within the national arena, the Labor Party lost its dominance and the Likud became the ruling party.[188] The Likud used local governments as a strategic base for its national political development, and localities became one of the pillars for its electoral success.[189]

As a corollary to these changes, the relationship between local leadership and national politics has transformed. Local leadership has strengthened, and mayors have become central figures not only in the local arena, but ~~also~~ in the national political sphere as well. Candidates in the parties' primary elections seek mayoral support, as the endorsement of influential mayors can bring them prestige, voters, and funds.[190] Mayors serve as channels to the electoral base, and their operational capabilities can help candidates' campaigns.[191] The affiliation of a mayor to a national

182. Ben-Elia, *Policymaking*, *supra* note 29, at 116.

183. Yishai Blank, *The Location of the Local: Local Government Law, Decentralization and Territorial Inequality in Israel*, 34 HEBREW UNIV. L. REV. 1, 66 (2004); Razin, *Local Government*, *supra* note 157, at 52–53.

184. Ben-Elia, *Policymaking*, *supra* note 29, at 116; Razin, *Local Government*, *supra* note 157, at 75.

185. Ben-Elia, *Policymaking*, *supra* note 29, at 116.

186. *Id.*

187. Dery, *Elected Mayors*, *supra* note 78, at 46.

188. Ben-Elia, *Policymaking*, *supra* note 29, at 116.

189. *Id.* at 116–17. The Likud nurtured the local leadership, and some of the local officials became central figures in the national levels (Knesset members and ministers). *See id.* at 117.

190. *Id.* at 117.

191. *See, e.g.*, Uri Blau, *Shaul Mofaz's Military Tactics to Take Over Kadima Party*, MARKER (Aug. 22, 2008), http://www.haaretz.com/print-edition/news/as-defense-chief-mofaz-failed-to-declare-brother-s-arms-business-1.252129. Blau quotes one of Mofaz's supporters that describes Mofaz's tactics to gain support in Kadima: "Mofaz works with mayors, even mayors that are not members of the Kadima party. He helped them with all

party is also perceived, not necessarily justifiably, as an indication of the party's popularity.[192] The mayor's support signifies the support of his city residents, and national parties boast the number of mayors they have as party members.[193] Thus, due to the mayor's political strength, state politicians are reluctant to create conflicts with him. Especially if a mayor is a member of a state politician's party, a conflict may be politically costly and can damage the state politician's career. Politicians are better off forming alliances with local leaders, rather than taking measures that may undermine their authority.[194]

Note, though, that seeking the support of a mayor does not necessarily mean maximizing the benefit of the mayor's locality. On the contrary, in many cases there is a severe agency problem between the mayor and the local residents, and advancing the mayor's interests comes at the expense of the local community. This is especially true with respect to the monitoring of local finance.

Residents, much like shareholders in commercial corporations, suffer from collective action problems when it comes to monitoring their local officials. Each resident enjoys only a fraction of the monitoring benefits, and so he has little incentive to invest the time and effort required to carry it out.[195] Due to lax residential monitoring, mayors can easily exploit local budgets. They can engage in corruption or poorly manage the locality, while the residents do little to discipline such behavior. Moreover, financial policy is often biased in favor of small, concentrated interest groups.[196] Interest groups are able to overcome the collective action problems from which residents generally suffer, and offer politicians significant political benefits.[197] Especially in politically fragmented localities, mayors tend to comply with interest groups' demands.[198] They need the interest groups to sustain their coalitions and are willing to

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sort of stuff before, and now they are helping him. They ask members of Kadima that reside in their city to vote for Mofaz." *Id.*

192. DANA BLUNDER, THE ISRAELI DEMOCRACY INSTITUTE, THE REASONS FOR THE NATIONAL PARTIES' DECLINE IN THE LOCAL POLITICS (2009), *available at* http://www.idi.org.il/breakingnews/pages/breaking_the_news_82.aspx.

193. *Id.; see also* Mazal Mualem, *Kadima and Likud Are Battling Over Mayors' Support*, HAARETZ (Aug. 31, 2006), http://news.walla.co.il/?w=/9/967198.

194. Razin, *Needs and Impediments*, *supra* note 141, at 635.

195. Clayton Gillette, *Can Public Debt Enhance Democracy?*, 50 WM. & MARY L. REV. 939, 955 (2008).

196. *See id.* at 957.

197. *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 9–16 (2d ed. 1971); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 12 (1971).

198. Wolff, *supra* note 74, at 42.

overspend local resources in their favor.[199] Thus, deficits are created, but the general local community does not necessarily enjoy the benefits of the expenditures that created those deficits.[200]

It is precisely because residents have difficulties monitoring their officials that the state should serve as an additional supervisor. The state needs to complement residents' monitoring and prevent mayors from engaging in policies that are detrimental to the local community as a whole. It should represent the interests of the general diffused public by making sure that the local fiscal policy is not geared toward the benefit of small groups or of the local politicians themselves. A political alliance between the state and local politicians interferes with this task. The state is unwilling to confront harmful mayors, so these mayors can continue to overspend to the detriment of the local residents. The creation of deficits or regulatory incompliance goes unsanctioned at the local community's expense.

Israel's central government's policy demonstrates this point. Although the state had ample supervisory powers, it was reluctant to use them.[201] It failed to examine local budgets, it overlooked budgetary deviations and it did not pay attention to the comments written in external auditors' reports.[202] Even when the Ministry knew about a locality's non-compliance with the Ministry's own regulations, it often preferred to ignore it, so as not to confront the disobeying locality's leadership.[203] This response was especially problematic when the Ministry had to intervene in local affairs and remove the incumbent mayor and councilmen from their post. In these cases, political considerations played a major role, and the Ministry often disregarded its supervisory duties. The city of Lod provides an excellent example.

Lod, a city in the center of Israel, had suffered for years from grave financial difficulties. It incurred huge budget deficits, it failed to provide basic services to its residents, and it suffered from high crime rates.[204] As a result of its economic condition, in 2004, the general manager of the Ministry of Interior appointed an investigation committee for the city.[205] The committee looked into Lod's financial situation and examined whether

199. *Id.* at 38.
200. *See id.*
201. *See supra* notes 69–115 and accompanying text.
202. *Id.*
203. Calev, *supra* note 93, at 36.
204. ISRAEL COMPTROLLER, ANNUAL REPORT 2008, *supra* note 21, at 119.
205. *Id.*

the state's intervention was required.[206] The committee's conclusions were unequivocal. The city's financial condition was atrocious, and its local officials were unable to change it.[207] The committee therefore recommended the removal of the incumbent leadership and the appointment of a state financial control board.[208] The Ministry of Interior, however, decided to reject the recommendations.[209] Benny Regev, Lod's mayor at the time, was a very influential member in the Likud.[210] Prime Minister Sharon, as well as other Likud members, insisted he should stay in office, and they pressured the Minister of Interior not to use his authority.[211] The Minister of Interior gave in to the political pressure and decided to keep Regev in office.[212]

As time passed, though, Lod's financial condition only got worse. Notwithstanding the central government's promises to help the city, Lod was unable to implement a successful rehabilitation plan.[213] The city's deficit grew at an alarming rate, while the level of services declined.[214] In March 2006, as the city's financial condition kept deteriorating, the city's residents petitioned to the High Court of Justice.[215] The residents asked the court to order the Minister to dismiss Regev and to appoint a financial control board instead.[216] Even after the petition, though, Ehud Olmert, then

206. According to the Municipalities Ordinance, the appointment of an investigation committee is the first step in the establishment of a state financial control board. The investigation committee examines the local economic condition, and determines whether the locality's incumbent leadership can continue to manage the city or whether the state's outside intervention is required. The committee hands its recommendation to the Minister of Interior, who in turn decides whether to accept or reject the committee's recommendation. *See* Municipalities Ordinance, 1964, M.Y. 8, § 143 (Isr.).

207. One of the committee's findings was that the city's councilmen owed the municipality 4.5 million shekels in property taxes. The municipality did not do anything to collect the debt, and it did not take any sanctions against the indebted councilmen. *See* Hanna Kim, *The Disengagement Plan and Omri Sharon's Cup of Coffee*, HAARETZ (Mar. 18, 2004), http://www.haaretz.co.il/No=406306 (on file with author).

208. *Id.*

209. *Id.*

210. *Id.*

211. Sharon Kedmi, *Sharon Instructed the Minister of Interior to Avoid Establishing a Financial Control Board to Replace Lod's Municipal Officials*, GLOBES (Mar. 25, 2004), http://www.globes.co.il/news/article.aspx?did=783896.

212. The Minister of Interior, Avraham Poraz, claimed that he kept Regev in office because he wanted to give him a second chance. *See* Amir Zohar, *A Bribe? I Don't Have Even One Shekel*, HAARETZ (Feb. 27, 2007).

213. Ido Efrati, *Lod's Rehabilitation Plan is a Sham*, YNET (Sept. 23, 2004), http://www.ynet.co.il/articles/1/7340/L-2980086/00.html.

214. *Id.*

215. Ido Efrati, *Lod's Residents to the High Court of Justice: Remove our Mayor from Office*, YNET (Mar. 6, 2006), http://www.ynet.co.il/articles/0,7340,L-3224487,00.html.

216. *Id.*

the head of Kadima who was in charge of the Ministry of Interior, refused to discharge Regev.[217] He was Regev's political ally and owed him for supporting Kadima in the national elections.[218] The fact that Regev was accused of corruption and had been indicted for taking bribes also did not convince Olmert to change his decision.[219]

In October 2006, perhaps due to the fact that Regev was no longer a political asset,[220] a newly appointed Minister of Interior eventually agreed to erect an additional investigation committee.[221] The committee recommended Regev and the Councilmen's removal,[222] and in February 2007, the Minister accepted the recommendations.[223] If the Ministry had supervised Lod's finances properly, though, Lod's residents would have been spared three years of poor management and corruption.

Although Lod's case is extreme, it exposes the tension between the Minister of Interior's role as the monitor of local finances and his role as a politician. As a monitor of local finance, the Minister of Interior should weigh only professional considerations. He should examine how the locality's incumbent leadership functions and whether the locality's fiscal status warrants the state's involvement. As a politician, the Minister of Interior considers whether his actions are likely to promote his chances for re-election. He aims to promote his political interests rather than the benefit of the distressed locality or the public as a whole. Within this conflict, it is not clear who triumphs—the monitor or the politician.

This tension was also at the center of the High Court of Justice's decision in *Assaraf v. Minister of Interior*.[224] In this case, the Minister of Interior, Meir Shitrit, removed the mayor of Ofakim, Avi Assaraf, from office.[225] The Minister's decision was based on the recommendation of a

217. *See id.*

218. Eli Senior & Rony Sofer, *Olmert: The Elections are Brutal and Malicious*, YNET (Mar. 1, 2006), http://www.ynetnews.com/articles/0,7340,L-3222817,00.html.

219. *See* Vered Lubich, *It is Now Final: An Indictment Against Lod's Mayor*, YNET (Mar. 5, 2006). Regev was later convicted of the charges. *See also* Gil Landau, *The Contractor Dudi Apple was Convicted of Giving Bribe to Lod's Mayor Benny Regev*, NEWS ISRAEL (Apr. 15, 2010), http://www.news-israel.net/PrintArticle.asp?Code=20483.

220. Zohar, *supra* note 212.

221. *Id.*

222. THE INVESTIGATION COMMITTEE FOR CITY OF LOD: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS (2007), *available at* http://www.moin.gov.il/SubjectDocuments/Gvulot30.pdf.

223. Eli Senior & Miri Hasson, *The Minister of Interior Removed Lod's Mayor from Office*, YNET (Feb. 4, 2007).

224. *See generally* HCJ 7767/07 Avi Assaraf v. Minister of Interior (Jan. 27, 2008) Nevo Legal Database (by subscription) (Isr.).

225. *Id.* at ¶ 1.

special investigation committee, and followed ministry economists' advice, but Assaraf still petitioned to the court in an attempt to void it.[226] Shitrit was a member of the Kadima party, whereas Assaraf was a member of the Likud.[227] A few months earlier, before the local elections and before Shitrit was appointed to minister, Shitrit publicly endorsed Kadima's candidate for the mayor of Ofakim.[228] He praised him and said that he would do anything in his power to promote his election.[229] Assaraf argued that Shitrit removed him from office to fulfill the electoral promise he gave Kadima's candidate.[230] He maintained that Shitrit's interests were in conflict, and that his decision should be annulled.[231]

The High Court of Justice accepted Assaraf's argument.[232] Notwithstanding the committee's and the economists' opinions about Ofakim's financial condition, the court determined that the Minister was precluded from exercising his statutory expelling powers.[233] According to the court's opinion, Shitrit's public statement "upgraded" the level of his conflict of interest.[234] It strengthened the tension between the Minister's supervising authorities and his political agenda, and rendered the decision void.[235] The court specifically stated that it did not base its decision on the fact that Shitrit and the incumbent mayor were from opposing parties (Kadima and Likud).[236] Such rivalry is prevalent in Israel, and the court explained that denying the minister's authorities in such cases would undermine the state's supervising ability.[237] Rather, Shitrit's public statement was the basis for the court's decision.[238]

The court's reasoning, however, raises doubts. It is not entirely clear why the public statement raises the level of conflict of interest, and why such utterance renders the minister incapable of exercising his legal authority. A conflict of interest between the minister's supervisory and political roles exists whether the minister expresses the conflict in public or

226. *Id.*
227. *Id.* at ¶ 2.
228. *Id.*
229. *Id.*
230. *Id.*
231. *Id.*
232. *Id.* at ¶ 15.
233. *Id.*
234. *Id.*
235. *Id.* at ¶ 15.
236. *Id.*
237. *Id.* at ¶ 14.
238. *Id.* at ¶ 15.

not. The statement does not strengthen or aggravate the conflict—it simply brings it out in the open.

The root of the problem lies in the fact that supervisors are politicians. Politicians pursue their political interests, whether they openly state it or not, and whether the relevant mayor is a political ally or foe. The question we need to ask, therefore, is not whether the minister revealed his conflict of interest in public, but rather how we should structurally minimize the conflict from the outset. What can we do to make the state's monitoring less politically motivated?

III. LESSONS FROM THE ISRAELI CRISIS

In a previous paper I wrote on the subject of municipal insolvency, I claimed that state intervention is the most effective response to a local fiscal crisis.[239] I argued that other potential remedies, such as mandamus to raise taxes or municipal bankruptcy, do not address the reasons for the local decline and cannot attain local rehabilitation.[240] At first glance, the Israeli experience seems to prove this theory wrong. State monitoring was of little help in Israel, because political interests got in the way and rendered it ineffective. So should the importance of the state's supervision of local finance be reevaluated?

Notwithstanding the problems in the state's supervision demonstrated thus far, I believe that a general conclusion that diminishes the state's role in local rehabilitation is mistaken. Despite the evident drawbacks, state monitoring is central for local finance, especially at times when localities suffer from fiscal distress.[241] The reason for this claim is that the problems distressed localities usually face cannot be addressed without the state.[242] The problems are fundamental, and the state is the only entity with both legal authority and political power to initiate the required reforms to solve them.[243]

239. Kimhi, *Reviving Cities*, *supra* note 92~~92~~, at 634.

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240. *Id.* at 649–50, 653–54.

241. *Id.* at 641.

242. *Id.*

243. In a commercial context, we usually distinguish between financially and economically distressed firms. A bankruptcy reorganization process is designed to help financially distressed firms—i.e. firms that suffer from liquidity problems. The bankruptcy filing facilitates a capital reorganization, which decreases the firm's debt burden and helps it to overcome temporary liquidity hurdles. Bankruptcy reorganization, however, does little to help economically distressed firms. Except decreasing the debt burden, bankruptcy offers no real rehabilitation process, and an economically distressed firm is better off liquidated. *See, e.g.*, Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 580–81 (1998); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 87–88 (1995). Municipal corporations

Usually municipalities that enter a financial crisis suffer from two types of problems: socioeconomic and political.[244] The socioeconomic problems have to do with external processes that decrease the city's revenues or increase its costs.[245] These processes are usually outside the city's realm of control, and they involve factors like the national economy (recession), population changes (suburbanization), or intergovernmental relations (such as a decrease in grants or an increase in unfunded mandates).[246] The political problems, on the other hand, are usually internal, and are associated with fragmentation. The fragmentation increases the power of interest groups in the locality and weakens its fiscal discipline.[247] State intervention is required to overcome both types of problems. First, the state is better equipped than a locality to tackle the socioeconomic processes. These processes require state or even nationwide solutions, and local officials can hardly tackle them on their own.[248] Second, the state is able to reform the locality's destructive political environment. The state's intervention in local fiscal affairs centralizes the locality's political environment, and centralization obligates the locality to exercise fiscal restraint.[249] Such reforms require the state's involvement, and an on-going state supervision of local finances.[250]

Indeed, even with respect to the Israeli crisis, it is hard to imagine how local recovery could have been achieved without the state's intervention. As we saw earlier, the reasons for the Israeli crisis were the sharp decline in

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usually suffer from economic distress. They reach insolvency due to fundamental socio-economic and political problems, and a bankruptcy reorganization process does not address those types of problems. *See* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351 (2010) [hereinafter Kimhi, *Chapter 9*].

244. *See* Kimhi, *Reviving Cities*, *supra* note 92, at 637–47.

245. *Id.*

246. *Id.* at 638–42; *see* HELEN F. LADD & JOHN YINGER, AMERICA'S AILING CITIES: FISCAL HEALTH AND THE DESIGN OF URBAN POLICY 291 (1989) ("As we measure it, a city's fiscal health, standardized or actual, depends on economic, social, and institutional factors that are largely outside the city's control."); PEARL M. KAMER, CRISIS IN URBAN PUBLIC FINANCE: A CASE STUDY OF THIRTY EIGHT CITIES 25–55 (1983).

247. Kimhi, *Reviving Cities, supra* note 92, at 642–47; *see also* BEN BASSAT & DAHAN, POLITICAL ECONOMY, *supra* note 73, at 59–60.

248. Kimhi, *Reviving Cities*, *supra* note 92, at 664–68.

249. *Id.* at 668–72. Theoretical and empirical studies show that a central authority, especially one with veto powers over the budget, can reduce the extent of political fragmentation and reduce deficits. *See* Baqir, *supra* note 74, at 1347–51. See also with regard to macroeconomic policy, Perotti & Kontopoulos, *supra* note 74, at 196–97; Hallenberg & Von Hagen, *supra* note 74, at 4–5; Torsten Persson & Guido Tabellini, *Political Economics and Macroeconomic Policy* 71–72 (Nat'l Bureau of Econ. Res. Working Paper No. 6329, 1997), *available at* http://www.nber.org/papers/w6329.pdf?new_window=1.

250. *See* Kimhi, *Reviving Cities, supra* note 92, at 680–84 .

intergovernmental transfers, mounting expenditures (a result of unfunded mandates), and the localities' political fragmentation.[251] The localities could not have independently solved these problems because they lacked the economic and political resources to do so. They needed the state's involvement to increase funding and to change the political environment.[252] It is true that state policies contributed to the deterioration of the municipal sector, but by the same token, the solutions to the localities' problems also had to come from the state.[253]

If the state's intervention is indeed necessary to maintain local fiscal health, we need to find ways to contain the political interests that stand in the way of efficient state supervision. We need to find mechanisms that will help the state reach decisions based on the cities' economic needs, and not on the political motives of state politicians. In this Section, I will discuss two such mechanisms. The first is a municipal bond market, and the second is a professional state body that will supervise local finance. I believe the implementation of both mechanisms could have mitigated the scope of the local crisis experienced by Israel, and can also assist other places.

A. The Importance of Efficient Credit Markets

The creditors' contribution to the monitoring of commercial firms is well documented in corporate law literature. The literature explains that the existence of debt reduces agency costs and contributes to the efficient management of the firm.[254] Creditors monitor the corporate officials and make sure that the firm will be able to meet its debt obligations.[255]

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251. *See supra* notes 25–58 and accompanying text.

252. *See supra* notes 13–68 and accompanying text.

253. Both in the United States and in Israel, localities that filed for bankruptcy without undergoing significant financial reforms returned to insolvency within a few years after the filing. The economic and political problems that were at the root of the insolvency were not solved, and the local fiscal condition quickly deteriorated again. This was the case, for example, with Macks Creek in the United States or with Taibe in Israel. *See* Kimhi, *Chapter 9, supra* note 243, at 381.

254. *See, e.g.*, Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986). Jensen explains that since the firm dedicates a certain portion of its cash flow to debt repayment, the amount available for spending at the discretion of the firm's managers decreases. The managers have fewer resources to control, and, hence, agency costs decrease.

255. The creditors' powers over the debtor can originate from different sources. Some creditors extend short-term credit, in which case, the debtor is forced to come back for additional funds in short intervals, and the creditors can refuse to loan or increase interest rates when the firm does not perform satisfactorily. *See* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 757 (1997). In other cases, usually when credit is extended for longer terms, creditors place restrictive covenants in the

As opposed to the ample literature on creditors of commercial corporations, however, the literature on creditors of municipal corporations is relatively scarce. Perhaps due to the democratic nature of local governments, the literature usually emphasizes the monitoring that residents conduct, either through the political process or through the market for residence, and less on the creditors' monitoring. But just like with commercial corporations, creditors monitoring local governments may have positive effects on local fiscal health.

Clayton Gillette explains that creditors' monitoring can help solve some of the collective action problems from which the residents' monitoring suffers.[256] He notices that public monitoring is not necessarily under supplied, but rather that it is mal-distributed.[257] Some city functions are overly monitored by interest groups, while other functions, those with more diffuse effects, are overlooked.[258] Gillette argues that under certain conditions the interests of the creditors and residents are sufficiently close, so that the creditors' monitoring can compliment that of the residents.[259] The creditors internalize, perhaps even better than the residents, the potential consequences of the current local decisions.[260] To avoid non-payment, they make sure that local officials will not jeopardize their interests and that the locality will not overspend its resources.[261]

firm's debt agreement. The covenants mandate a certain level of performance or prohibit certain types of behaviors, and to the extent the covenants are violated the creditors may gain control rights over the firm. *See id*; *see also* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209 (2006); Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 147–48 (1979).

256. Gillette, *supra* note 195, at 966.

257. *Id.*

258. *Id.* at 966.

259. *Id.*

260. *Id.* at 974.

261. There are, however, significant differences between commercial and municipal creditors that render the creditors monitoring over municipalities much less effective. When a commercial firm defaults or breaches a contractual covenant, the creditors can gain control rights over the firm or at least part of it. They can ask for the firm's liquidation, foreclose some of its assets, or receive shares in lieu of debt payment. Shleifer & Vishney, *supra* note 255, at 757. The same is not true with regard to municipal creditors. Municipal creditors are unable to seize most of the locality's assets, and they cannot receive the shares of a defaulting city. The legal remedies available to them are extremely limited, because the control of the municipality always remains with the sovereign. *See* Capps v. Citizens Nat'l Bank, 134 S.W. 808, 810 (Tex. Civ. App. 1911); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 429–34 (1993). Moreover, as explained earlier, a local fiscal crisis is often the result of circumstances that are beyond the local officials' realm of control. The officials themselves cannot address the socio-economic causes that are at the root of the crisis, and political circumstances hinder them from cutting costs. In this situation, the

But on top of the creditors' ongoing monitoring efforts, a municipal bond market has an additional benefit in times of a local fiscal crisis. At this point the market can serve as a channel through which the state politicians internalize the local crisis' costs. The state politicians often view the local crisis as a local event, and the markets can help render them more conscious to its wide-ranging implications.

The markets view a local crisis not as an isolated event but rather as a warning sign for the condition of other localities.[262] If a state allows the default of one locality, other municipalities might suffer from similar problems and follow suit.[263] The default, therefore, can increase the price of credit for all public issuers in the state, even for those issuers that have no direct connection with the city's default.[264] The state itself can also

financial creditors' pressures to stop spending or to change the financial practices will do little good. The officials are very much the victims of a situation that requires a much wider solution, and they cannot comply, even if they want to, with the creditors' instructions. The creditors' weakness in times of a fiscal crisis was evident in the New York City crisis of 1975. In this case, when realizing the gravity of New York's financial difficulties, the creditors organized a creditors group (the Financial Community Liaison Group—the FCLG). The group tried to pressure New York City's officials to cut spending, but their efforts were in vain. They refused to extend the city any more credit, but they could not change the city's financial practices. The problem was that the city's officials were politically unable to implement the creditors' suggested measures. The city's rehabilitation required reforms, which neither the creditors nor the local officials could have implemented without the state's help. For a more detailed discussion of the FCLG, see ROBERT W. BAILEY, THE CRISIS REGIME: THE MAC, THE EFCB, AND THE POLITICAL IMPACT OF THE NEW YORK CITY FINANCIAL CRISIS 17–23 (1984).

262. *See* Kimhi, *Chapter 9*, *supra* note 243, at 382–83; *see also* Dennis Epple & Chester Spatt, *State Restrictions on Local Debt: Their Role in Preventing Default*, 29 J. PUB. ECON. 199, 219 (1986).

263. Kimhi, *Chapter 9*, *supra* note 243, at 382–83; *see also* Clayton P. Gillette, *Political Will and Fiscal Federalism in Municipal Bankruptcy* 23–29 (NYU Sch. of Law Pub. Law & Legal Theory Research Paper Series, Working Paper No. 11-22, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1793173.

264. The contagion effects can stem from either malign or benign reasons. The malign reasons have to do with information gaps about the actual financial status of the different localities. Investors cannot easily differentiate between distressed and healthy localities, and so when one locality defaults they raise the interest rates for all localities. The benign reasons have to do with the pricing of state policies towards the local sector. States' policies impact the financial condition of localities all over the state. States determine localities' taxing powers, spending authorities, and debt limitations, and their policies are usually directed to whole or parts of the municipal sector and not to a single isolated locality. Therefore, a default of one locality can reveal new information about the financial condition of other localities in the same state.

The Orange County example is particularly interesting because at first glance, the county's financial troubles seem unrelated to the financial situation of other local governments in the state. The bankruptcy occurred due to bad investments made by the County's treasurer—investments made without the state's approval and without proper financial disclosure. A closer look at the circumstances surrounding the crisis however, does reveal a connection suffer from the local default. Creditors can view the default as a signal for the state's economic condition and downgrade the state's own credit rating.[265] These contagion effects were evident in the Orange County bankruptcy. Studies of the County's bankruptcy show that it had adversely affected the entire municipal bond market, and especially public issuers in California.[266]

The contagion effects render the local crisis a state issue, rather than a local issue. Because a local default may increase the interest rates paid by all local governments in the state, state politicians intervene to prevent it.[267] The intervention is not motivated by a concern for the efficient allocation of public goods in a specific distressed locality, but rather by the fear of the wide implications that a default of even one locality can trigger.[268] House Representative Barney Frank explained this point in a Congressional hearing before the house committee on financial services:

> [L]et me just underline what's been said. Several of us here were state legislators . . . and were mayors. Here is the point: no state—no state legislators, no governor, can allow any one of its municipalities to default because then every other municipality would pay through the nose. So that is why this is not just some charity here; this is self-defense.[269]

Governor Ed Rendell cited the same reasons for helping the city of Harrisburg avoid a default: "[w]e could not stand by and let the city default on these bonds."[270] Rendell added that Harrisburg's default would boost

between the crisis and the state's policies. The genesis of the Orange County Bankruptcy can be traced back to the approval of California's Proposition 13. *See* BALDSSARE, *supra* note 12, at 26. Proposition 13 imposed limits on property tax increases, and had a devastating effect on the local governments' tax base. *Id.* This caused the County's treasurer, as well as other local government officials, to invest in risky investments to make up for the lost revenues. *Id.*

265. Dwight V. Denison, *Did the Bond Fund Investors Anticipate the Financial Crisis of Orange County?*, 21 MUN. FIN. J. 24, 24–26 (2000); John M. Halstead et al., *Orange County Bankruptcy: Financial Contagion in Municipal Bond and Bank Equity Markets*, 39 FIN. REV. 293, 313 (2004).

266. Denison, *supra* note 265, at 24–26; Halstead, *supra* note 265, at 313.

267. *See infra* notes 268–271 and accompanying text.

268. *See Municipal Bond Turmoil: Impact on Cities, Towns, and States, Hearing Before the H. Comm. on Financial Services*, 110th Cong. 25 (2008) (statement of Rep. Barney Frank, Chairman, H. Comm. on Fin. Servs.).

269. *Id.*

270. *See* Dunstan McNichol, *Harrisburg, Pennsylvania, Bond Default Averted with State Aid*, BLOOMBERG.COM (Sept. 13, 2010), http://www.bloomberg.com/news/2010-09-12/harrisburg-pennyslvania-bond-default-is-averted-by-advance-on-state-aid.html.

borrowing costs or make credit unobtainable for other Pennsylvania municipalities and school districts.[271]

Indeed, since the Great Depression, no local crisis in the United States has even resembled the one that Israel experienced.[272] Local governments rarely default on the general obligation debt, and they have not failed to pay their employees for such long periods of time.[273]

Note though that the state's involvement does not necessarily have positive effects. If the state just gives funds to localities to avoid a default (bailout), then the local expenditures are simply shifted from the locality's residents to the state taxpayer.[274] No net benefit is created, because the reasons that led to the local insolvency remain unchanged.[275] The bailout may even worsen the situation, as it incentivizes localities to overspend, because localities know that the state will eventually pay for their inflated expenditures.[276] If, however, the state's involvement entails financial reforms, then local expenditure patterns can change.[277] Not just a single default is prevented, but the locality, like other localities in the state, can enjoy better fiscal health in the long run.[278] An efficient municipal credit market is able to price these different state strategies.[279] Evidence shows that states that invest resources in an ongoing monitoring of local finance, rather than just a bailout of insolvent localities, are rewarded by the credit markets.[280] The creditors understand that the state policies make their

271. *Id.*; *see also* New York State Financial Emergency Act for the City of New York, ch. 868, § 1, 1975 N.Y. Laws 1405–07; Mike Williams, *Around the South: Bankruptcy Not an Option in Solving Miami's Fiscal Crisis*, ATLANTA J. CONST., Dec. 17, 1996, at 18D (interviewing Lt. Gov. Buddy MacKay, then the head of Miami's state oversight board, about the Miami fiscal crisis. MacKay said: "Bankruptcy is not an option. That could have repercussions in the financial markets for the state and its other local governments as well.").

272. *See* FITCH RATINGS, LOCAL GOVERNMENT GENERAL OBLIGATION RATING GUIDELINES 1 (2004) ("In the extreme, it is theoretically possible for a municipality to become so economically void, so that it does not have the financial means to repay debt. Fortunately, this circumstance has not existed since the Great Depression.").

273. Michael McDonald, *Meredith Whitney Loses Credibility as Muni Defaults Fall 60%*, BLOOMBERG.COM (July 15, 2011), http://www.bloomberg.com/news/2011-07-15/muni-default-plunge-belies-whitney-prediction-as-borrowers-shun-insolvency.html.

274. *See* Robert P. Inman, *Transfers and Bailouts: Institutions for Enforcing Local Fiscal Discipline*, 12 CONST. POL. ECON. 141, 142 (2001).

275. *See id.* at 142–43.

276. *Id.*

277. Kimhi, *Reviving Cities*, *supra* note 92, at 664–72.

278. *Id.*

279. Inman, *supra* note 274, at 155–56. With regard to North Carolina, see Mayraj Fahim, *North Carolina Still Influences U.S. Local Government Finance*, CITY MAYORS (Mar. 31, 2005), http://www.citymayors.com/finance/nc_finance.html.

280. *See* Inman, *supra* note 274, at 142.

loans to localities safer, and they are willing to charge lower interest rates.[281]

Israel, unfortunately, does not have an efficient municipal bond market. Localities usually take credit only from banks, and there is no formal credit rating to evaluate the local financial condition.[282] The state is not affected in any way when a locality defaults, and it pays a small financial price for neglecting the municipal sector. Absent significant contagion effects, the central government actually assisted local governments to shift costs to the creditors. In 2004, the Knesset enacted a statute that protected previously seizable assets from creditors' reach.[283] As a result of the legislation, creditors could not attach liens or foreclose funds that were deposited in special accounts, and localities in a rehabilitation process could use these funds to finance their expenses.[284]

This forced statutory arrangement was avoidable. Despite the local difficulties, the banks were willing to negotiate a voluntary debt readjustment plan, which would have included a consensual waiver of their execution rights.[285] The Knesset and the local governments, however, refused.[286] With no channel through which state officials internalized the costs of this cost-shifting to the creditors, they preferred an easy statutory solution over the implementation of hard and demanding reforms. This way, the state did not need to increase state funding or to intervene in local affairs contrary to the wishes of the local leadership.

B. A Procedural Process for State Intervention

The problem with state monitoring is not only that state politicians do not internalize the costs of a local crisis, but also that their decisions are

281. *See* Richard Larkin & Jeff Schaub, *State of North Carolina Local Government Commission: Credit Enhancement Program Review*, FITCH IBCA 1 (Mar. 29, 1999), http://www.nira.or.jp/past/newsj/seisakuf/04/siryou/08.pdf.

282. Eliyahu Gabai, *Encourage a Municipal Bond Market Rather than Spill Money on Localities*, HAARETZ, June 21, 2007 (reporting that until June 2007 only four localities issued municipal bonds); Tali Levy, *The Deputy Governor of the Bank of Israel: The Development of a Bond Market Is Important to the Market in Order to Create Alternative Financing Sources to the Banking System*, THE MARKER (Jan. 30, 2006), http://www.themarker.com/misc/article-print-page/1.393493.

283. The Budget Foundations Act (Amend. No. 31), 2004, SH No. 1943 p. 402 (Isr.).

284. *See id.* Despite the banks' protests, the statute was implemented retroactively, so that even those creditors who had already acquired security rights or liens prior to the legislation could not exercise their rights.

285. Noam Sharvit, *Banks Petitioned to the High Court of Justice Against the Statute that Enables Salary Payments to Local Government's Employees*, NEWS1 (June 30, 2004), http://www.news1.co.il/Archive/001-D-49289-00.html.

286. *Id.*

entangled with political considerations. As the Israeli experience suggests, there is an inherent conflict of interest between the state's monitoring role and state politicians' personal interests. Often personal interests get in the way of efficient monitoring. To improve the state's monitoring, we ought to untangle this conflict. The supervision of local finance should be more professional and less politically motivated.

The de-politicization of the state's monitoring system can be promoted by the implementation of administrative and procedural rules. These rules will limit the individual politician's ability to take advantage of the state's authorities, and will diminish the effect of personal political interests.[287] Two principles are especially important in this respect: the legislation of ex-ante guidelines for the state's supervision measures, and the creation of an insulated local government commission.

One of the problems in the state's monitoring is that the state's intervention measures usually take place only *ex post*.[288] First, a certain locality fails to meet its financial obligations, and only then the state decides how to react and whether to intervene in the locality's financial affairs. In the midst of the locality's financial suffering, however, political pressures undermine the prospects of efficient state action. State politicians already know the mayor involved and whether it is politically advantageous to initiate a confrontation. Interest groups in the city may have connections with the central government, and they too may lobby to prevent certain state measures. The locality's religious, ethnic, and political affiliations are known, and may also create biases when deciding on the state's measures. In short, when the state involves itself *ex post*, external considerations

287. Daphne Barak-Erez, *The Role And Limits of Legal Regulation of Conflict of Interests (Part 1): The Administrative Process as a Domain of Conflicting Interests*, 6 THEORETICAL INQ. L. 193, 201 (2005) (arguing that administrative decision-making should be understood as devoted to the balancing between conflicting interests of individuals or groups, usually when none of the affected parties has predefined legal rights that are relevant to the substantial content of the administrative decision).

This situation is not unlike the regulation of conflicts of interests in commercial corporations. Corporate boards are also required to follow certain procedural rules when faced with situations of conflict of interests, and the procedures are designed to mitigate agency costs. *See, e.g.*, Scott V. Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interests*, 43 BUS. LAW. 665 (1988).

288. *Cf.* Beth Walter Honadle, *The States' Role in U.S. Local Government Fiscal Crises: A Theoretical Model and Results of a National Survey*, 26 INT'L J. PUB. ADMIN. 1431, 1461 (2003) (concluding from a survey of fifty U.S. states on their roles in local fiscal crises, that the states usually get involved only after the crises occur, and usually do not know about local crises beforehand; and that even when states do know of impending crises, they generally do not prevent them).

which have little to do with the locality's economic condition can influence the state's decisions.[289]

To lessen these political pressures, the state should create *ex ante* statutory guidelines for its intervention measures.[290] The guidelines need to detail a series of financial indicators and specify how the state should respond when these indicators are triggered.[291] The triggers for example, can be a deficit level, tax collection rates, or amounts of financial reserves, and the statute should specify the state's supervision level when the different triggering events occur.[292] For example, when the deficit reaches a 5% level, the state should appoint an external comptroller for the locality; when the deficit reaches a 10% level, it must appoint an oversight board; and at 15%, deficit or higher, it can take over the locality's finances altogether. Some scholars have suggested the use of more sophisticated indicators.[293] These indicators use dynamic models, which compare the economic performance of localities both over time and in comparison with other localities.[294] This facilitates the prediction of potential crises in the future, and allows for earlier and more efficient state action.[295]

289. *See* Barak-Erez, *supra* note 287, at 200–01.

290. Anthony G. Cahill et al., *State Government Responses to Municipal Fiscal Distress: A Brave New World for State-Local Intergovernmental Relations*, 17 PUB. PRODUCTIVITY & MGMT. REV. 253, 256 (1994).

291. *See id.*

292. Philip Kloha et al., *Someone to Watch over Me—State Monitoring of Local Fiscal Conditions*, 35 AM. REV. PUB. ADMIN. 236, 237 (2005) (surveying forty-eight states in the U.S to examine whether they use financial indicators to evaluate their localities' fiscal condition). Kloha found that about a third of the states use such indicators, and on average, each state uses twelve different indicators. The authors divided these indicators into eight different categories: Revenues (including per capita revenues, uncollected property tax revenues, and revenue shortfalls); Expenditures (indicators such as: per capita expenditures, employees per capita, and fixed costs); Operating Position (including operating deficits, fund balances, and liquidity); Debt Ratios (including current liabilities, debt service, and any indicator that involves the locality's inability to make payments when due); Unfunded Liabilities (pension liabilities and post-employment benefits); Legal or Technical Violations (including compliance with filing requirements, compliance with timing issues, compliance with accounting and auditing requirements); Community Needs and Resources (indicators such as: population changes, median age, personal income per capita, poverty households rate); Miscellaneous Category. *Id.* at 242. Each of these categories represents a factor that influences the local economy, and taken together, the different categories are able to monitor the changes in the local economy as a whole. For a somewhat different categorization, see generally SANFORD M. GROVES ET AL., EVALUATING FINANCIAL CONDITION: A HANDBOOK FOR LOCAL GOVERNMENT (4th ed. 2003).

293. Ken W. Brown, *The 10-Point Test of Financial Condition: Towards an Easy-to-Use Assessment Tool for Smaller Cities*, 9 GOV'T FIN. REV. 21 (1993).

294. *Id.*

295. *See id.;* Philip Kloha et al., *Developing and Testing a Composite Model to Predict Local Fiscal Distress*, 65 PUB. ADMIN. REV. 313, 320 (2005).

The advantages of such statutory guidelines are twofold. First, they are created behind a kind of "veil of ignorance."[296] At the time the guidelines are adopted it is still unknown which locality will enter financial difficulties and will need the state's assistance. This approach induces politicians to consider the best interests of the local sector in general, and not of particular distressed municipality. Second, the guidelines serve as a commitment device. Since the guidelines prescribe standards for the state's behavior in cases of local financial emergencies, state politicians are more constrained in their actions. They should follow the statutory instructions and their individual political interests play a smaller role.

To lessen the political pressures even further, the implementation of the guidelines should be left in the hands of an insulated professional state agency. An insulated agency (a local government commission) will minimize the politicization of the monitoring activities and will decrease pressure on the local leadership.[297] Although the advantages of independent agencies have been widely debated in the literature,[298] there are indications that when given certain institutional mechanisms, these agencies can diminish political influences.[299] These institutional

296. *Cf.* JOHN RAWLS, A THEORY OF JUSTICE 11 (rev. ed. 1999).

297. Marshall J. Breger & Gary J. Edles, *Established by Practice: The Theory and Operation of Independent Federal Agencies*, 52 ADMIN. L. REV. 1111, 1207 (2000).

298. Independent agencies have been criticized from two main directions: constitutional and functional. From a constitutional viewpoint, independent agencies violate the separation of powers. They blend the powers of all three branches of government, but are creatures of none. From a functional viewpoint the agencies are "organizationally dysfunctional." *See* Susan Bertlett Foote, *Independent Agencies Under Attack: A Skeptical View of the Importance of the Debate*, 1988 DUKE L. J. 223, 223 (1988). Since they have no clear lines of authority, they are politically unaccountable, and are therefore vulnerable to regulatory inefficiency and external manipulation. *Id. See generally* Geoffrey Miller, *Independent Agencies*, 1986 SUP. CT. REV. 41 (1986).

299. *See* John M. Ackerman, *Understanding Independent Accountability Agencies*, *in* COMP. ADMIN. L. 266–67 (Susan Rose Ackerman & Peter Lindseth eds., 2010) ("What determines whether an independent agency ends up as an authoritarian cover up or as a positive force for accountable governance? I suggest that the answer lies in how these agencies respond to and deal with a series of challenges which together constitute what I call their institutional situation. Based on previous research on this topic, I propose four areas of particular importance: public legitimacy, institutional strength, second order accountability and bureaucratic stagnation."); Rachel E. Barkow, *Insulating Agencies: Avoiding Capture Through Institutional Design*, 89 TEX. L. REV. 15 (2010) (arguing that the traditional metrics for an independent agency are not the only effective ways in which insulation from interest group pressures can be achieved, and identifying additional, perhaps more effective, mechanisms to reach political independence); Marc Quintyn, *Independent Agencies: More Than a Cheap Copy of Independent Central Banks*, 20 CONST. POL. ECON. 267, 277 (2009) (presenting a model for independent agencies based on lessons from central banks' independence and four pillars: independence, accountability, transparency, and integrity); Daniel Halberstam, *The Promise of Comparative Administrative Law: A Constitutional Perspective on Independent Agencies, in* COMP. ADMIN. L. 201 (Susan Rose

mechanisms are designed to facilitate greater political autonomy, decrease interest group pressure and improve the agency's governance and legitimacy.[300]

It is not within the scope of this Article to discuss the exact organizational characteristics of a local government monitoring commission, but clearly the monitoring activities should not be headed by a single state politician. A single politician is extremely vulnerable to political pressures because he bears the entire political costs of confronting the local leadership, but the financial health of a locality will not necessarily be accredited to him.[301] A multi-member commission, headed by appointed professionals or by a combination of professionals and politicians, is better suited to handle the political pressures.[302] The commission should hire experts (economists and accountants) to analyze localities' financial condition, and to decide whether the financial indicators specified in the statutory guidelines are triggered. To the extent the indicators are triggered and a locality is in financial distress, the commission should implement rehabilitation measures, such as the appointment of an outside tax collector, comptroller, or control board.

Note that I do not claim that such local government commission should determine the state's policies towards the local sector. The relationship between the state and its localities is by its nature political,[303] and state policies in matters like local autonomy or local finance ought to be decided by the public's representatives.[304] I do, however, differentiate between

Ackerman & Peter Lindseth eds., 2010) ("But it would be mistaken to view such agencies as mere appendages or servants of parliament, the executive, or the judiciary. Instead, we must recognize them for what they are: partially autonomous institutions of public governance demanding independent jurisdiction within the constitutional constellation of which they form a part.").

300. Scholars recommend a variety of mechanisms: removal of the agency's officials only for cause, employment restrictions, independent funding, transparency, procedural restrictions such as notices and hearings, tools to generate and disseminate information, and more. *See* Barkow, *supra* note 299, at 27–28.

301. As explained earlier, residents often ignore the link between state policies and the local fiscal condition, and local policies are not very important in national elections. *See supra* Part II.A.

302. *See* Barkow, *supra* note 299, at 37–38.

303. Politics, broadly defined, is the process by which decisions are made about the allocation of goods in the society. *See generally* DAVID EASTON, A SYSTEMS ANALYSIS OF POLITICAL LIFE 40–50 (1965).

304. Issues like the extent of local autonomy or the way localities should be financed are by their nature political. They are connected to our beliefs about the extent of the state's involvement in the economy, or to the way we view our democratic system. They involve ideology and values, and cannot be considered merely technical or professional. Thus, decision makers should have democratic accountability. They should represent their constituencies' principles and beliefs, and be replaced to the extent their actions do not

policy-making and monitoring activities. When it comes to monitoring, the balance between the political and the bureaucratic should change. More emphasis should be put on expertise and less on representation. The monitoring of local finance, after all, is a professional task. It involves economic judgments, which are more technical in nature, and are based on objective indicia. Different constituencies should not play a role when determining the financial status of a certain locality, and political views should not be a factor when deciding on financial rehabilitation measures.

Clearly there is no procedural process that can guarantee that the state's monitoring will be done effectively. Political interests will always exist, and independent agencies are not immunized from pressures. Evidence shows, however, that states that have implemented this type of process have improved their localities' fiscal health. This was the case in North Carolina and Ohio, which enacted special municipal insolvency statutes, and created an orderly procedural mechanism to help distressed localities.[305] Jane Beckett-Camarata examined the effects of the Ohio legislation.[306] She concluded that the legislation had noticeable positive long term effects because the state was able to change the distressed localities' destructive spending patterns.[307] The effects of the local government commission in North Carolina were even more outstanding.[308] Credit rating agencies appreciated the positive effects of the commission's

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correspond to the needs and wishes of those who chose them. *Cf.* Gerald Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1059, 1059 (1980) (arguing that the law governing cities should be explained as a political choice).

305. Ohio's monitoring is conducted by the Office of the State's Auditor. Depending on the severity of the local government's problem, the Auditor may declare the government to be in fiscal watch or fiscal emergency. If a locality is placed in fiscal watch, the Auditor's Office provides free assistance to help the government regain its financial footing. If a fiscal emergency is declared, a commission is appointed to oversee the financial activities of the government until the emergency is terminated. *See An Introduction to Fiscal Emergency*, OHIO AUDITOR OF STATE 1, 17 (July 2004), http://www.auditor.state.oh.us/services/lgs/publications/GeneralPublications/IntroToFiscalEmergency.pdf. North Carolina created a special commission to supervise local finance. The commission reviews and approves all issuances of local government debt, and it closely watches the local fiscal performance. In case of financial difficulties, it assists the troubled locality, and assumes fiscal responsibility if needed. *See* Charles K. Coe, *Preventing Local Government Fiscal Crises: The North Carolina Approach*, 27 PUB. BUDGETING & FIN. 39, 40 (2007).

306. Jane Beckett-Camarata, *Identifying and Coping with Fiscal Emergencies in Ohio Local Governments*, 27 INT'L J. PUB. ADMIN. 615, 616 (2004).

307. *Id.* at 626–28; *see also* Jim Petro, *Ohio's Fiscal Emergency Law Works: Protecting Tax Payers Dollars*, CALL & POST (July 18, 1996), http://www.highbeam.com/doc/1P3-582080331.html ("Ohio Fiscal Emergency Law is an example of efficient government action that protects and saves your money. How? By setting up an early warning system, the law helps local governments before they enter a full blown fiscal emergency.").

308. *See* Coe, *supra* note 305, at 39.

monitoring, and rewarded it with increased credit ratings and lower interest rates.[309]

In 2004, Israel enacted an amendment to the municipal ordinance that established *ex ante* guidelines to the state's monitoring.[310] The ordinance contains various financial indicators, and specifies different measures that the minister can implement depending on the locality's fiscal condition. The minister can appoint an external tax collector; he can appoint an external comptroller and he can even remove the local officials from their office.[311] The *ex ante* guidelines improved the local fiscal health,[312] but since all the authorities are vested with the Minister of Interior, the situation is still far from optimal. As we have seen, the Minister is subject to heavy political pressure, and he does not always use his discretion to the best interests of the local sector.[313] In 2007, the Minister of Interior even attempted to discharge a senior official in the Ministry for not favoring Kadima mayors.[314] The official declined to approve Kadima members to various positions in the local sector, and was unwilling to follow the Minister's instructions to terminate the appointment of external comptrollers appointed in localities whose mayor is a Kadima member.[315] In the end, the discharge was not carried out,[316] but the affair shows the extent of politicization in the Ministry of Interior.

309. *See id.*; Fahim, *supra* note 279; Larkin & Schaub, supra note 281, at 1.

310. *See* The Law of Economic Policy for Fiscal Year, 2004, SH No. 1920, p. 111 (Isr.).

311. If the minister finds that a locality does not collect its taxes efficiently, he may appoint an external tax collector to levy the required taxes. *See* Municipalities Ordinance, 1964, M.Y. 8, § 142A (Isr.). If a locality has a high level of deficit (10% or more of its current budget or 15% or more of its accumulative deficit), the minister can appoint an external comptroller. *See* Municipalities Ordinance, 1964, M.Y. 8, (Isr.). The comptroller must approve all local expenditures, and the locality cannot enter into contractual obligations without the comptroller's consent. Third, if the minister or an appointed investigation committee determines that the local officials do not perform their legal tasks properly, then the minister is entitled to remove the mayor and the aldermen from office and to appoint a control board. *See* Municipalities Ordinance, 1964, M.Y. 8, §§ 143–143A (Isr.). The chairman of the board possesses the mayor's authorities, and the board members serve as aldermen.

312. *See* BEN BASSAT & DAHAN, LOCAL GOVERNMENT CRISIS, *supra* note 165, at 51 (noting that after 2004 the central government increased its involvement in the local sector, it improved the local sector fiscal condition).

313. See *supra* notes 204–38 and accompanying text.

314. *See The Head of the Local Government Monitoring Department in the Ministry of Interior Refused to Favor Kadima Mayors—and Was Discharged Due to Lack of Managerial Skills*, GLOBES (Aug. 24, 2008), http://www.globes.co.il/news/article.aspx?did=1000375022 (on file with author).

315. *Id.*

316. *See Rani Fintzi's Discharge Was Annulled—The Ministry of Interior Called off the Search for His Replacement*, GLOBES (Aug. 27, 2008), http://www.globes.co.il/news/article.aspx?did=1000376261.

CONCLUSION

The Israeli local crisis is still far from resolved. The 2004 amendments improved the state's supervision, but many local governments, especially Arab municipalities, still face severe financial difficulties. The central government ~~still~~ does not adequately finance the local sector, and the chronic problems described in this Article have not disappeared.[317] Attempts to reform the state monitoring system and render it more politically independent have failed, mainly as a result of the Ministry of Interior's resistance. The Ministry was reluctant to lose its control and objected to the creation of a more professional local government commission.[318]

This Article attempted to analyze the motives behind such state behaviors. It showed the complexity of the relationship between the two levels of government and the inherent conflicts of interest that exist in the state's monitoring. Through the Israeli experience, we see the benefits that state politicians can derive from a feeble local sector and the political costs that are associated with efficient state supervision. This Article does not claim to offer an exhaustive solution to these problems, but it does suggest that an efficient credit market and certain procedural mechanisms may help mitigate some of the difficulties.

317. The Local Fiscal Crisis, Hearing Before the Parliamentary Finance Committee of the Knesset (Oct. 11, 2010).

318. *See, e.g.* MINISTRY OF FINANCE, A PROPOSAL FOR STRUCTURAL REFORMS FOR THE YEARS 2009–2010, at 202 (2009), *available at* http://www.shelly.org.il/files/hesderim2009.pdf.