
**REVIVING CITIES:
LEGAL REMEDIES TO MUNICIPAL FINANCIAL CRISES**

OMER KIMHI *

INTRODUCTION	634
I. THE CAUSES OF MUNICIPAL FINANCIAL DISTRESS	637
A. <i>The Socioeconomic-Decline Approach</i>	638
1. The National Economy.....	639
2. Suburbanization and Population Changes	640
3. Intergovernmental Policies.....	641
B. <i>The Local-Management Approach</i>	642
1. Municipal Officials.....	642
2. The Political Environment.....	643
II. THE LEGAL REMEDIES FOR MUNICIPAL INSOLVENCY	647
A. <i>The Creditors' Remedies</i>	647
B. <i>Chapter 9 of the Bankruptcy Code</i>	650
C. <i>State Financial Boards and State Municipal Insolvency Statutes</i>	654
III. THE SUPERIOR RISK BEARER OF MUNICIPAL INSOLVENCY	656
A. <i>The Residents as Risk Bearers</i>	656
B. <i>Who Is the Superior Risk Bearer: Creditors or the State?</i>	660
C. <i>The State as the Superior Risk Bearer</i>	664
1. The State Can Better Deal with the Socioeconomic Processes	664
2. The State Can Address the Political Causes of the Crisis.....	668
IV. MUNICIPAL INSOLVENCY LEGISLATION	672
A. <i>The Need for Municipal Insolvency Legislation</i>	675
B. <i>The Advantages of State Intervention: North Carolina's Example</i>	679
CONCLUSION.....	683

Local fiscal crises are by no means a negligible phenomenon. In the last thirty years, a significant number of the nation's cities have suffered from serious financial strain, and several large and important cities such as New York, Philadelphia, and Miami have even experienced full-blown crises where

* Adjunct Prof. of Bankruptcy Law in the Hebrew University (Jerusalem, Israel). The paper is based on three years of research I did on the subject of municipal insolvency at New York University School of Law, and is part of my doctoral (JSD) dissertation. I wish to thank my doctoral committee, Clayton Gillette, Geoffrey Miller and Dick Netzer, for their comments and support. I also wish to thank Barry Adler, Shmuel Leshem, Doreen Lustig, Oshrat Sity, Avi Eldor, Rotem Bar Kockva and the members of the Hebrew University Faculty Workshop for their comments on earlier drafts.

they did not have sufficient resources to finance basic public services. In this Article, I discuss the legal remedies developed over the years to address local insolvency – creditors’ remedies, Chapter 9 of the Bankruptcy Code, and state financial boards – and I explain the logic and limits of each remedy. My analysis suggests that state financial boards are the most effective response to a local crisis. Using both theoretical arguments and examples of actual cases, I describe the advantages of this remedy, and explain how it should be successfully implemented in legislation. Using the case study of North Carolina, I show that such legislation can improve local fiscal health and facilitate huge interest-rates savings on a regular basis.

INTRODUCTION

It is commonly recognized that Bridgeport, like many cities in the northeast and other areas of the country, is financially distressed and has been for many years. The Chief of Police, Thomas J. Sweeney, testified that . . . there are neighborhoods in Bridgeport which have been surrendered to drug dealers and in which people are reluctant to leave their homes; that there were fifty-eight murders in Bridgeport in 1990; that his staff of twenty-three detectives, approximately half of what is needed, is so overworked that there is almost no investigation of property crime . . . and that response to emergency or so-called “hot” calls is often delayed because there is no available police officer.¹

Local governments are the primary providers of public services in the United States. We all receive various types of services from our localities, and our day-to-day lives very much depend on the localities’ smooth and efficient functioning: we attend public schools, walk and drive the streets, drink clean water, enjoy the protection of the police and fire departments, look at the beauty of public parks, and so on. So what happens when a local government’s fiscal condition deteriorates and it becomes insolvent? What should we do when a locality no longer has sufficient resources to finance the public goods we all consume and need?

This question is by no means only theoretical. Although municipal financial crises are not prevalent, they occasionally do occur; and even large and important municipalities have found themselves, at one time or another, in a position in which they had difficulties providing even basic services to their residents. New York City (1975), Cleveland (1979), Philadelphia (1990), Bridgeport (1991), Orange County (1994), Washington D.C. (1995), Miami (1996), Camden (1999), and Pittsburgh (2004) are but several examples of this

¹ *In re City Of Bridgeport*, 129 B.R. 332, 335 (Bankr. D. Conn. 1991). In 1991, Bridgeport, one of the largest cities in Connecticut, suffered from a severe financial crisis, and filed for bankruptcy under chapter 9 of the Bankruptcy Code. *Id.* at 333.

phenomenon.² Financial crises have had an important impact on the development of cities, and they have affected (and will probably continue to affect) the lives of millions of city residents.³ As the excerpt above, from the Bridgeport bankruptcy case, so bluntly shows, cities that suffer from financial crises are often unable to provide even basic public services, and their residents may suffer from crime, poor education, and decaying infrastructure as a result.

However, notwithstanding the subject's importance, from a legal perspective municipal insolvency is still very much an uncharted area. There is hardly any legal writing about municipal financial crises, and researchers have not sufficiently explored how the legal system deals, or should deal, with this problem. Those scholars who have addressed this issue have mostly focused on one specific remedy to the local crisis: chapter 9 of the Bankruptcy Code, which deals with municipal bankruptcy. They have assumed – either explicitly or implicitly – that municipal insolvency, like corporate insolvency, should be dealt with through bankruptcy law, and have neglected other better, and more common, solutions to the problem.⁴ In this Article I set out to start filling this gap in the literature. I discuss municipal insolvency as a general

² According to a survey conducted by Beth Honadle in 2003, about a hundred local governments have suffered from a financial crisis in recent years. *See* 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, 1463-1470 (2003). Honadle's conclusion about the prevalence of local fiscal crises is also consistent with the writings of several other scholars who have dealt with this subject. *See, e.g.*, Anthony G. Cahill & Joseph A. James, *Responding to Municipal Fiscal Distress: An Emerging Issue for State Governments in the 1990s*, 52 PUB. ADMIN. REV. 88, 88 (1992) ("Relatively less attention, however, has been given to what is an increasingly common phenomenon: municipalities of all sizes which, for a variety of reasons, are failing on a regular basis to balance revenues and expenditure flows."); *see also* WILLIAM J. PAMMER, JR., *MANAGING FISCAL STRAIN IN MAJOR AMERICAN CITIES: UNDERSTANDING RETRENCHMENT IN THE PUBLIC SECTOR*, at xiii (1990) (explaining that, according to several studies, a significant portion of the nation's cities were experiencing some degree of financial strain in the 1970s, and this trend continued (albeit to a lesser extent) in the 1980s and 1990s).

³ MARTIN SHEFTER, *POLITICAL CRISIS/FISCAL CRISIS: THE COLLAPSE AND REVIVAL OF NEW YORK CITY*, at xiii (1985) ("Indeed, these [municipal fiscal crises] occur with sufficient regularity that fiscal crises should be regarded not as aberrations, but as an integral part of American urban politics.").

⁴ *See, e.g.*, Lawrence P. King, *Municipal Insolvency: The New Chapter IX of the Bankruptcy Act*, 1976 DUKE L.J. 1157, 1175; Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1040 (1997); Michael W. McConnell & Randal C. Picker, *When Cities Go Broke, A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 450 (1993); Steven L. Schwarcz, *Global Decentralization and the Subnational Debt Problem*, 51 DUKE L.J. 1179, 1190 (2002); Frederick Tung, *After Orange County: Reforming California Municipal Bankruptcy Law*, 53 HASTINGS L.J. 885, 907 (2002); Barry Winograd, *San Jose Revisited: A Proposal For Negotiated Modification of Public Sector Bargaining Agreements Rejected Under Chapter 9 of the Bankruptcy Code*, 37 HASTINGS L. J. 231, 235 (1985).

phenomenon experienced by American cities, and present several possible remedies or approaches to deal with it. My analysis shows that notwithstanding academics' focus on the bankruptcy code, a different remedy – state financial boards, on which there is hardly any legal writing – can address local crises more effectively.⁵

This Article discusses three types of remedies that have been developed over the years to address municipal financial crises: creditors' remedies, the Bankruptcy Code and state financial boards. Each of these remedies represents a distinct approach to the problem of local insolvency, and each places the burden of the crisis on a different entity. One approach, represented by the creditors' remedies, requires the residents to pay the locality's debts through raising the local taxes. According to this approach, since the residents enjoy the services the locality provides, they should also be the ones financing the local obligations with the taxes they pay. A second approach, represented by chapter 9 of the Bankruptcy Code, allows an insolvent municipality to shift part of its costs onto its creditors by discharging part of the local debt in bankruptcy. This approach places the burden of the crisis on the creditors, in an attempt to help the locality increase its productivity and recover. Yet a third approach – the remedy of state financial boards – deals with the crisis with the help of the state. The state intervenes in the distressed locality's fiscal affairs and tries to help the locality recover. This Article analyzes the advantages and shortcomings of these approaches, with a special emphasis on the entities who are made to bear the burden of remedying the crisis under each approach.

In this Article I claim that the third remedy – state financial boards, which place the burden of the crisis on the state – is the most efficient remedy for local crises. The reason for this claim is that the state, as opposed to the residents or the creditors, has the ability to prevent potential crises and to minimize their harmful effects. Neither creditors nor local residents can avoid looming crises, because often the causes of these crises are outside their (and the local officials') realm of control. The state, on the other hand, has both the legal authority and the political power to deal with the causes of urban crisis, and thereby to rehabilitate ailing localities.

The analysis presented in this Article has important practical implications. Despite the importance of state intervention in times of local distress, only a few states have codified their policy on this issue, and the absence of such codification has often delayed state assistance to localities in poor financial

⁵ One exception to the legal community's general disregard of state financial boards is a note published in *Harvard Law Review* in 1996. Note, *Missed Opportunity: Urban Fiscal Crises and Financial Control Boards*, 110 HARV. L. REV. 733, 735-45 (1996) [hereinafter *Missed Opportunity*]. However, even this note mentions the lack of legal research on this subject, indicating that "[t]o date, no one has undertaken a systematic study of financial control boards as a genre of state institutional responses to urban fiscal crises." *Id.* at 734 n.8.

health.⁶ Without a statutory obligation to address local fiscal decline, cities have been left to suffer from financial crises that perhaps could have been avoided with the state's help. This Article explains how codifying the state financial boards approach can mitigate these problems and details the advantages of codification to both cities and states. I show not only that such legislation can contribute to the fiscal health of local governments, but also that it can help cities reduce the interest rates they pay on a regular basis. North Carolina's local governments, for example, save up to \$100 million per year as a result of a system of state supervision of local fiscal health⁷ similar to the system I propose in this Article. This, of course, facilitates lower tax rates and better services to local residents.

The rest of this Article proceeds as follows. I first provide background for the argument: Part I explores the causes of local financial decline, and Part II examines the various remedies the legal system currently offers. After laying down the necessary foundations, Part III studies the adequacy of the different remedies, with a special focus on state intervention. I argue that state intervention is the most effective remedy for local financial crises, and explain why the state can deal with local crises in cases where residents, creditors, and local officials have failed. Part IV of the Article discusses municipal insolvency statutes, and demonstrates their advantages through a case study of the legislation in North Carolina.

I. THE CAUSES OF MUNICIPAL FINANCIAL DISTRESS

At first glance it seems that a city's economic situation should be fairly stable. On the revenue side, most cities' primary source of income is property tax.⁸ Property tax is considered to be a relatively reliable revenue source because it fluctuates less than comparable taxes, such as income and sales taxes, and municipalities have reasonably good ways of collecting it.⁹ On the expenditure side, municipalities usually don't have large, unexpected

⁶ See discussion *infra* Part IV.

⁷ See discussion *infra* Part IV.B.

⁸ 4 ANTIEAU ON LOCAL GOVERNMENT LAW § 64.19 (Sandra M. Stevenson ed., 2d ed. 2007).

⁹ In many states, local governments are required to establish property tax rates that will yield the same amount of revenue given current assessed values as collected in the prior fiscal year, and these municipalities are barred from adopting rates that will generate more revenue unless they act in accordance with special procedures. RONALD C. FISHER, STATE AND LOCAL PUBLIC FINANCE 330 (1996). Tax collection efforts are highly effective because property tax debts become a lien on the real property. 4 ANTIEAU ON LOCAL GOVERNMENT LAW, *supra* note 8, § 64.27[3]. The property cannot be sold without paying the property taxes in full, and even if the owner of the property does not sell it, the municipality can execute on the property and get the tax debt back. *Id.* § 64.27[4].

expenses.¹⁰ They can plan their spending relatively well and they can use revenue estimates to match their costs with their future income.¹¹ A municipal financial crisis, therefore, may seem unlikely. Nonetheless, it is not unheard of for American cities to experience severe financial strain. In the past thirty years, several of the largest U.S. cities have undergone a crisis, and many others have experienced at least some degree of financial distress.¹² The question thus arises: why do some municipalities suffer from severe economic difficulties despite their seemingly stable economies?

A financial crisis does not evolve for one single reason;¹³ rather, a combination of several factors is usually responsible for the decline in a city's economic wellbeing, and different circumstances may make one city more financially vulnerable than others. Scholars, however, disagree on the exact nature of these factors, and especially on their relative importance. Examining the literature on this subject reveals two major approaches:¹⁴ some argue that socioeconomic processes beyond the control of local officials are at the root of the local crisis, while others believe that the local management and the political environment are the real reasons for the financial decline.

A. *The Socioeconomic-Decline Approach*

The socioeconomic-decline approach views external economic and social changes, rather than internal political decisions, as the primary causes of urban crises. This approach attributes municipal financial distress mostly to demographic and structural circumstances that are beyond the control of local officials.¹⁵ Helen Ladd and John Yinger, for example, advocate this view in their book *America's Ailing Cities*.¹⁶ After studying the fiscal health of eighty-six American cities, the authors concluded:

¹⁰ A major component of local government finance is labor costs, which are relatively stable and thus highly amenable to future planning. See FISHER, *supra* note 9, at 151.

¹¹ See *id.* at 268-85.

¹² See *supra* note 2 and accompanying text.

¹³ An exception would be, for example, a small town with a few dozen residents which faces an unexpected financial shock, such as the loss of a personal injury lawsuit or a natural disaster. An example of such a case is the city of Bay St. Louis, which lost a personal injury lawsuit and was ordered to pay the plaintiff \$375,000. The city could not afford to pay the plaintiff and filed for bankruptcy. See ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, BANKRUPTCIES, DEFAULTS, AND OTHER LOCAL GOVERNMENT FINANCIAL EMERGENCIES 8-10 (1985).

¹⁴ David R. Morgan & Robert E. England, *Explaining Fiscal Stress Among Large U.S. Cities: Toward an Integrative Model*, 3 POL'Y STUD. REV. 73, 73-74 (1983).

¹⁵ *Id.* at 73; see also Larry C. Ledebur, *City Fiscal Distress: Structural, Demographic and Institutional Causes*, in *Problems of Urban America: Hearing Before the H. Comm. on Gov't Reform*, 102d Cong. 230, 232 (1991) (report of the National League of Cities); HELEN F. LADD & JOHN YINGER, *AMERICA'S AILING CITIES: FISCAL HEALTH AND THE DESIGN OF URBAN POLICY* 3-6 (1989).

¹⁶ LADD & YINGER, *supra* note 15.

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. Poor fiscal health is not caused by poor management, corruption or profligate spending, and a city government's ability to alter the city's fiscal health is severely limited.¹⁷

Instead of managerial factors, the socioeconomic decline approach emphasizes three groups of causes that explain cities' fiscal stress: national business cycles, suburbanization and decline in local business activity, and state and federal policies towards local governments. Usually, it is the combination of these factors that results in a fiscal crisis, but for analytical purposes I review them one by one.

1. The National Economy

The national economy goes through different economic periods; some are periods of growth and prosperity, while others are characterized by recession and unemployment. Evidence suggests that local economies (and, to a lesser extent, the private and federal sectors) are influenced by these trends in the national economy.¹⁸ The effects of national economic cycles on local governments are understandable; in times of recession the municipality's ability to generate revenues from taxes declines,¹⁹ while municipal expenditures, especially welfare costs, increase.²⁰ In addition, when inflation strikes, municipal tax revenues (usually in the form of property tax) often do not catch up, and so the locality's income lags behind the nominal growth of expenditures (mostly in the form of employment costs).²¹ Research thus shows that municipal defaults are closely related to the country's business cycles. The greatest number of defaults occurred during periods of recession, and these periods have been followed by economic expansion, in which municipalities have also experienced relatively strong growth.²²

¹⁷ *Id.* at 291.

¹⁸ See TERRY N. CLARK & LORNA C. FERGUSON, *CITY MONEY: POLITICAL PROCESSES, FISCAL STRAIN, AND RETRENCHMENT* 85-91 (1983); PEARL M. KAMER, *CRISIS IN URBAN PUBLIC FINANCE: A CASE STUDY OF THIRTY-EIGHT CITIES* 40-43 (1983).

¹⁹ See KAMER, *supra* note 18, at 41-43; see also CLARK & FERGUSON, *supra* note 18, at 90.

²⁰ KAMER, *supra* note 18, at 129-31.

²¹ CLARK & FERGUSON, *supra* note 18, at 85-91; KAMER, *supra* note 18, at 40-43.

²² Natalie R. Cohen, *Municipal Default Patterns: An Historical Study*, 9 *PUB. BUDGETING & FIN.* 55, 55 (1989). On the effect of macroeconomic parameters on the municipal bond market, see generally Bradley T. Ewing, *Economic Forces and the Municipal Bond Default Risk Premium*, 23 *MUN. FIN. J.* 17, 17 (2002).

2. Suburbanization and Population Changes

Another important socioeconomic cause of cities' economic decline is demographic change and suburbanization.²³ Suburbanization is the mass movement of households and firms out of the city and into the suburbs.²⁴ Usually, it is businesses and middle- or upper-class residents who leave, while the city is left with a higher percentage of poor residents. Suburbanization, then, has a doubly negative effect on a city. First, the city's tax base decreases significantly due to out-migration of affluent taxpayers. Second, the city's expenditures increase due to the in-migration of a more economically deprived population (which presumably requires more welfare and social services).²⁵

Thus, a vicious circle, which can potentially lead the city into economic crisis, begins; in order to finance the growing expenditures, taxes are raised. Higher taxes trigger an out-migration of even more corporations and individuals, and so additional taxes are, again, necessary.²⁶ These additional taxes drive even more residents out, and so on. Moreover, suburbanization causes the city to lose its agglomeration economies.²⁷ Middle class residents want to live with their former neighbors and friends, and they follow them to the suburbs.²⁸ Service industries and cultural activity providers suffer from reduced patronage, and (following their former clients) also move out of the city.²⁹ This further reinforces the decline of the city.³⁰

Examples of this phenomenon are numerous. In the United States, a major process of suburbanization took place during the 1960s and 1970s. The negative consequences of the suburban development were felt mostly in northern cities. Unlike cities in the South and West, the northern cities were unable to annex surrounding territories and thereby recapture the lost population and economic activity.³¹ Thus, cities like New York, Baltimore,

²³ PAMMER, *supra* note 2, at 5; *see also* JAMES M. HOWELL & CHARLES F. STAMM, *URBAN FISCAL STRESS: A COMPARATIVE ANALYSIS OF 66 U.S. CITIES 4-6* (1979) (analyzing the fiscal health of sixty-six mid-sized American cities, and concluding that older industrial cities are the most likely to be in financial trouble); IRENE S. RUBIN, *RUNNING IN THE RED: THE POLITICAL DYNAMICS OF URBAN FISCAL STRESS 5-7* (1982); Katherine L. Bradbury, Anthony Downs & Kenneth A. Small, *Some Dynamics of Central City-Suburban Interactions*, 70 *AM. ECON. REV.* 410, 411 (1984).

²⁴ *See* KAMER, *supra* note 21, at 25-30.

²⁵ These effects were a major cause of New York City's fiscal crisis. *See* Donna E. Shalala & Carol Bellamy, *A State Saves a City: The New York Case*, 1976 *DUKE L.J.* 1119, 1119-20.

²⁶ *See* KAMER, *supra* note 18, at 26, 28.

²⁷ *Id.* at 28.

²⁸ *Id.*

²⁹ *Id.*

³⁰ Anne Marie Vassallo, Note, *Solving Camden's Crisis: Makeover or Takeover?*, 33 *RUTGERS L.J.* 185, 189 (2001).

³¹ Kamer reports that in the 1960s the five northern cities she studied failed to annex surrounding territory, whereas seven of the ten southern cities and seven of the ten western

and Philadelphia lost a significant number of jobs and taxpaying businesses, and they suffered from severe fiscal stress.³²

3. Intergovernmental Policies

Yet a third reason for the local decline is intergovernmental – especially state – policies regarding local governments. States have an enormous effect on the local economy and their actions sometimes contribute to local fiscal stress or even to financial crises.

Generally speaking, state involvement in local finances affects both the ability of municipalities to generate revenue and their level of expenditures. On the revenue side, states often control which taxes local governments may collect and the rules under which such taxes are collected.³³ They also give taxing authority to overlapping jurisdictions, such as counties or districts.³⁴ In addition, states usually dispense intergovernmental aid, and these funds comprise a significant portion of many localities' income.³⁵ On the expenditure side, states decide the public services for which cities are responsible, and determine the level at which these services are provided.³⁶ Local fiscal problems thus occur when states assign local governments (especially large cities) too many public responsibilities, and do not give them appropriate taxation tools or transfer sufficient funds to finance the assigned services.³⁷

This was the case with several cities during the 1980s. In the early 1980s, the federal government significantly reduced the aid it offered local governments.³⁸ This decrease in intergovernmental aid was not accompanied with a corresponding decline in the services local governments were

cities she studied did annex formerly suburban cities and thereby gained 380,000 residents. During the 1970s, the Northern cities again failed to annex surrounding territory, but Southern cities annexed approximately 360 square miles, thereby gaining 320,000 residents. KAMER, *supra* note 21, at 27.

³² See Honadle, *supra* note 2, at 1463-70.

³³ 4 ANTIEAU ON LOCAL GOVERNMENT LAW, *supra* note 8, §§ 64.01, 64.03.

³⁴ Cf. *id.* § 64.03 (observing that “[s]ome state legislatures have conferred upon local governments the power to tax properties and events outside the local limits,” or have allowed “local governments to create joint economic development districts which could levy and impose income taxes”).

³⁵ See FISHER, *supra* note 9, at 273-74.

³⁶ See generally JOHN E. PETERSEN, WAYNE STALLINGS & CATHERINE L. SPAIN, STATE ROLES IN LOCAL GOVERNMENT FINANCIAL MANAGEMENT: A COMPARATIVE ANALYSIS (1979) (analyzing nine different states and finding moderate to high levels of state involvement in local financial management in most of those states).

³⁷ LADD & YINGER, *supra* note 15, at 8-9. For an in-depth analysis of unfunded state mandates, 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, 1359 (1993).

³⁸ Ledebur, *supra* note 15, at 242.

responsible for, and as a result many local governments suffered from fiscal strain.³⁹ Robert Inman, for example, lists the lack of intergovernmental support as one of the causes of the Philadelphia financial crisis.⁴⁰

We can see, therefore, that various socioeconomic factors beyond the local officials' realm of control can cause municipal financial difficulties. However, even in the presence of some or all of the socioeconomic forces described above, many scholars believe that circumstances internal to the locality are the main reason for financial crises. The views of these scholars are discussed in the next Section.

B. *The Local-Management Approach*

The local-management approach focuses on the municipality's political and financial management. According to this perspective, it is the distribution of power inside a community and how the city manages its resources that determine its fiscal fate.⁴¹ Advocates of this approach do not ignore the socioeconomic processes the city undergoes and they acknowledge that external factors influence a city's financial status.⁴² However, they claim that the city's political system is the ultimate determinant of whether the city will deteriorate into a crisis or will remain in relatively good fiscal health.⁴³

Within the local-management approach there are two somewhat opposing views. One view regards the local officials' skill and competence as the determining factor in the city's financial fate, while the other, more common view focuses not on the officials themselves, but rather on the political system in which they operate.

1. Municipal Officials

According to this view, the abilities and skills of municipal officials determine a city's financial fate. Incompetent local officials will often implement unsound financial practices, and these in turn may result in fiscal

³⁹ *Id.*

⁴⁰ Robert P. Inman, *How To Have a Fiscal Crisis: Lessons from Philadelphia*, 85 AM. ECON. REV. 378, 380-83 (1995) (comparing Philadelphia's per-resident federal and state aid to that of other cities). Inman shows that, just like other cities, Philadelphia lost significant federal aid during the 1980s. *Id.* However, whereas state aid to other cities rose to offset this decline, Philadelphia did not enjoy the same increase. *Id.* Philadelphians gained only \$0.61 for each dollar increase in per-resident state aid gained by other cities. *Id.* Thus, on balance the city's position deteriorated.

⁴¹ See, e.g., JOAN K. MARTIN, URBAN FINANCIAL STRESS: WHY CITIES GO BROKE 129 (1982) (arguing that many local fiscal problems derive from managers' manipulations of local accounting procedures).

⁴² *Id.* ("Some structural constraints definitely cause very large deficits, but accumulating deficits come from accounting manipulations perpetrated by management.").

⁴³ *Id.*

crisis.⁴⁴ Scholars who advocate this approach tend to focus on the distressed locality's financial disclosure practices, and have shown that when faced with declining revenues, local officials do not cut costs, but rather use financial and accounting gimmicks to create the appearance of a healthy locality.⁴⁵ These tricks enable the officials to continue with high levels of public spending notwithstanding the dwindling revenues; eventually, however, the economic reality catches up, and a financial crisis develops.⁴⁶

Joan Martin studied the financial distress of Boston⁴⁷ and Detroit,⁴⁸ and argued that in both cases official financial management was a core reason for the cities' deterioration.⁴⁹ The cities' officials constantly overestimated the forthcoming revenues and underestimated the city's fund reserves problem, and so they justified large spending that had no real connection to the city's actual economic base.⁵⁰ Martin concluded, therefore, that the accumulating municipal deficits resulted from accounting manipulations that local management perpetuated.⁵¹

A view that focuses solely on municipal officials, however, misses a far richer and contextual perspective about the environment in which the officials operate. Often, these officials' accounting gimmicks and short-term thinking are but symptoms of deeper problems rooted in the political pressures under which officials work. A second, more common view of the local-management approach focuses on the political environment.

2. The Political Environment

The political-environment view focuses not on the municipal officials themselves, whether or not corrupt, but rather on the political system that constrains the officials' decisions. According to this view, differences in political characteristics can explain why certain municipalities, other socioeconomic conditions being equal, enter into financial crises while others do not. Research on the subject, in the context of both cities and sovereigns,

⁴⁴ See, e.g., MARTIN, *supra* note 41, at 47-52; PAMMER, *supra* note 2, at 8-9.

⁴⁵ For example, officials might use debt proceeds to help the city pay for ongoing (non-capital) expenditures, recognize revenues the locality still hasn't collected, or not take into account already accrued expenditures. See, e.g., STAFF OF THE SEC. & EXCH. COMM'N, REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK, ch. 1, at 188 (Comm. Print 1977).

⁴⁶ PAMMER, *supra* note 2, at 8.

⁴⁷ MARTIN, *supra* note 41, at 45-52.

⁴⁸ *Id.* at 53.

⁴⁹ *Id.* at 45.

⁵⁰ *Id.* at 46-47.

⁵¹ *Id.* at 129.

emphasizes political fragmentation as a key reason for excessive public spending and for the creation of deficits.⁵²

Political fragmentation measures the degree to which the cost of a dollar of aggregate expenditure is internalized by the individual fiscal decision-maker.⁵³ The more fragmented the political system, the more likely the local government will suffer from financial difficulties. Scholarly writing about fragmentation often distinguishes between two of its aspects: size and procedure.⁵⁴

Size fragmentation is related to the number of social groups that participate in the budgetary process through their representatives. As the number of participants increases, the total budget expenditure increases as well.⁵⁵ The reasoning behind this observation derives from the common pool problem: when multiple fragments of the community participate via their representatives in the budget process, each fragment fully enjoys the benefits of its own (successful) budgetary demands, but shares the costs of those demands with all other residents.⁵⁶ Each group internalizes only a fraction of the costs of its demands and thus has an incentive to increase the value of the demands.⁵⁷ Because all the groups that participate in the process are subject to the same incentive structure, they will all tend to increase their budgetary demands and expenditures are thus inflated.⁵⁸

⁵² Reza Baqir, *Districting and Government Overspending*, 110 J. POL. ECON. 1318, 1347 (2002); 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, 369 (2004); Nouriel Roubini & Jeffrey D. Sachs, *Political and Economic Determinants of Budget Deficits in the Industrial Democracies*, 33 EUR. ECON. REV. 903, 922 (1989) (“Our main finding is that multi-party coalition governments, especially those with a short expected tenure, are poor at reducing budget deficits.”); Mark Hallerberg & Jürgen von Hagen, *Electoral Institutions, Cabinet Negotiations, and Budget Deficits in the European Union* 9 (Nat’l Bureau of Econ. Research, Working Paper No. 6341, 1997), available at <http://www.nber.org/papers/w6341.pdf>; Guntram B. Wolff, *Fiscal Crisis in U.S. Cities: Structural and Non-Structural Causes* 17 (Ctr. for European Integration Studies, Working Paper No. B28, 2004), available at http://www.zei.de/download/zei_wp/B04-28.pdf (“Increased fragmentation is found to be positively associated with the level of property taxation and there is some evidence for increased spending as well.”).

⁵³ Perotti & Kontopoulos, *supra* note 52, at 192.

⁵⁴ *Id.* at 192-93.

⁵⁵ *Id.* at 195.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ Assuming n is the number of different groups participating in the budgetary process, then each group internalizes $1/n$ of the costs of its demands. In a fragmented community, as n increases, $1/n$ decreases, and so each group internalizes the repercussions of its demands to a lesser extent. The total expenditure, therefore, increases. *Id.*; Barry R. Weingast, Kenneth A. Shepsle & Christopher Johnsen, *The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics*, 89 J. POL. ECON. 642, 653 (1981); Wolff,

Take, for example, the building of public swimming pools.⁵⁹ Usually, the costs of construction are taken from the public budget, but the pool will be used only by a specific segment of the community, i.e., those who like swimming and live relatively close to the pool. Nearby swimmers, therefore, have an incentive to pressure politicians to build a larger, more expensive pool. The swimmers will enjoy the pool's benefits, while the costs will be shared with the entire community. The same rationale of course applies not just to users of public facilities, but to many other local groups who enjoy a restricted benefit from local expenditures while the cost of that benefit is paid for out of the local fisc, such as districts, religious groups, racial groups, business firms, and the like.⁶⁰ Naturally, as the number of groups in the community increases (or, in other words, as size fragmentation increases), so do the budgetary pressures. Each group internalizes a smaller fraction of the costs it wishes to impose on the community.⁶¹

Furthermore, within a fragmented political environment, interest groups play a very dominant role. Public officials often need interest-group support to be re-elected, and so interest groups have considerable influence over government policies, especially financial policies.⁶² By definition, however, interest groups represent only a certain sector of the community. They promote the group's narrow interest, sometimes at the expense of the community as a whole. The common pool problem is thus aggravated.⁶³ In many cases of local crises, perhaps the most important and influential interest

supra note 52, at 5-7 (presenting a model of municipal demand for public goods, in which there is no heterogeneity of preferences).

⁵⁹ The example is taken from Wolff, *supra* note 52, at 5.

⁶⁰ *See id.*

⁶¹ The effects of the budgetary pressures may not be severe in cases in which the mayor enjoys the support of an absolute majority of the local residents. In these cases the mayor can prioritize the different demands and has the power to resist pressures to spend more than the locality can afford. Usually, however, and especially in fragmented localities, the mayor does not govern alone and needs to form a coalition to take power. Therefore, politically, the mayor is obligated to comply with the demands of different groups, even those demands the locality cannot afford. The mayor needs to sustain a coalition, and he or she may do so even at the expense of the locality's long-term financial health. Indeed, empirical evidence shows that large coalitions and (for nations) large cabinet sizes tend to result in larger deficits and lack of fiscal control. *See Ricciuti, supra* note 52, at 381-83. Ricciuti provides a review of the empirical literature regarding political fragmentation. *Id.* at 366-68; *see also* Wolff, *supra* note 52, at 17 ("Increased fragmentation is found to be positively associated with the level of property taxation and there is some evidence for increased spending as well.").

⁶² *Cf. Ricciuti, supra* note 52, at 370-71 (discussing the influence wielded by interest groups and opposition members in parliaments and the effects of that influence on fiscal policy outcomes).

⁶³ Indeed, the more interest groups there are in a locality, the more likely it is the locality will enter a financial crisis. *See Wolff, supra* note 52, at 38-39.

groups are public employees unions.⁶⁴ Pietro Nivola has shown that the level of unionization among city employees is significantly correlated with local fiscal strain indicators.⁶⁵ Nivola explains that due to the city's political structure, municipal officials cannot resist the unions' "raid on their treasuries," and the city consequently enters a financial crisis.⁶⁶

An additional aspect of political fragmentation – apart from the size fragmentation discussed so far – is procedural. Procedural fragmentation has to do with the procedure according to which fiscal policy is ultimately decided.⁶⁷ Indeed, not only does the number of decision makers affect government spending, but so also does the way in which decision makers interact with one other. For example, research shows that when the budgetary process is decentralized (each decision maker has the same voting power, with no one entity controlling the process) spending tends to increase.⁶⁸ On the other hand, granting one entity (e.g., the treasurer or the minister of finance) a right to veto the budget's approval can significantly reduce the government's deficit.⁶⁹ Procedural changes can thereby improve local fiscal health, even for localities suffering from a given level of size fragmentation.⁷⁰

Ester Fuchs has demonstrated the importance of the political environment to the development of a fiscal crisis by pointing out the differences between the respective experiences of Chicago and New York in the 1970s.⁷¹ Fuchs has shown that although the two cities experienced similar socioeconomic processes, New York underwent a severe fiscal crisis whereas Chicago stayed in relative financial health.⁷² The reason for their different financial fates, according to Fuchs, lay in the cities' different political environments.⁷³ Whereas New York was dominated by multiple interest groups with no one central authority that controlled the budget,⁷⁴ Chicago had a strong party

⁶⁴ "As the head of New York's sanitation union once declared: 'We have a natural advantage that no [private sector] union has. We can elect our employers.'" Pietro S. Nivola, *Apocalypse Now? Whither the Urban Fiscal Crisis*, 14 *POLITY* 371, 376 (1982).

⁶⁵ *Id.* at 384.

⁶⁶ *Id.* at 375.

⁶⁷ Perotti & Kontopoulos, *supra* note 52, at 196-97.

⁶⁸ See Riciutti, *supra* note 52, at 369.

⁶⁹ Perotti & Kontopoulos, *supra* note 52, at 196.

⁷⁰ See *id.* Perotti and Kontopoulos cite Hallerberg and von Hagen, who emphasize the importance of sequencing the different stages of the budgetary process. See Mark Hallerberg & Jürgen von Hagen, *Sequencing and the Size of the Budget: A Reconsideration* 6-11 (Ctr. for Econ. Policy Research, Working Paper No. 1589, 1997), available at <http://www.cepr.org/pubs/dps/DP1589.asp>; see also Baqir, *supra* note 52, at 1347 (discussing variations of forms of government at the city level).

⁷¹ See generally ESTER R. FUCHS, *MAYORS AND MONEY: FISCAL POLICY IN NEW YORK AND CHICAGO* (1992).

⁷² *Id.* at 5-6.

⁷³ *Id.* at 6-7.

⁷⁴ *Id.* at 242-50.

machine that was able to resist budgetary pressures.⁷⁵ Chicago, therefore, was able to respond to the socio-economic changes, while New York spent its way to a fiscal crisis.

Note, however, that municipal officials arguably are very much the “victims” of the political environment that caused the crisis, rather than the crisis’s creators. The mayor does not determine the level of fragmentation in a city, and the mayor has a limited ability to change the budgetary procedures. The mayor operates within the political system, and so in many ways has no option but to respond to the system’s mandates. Therefore, even if we subscribe to the local-management view, the underlying causes of local crises might still be very much outside the local officials’ realm of control.

II. THE LEGAL REMEDIES FOR MUNICIPAL INSOLVENCY

Over the years, as a consequence of different periods of local crises, three types of legal remedies have been developed to address municipal insolvency: creditors’ remedies, chapter 9 of the Bankruptcy Code, and state financial boards. Each one of these remedies establishes a different procedure for dealing with a local financial crisis, and each remedy differently balances the interests of the players involved: the residents, the creditors, and the state.

In this Part, I briefly describe each of these remedies. This description does not purport to be an in-depth analysis, but rather provides an outline of each type of remedy. Specifically, I examine what procedures each remedy prescribes, and what rights each assigns to the creditors and to the locality.

A. *The Creditors’ Remedies*

Generally speaking, both in the private and the municipal contexts, when a debtor does not pay its debts in full, its creditors can go to court to coerce the repayment of their obligation. If the creditors prevail in their lawsuit, they receive a judgment in their favor, and then – to the extent the debtor still refuses to pay – they may resort to various remedies to enforce the judgment.⁷⁶ In the private sphere, the enforcement of a judgment usually entails its “execution,”: the creditors may foreclose on the debtor’s real estate, might physically take personal goods, and might even resort to “garnishment,” requiring a third party to pay the creditor part of what the third party owes to the debtor.⁷⁷ In the municipal context, however, even if the creditors receive a favorable judgment against a locality, their ability to enforce the judgment is very limited.

⁷⁵ *Id.* at 251-61.

⁷⁶ The rationale behind these remedies is that without the means to force debtors to repay their creditors, individuals and institutions would be unwilling to extend credit, and the lack of credit would damage the economy as a whole. See Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 315-16.

⁷⁷ See DAVID G. EPSTEIN, *BANKRUPTCY AND RELATED LAW IN A NUTSHELL* 38-59 (7th ed. 2002).

In most jurisdictions, the remedies of execution or garnishment are largely unavailable to aid municipal bondholders.⁷⁸ In some states, the legislature has expressly immunized municipal property from execution by statute.⁷⁹ In other states, courts have reached similar results by interpreting remedial statutes narrowly.⁸⁰ Whatever the source of the prohibition, most of the locality's assets are out of the creditors' reach.⁸¹ The prohibition on execution encompasses not only tangible assets – such as police cars, streets, or municipal buildings – but also financial assets.⁸² The latter category includes not only funds that are part of the local budget, but also funds such as rent⁸³ or insurance proceeds⁸⁴ that localities receive. As long as the funds are slated to finance the locality's public expenditures, they cannot be reached by the creditors. The rationale for this rule was explained by the Texas Court of Appeals:

It is easy to foresee what would be some of the results of an exercise of such a right by creditors of a city. Its revenues, which should be devoted to the accomplishment of the purposes for which it exists as a municipality, would be wasted in the payment of court costs, etc., and it soon would be without means to carry on its governmental affairs. We are unwilling to concede that a right, the exercise of which might be fraught with such consequences to a city, exists in favor of its creditors.⁸⁵

⁷⁸ Most jurisdictions distinguish between “public assets,” which are essential for performance of the localities' duties (and thus are not subject to execution), and “private [proprietary] assets,” which are not essential for public purposes (and therefore are subject to execution). In practice, however, the tests courts use to distinguish between the different kinds of assets are extremely vague, and courts have found public characteristics in virtually every municipal asset. The vast majority of municipal assets, therefore, cannot be reached by the creditors. See ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, *MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE* § 5.4.3, at 248-49 (1992); McConnell & Picker, *supra* note 4, at 432-33.

⁷⁹ 17 EUGENE MCQUILLIN, *THE LAW OF MUNICIPAL CORPORATIONS* § 49:44, at 397 & nn.9-10 (3d ed. rev. 2004).

⁸⁰ *Id.* § 49:44, at 394 & n.1.

⁸¹ See *Bd. of Councilmen v. White*, 6 S.W.2d 699, 701 (Ky. 1928); *American-La France & Foamite Indus., Inc. v. Town of Winnfield*, 168 So. 293, 295 (La. 1936); *Lyon v. City of Elizabeth*, 43 N.J.L. 158, 161-64 (1881); Jeff B. Fordham, *Methods of Enforcing Satisfaction of Obligation of Public Corporations*, 33 COLUM. L. REV. 28, 29 (1933); Note, *Creditors' Remedies in Municipal Default*, 1976 DUKE L.J. 1363, 1369.

⁸² AMDURSKY & GILLETTE, *supra* note 78, § 5.4.4, at 252; Fordham, *supra* note 81, at 30-32.

⁸³ *Klein v. New Orleans*, 99 U.S. 149, 151 (1878); *Lee v. City of Fairfield*, 145 So. 669, 671 (Ala. 1933).

⁸⁴ *Ellis v. Pratt City*, 20 S. 649, 650 (Ala. 1896).

⁸⁵ *Capps v. Citizens Nat'l Bank*, 134 S.W. 808, 810 (Tex. Civ. App. 1911); see also *Estate of DeBow v. City of E. St. Louis*, 592 N.E.2d 1137, 1140-42 (Ill. App. Ct. 1992).

Due to these limitations, creditors find little comfort in traditional creditors' remedies. As an alternative, a specific remedy for creditors of municipalities has evolved – a writ of mandamus to collect taxes,⁸⁶ which is a court order that instructs a locality to levy and collect taxes in an amount sufficient to pay a judgment rendered against the locality.⁸⁷ The scope of the writ may vary from case to case, but usually the court will instruct the municipality to include a tax levy sufficient to pay the judgment in full in the next current budget.⁸⁸ Pursuant to the mandamus, then, the municipality must levy a special tax or increase the rates of existing taxes, while it transfers the extra tax revenues to the creditors as payment for their claims.⁸⁹ The mandamus thus forces the residents to finance the municipality's financial obligations through increased tax payments. Note, however, that the court itself does not directly impose the taxes.⁹⁰ The writ is addressed to the municipal officers who generally have the authority to levy and collect taxes, and the tax is imposed in accordance with the general state laws and constitution.⁹¹ Thus, the court may not force a locality to increase its taxes above any limits prescribed in the state's statutes, and the creditors can use only the surplus of the revenues the municipality receives above the amount it needs for the local operating expenses.⁹²

Despite its limitations, however, the mandamus remedy is essentially based on the premise that the residents of a locality should pay for the debts that their locality has incurred.⁹³ Thus, courts do not allow localities to repudiate their financial obligations when they are legally and economically able to collect

(holding as a matter of public policy that a judgment creditor may not execute on city property to satisfy a debt).

⁸⁶ The writ of mandamus is generally defined thus:

[A] command, issuing from a court of competent jurisdiction, in the name of the state or sovereign, directed to some corporation, public or private, or an officer of it . . . requiring the performance of a particular specified duty which results from the official station of the party to whom the writ is directed, or from the operation of law.

See 17 MCQUILLIN, *supra* note 79, § 51:2, at 700-01.

⁸⁷ See AMDURSKY & GILLETTE, *supra* note 78, § 5.4.1, at 241; A.M. HILLHOUSE, MUNICIPAL BONDS: A CENTURY OF EXPERIENCE 297 (1936); Fordham, *supra* note 81, at 32.

⁸⁸ HILLHOUSE, *supra* note 87, at 280.

⁸⁹ *Id.*

⁹⁰ "The writ, when granted, directs *the appropriate official* to levy and collect taxes or to pay debt service out of funds already in the treasury." AMDURSKY & GILLETTE, *supra* note 78, § 5.4.1, at 241 (emphasis added).

⁹¹ See *id.* § 5.4.1, at 242-44.

⁹² See, e.g., Defoe v. Town of Rutherfordton, 122 F.2d 342, 344 (4th Cir. 1941); Md. Cas. Co. v. Leland, 199 S.E. 7, 9 (N.C. 1938); AMDURSKY & GILLETTE, *supra* note 78, § 5.4.1, at 244; HILLHOUSE, *supra* note 87, at 279-80; 17 MCQUILLIN, *supra* note 79, § 49:43, at 393.

⁹³ Cf. AMDURSKY & GILLETTE, *supra* note 78, § 5.4.1, at 242-43 ("It is, of course, not depletion of the public treasury that is the ultimate concern of the courts. Up to the point of any statutory or constitutional tax limit, the treasury could be replenished by imposing additional taxes on the issuer's constituents.").

revenues that can be paid to the creditors and localities are expected to maximize their tax-raising capacity before defaulting on their obligations. Conceptually, then, the writ can be thought of as placing the burden of the local crisis on the residents. The residents finance the local deficit and settle the local debts with the taxes they pay.⁹⁴

B. *Chapter 9 of the Bankruptcy Code*

The federal Bankruptcy Code deals with insolvent municipalities in a different manner. Chapter 9, the municipal bankruptcy chapter, enables insolvent localities to seek bankruptcy protection from their creditors, and it provides them with a breathing spell during which to negotiate a debt readjustment plan. In this Section I briefly discuss the municipal bankruptcy procedure, and especially focus on those aspects which distinguish it from corporate bankruptcy.

Perhaps the first difference to note between chapter 9 and other bankruptcy procedures is that municipal bankruptcy is not readily accessible. To enjoy bankruptcy protection, a locality must meet five threshold requirements, which are different (and more difficult) than the requirements other debtors face.⁹⁵ These threshold requirements include, *inter alia*, express and direct state approval for the bankruptcy filing,⁹⁶ as well as an insolvency requirement.⁹⁷

Assuming these threshold requirements are met, the first step in the municipal bankruptcy process is the implementation of an automatic stay.⁹⁸

⁹⁴ Massachusetts and some other New England states went even one step further in placing the responsibility for the locality's obligations on the residents. These states allowed the creditors to execute the residents' private property in satisfaction of the local debts. However, this extreme remedy was rejected in most other states. AMDURSKY & GILLETTE, *supra* note 78, § 5.4.3, at 250-51.

⁹⁵ The requirements set forth in Section 109(c) of the Bankruptcy Code are: (1) the debtor must be a municipality; (2) the debtor must be specifically authorized by the state; (3) the debtor must be insolvent; (4) the municipality has to show that it desires to effect a plan to adjust its financial obligations; and (5) the locality must show that it tried to negotiate a debt readjustment agreement with its creditors, or that such negotiations are impracticable. 11 U.S.C. § 109(c) (2000). To be a debtor under chapters 7 or 11, on the other hand, all a person need prove is that he or she resides or has a domicile, a place of business, or property in the United States. *Id.* § 109(a).

⁹⁶ *Id.* § 109(c)(2).

⁹⁷ To show its insolvency, the locality must show that it cannot pay its debts when they are due. *Id.* § 101(32)(C). McConnell and Picker criticize the insolvency requirement set forth in section 109(c), arguing that it postpones the bankruptcy filing while the city continues to incur more and more debt at increasing interest rates, which in turn burdens the municipal budget and ensures that each creditor will receive less in bankruptcy. McConnell & Picker, *supra* note 4, at 456-57.

⁹⁸ An automatic stay means that the mere filing of a petition under chapter 9 acts as a procedural halt to all judicial proceedings against the municipality. No creditor can commence or continue any legal action to recover its debt, and no creditor can demand any

The stay is implemented at the moment of the bankruptcy filing and immediately halts all collection efforts by the creditors.⁹⁹ As a result of the stay, creditors can no longer enforce their prepetition claims against the debtor, and cannot demand any payments from the municipality.¹⁰⁰ Under the auspices of the stay, the municipality and its creditors begin negotiations on a debt readjustment plan.¹⁰¹ During these negotiations the municipality enjoys the exclusive right to submit such plans to the court, and the creditors can only approve or disapprove the plans the locality submits.¹⁰² Naturally, this gives the locality great leverage in the negotiations. The creditors not only do not get any payments during the period of negotiations because of the automatic stay, but they also cannot submit debt readjustment plans of their own, and so creditors are very much at the mercy of the locality that controls the process. Localities, therefore, can take advantage of this situation and force the creditors to make concessions they would not otherwise make.¹⁰³

Once the locality constructs a debt readjustment plan, it submits the plan for the court's confirmation.¹⁰⁴ Similar to chapter 11's procedures, chapter 9 offers two routes for the plan's confirmation: one requires the approval of all classes of creditors, while the other forces the plan on at least some creditors

payment from the debtor. 11 U.S.C. § 362(a)(1). The automatic stay provided in chapter 9 has two legal sources. The first is section 362, incorporated into chapter 9 via section 901. *See* 11 U.S.C. §§ 362, 901(a) (Supp. V 2005). The second source is section 922, which broadens the protection afforded under chapter 9 to protect not only the debtor or municipality, but also "an officer or inhabitant of the debtor." *Id.* § 922(a)(1).

⁹⁹ *Id.* §§ 301, 362(a)(6), 901(a).

¹⁰⁰ *Id.* § 362(a)(1), (2) & (6).

¹⁰¹ *See id.* § 941 ("The debtor shall file a plan for the adjustment of the debtor's debts."); *id.* § 943(b)(7) (requiring a reorganization plan to be both "in the best interests of creditors" and "feasible" to be confirmed); *id.* §§ 901(a), 1128(b) (providing that a "party in interest" may object to the confirmation of the reorganization plan).

¹⁰² Under chapter 11 the exclusivity period is limited to 120 days, and afterwards the court may also accept plans from the creditors or other interested parties. *Id.* § 1121(b), (c). Under chapter 9, the exclusivity period is not limited in time, and so it continues as long as the municipality is in bankruptcy. *Id.* § 941 (providing that "[t]he debtor shall file a plan for the adjustment of the debtor's debts," and making no reference to the right of any other person to file such a plan). This distinction is connected to the special nature of the municipality as a debtor. Congress did not want the creditors to submit plans that might influence the internal condition in the locality. *See* 6 COLLIER ON BANKRUPTCY ¶ 941.02 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2007).

¹⁰³ Problems in the bargaining model also exist in corporate reorganizations. *See generally* Lucian Ayre Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253 (1992). The problems of corporate bankruptcy, however, are aggravated in the municipal context due to the absolute exclusivity a municipal debtor enjoys.

¹⁰⁴ *See* 11 U.S.C. § 941.

despite their objection - a “cram down.”¹⁰⁵ In both types of confirmation, the court examines the suggested plan, and confirms the plan only where it meets certain conditions specified in the code.¹⁰⁶ Although most of the approval conditions are incorporated from chapter 11,¹⁰⁷ the application of these conditions to the municipal context is not always successful, and the conditions do not always provide adequate protection to the creditors of the municipality.

Perhaps the best example of this problem concerns the application of the absolute priority rule.¹⁰⁸ Under this rule, if senior creditors get less than their full claims from a reorganization plan, then junior creditors get nothing.¹⁰⁹ In the private context, this is an extremely potent protection, because if shareholders (the creditors with the lowest priority) want to continue to keep their holdings in the company, then they must pay in full the debts owed to all other senior creditors, including, of course, the unsecured creditors.¹¹⁰ However, this mechanism provides only limited protection in the municipal context. Unlike a private corporation, a municipality has no shareholders. The residents – the conceptual equivalent of shareholders – are not considered “creditors” in the legal sense, and so the locality’s unsecured creditors are the lowest priority creditors under the plan. Thus, the municipality may frustrate the unsecured creditors by paying them less than their full claims, while still continuing to render services to the residents. Despite the formal incorporation of the absolute priority rule, unsecured creditors may have difficulty protecting themselves from reorganization plans that harm their basic interests.¹¹¹

If the court finds that the submitted plan meets the conditions set forth in chapter 9, then the plan is confirmed and considered binding upon all creditors. The municipality’s prepetition obligations thereafter consist only of those it has assumed under the plan, and the rest of the local debts are discharged.¹¹² If the court does not confirm the plan (or if the municipality fails to submit a

¹⁰⁵ Sections 1129(a) and 1129(b) are partially incorporated into chapter 9 via Section 901. See 11 U.S.C. §§ 901(a), 1129(a), 1129(b) (Supp. V 2005).

¹⁰⁶ See 6 COLLIER ON BANKRUPTCY, *supra* note 102, ¶ 943.03 (“While the section does not state that the court may confirm a plan *only if* all of these seven conditions are met, the strong implication is that the conditions are necessary to confirmation.”).

¹⁰⁷ See 11 U.S.C. § 901(a) (incorporating the approval requirements of subsections 1129(a)(2), 1129(a)(3), 1129(a)(6), 1129(a)(8), and 1129(a)(10) into chapter 9 of the Bankruptcy Code).

¹⁰⁸ Douglas Baird argues that the absolute priority rule is the most important and powerful creditor protection mechanism in chapter 11. See DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 66 (4th ed. 2006).

¹⁰⁹ *Id.* at 69.

¹¹⁰ 11 U.S.C. § 1129(b)(2).

¹¹¹ 6 COLLIER ON BANKRUPTCY, *supra* note 102, ¶ 943.03[1][f]; McConnell & Picker, *supra* note 4, at 464.

¹¹² 11 U.S.C. § 944(b).

plan), then the court may dismiss the case, and the locality loses bankruptcy protection.¹¹³

Note, however, that the court's powers are limited to confirming or rejecting the plan the locality submits. According to chapter 9, the court cannot change the submitted plan, or interfere in any other way in the governmental or political affairs of the locality.¹¹⁴ This is particularly important with regard to tax collections. Whereas outside of bankruptcy, creditors can use the mandamus remedy and force municipalities to raise their tax rates, in bankruptcy both the creditors and the court are subject to the tax rates set by the municipality itself. So, as long as the municipality is under bankruptcy protection, the court cannot order a tax increase, whether or not the local revenues are sufficient to pay the creditors in full. This limitation clearly raises a concern that the locality will not exhaust its tax-raising capacity, and that its revenues will be insufficient to repay its debts.¹¹⁵

The municipal bankruptcy process thus offers municipalities relatively easy debt relief. Using chapter 9, insolvent localities can pressure creditors to agree to unfavorable debt readjustment plans, and due to the lack of creditor protection mechanisms, they can also force plans on unwilling creditors. Unlike the creditors' mandamus remedies, bankruptcy places the burden of a financial crisis on the creditors. Bankruptcy allows insolvent localities to avoid full repayment by refusing to maximize their tax-raising capacity.¹¹⁶

The justification for placing the burden of the local crisis on the creditors may be perceived as one of insurance.¹¹⁷ According to this view, without bankruptcy law in times of local financial crisis, the locality would be forced to increase its tax rates,¹¹⁸ but the residents of the locality would not enjoy more benefits.¹¹⁹ Residents would pay more to the locality, but the tax proceeds would be used for debt service rather than local public goods. Municipal bankruptcy is designed to prevent this outcome. Using bankruptcy, the locality

¹¹³ *Id.* § 930.

¹¹⁴ The court may not interfere with any of the debtor's political or governmental powers. *Id.* § 904.

¹¹⁵ Note that in order to confirm the plan, the bankruptcy court needs to be convinced the plan is in the best interest of the creditors, *id.* § 943(b)(7), but in many cases courts have confirmed plans even when the locality did not reach its maximum tax-levy capacity. *See, e.g., In re Sanitary & Improvement Dist. No.7*, 98 B.R. 970, 974 (Bankr. D. Neb. 1989); *see also In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34 (Bankr. D. Colo. 1999) (refusing to confirm the plan on grounds other than the best interest of the creditors test). For a theoretical justification of this approach, see Kordana, *supra* note 4, at 1066-1105.

¹¹⁶ *See* William D. Baker, *Chapter 9 Bankruptcy: A Haven for Central Arizona Project Irrigation Districts?*, 27 ARIZ. ST. L.J. 663, 674-675 (1995).

¹¹⁷ An "insurance" rationale is often given for the fresh start policy in consumer bankruptcy. BAIRD, *supra* note 108, at 34-35; *see also* DOUGLAS G. BAIRD ET AL., CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 470 (3d ed., rev. 2001).

¹¹⁸ *But see supra* notes 91-92 and accompanying text.

¹¹⁹ *See supra* notes 18-22 and accompanying text.

can decrease its debt burden and reduce its local tax rates. The relatively low tax rates promote productivity, improve local economic performance, and help the locality recover.¹²⁰ The underlying assumption is that mitigating the city's financial hardship provides the locality with a fresh start and enables its rehabilitation, to the benefit of both residents and creditors.

C. *State Financial Boards and State Municipal Insolvency Statutes*

State financial boards offer a third approach to municipal insolvency. A state financial board is a state agency created to help a distressed locality overcome its economic troubles.¹²¹ The board usually oversees the financial affairs of the city during its time of crisis, and initiates a rehabilitation process designed to help the locality recover.¹²² Ideally, with the help of the board, the city is able to address the causes of its financial decline and gradually regain financial stability.¹²³

In most states the decision to form a state financial board is an ad hoc one. Most states do not have clear criteria as to when a board should be established, and the decision often depends on the political situation in the state and the gravity of the city's economic need.¹²⁴ Usually, states decide to intervene only after a city's credit rating falls below investment grade, or when the city is unable to finance its operating expenses.¹²⁵ In a few states, however, the decision to establish a board takes a more systematic form. These states have enacted municipal insolvency statutes that list a set of economic criteria, and state boards are established when a certain municipality meets one of these criteria (for example, the locality's deficit reaches a certain level).¹²⁶

While boards' actions differ among cities, some typical characteristics do exist. Boards usually engage in three types of activities: gathering information, debt management, and fiscal management.¹²⁷ Information gathering includes

¹²⁰ See McConnell & Picker, *supra* note 4, at 470.

¹²¹ See *Missed Opportunity*, *supra* note 5, at 734.

¹²² *Id.* at 736-38.

¹²³ *Id.* at 736-37.

¹²⁴ *Id.* at 736 n.15 (noting that "in many instances, financial control boards have been created pursuant to special legislation passed in response to particular urban crises").

¹²⁵ See Honadle, *supra* note 2, at 1461; see also *Actions Taken by Five Cities to Restore Their Financial Health: Hearing Before the Subcomm. on the Dist. of Columbia of the H. Comm. on Gov't Reform and Oversight*, 104th Cong. 47 (1995) (report of Nonna A. Noto, Congressional Research Service Analyst) [hereinafter *Actions Taken by Five Cities*]; David R. Berman, *Takeovers of Local Governments: An Overview and Evaluation of State Policies*, 25 PUBLIUS 55, 56-58 (1995).

¹²⁶ See generally Philip Kloha et al., *Someone To Watch Over Me, State Monitoring of Local Fiscal Conditions*, 35 AM. REV. PUB. ADMIN. 236 (2005) (outlining the results of a fifty-state survey focusing on state methods of monitoring local governments). A more elaborate discussion of these statutes is provided *infra* Part IV.

¹²⁷ *Missed Opportunity*, *supra* note 5, at 738.

activities such as conducting financial inquiries, auditing, and implementing better disclosure practices.¹²⁸ These activities are designed to provide the board with better knowledge of local financial practices, so that it can address the root of the city's economic problems. Debt management usually involves obtaining additional funds for the city.¹²⁹ As a result of the crisis, localities often do not have sufficient funds to pay for their debt and operating expenses, so the state board supplies the distressed city with interim financing. Usually, the board does not simply transfer funds to the city, but rather facilitates the city's continued access to the credit markets by providing creditors with guarantees for their loans, though it is the city that has to pay back the debts with its own resources.¹³⁰ Fiscal management consists of actions the board takes to help the city recover. In most cases, the board prepares a rehabilitation plan, and oversees the locality's adherence to that plan.¹³¹ The plan obligates the city to take the required actions towards recovery – for example, decreasing the city's expenditures, increasing taxation, or changing the political environment – and with the implementation of these measures the locality regains its financial stability.¹³²

Usually, as soon as the city's economic condition improves, the board dissolves, and the city's governance returns to normal: the elected local officials resume their previous posts, and the state no longer takes such an active role in the management of the locality.¹³³ However, even in those cases where the board stays for longer periods (e.g., ten to twenty years), after a few years the board's role is usually reduced from an oversight to an advisory role.¹³⁴

¹²⁸ See, e.g., *Actions Taken by Five Cities*, *supra* note 125, at 52-53.

¹²⁹ See *id.* at 53.

¹³⁰ See *id.* at 48. The Chicago School Finance Authority, for example, issued four series of bonds primarily to provide financial assistance to the Chicago School Board. The bonds were payable out of dedicated taxes levied on all taxable property in the city of Chicago. *Id.* at 59. PICA, the financial board established for Philadelphia, also issued debt to raise cash for Philadelphia's operating costs. A PICA "authority tax" was approved in order to pay back the debt, and so the city paid for the debt service from its own resources. *Id.* at 75. A similar financial arrangement took place in New York. See ROBERT W. BAILEY, *THE CRISIS REGIME: THE MAC, THE EFCB, AND THE POLITICAL IMPACT OF THE NEW YORK CITY FINANCIAL CRISIS* 27-28 (1984).

¹³¹ See *Missed Opportunity*, *supra* note 5, at 738 ("In the area of financial reform, the principal duty of most FCBs is to aid the city's elected officials in developing and adhering to a balanced budget.").

¹³² *Actions Taken by Five Cities*, *supra* note 125, at 53. A more detailed discussion of some of the rehabilitation measures state boards can take is provided *infra* Part III.C.

¹³³ See *Missed Opportunity*, *supra* note 5, at 740 (criticizing the generally temporary nature of financial control boards as leading to "short-term responses" to "perennial" fiscal crises rather than long-term reform).

¹³⁴ See *Actions Taken by Five Cities*, *supra* note 125, at 49.

III. THE SUPERIOR RISK BEARER OF MUNICIPAL INSOLVENCY

Each of the remedies previously described can be viewed as placing the burden of a local financial crisis – or at least a substantial part of it – on a different entity. Creditors' remedies place the burden of a crisis on the residents of the locality; the Bankruptcy Code, on the other hand, places the burden of the crisis on the locality's creditors; and finally, state financial boards place the burden on the state. In this Part of the Article, I examine these three possible approaches to municipal insolvency, and consider which of the three entities burdened by each approach – the residents, the creditors, or the state – is the most effective risk bearer of a municipal financial crisis. I also consider the ways in which a local fiscal distress can best be resolved.¹³⁵ I start with the residents.¹³⁶

A. *The Residents as Risk Bearers*

One option is to place the risk of municipal insolvency on the residents. This means the municipality is not allowed to default, since that would prejudice the interests of creditors, and the municipality must pay its debts in full from its own resources only.

Supporters of placing the burden solely on the residents argue that this option forces the municipality to internalize the full costs of its budgetary actions.¹³⁷ They claim that a different rule – permitting the municipality to default or enabling the state to bail the municipality out – would shift part of the municipal expenditures onto third parties (i.e., the creditors or the state), and would allow the residents to enjoy a windfall from receiving municipal goods and services without bearing their full cost.¹³⁸ This result would induce the municipality to over-consume, creating inefficiency.¹³⁹

¹³⁵ For analytical purposes, I study each possible risk bearer as if it bears the risk of the crisis alone.

¹³⁶ Kordana also discusses the conceptual question of the efficient risk bearing of a municipal crisis. Kordana, *supra* note 4, at 1096-1105. However, he fails to examine the state as a risk bearer, and he presents the residents and the creditors as the only possible options. *See id.*

¹³⁷ *See id.* at 1067-69.

¹³⁸ *See id.*

¹³⁹ In case of a bailout, the state transfers funds to finance part of the local goods and services. The residents, therefore, do not internalize the full cost of the local goods, and so they have an incentive to over-consume. *See* Robert P. Inman, *Transfers and Bailouts: Institutions for Enforcing Local Fiscal Discipline*, 12 CONST. POL. ECON. 141, 142-44 (2001); *see also* Timothy J. Goodspeed, *Bailouts in a Federation*, 9 INT'L TAX & PUB. FIN. 409, 418-19 (2004). Correspondingly, in case of bankruptcy filing, the municipality consumes local goods and services with debt proceeds, but it does not repay its creditors back in full. *See* Kordana, *supra* note 4, at 1066 (discussing the moral hazard problem that chapter 9 of the Bankruptcy Code creates and arguing that reputation effects can mitigate this problem).

Placing the risk on the residents, on the other hand, would promote efficient resource allocation. The municipality in such situations knows that it will ultimately pay for whatever its residents consume, and so it would have to be fiscally responsible.¹⁴⁰ Moreover, placing the risk of a local financial crisis on the residents is arguably justified because the residents can determine the financial policies of the locality through the political process.¹⁴¹ They can elect financially responsible public officials, who will keep expenditures at a level the locality can meet, thus avoiding potential crises. Since the residents are in a position to prevent a crisis, they should also bear the potential risks of its occurrence.

However, notwithstanding these arguments, I claim that addressing a financial crisis through placing the burden solely on the residents is problematic. First, from an *ex ante* perspective, it is not entirely clear that the residents can indeed determine the locality's financial policies and can prevent a crisis. Second, from an *ex post* perspective, to the extent a crisis has already occurred, the residents cannot be expected to cope with its consequences alone.

The first, *ex ante* objection derives from the premise that, despite the political process, residents do not control the locality's financial situation.¹⁴² It is true that the residents elect political officials who determine the local fiscal policies, but elections do not provide residents with a sufficient tool to prevent, or deal with, a potential crisis. One reason for the residents' lack of control is simply agency costs. Although the residents elect political officials, once in office, officials often act to maximize their own political interests, rather than the interests of the residents or of the locality as a whole.¹⁴³ The officials might implement policies that ensure their political survival (or re-election), even when those policies damage the locality's economic performance and this may result in future financial deterioration. The residents' collective action problems may aggravate these agency costs. As a large disorganized group, residents have difficulty monitoring local officials, and so fiscal policy will often be biased in favor of small, yet powerful interest groups that can offer political support.¹⁴⁴ The officials thus comply with the financial demands of

¹⁴⁰ Inman, *supra* note 139, at 142-44, 154-55.

¹⁴¹ Cf. Clayton P. Gillette, *Kelo and the Local Political Process*, 34 HOFSTRA L. REV. 13, 14-15 (2005) (emphasizing the strength of the political process in the context of eminent domain).

¹⁴² See, e.g., Robert J. Barro, *The Control of Politicians: An Economic Model*, 14 PUB. CHOICE 19, 26-32 (1973) (analyzing the effect of popular electoral control on the incentives of political officeholders to act in the voters' interests).

¹⁴³ See *id.* at 22-26 (explaining that, without adequate electoral controls to constrain their behavior, political officeholders have strong incentives to further their own self-interest at the expense of the public interest).

¹⁴⁴ See Einer R. Elhauge, *Does Interest Group Theory Justify More Intrusive Judicial Review?*, 101 YALE L.J. 31, 35-41 (1991) (explaining that under group theory, all participants act to further their own self-interest, creating results that are not necessarily in the public interest).

minority interest groups, and overspend local resources at the expense of the majority of residents.¹⁴⁵

However, even if we assume there are no agency costs and that officials will implement policies that represent the residents' wishes, it is still not evident that the residents can prevent local fiscal crises. As previously explained, the causes of a local crisis are often outside the local officials' realm of control.¹⁴⁶ Local officials can hardly change the socioeconomic factors that are at the root of the financial decline, and the officials are part of a political environment that mandates continued spending. Thus, since the local officials themselves cannot prevent an impending crisis, it is unlikely that residents, who exercise their powers only through electing those officials, can prevent crises either. Like local officials, the residents are victims of the external and political circumstances that caused the crisis, but have little ability to prevent it.

Placing the burden of a crisis on the residents seems even more problematic when we consider the *ex post* implications of such a policy. Placing the burden on the residents means they alone pay for the locality's debts and operating expenses, which obligates the locality to either raise the local tax rates or cut expenditures for public services. In a local crisis, however, neither option is desirable. First, there is a limit to the level of taxes that a government can impose. When taxes are raised above a certain limit (i.e., the peak of the Laffer curve), the tax base shrinks, and the revenues available to the government start to decrease.¹⁴⁷ This is especially true with regard to local taxes. When a locality raises taxes, its residents can simply move to a different city, and the locality is liable to lose revenues rather than earn more.¹⁴⁸ Therefore, significant and disproportionate increases in the local taxes usually do not solve fiscal problems, and they may even damage the locality rather than help it recover.¹⁴⁹

¹⁴⁵ MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 9-16 (2d ed. 1971); Elhauge, *supra* note 144, at 36-41; *see also* Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 211-13 (1976); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 10-13 (1971).

¹⁴⁶ *See* discussion *supra* Part I.A.

¹⁴⁷ The Laffer curve denotes the connection between the tax rate and the revenues that the government receives from taxes. The curve is named after the economist Art Laffer, who suggested that, although generally increased tax rates produce higher tax collections, there is a point where tax revenues start to decline notwithstanding the higher tax rates. High tax rates reduce the residents' incentive to generate revenues, and as a result the tax base shrinks. For further analysis of the Laffer curve concept, *see generally* James M. Buchanan & Dwight R. Lee, *Politics, Time and The Laffer Curve*, 90 J. POL. ECON. 816 (1982).

¹⁴⁸ *See* discussion *supra* Part I.A.2.

¹⁴⁹ In the municipal context, the Laffer curve (or the revenue hill) is especially low, because local residents can relatively easily move away from the locality and stop paying taxes. *See* Andrew F. Haughwout et al., *Local Revenue Hills: Evidence from Four U.S.*

Likewise, there is also a limit to the amount of services a locality can cut. Local governments are the main providers of public services in the United States, and they supply services that are essential to residents' lives.¹⁵⁰ Placing the burden of a crisis solely on the residents may jeopardize the supply of these essential services and severely damage the local community. The crisis can affect the quality of local education, the quality of the public utilities (e.g., water and sanitation), the safety of the community, and in severe cases it may even cost lives. This situation is not merely theoretical. Bridgeport, Connecticut, for example, suffered from a serious financial crisis at the beginning of the 1990s, which resulted in a severe lack of police personnel. As a consequence, murder cases in the city were not properly investigated, drug dealers controlled neighborhoods, and there were not enough police officers to respond even to emergency calls.¹⁵¹ Another example is that of Chelsea, Massachusetts, also at the beginning of the 1990s. A severe fiscal crisis in Chelsea caused the city's educational system to collapse. The city had to dismiss at least a third of the public school teachers, and in September 1991 the city could not even afford to open the schools for the new school year.¹⁵²

In light of the serious consequences of a local financial crisis, and the fact that residents have limited control over such an occurrence, risk-averse residents should prefer to purchase "insurance" against a crisis.¹⁵³ This insurance would allow municipalities facing a financial crisis to shift costs to third parties – namely the creditors or the state – so that the municipality could continue to function, even in times of severe financial difficulty. Creditors can provide such "insurance" if insolvent municipalities will not be obligated to pay their debts in full. Thus, all municipalities will pay higher interest rates to

Cities 25-29 (Nat'l Bureau of Econ. Res., Working Paper No. 9686, 2003), available at <http://ideas.repec.org/p/nbr/nberwo/9686.html> (examining the tax rates of four cities, and finding that three out of the four cities were very close to the peak of their local Laffer curve).

¹⁵⁰ Some examples include the provision of local residents' water supply, sanitation, police and fire protection, education, and recreational activities. See 6 ANTIEAU ON LOCAL GOVERNMENT LAW, *supra* note 8, § 82.01[1].

¹⁵¹ See *In re City of Bridgeport*, 129 B.R. 332, 335 (Bankr. D. Conn. 1991).

¹⁵² Florin Pasnicu, *Fiscal Fiasco for Tiny Chelsea, Mass.*, CHRISTIAN SCI. MONITOR, Aug. 9, 1991, at A8; *Receivership Sought for Bankrupt City*, UNITED PRESS INT'L, Sept. 6, 1991.

¹⁵³ This terminology ("insurance") is taken from the analysis usually made with regard to individuals in consumer bankruptcy. See authorities cited *supra* note 117. The situation in some ways also resembles the need for the limited liability provided to the shareholders of a company. Limited liability, which can be viewed as a kind of a shareholders' "insurance," is especially necessary when the shareholders are dispersed and do not have a great degree of control over the company's affairs. Cf. Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 96-97 (1985) (arguing that limited liability is beneficial to shareholders because it allows for more efficient investment portfolio diversification, thus mitigating investors' risk).

the creditors, but in return the creditors will bear some of the losses in case a particular municipality falls on hard times and defaults.¹⁵⁴ In the same way, the state could also provide such insurance. The state can help local governments when they encounter financial difficulties, but in return (presumably) state residents would have to pay more taxes to the state.¹⁵⁵ In both cases, however, the consequences of the local crisis are not borne by the municipal residents alone, because the municipality transfers part of its financial burden to third parties.

The advantage of the state and the creditors playing the role of insurer is that they supply this insurance to a wide range of local governments, which together operate as a sort of risk pool. Since they deal with multiple municipalities, they can diversify the risks of a crisis, and offset the damage suffered by one locality with the success of other localities. The residents of a single municipality, on the other hand, cannot diversify the risk among themselves.¹⁵⁶ Faced with a financial crisis, municipal residents will be forced to absorb all of its negative consequences – paying higher taxes and receiving fewer and poorer municipal services.

It is important to note, however, that placing the risk of municipal insolvency on either the creditors or the state does not mean cities and their residents will completely stop bearing the costs of municipal financial distress. On the contrary: if we place the risk on the creditors, then municipalities will have to pay higher interest rates to compensate the creditors for the risk the creditors are taking;¹⁵⁷ and if we place the risk on the state, then state residents (who are also municipal residents) will either have to pay higher taxes to the state or tolerate a reduction in the number or quality of public services provided by the state.¹⁵⁸ The question, therefore, is not which of these two entities – the state or the creditors – can better absorb the costs of a financial crisis, but rather which of the two outcomes – increased tax payments to the state or increased interest payments to the creditors – is cheaper.

B. *Who Is the Superior Risk Bearer: Creditors or the State?*

Having seen the problems that arise from placing the risk of a municipal crisis on the residents, in this Section I analyze the creditors and the state. I

¹⁵⁴ As previously discussed, this “insurance” function is a goal of bankruptcy law. See *supra* Part II.B; see also McConnell & Picker, *supra* note 4, at 470.

¹⁵⁵ Cf. *supra* notes 117-120 and accompanying text.

¹⁵⁶ Kordana, *supra* note 4, at 1096-1106. Kordana also makes the claim that, on average, creditors are wealthier than residents, and wealthier people tend to be less risk-averse on the margin. Due to the fact that creditors are less risk-averse than bondholders, they are superior risk bearers. *Id.*

¹⁵⁷ See Kordana, *supra* note 4, at 1067.

¹⁵⁸ The vast majority of states are legally prohibited from engaging in deficit spending, which is common at the federal level, as a means of deferring the expense by carrying over a current budget deficit to a future year. FISHER, *supra* note 9, at 274-76.

argue that the state is the superior bearer of local insolvency because it can address the causes of a local crisis, or deal with its consequences, better than the creditors can.

When a locality suffers from financial distress, certain measures are often required to help it regain financial stability. The locality needs to reform its tax system, cut labor expenses, increase efficiency, and take other actions designed to reduce the deficit and to enable it to recuperate.¹⁵⁹ As will be discussed below, the state can use its legal and political powers to initiate such rehabilitative measures.¹⁶⁰ The state can intervene in local fiscal affairs and help the locality overcome its financial difficulties.¹⁶¹ The creditors, on the other hand, lack the state's powers. By themselves, the creditors cannot implement the required economic reforms at the local level, and they also do not have the requisite legal powers to force the locality to take remedial action. Therefore, since the creditors are in a worse position than the state to avoid a local crisis or to minimize its consequences, it is less efficient to place the burden of the crisis on their shoulders.

An argument can be made, however, that although the creditors do not have the legal authority to force municipalities to implement economic policies, they can affect the local policies through the financial markets. The creditors, after all, control the locality's most important resource – money – and this control may enable them to pressure the local officials into taking the steps creditors think necessary.¹⁶² Localities often need the funds that creditors supply, so officials are often coerced into following the creditors' demands.¹⁶³ The creditors can set the conditions for extending loans to the locality, and this gives them leverage to force the locality to undergo a recovery process. Moreover, since municipalities wish to pay the lowest interest rates they possibly can on their loans, the credit markets – even when the creditors are dispersed and unorganized – may push local officials to improve the local financial condition.¹⁶⁴ The better the local financial condition is, the higher the locality's credit rating and the lower the interest rates the locality has to pay on its debts. Thus, market forces, rather than legal authority, can steer

¹⁵⁹ PAMMER, *supra* note 2, at 16.

¹⁶⁰ See *infra* Part III.C.

¹⁶¹ A more elaborate analysis of the state's powers in this context is provided *infra* Part III.C.

¹⁶² Cf. George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 82 CAL. L. REV. 1073, 1080 (1995) (“[D]ebt is a potent and flexible [corporate] governance instrument and . . . banks are effective governance players.”).

¹⁶³ Cf. *id.* at 1082-1103 (discussing the role of bank creditors by using the threat of “exit” to deter and correct corporate mismanagement).

¹⁶⁴ Cf. *id.*

municipalities in the right financial direction and urge local officials to take measures to regain or maintain the local fiscal health.¹⁶⁵

Despite the strength of this argument, I believe creditors' monitoring is inadequate to force municipalities to address financial crises. The reason is that while the creditors' pressures are directed at local officials, the officials themselves may be unable to address the underlying causes of the financial deterioration. The creditors can try to force the local officials to take measures to rehabilitate the locality, but the local officials often lack the legal authority or the political power to take the required action. To better understand this claim, it is important to recall the reasons for municipal insolvency.¹⁶⁶

According to one view, municipal insolvency is mainly caused by socioeconomic changes. This view emphasizes such factors as economic cycles, suburbanization, or intergovernmental transfers, which are usually external to the municipality and involve state or even nationwide processes.¹⁶⁷ Thus, if the processes which cause the local financial decline are beyond the local officials' realm of control, then creditors' pressures directed at the local officials will also be ineffective. The creditors can signal to local officials that the locality's financial condition has declined, but the officials themselves are often helpless in the face of the problems the locality confronts. They cannot do much about a national recession, they are unable to stop suburbanization, and they certainly cannot compel the state to send more funds their way or force it to decrease the amount of unfunded mandates. Thus, under these circumstances the creditors' pressures on local officials – and in particular, pressure in the form of higher interest rates – can do little to help the distressed locality recover.

Even if we subscribe to the second approach, which emphasizes the role of the local political management in the financial decline,¹⁶⁸ it is not clear whether the creditors can cause local officials to change their financial behavior. As previously discussed, the nature of the political system will in many cases dictate the local officials' fiscal policies.¹⁶⁹ A fragmented political environment creates weak municipal leadership, which is unable to take a strong stand against budgetary pressures. The problem is that local officials may see the political system as a given. They have a limited ability to decrease the extent of political fragmentation, and they may face difficulties when

¹⁶⁵ In a private corporation, the creditors are often viewed as monitors of the corporate officials. Especially in small- and medium-size firms, banks provide the bulk of the firm's credit. Therefore they are able to exercise a great deal of control over the corporate policies, and can thereby discipline the corporate managers. *See generally* Randal C. Picker, *Security Interests, Misbehavior, and Common Pools*, 59 U. CHI. L. REV. 645 (1992) (focusing on secured creditors, and proposing secured credit as a response to creditor misbehavior).

¹⁶⁶ *See* discussion *supra* Part I.

¹⁶⁷ *See* discussion *supra* Part I.A.

¹⁶⁸ *See* discussion *supra* Part I.B.

¹⁶⁹ *See* discussion *supra* Part I.B.2.

trying to weaken the influence of the interest groups. Therefore, even if we subscribe to this view of local crises, pressures from the creditors directed at local officials may also fail to bring a positive change. The creditors can raise the price of credit or even stop lending to the locality altogether, but the local officials may yet be trapped in spending patterns dictated by their political systems.

Perhaps the best example of the creditors' failure to stop a city's financial decline is the crisis in New York City.¹⁷⁰ In this case, the city's creditors organized a creditors' group, the Financial Community Liaison Group (FCLG), which tried to pressure the city's officials into changing their financial policies by decreasing labor costs, raising taxes, and cutting welfare expenditures, among other things.¹⁷¹ At first, the creditors met with city officials and tried to persuade them to initiate a rehabilitation process,¹⁷² but when these attempts failed, the creditors applied drastic sanctions against the city. Interest rates increased significantly,¹⁷³ and, at the beginning of 1975, creditors refused to extend the city any more credit.¹⁷⁴ Even faced with these extreme pressures by the creditors, and with the city on the verge of financial calamity, New York's officials did not initiate the required reforms.¹⁷⁵ Clearly the officials understood the gravity of the city's financial position, but the political environment did not allow them to take the steps needed for rehabilitation. The city was fragmented, its decision-making process was disorganized and lacked adequate financial planning, and interest groups blocked any possibility of a significant change.¹⁷⁶ Under these circumstances, even the creditors' strongest pressures were to no avail. The city needed the state's intervention.

This is not to dismiss the importance of the creditors' monitoring. On the contrary, credit markets have an important role in maintaining local fiscal health, and creditors can – and in certain cases do – help prevent local financial decline.¹⁷⁷ I argue, however, that since the causes of local financial crises are often out of the local officials' realm of control, the state's involvement is warranted. When a municipality suffers from severe financial difficulties that

¹⁷⁰ BAILEY, *supra* note 130, at 18-20.

¹⁷¹ *Id.* at 20-21.

¹⁷² STAFF OF THE SEC. & EXCH. COMM'N, *supra* note 45, ch. 1, at 88-91, 186-91 (Comm. Print 1977).

¹⁷³ *Id.* ch. 1, at 53-57.

¹⁷⁴ *Id.* ch. 1, at 248.

¹⁷⁵ *Id.* ch. 3, at 135-38.

¹⁷⁶ For a more detailed discussion of the FCLG and its failure in the rehabilitation of New York City, see BAILEY, *supra* note 130, at 17-23.

¹⁷⁷ See *supra* notes 162-68 and accompanying text. The creditors' efforts can be successful when the local officials have the powers to address the causes of the financial decline, and when the political system enables them to adequately respond to the economic circumstances at the root of the crisis. As we saw in the first part of this chapter, however, usually the reasons for financial crises (as opposed to less serious financial distress) are beyond the local officials' realm of control. See *supra* Part I.A.

the creditors and local officials were evidently unable to prevent, the state should step in and try to assist the locality in avoiding further financial deterioration. The state can take measures to address the causes of local financial crises, and can help localities regain their fiscal health even in cases where local officials and creditors have failed. In the following Section I discuss the role of the state and explain its comparative advantages in remedying urban crisis.

C. *The State as the Superior Risk Bearer*

Up until now my argument has been of a negative nature. I have discussed the difficulties of placing the risk of a financial crisis on the residents and the creditors, and I have explained why both of these parties have a limited ability to prevent a crisis or reduce its damages. In this Section, I set out to examine why the state's intervention is required in times of financial crisis. How can the state address financial crises with which municipal officials cannot deal?

The answer to this question again relates to the causes of municipal insolvency examined in Part I of this Article.¹⁷⁸ Some scholars believe that municipal financial crises are the result of external socioeconomic processes,¹⁷⁹ while others focus on the political system and the local management.¹⁸⁰ But whether one adheres to one approach or to the other, the state is in a better position than municipal officials to address the underlying causes of a financial crisis. The reason is twofold. First, the state has broader legal authority than municipal officials, and so it can better address the external socioeconomic processes. Second, the state has the ability to change the political environment in the municipality, and thus the state can decrease the political pressures that contribute to overspending.

1. *The State Can Better Deal with the Socioeconomic Processes*

The starting point for the state's ability to deal with the socioeconomic processes is simply its superior legal authority. An elementary proposition of local government law is that municipalities are creatures of the state: states have plenary powers with regard to their localities, and localities have only those powers that the state has delegated to them.¹⁸¹ Most states allow their

¹⁷⁸ See discussion *supra* Part I.

¹⁷⁹ See discussion *supra* Part I.A.

¹⁸⁰ See discussion *supra* Part I.B.

¹⁸¹ See *Hunter v. City of Pittsburgh*, 207 U.S. 161, 178-79 (1907); 1 ANTIEAU ON LOCAL GOVERNMENT LAW, *supra* note 8, § 13.01; Richard Briffault, *Our Localism: Part I – The Structure of Local Government Law*, 90 COLUM. L. REV. 1, 6-9 (1990); Gerald E. Frug, *The City as a Legal Concept*, 93 HARV. L. REV. 1057, 1080-1120 (1980); Clayton P. Gillette, *In Partial Praise of Dillon's Rule, or, Can Public Choice Theory Justify Local Government Law?*, 67 CHI.-KENT L. REV. 959, 963-68 (1991); see also PETERSEN ET AL., *supra* note 36, passim (reporting on the role of states in the financial management of local government for the Department of Housing and Urban Development).

local governments some degree of autonomy, but (especially in financial matters) states tend to limit the local officials' powers to independently regulate.¹⁸² Therefore, regarding many issues (e.g., the local tax system, debt issuances, financial disclosure, etc.) municipal officials do not have the powers the state has,¹⁸³ and correspondingly their ability to address economic changes is limited. Dealing with a crisis involves adapting the urban economy to the complex socioeconomic environment, and this in turn may require the regulation of areas that are not within the local officials' realm of authority.

The core problem in dealing with socioeconomic processes is that they are usually external to the municipality. They involve forces that the local officials can hardly affect, and entities, like the suburbs or the state, that the locality cannot control.¹⁸⁴ Addressing problems caused by socioeconomic processes therefore requires a comprehensive and overarching solution. Local officials, however, simply do not have the authority to initiate the required reforms. This is the case both with regard to suburbanization (which involves both the city and its suburbs), and with regard to intergovernmental relations (which involve the city, the state, and other localities within the state).¹⁸⁵

Take, for example, suburbanization. This process may lead to crisis when businesses or individuals move out of the city, leaving it with both an increasing level of expenditures and a shrinking tax base.¹⁸⁶ Naturally, the

¹⁸² Most states have accepted some sort of constitutional amendment that allows local governments to independently regulate local affairs; these amendments are called home-rule amendments. Notwithstanding the home-rule amendments, however, the powers of local governments are still limited. First, these amendments usually allow local governments to regulate only in certain defined areas that are in general purely local: often, fiscal affairs, such as taxation or debt, are outside the localities' realm of authority. Second, states can still review localities' regulations, and they can pass statutes that will trump the local policies. In most cases, therefore, the state's supremacy has been preserved. For a closer look at local autonomy and home-rule amendments, see U.S. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, LOCAL GOVERNMENT AUTONOMY: NEEDS FOR STATE CONSTITUTIONAL, STATUTORY, AND JUDICIAL CLARIFICATION 1-3 (1993) [hereinafter LOCAL GOVERNMENT AUTONOMY]; David J. Barron, *A Localist Critique of the New Federalism*, 51 DUKE L.J. 377, 377 (2001) ("[T]hose who are attracted to . . . localist orientation should be wary of the recent federalism revival. This revival focuses on protecting the autonomy of state and local governments by limiting the power of the central government."); Briffault, *supra* note 181, at 9-18; Frug, *supra* note 181, at 1116; Terrance Sandalow, *The Limits of Municipal Power Under Home Rule: A Role for the Courts*, 48 MINN. L. REV. 643, 658-68 (1964).

¹⁸³ See LOCAL GOVERNMENT AUTONOMY, *supra* note 182, at 14.

¹⁸⁴ See LADD & YINGER, *supra* note 15, at 291.

¹⁸⁵ See *supra* Part I.A.1-2.

¹⁸⁶ At the beginning of the 1990s in Washington, D.C., for example, almost half a million non-D.C. residents worked in the city, whereas only 300,000 D.C. residents were employed, including 70,000 residents who worked outside the district. This imbalance created enormous pressure on the city's budget, and was among the causes of the city's severe financial crisis in the mid-1990s. Robert P. Strauss, *The Income of Central City and*

solution for this problem cannot come from regulating the city alone. The city has only limited resources, and imposing more taxes or cutting more services will not necessarily help. The solution must come from looking at the suburbs and the city together – considering both their interests – and understanding that the suburbs must help the city deal with its economic problems.¹⁸⁷ The city, of course, does not have the authority to force its suburbs to share the costs or contribute revenues. But the state, with its plenary legal powers, can take the necessary actions.

One measure the state can take is to reform the local tax system, especially by allowing the locality to impose taxes on non-residents, such as commuter taxes or non-resident income taxes. By taxing non-residents, the city can broaden its tax base and extract revenues from affluent residents who have fled to the suburbs. Through tax reform the state forces suburban residents to share the city's expenses, and thereby relieve the city of its financial burden. Indeed, in several cases of financial crisis, especially of large cities, states have imposed or increased non-resident taxes.¹⁸⁸

Another measure that the state can take is the creation of special districts. Special districts are municipal corporations that provide a service or perform a function for a certain jurisdiction (usually different – larger or smaller – than that of the city).¹⁸⁹ The special districts have the authority to independently collect taxes in their jurisdictions, and use these taxes to finance the services they provide.¹⁹⁰ If the district's jurisdiction includes both parts of the city and parts of the suburbs, then financial responsibility for the provision of the district's services naturally will be shared among the residents of both entities.¹⁹¹ Thus, by assigning some of the city's services to a special district, the state can lift some of the financial burden from the distressed municipality.¹⁹² Ester Fuchs explains that the creation of special districts

Suburban Migrants: A Case Study of the Washington, D.C. Metropolitan Area, 51 NAT'L TAX J. 493, 512 (1998).

¹⁸⁷ For theoretical explanations and empirical evidence for the reasons suburbs should help their central cities, see Andrew F. Haughwout & Robert P. Inman, *Should Suburbs Help Their Central City?*, in BROOKINGS WHARTON PAPERS ON URBAN AFFAIRS 45, 47 (2002), available at http://muse.jhu.edu/journals/brookings-wharton_papers_on_urban_affairs/v2002/2002.1henderson.pdf (“[W]hen city agglomeration economies are important and city fiscal institutions lead to inefficient allocations or require significant fiscal redistributions, there is a plausible case for suburb-to-city aid.”).

¹⁸⁸ In Cleveland, for example, there was an increase of local income tax from 1.5 percent to 2 percent; the Cleveland income tax is imposed also on non-residents working in the city. See *Actions Taken by Five Cities*, *supra* note 125, at 65. In Yonkers, state legislation established a 0.5-percent income tax rate for non-residents working in the city. See *id.* at 81. Finally, in New York the state increased the transit fares in and out of the city. See *id.* at 72.

¹⁸⁹ 1 MCQUILLIN, *supra* note 79, § 2.28.

¹⁹⁰ *Id.*

¹⁹¹ FUCHS, *supra* note 71, at 194.

¹⁹² *Id.* at 192-94.

helped Chicago avoid a financial crisis, observing that in 1975 more than ten local government jurisdictions supported Chicago's taxpayers, and several of them had boundaries that also included the city's suburbs.¹⁹³

Note that municipal officials do not independently have the power to take these (and other)¹⁹⁴ important rehabilitating measures. The state is usually the only entity that can enable the city to impose taxes on non-residents, and it is the only entity that can create special districts.¹⁹⁵ The key to the resolution of the financial difficulties is not, therefore, in the hands of local officials, but is rather in those of the state.

The state's involvement is also necessary when changes in the intergovernmental support system contribute to a city's financial crisis. Placing the burden of municipal insolvency on the state in this context has two advantages. First, the state has the ability, on an *ex post* basis, to decrease the amount of unfunded mandates it imposes, or to increase the financial support it provides to the distressed municipality.¹⁹⁶ The state can also fully or partially assume the costs of some of the services it previously assigned to municipalities – services that can be more efficiently financed by the state itself.¹⁹⁷ By decreasing the level of unfunded mandates or by assuming the cost of local services, the state removes part of the economic pressure from the municipal budget and helps the city recover.¹⁹⁸ Second, from an *ex ante* perspective, placing the risk of a municipal crisis on the state may reduce the number of unfunded mandates the state imposes on local governments in the

¹⁹³ *Id.* at 195-207.

¹⁹⁴ Another measure only states can take in order to help distressed municipalities is annexation. Liberalizing their annexation policies helped southern states address local financial crises in the 1970s. KAMER, *supra* note 18, at 27. Studies show that in the 1970s northern cities in the so-called "snow belt" suffered from financial difficulties partly because their states did not enable them to annex surrounding territories. *Id.* at 27-30. Southern cities (the sun belt), on the other hand, avoided those crises partly as a result of liberal annexation policies by their states. *Id.* at 30-37.

¹⁹⁵ FUCHS, *supra* note 71, at 192.

¹⁹⁶ This is not to suggest that the state should increase the monetary aid to municipalities every time a municipality enters into financial distress. However, when a city becomes financially distressed because it does not receive its fair share of intergovernmental assistance (as in the case of Philadelphia, briefly discussed *supra* note 40), the state should interfere. In those cases it is only just that the state will equalize the amount of intergovernmental transfers to the distressed city. See Inman, *supra* note 40, at 380, 383.

¹⁹⁷ The best example is welfare services. It is widely agreed that state or federal governments can finance income redistributive services more effectively than local governments, because when local taxes finance these services affluent residents simply move to the suburbs. In other words, the scope for local redistributive programs is limited by the potential mobility of the residents, which tends to be greater the smaller the jurisdiction under consideration. See FISHER, *supra* note 9, at 586-92.

¹⁹⁸ For example, as a result of the New York City crisis, the state assumed the costs of the higher education system and those costs of the state's courts system that were, prior to the crisis, borne by the city. See BAILEY, *supra* note 130, at 152-54.

first place. If state politicians know that the state has the ultimate responsibility for local fiscal health, they may be more reluctant to shift costs onto the local governments through unfunded mandates. The state will better internalize the costs of its mandates because in case of a crisis the state would ultimately pay for them.

We can thus see that the state has a greater ability than municipal officials to address the socioeconomic causes at the heart of a municipal crisis. The reason is that in most cases the socioeconomic processes are external to the municipality, and so the local officials cannot address them. The state has superior legal powers and it can control a larger geographical boundary. Therefore, the state is capable of taking the actions necessary to help the locality recover.

2. The State Can Address the Political Causes of the Crisis

So far we have seen the advantages of the state with respect to the socioeconomic causes of municipal crises. As mentioned earlier, however, many scholars believe that the underlying causes of the crises have to do not with external factors but with the local management.¹⁹⁹ According to this view, the political environment, and especially its level of fragmentation, determines the city's fiscal fate. In order to initiate a recovery process the state should address not only external economic circumstances but also political aspects.

To better understand the state's ability to address the political causes of a municipal crisis, it is useful to recall the distinction made earlier between size and procedural fragmentation.²⁰⁰ Size fragmentation relates to the number of decision makers that participate in the budgetary process, and it can be thought of as a form of a common pool problem: as the number of financial decision makers rises, so do the government's expenditures, because each decision maker internalizes a smaller fraction of the costs imposed on the government.²⁰¹ Procedural fragmentation, on the other hand, has to do with the procedures through which fiscal policy is ultimately decided: if the budgetary process is disorganized and lacks central control, the government tends to spend more and incur additional obligations.²⁰² Distressed municipalities tend to suffer from both size and procedural fragmentation. While they have a large number of groups (including strong interest groups) that create pressure on the

¹⁹⁹ See discussion *supra* Part I.B.

²⁰⁰ See discussion *supra* Part I.B.2.

²⁰¹ Each decision maker (and the sector she represents) enjoys the full benefits of her budgetary demands, but she shares the costs of those demands with all the other decision-makers (and the populations they represent). Therefore, the more groups there are in a locality, the greater the pressure the locality will be under to overspend. See Perotti & Kontopoulos, *supra* note 52, at 195; Wolff, *supra* note 52, at 5.

²⁰² Perotti & Kontopoulos, *supra* note 52, at 196.

local budget, they also tend to have a decentralized financial decision-making process, with no single authority to ultimately control expenditures.²⁰³

The state's ability to address the political causes of municipal financial crises derives from its power to minimize the procedural fragmentation in the locality. Whereas local officials are trapped in the political system in which they operate, the state has both the legal authority and the political capacity to change the political environment, at least procedurally. The state's intervention alters the decision-making process in the locality, and through procedural changes it can minimize the effects of size fragmentation.

Generally speaking, studies have shown that certain budgetary procedures afford better control over spending and enable governments to minimize their deficits. For example, a centralized budgetary process enables the government to restrain its expenditures and suppress interest group pressures.²⁰⁴ Empirical research suggests that when national governments have a finance minister with strong authority over the budget, they also tend to have lower deficits.²⁰⁵ The same holds true with regard to local governments. Reza Baqir, for example, shows that a strong and centralized municipal executive authority, in particular one with veto powers over the budget, can ameliorate the effects of size fragmentation.²⁰⁶ Another procedural means of decreasing spending pressures involves splitting the budgetary process into two stages. First, one group determines the budgetary frame, and only later does a different group of people decide the allocation of the budget.²⁰⁷ Studies show that introducing this relatively simple procedure helps governments avoid public debt problems, and contributes to lower levels of deficit.²⁰⁸ The state's intervention in local

²⁰³ See discussion *supra* Part I.B.2.

²⁰⁴ Baqir, *supra* note 52, at 1347; Hallerberg & von Hagen, *supra* note 52, at 9; Perotti & Kontopoulos, *supra* note 52, at 196.

²⁰⁵ Hallerberg & von Hagen, *supra* note 52, at 19; cf. Nouriel Roubini & Jeffrey Sachs, *Government Spending and Budget Deficits in the Industrial Countries*, 4 *ECON. POL'Y* 99, 114 (1989) ("[C]oalition governments will have a bias towards higher levels of government spending relative to majority party governments, as the various constituencies in the government undertake logrolling agreements to secure greater spending for their individual constituencies.").

²⁰⁶ Baqir, *supra* note 52, at 1347-51.

²⁰⁷ Two different groups of decision makers must make the decisions in the two stages; otherwise, the decisions in the second stage will affect the outcome of the initial stage. In other words, the size of the budget will be determined (through backwards induction) by the allocations the decision makers want to make in the second stage.

²⁰⁸ Torsten Persson & Guido Tabellini, *Political Economics and Macroeconomic Policy* 71-72 (1997), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=57408&download=yes. For additional empirical research supporting this assertion, see generally Alberto Alesina et al., *Political Instability and Economic Growth*, 1 *J. ECON. GROWTH*, 189 (1996); Jürgen von Hagen, *Budgeting Procedures and Fiscal Performance in the European Community*, *ECON. PAPERS NO. 96*, EUR. COMMISSION (1992); Jürgen von

financial affairs promotes changes in exactly these directions: the state centralizes the budgetary procedures and splits the budgetary process into two stages.

Usually, states implement these procedural changes through the creation of a State Financial Board (or "Board").²⁰⁹ As opposed to the situation in the fragmented municipality, the Board, which is usually comprised of a few individuals appointed by the governor, centralizes fiscal decision making. The Board determines the locality's economic policies, oversees its expenditures, and generally makes sure the locality maintains a balanced budget. Perhaps the Board's most important authority involves its veto powers. The Board can veto the approval of the local budget (and sometimes even has a line-item veto over individual expenditures) and will reject budgets that exceed the distressed locality's revenue limits. By centralizing the decision-making process, the Board mitigates the common pool problem from which the city suffers.²¹⁰

In addition, the existence of the Board splits the budgetary process into two stages. First, the Board sets the maximum level of expenditures that the municipality may spend, and only then, after the Board has approved the budget's frame, may the local officials allocate funds to purchase the various public goods they wish to provide. Since the Board determines the budget's frame according to expected local income, this process forces the municipality to spend only its available resources. Thus, the Board prevents the locality from enlarging its deficit and facilitates its rehabilitation in times of financial distress.²¹¹

Hagen & Ian J. Harden, *Budget Processes and Commitment to Fiscal Discipline*, 39 EUR. ECON. REV. 771 (1995).

²⁰⁹ See MILAN J. DLUHY & HOWARD A. FRANK, *THE MIAMI FISCAL CRISIS: CAN A POOR CITY REGAIN PROSPERITY?* 74 (2002); Berman, *supra* note 125, at 56-57; Honadle, *supra* note 2, at 1461.

²¹⁰ The rehabilitation of New York City provides an example of this process. Prior to the creation of the Board (or as it was called in New York, The Emergency Financial Control Board), New York suffered from extreme political fragmentation. It was dominated by a large number of social and political groups, with no central authority to hold the various groups together. Martin Shefter, who studied the New York crisis, called this the "pluralist regime." SHEFTER, *supra* note 3, at 29-37. The Board used its broad legal powers (including the authority to veto the city's expenditures and the power to negotiate labor agreements) to centralize the city's political environment, and it saved the city from financial calamity. For an in-depth look at New York's rehabilitation process, see generally BAILEY, *supra* note 130.

²¹¹ This kind of Board was created to assist the city of Philadelphia in 1991. The Board approved a five-year financial rehabilitation plan and made sure that the city strictly adhered to the plan and did not spend more funds than the plan allowed. As Bernard E. Andersen, the Board's chairman, explained in a Congressional hearing:

The city would then be required to submit monthly reports to the board, and the mayor then would be informed that he had 30 days to come up with a plan to balance the budget in the future, that is in the next quarterly report and every quarterly report after that. If over a period of 30 days, I believe, the variance [with the five-year financial

The existence of a State Financial Board also diminishes the power of interest groups in the locality. As mentioned, interest groups (especially unions) have a great deal of influence on economic policies in a fragmented locality.²¹² Local elected officials very much depend on the interest groups' support and often give in to their financial demands. A State Financial Board, however, can better confront the interest groups and resist their budgetary pressures.²¹³ First, a Board's members are not elected but rather are appointed by the state. As such, many of the political benefits that interest groups usually confer upon public officials are not as relevant to the Board. With fewer political "gifts" to bestow, the power of interest groups to influence the Board members diminishes. Second, free from the need to take electoral considerations into account, a Board also becomes less vulnerable to interest group pressures. A Board is more likely to stand strong in the face of political threats simply because it is not concerned with its popularity among city residents. This advantage is particularly important when confronting unions. A Board can endure union strikes with much greater ease than local officials because it is focused on the locality's long-term economic interests, rather than the next election.

Due to the interests groups' diminished power, the Board can better implement retrenchment policies, especially when it comes to cutting a city's labor costs. The city of Chelsea, Massachusetts provides a good example. At the beginning of the 1990s, Chelsea faced a grave financial crisis.²¹⁴ One of the important causes of the crisis was the strength of the local unions.²¹⁵ Due to the city's political structure, the unions had a large degree of control over the results of local elections, so local politicians were either incapable of resisting their demands or unwilling to do so. The municipality consequently spent large amounts of money, especially on labor costs, which exacerbated the

plan] which was established or identified in a quarterly report was not corrected, then the board had the obligation to inform the State of this development and we had the authority to withhold tax revenues, State funds . . . until such time as the variance was corrected.

Financial Control Boards: Hearing Before the Subcomm. on the District of Columbia of the H. Comm. on Government Reform and Oversight, 104th Cong. 57 (1995) (statement of Bernard E. Andersen, Former Chairman, Pennsylvania Intergovernmental Cooperative Authority).

²¹² See *supra* Part I.B.2.

²¹³ Cf. BAILEY, *supra* note 130, at 181-88 ("The fundamental goal of the *crisis regime* was to gain control over the context in which interest group politics occur. In so doing, it also created a policy arena in which only the most significant interests . . . could play.").

²¹⁴ In 1991, the city had an estimated \$9 million deficit in its \$48 million budget, and the state was already contributing almost fifty percent of the budget. More than a third of the city's residents earned less than \$10,000 a year, and tax collections were dropping yearly. See Fox Butterfield, *Insolvent Boston Suburb Faces Threat of Takeover*, N.Y. TIMES, Sept. 8, 1991, at A18; *Receivership Sought for Bankrupt City*, *supra* note 152.

²¹⁵ See Ed Cyr, *Thoughts on the Chelsea Receivership*, 9 GOV'T FIN. REV. 23, 23 (1993).

growing budget deficit.²¹⁶ This situation changed with the creation of a state receivership. Unlike the elected municipal officials, the state receiver was not politically dependent on the unions, and he was able to break free from their paralyzing grip on the city's finances.²¹⁷ He cut the number of municipal public employees by more than twenty-five percent, reduced by seventy-five percent the amount spent on overtime, eliminated employment benefits like unlimited sick leave and overly generous vacation plans, and implemented plans to increase workers' efficiency.²¹⁸ As a result, within half a fiscal year after his appointment, the state receiver managed to cut the city's expenses by \$5 million (more than ten percent of the budget), and within a year, the city of Chelsea recovered from a grave financial crisis that had lasted more than twenty years.²¹⁹

We can thus see that even when a financial crisis is caused by the political system, the state can take measures to rehabilitate the city. The state can centralize the fiscal decision-making process and decrease the level of procedural fragmentation (and thus the effects of the size fragmentation). Just as in the Chelsea example, municipal officials often lack the ability to alter their financial practices independently. They are part of the local political environment, and they are forced to comply with various political demands, especially those of interest groups. State intervention may thus be necessary to change a distressed locality's economic behavior and enable it to recover.

IV. MUNICIPAL INSOLVENCY LEGISLATION

So far, I have discussed the advantages of state intervention. The starting point of my analysis was the premise that, perhaps contrary to our intuition, local officials have only a limited ability to address the causes of a local fiscal

²¹⁶ Employees grossly abused overtime (indeed, the city spent five percent of its annual budget on overtime), labor contracts included minimum staffing clauses, department heads had life tenure, and departments were generally overstaffed and inefficient. See William Cox, *Lessons of Receivership: The Legacy of Chelsea*, 9 GOV'T FIN. REV. 21, 22 (1993); Cyr, *supra* note 215, at 23; Ted Hampton, *Chelsea Receiver Trims Finances of a "Tough Town,"* BOND BUYER, June 16, 1992, at 6 (interview with James F. Carlin).

²¹⁷ One example of Carlin's policy was the renegotiation of the firefighters' contract. Prior to the receivership, due to the firefighters' political power, Chelsea was one of the most fire-protected cities. It had four fully-functioning fire stations for an area of about 1.8 square miles. Hampton, *supra* note 216, at 6. Each station was staffed 24 hours a day, and each firefighter enjoyed lucrative working conditions and benefits. Cyr, *supra* note 215, at 23. Carlin, who did not have to worry about winning the next election, changed this costly situation. He managed to close down two of the stations and significantly decreased the cost of the firefighters' working conditions to the municipality. Cyr, *supra* note 215, at 23; Hampton, *supra* note 216, at 6.

²¹⁸ See Cyr, *supra* note 215, at 23.

²¹⁹ Hampton, *supra* note 216, at 6; see also William Claiborne, *Bringing a Battered City Back from the Brink: Consensus-Building Process Inspires Citizen Involvement and a New Charter in Chelsea, Mass.*, WASH. POST, Sept. 7, 1994, at A3.

crisis. They can hardly affect the socioeconomic processes that create the financial decline, and they are part of a political system that often fuels the loss of fiscal restraint. Since the local officials may be unable to rehabilitate the distressed municipality, residents' and creditors' pressures on the local officials will not help either. Residents and creditors cannot force the local officials to take actions that the local officials are unable to take. In times of a local crisis, therefore, a locality needs the state's intervention. The state has both the legal authority and the political powers to address the causes of the crisis and to assist the locality's rehabilitation.

This rehabilitative goal is perhaps what distinguishes corporate bankruptcy law, on which chapter 9 is based,²²⁰ from municipal insolvency law and the creation of State Financial Boards. Corporate bankruptcy law aims not to rehabilitate distressed companies but rather to preserve their going concern value. Chapter 11 enables a bankrupt corporation to continue to function only if it is economically viable and in the creditors' best interests to keep it alive.²²¹ Economically distressed (as opposed to financially distressed) corporations are "sent" to liquidation so that they will give way to more successful and innovative companies. Some argue that this selection – a rule akin to "survival of the fittest corporations" – increases society's total wealth.²²²

The purpose of municipal insolvency law, however, is different. A municipality, unlike a private corporation, is not created to generate profits but to provide public services to its residents, and it has an obligation to continue providing these services even when facing economic difficulties. Local economic failure does not justify leaving the residents without education or police, and the competition among localities should not cast away localities or leave residents behind. The solution to municipal insolvency, therefore, must also offer a remedy when a municipality's problems are fundamental, and even when local officials cannot resolve them. The best way to achieve such rehabilitation is through state intervention.

Thus, it may come as no surprise that State Financial Boards are the most common remedy for municipal financial crises. States understand that other types of remedies (i.e., creditors' remedies or the Bankruptcy Code) do not help a distressed city recover, and states prefer to intervene and assist the city

²²⁰ See H.R. REP. NO. 95-595, at 263 (1977).

²²¹ THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 2 (1986); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 98-101 (1984).

²²² Douglas G. Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 183 (1987); Matthias Kahl, *Financial Distress as a Selection Mechanism: Evidence from the United States* 29 (UCLA Anderson Graduate Sch. of Mgmt., Working Paper No. 16-01, 2002), available at <http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1017&context=anderson/fin>.

themselves.²²³ Indeed, notwithstanding the legal academy's focus on chapter 9 of the bankruptcy code,²²⁴ in practice most municipal crises are resolved with the states' help. As the rating agency Standard & Poor's has observed in a study on municipal debt, distressed localities rarely default or file for bankruptcy; instead, the state intervenes in their fiscal affairs.²²⁵ This is because

[b]ankruptcies are usually not an option. Distressed municipalities in most states do not have a bankruptcy option; it is frequently restricted by law Distressed municipalities will typically receive some type of additional state aid, oversight, or other outside intervention that prevents the dramatic credit deterioration that [municipal] corporations may suffer.²²⁶

State Financial Boards have managed to rehabilitate both large cities, such as New York,²²⁷ Philadelphia,²²⁸ and Miami,²²⁹ and small towns such as Chelsea,²³⁰ Princeville,²³¹ and the Village of Maywood.²³²

Notwithstanding the advantages of State Financial Boards, this remedy is not properly codified in most states. There is no general statute that determines when a state should create a Board or how the state should get involved in a distressed locality's financial affairs.²³³ State intervention is

²²³ See *Economic Distress in Our Cities: Bridgeport, Connecticut: Field Hearing Before the H. Comm. on Banking, Finance and Urban Affairs*, 102d Cong. 161-62 (1992) (statement of Richard Blumenthal); Ledebur, *supra* note 15, at 242-46.

²²⁴ See *supra* note 4 and accompanying text.

²²⁵ Colleen Woodell et al., *U.S. Municipal Rating Transitions and Defaults, 1986-2003*, 24 MUN. FIN. J. 49, 54-55 (2004).

²²⁶ *Id.* at 55; see also DLUHY & FRANK, *supra* note 209, at 74; Berman *supra* note 125, at 56; David Litvack & Frank Rizzo, *Municipal Default Risk*, 21 MUN. FIN. J. 25, 32 (2000).

²²⁷ See generally BAILEY, *supra* note 130.

²²⁸ See generally Inman, *supra* note 40.

²²⁹ See generally DLUHY & FRANK, *supra* note 209.

²³⁰ See authorities cited *supra* notes 214-23.

²³¹ See Rob Christensen, *A Big Government Idea That Makes Conservatives Proud*, NEWS & OBSERVER (Raleigh, NC), Jan. 12, 1998, at A3; Alan Scher Zagier, *Princeville's State of Crisis*, NEWS & OBSERVER (Raleigh, NC), Dec. 15, 1996, at B1.

²³² See generally Charles L. Jarik et al., *Municipal Financial Distress: A Case Study of a Partnership Between the Village of Maywood and the Illinois Development Finance Authority*, 25 URB. LAW. 995 (1993).

²³³ Kloha et al., *supra* note 126, at 240 (describing the results of a state survey regarding state approaches to local financial crises, which show that only fifteen states use formal "indicators to evaluate their local governments' fiscal positions" on a regular basis); see also 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, 254-55 (1994).

usually ad hoc, with the state legislature enacting a special statute for each crisis event.²³⁴

At first glance, this ad hoc policy may appear adequate or even desirable. It affords flexibility, and allows the state to adapt its reaction to the changing circumstances of each crisis. However, a more careful analysis reveals that an ad hoc policy can be problematic. Absent a general, preferably codified, policy, state intervention is often delayed, and cities do not receive the assistance they need in order to recover from financial decline in a timely fashion.

In this Part of the Article, I therefore examine the enactment of municipal insolvency legislation, which codifies the timing and scope of state intervention. First, I elaborate on the need for such legislation, and then demonstrate its advantages using the state of North Carolina as an example.

A. *The Need for Municipal Insolvency Legislation*

Generally speaking, states can take two types of approaches with regard to their involvement in local financial crises: a proactive, *ex ante* approach or a reactive *ex post* approach. The proactive approach aims to monitor municipal financial activities and help local governments avoid a financial crisis before it actually occurs. The state supervises the fiscal affairs of local governments on a regular, ongoing basis, and intervenes more extensively when local governments first show signs of economic decline to prevent further financial deterioration. The reactive approach, on the other hand, deals with a crisis after it occurs. It usually takes place only when a city nears default, and the state targets its activity to solving the particular financial emergency and preventing the consequences of a possible default.²³⁵

Although the advantages of proactive state intervention are apparent – the state can help cities avoid potential crises, and can save cities from the harm associated with crisis events – most states take a reactive approach.²³⁶ States often create State Financial Boards too late, forcing cities to undergo severe financial difficulties before they receive the required assistance. The reason

²³⁴ For example, Pennsylvania enacted the PICA Act to establish a State Board for Philadelphia, New York State enacted the Financial Emergency Act to establish a State Board for New York, and Massachusetts enacted the receivership act for Chelsea. See An Act Establishing a Receivership for the City of Chelsea, 1991 MASS. ACTS 679-86; New York State Financial Emergency Act for the City of New York, 1975 N.Y. SESS. LAWS 1405-44 (McKinney); Pennsylvania Intergovernmental Cooperation Authority Act for Cities in the First Class, 53 PA. CONS. STAT. ANN. § 12720.101-.709 (West 1991).

²³⁵ See Berman, *supra* note 125, at 57; Kloha et al., *supra* note 126, at 236-37.

²³⁶ See Honadle, *supra* note 2, at 1461 (concluding from a survey on states' roles in local fiscal crises that states get involved after the crises occur and usually do not know about them beforehand; even when states do know of impending crises, they generally do not prevent them); Kloha et al., *supra* note 126, at 252-53 (presenting a survey that shows that only seven states use a proactive approach in their legislation; among these states are North Carolina, New Jersey, Ohio, Pennsylvania, New Hampshire, Maryland, and Florida).

for this “late intervention” is rooted in the political interests of state and local officials. These officials often lack the incentive to help ailing cities, and prefer to ignore the situation as much as they can rather than deal with it.

State officials often prove reluctant to incur the costs associated with a local rehabilitation process. The state does not have unlimited resources, and investing state funds in the recovery of a distressed locality comes at the expense of other state objectives, some of which may be more politically attractive to the state officials. The state officials’ reluctance to initiate a recovery process may be especially acute due to fragmentation in the state legislature. State politicians often represent a certain municipality or geographical area, and they strive to maximize the utility of their own constituency rather than the welfare of the state or of other localities.²³⁷ A state-funded recovery process, however, is generally perceived to serve the narrow benefit of the distressed locality. The funds are taken from the general state budget, and it appears as though most other constituencies do not profit from the locality’s rehabilitation. State politicians thus have an incentive to reject investing state resources in recovery processes for localities that they do not represent, and state intervention is thereby delayed.²³⁸

Local officials and local interest groups may also object to the creation of State Financial Boards. Boards often weaken the position of both officials and interest groups, so these players may try to prevent or limit the state’s involvement. This type of objection can be viewed as an agency cost. Although the vast majority of residents may benefit from the creation of a State Financial Board, those who hold power in the locality resist the Board. The agents (i.e., local officials) do not have the best interests of their principals (i.e., local residents) in mind, so they oppose the creation of a Board even when it can potentially improve the local fiscal health.²³⁹

How then can timely state intervention be achieved despite the political interests of both state and local officials? One possible solution is the creation of a general municipal insolvency statute. Such statutes establish a general state policy with regard to local financial distress, and it determines the timing for the state’s actions and the authority that the Board would possess. To do this, these statutes specify several financial indicators, the presence of which

²³⁷ Daniel B. Rodriguez, *Localism and Lawmaking*, 32 RUTGERS L.J. 627, 648-62 (2001).

²³⁸ See Sheryll D. Cashin, *Localism, Self-Interest, and the Tyranny of the Favored Quarter: Addressing the Barriers to New Regionalism*, 88 GEO. L.J. 1985, 2023-25 (2000); Margaret Weir, *Central Cities’ Loss of Power in State Politics*, 2 CITYSCAPE: J. POL’Y DEV. & RES. 23, 36 (1996).

²³⁹ Chelsea, Massachusetts provides a good example. In Chelsea, both the Board of Aldermen and the unions lobbied in the state legislature to prevent the establishment of a receivership. They argued that the situation did not warrant such a drastic measure and expressed doubts about whether an “outsider,” the receiver, could solve the city’s problems. Brian McGrory, *Chelsea Receivership Asked: Weld Takes Unprecedented Step for Fiscally Ailing City*, BOSTON GLOBE, Sept. 6, 1991, at B1; Brian McGrory, *Legislative Panel Backs Chelsea Receivership*, BOSTON GLOBE, Sept. 8, 1991, at B1.

signals the occurrence of an incipient financial crisis. When a locality's actions or omissions trigger the statutory indicators, its financial condition warrants state intervention, and the statute obligates the state to intervene and prevent further financial deterioration.²⁴⁰ For example, the statute can set as an indicator a certain maximum level of aggregate local deficit. As the state monitors local finances, an increase in the locality's aggregate deficit beyond the statutory threshold would trigger state intervention. The municipal insolvency legislation thus implements and promotes proactive state involvement in local affairs. Using the various statutory indicators, the state constantly monitors a locality's financial condition and more effectively determines when to intervene.²⁴¹ Essentially, the municipal insolvency legislation determines the best timing of the state's intervention, directing the state to act when there are financial justifications, but before a full-blown crisis has developed.²⁴²

In the following Section, I detail the advantages a municipal insolvency statute brings to state and local governments. Before describing the advantages of the legislation, however, a preliminary question is in order: why should state politicians agree to implement a proactive policy in an insolvency statute when, as we have seen, they do not have an incentive to implement such a policy ad hoc without a statute? How does municipal insolvency legislation overcome the incentives of local and state officials discussed earlier in this Section? The advantages of insolvency legislation in this context are twofold.

²⁴⁰ For a survey of the indicators used by the different states, see Kloha et al., *supra* note 126, at 242-48 (describing six categories of indicators: revenue, expenditure, operating position, debt, unfunded liabilities, and community needs and resources). For examples of specific sections in municipal insolvency statutes specifying the indicators, see NEV. REV. STAT. § 354.685 (2007); OHIO REV. CODE ANN. §§ 118.022-.03 (LexisNexis 2007); Municipalities Financial Recovery Act, 53 PA. CONS. STAT. ANN. § 11701.201 (West 1997).

²⁴¹ For more sophisticated models for predicting forthcoming local fiscal crises, see Ken W. Brown, *The 10-Point Test of Financial Condition: Toward an Easy-to-Use Assessment Tool for Smaller Cities*, GOV'T FIN. REV., Dec. 1993, at 21, 21-23; Robert Kleine et al., *Monitoring Local Government Fiscal Health: Michigan's New 10 Point Scale of Fiscal Distress*, GOV'T FIN. REV., June 2003, at 19, 20-23.

²⁴² Municipal insolvency legislation also helps local governments protect their local autonomy. A state insolvency statute renders the criteria for the state's action more objective, forcing the state to prove the existence of these criteria before it intervenes in the local affairs. *Cf.* Kloha et al., *supra* note 126, at 236-37 (highlighting the importance of the criteria states use to determine when to intervene in local financial affairs, since such interventions are "often controversial" and "may conflict with the norm of local autonomy"). This enables better judicial review of the state's actions, and decreases the chances of arbitrary interventions, perhaps motivated by the political agenda of state officials.

First, as opposed to an ad hoc intervention, states enact municipal insolvency legislation behind a “veil of ignorance.”²⁴³ At the time of enactment, no one knows which locality will experience economic difficulties, so the legislation can potentially help every locality – if and when it encounters municipal financial distress. The generality of the statute allows state legislators to evaluate a locality’s financial situation in a more objective manner. In adopting an insolvency statute, politicians do not consider whether it is in their interest to help a specific suffering locality, nor do they need to. Rather, they consider whether the method of proactive state intervention is generally more beneficial.²⁴⁴

Second, and perhaps more importantly, a municipal insolvency statute can reduce the local governments’ cost of capital. The implementation of municipal insolvency legislation sends a signal to the credit markets and to the credit rating agencies: the state shows its commitment to preventing local crises, and its refusal to let its municipalities default. Thus, the state essentially reduces the risk associated with the local debt, and the creditors reward the localities with lower interest rates. Because a proactive municipal insolvency statute can potentially reduce the interest rates of many local governments in the state, state and local officials may find it worthwhile to support such a statute.²⁴⁵

In the next Section, I demonstrate this claim through a case study of North Carolina. North Carolina implements a proactive model of state intervention, which enables its local governments to enjoy substantial savings in interest rates.

²⁴³ Cf. JOHN RAWLS, A THEORY OF JUSTICE 11 (rev. ed. 1999) (“Among the essential features of this situation is that no one knows his place in society, his class position or social status The principles of justice are chosen behind a veil of ignorance.”).

²⁴⁴ I do not argue that a general municipal insolvency statute is legislated free of political interests. Municipal officials, local unions, and other interest groups certainly lobby with regard to these statutes, and the pressures from the different groups in the state do affect the outcome of the legislation. I do argue, however, that due to the generality of such a statute, ad hoc political considerations do not play as dominant a role in the state’s decisions. Such a statute reflects the state’s position on how to address municipal insolvency in general, and relates less to the political interests and circumstances of a particular crisis.

²⁴⁵ In Dennis Epple & Chester Spatt, *State Restrictions on Local Debt: Their Role in Preventing Default*, 29 J. PUB. ECON. 199 (1986), the authors developed a model to explain state restrictions on local debt. They argue that a default of one local government may affect the interest rates of other local governments in the state as well. *See id.* at 200-01. As a result, local governments – those that do not wish to default – have an interest in maintaining their state’s reputation in the enforcement of local debts. *Id.* at 218. Since a debt limit reduces the number of localities that are prone to default, various local governments in the state benefit from the debt limit and support it. The same logic applies here. Proactive municipal insolvency legislation promotes the state’s reputation for the enforcement of local debts. Such legislation thereby reduces the interest rates local governments have to pay, and benefits all local governments.

B. *The Advantages of State Intervention: North Carolina's Example*

North Carolina is considered a model state in terms of local government finance.²⁴⁶ North Carolina has the largest number of top-rated (AAA-rated) local units in the country, and its localities enjoy the confidence of the credit markets and pay low interest rates, even when compared with equally-rated municipalities in other states.²⁴⁷

The success of North Carolina's localities is usually attributed to the state's oversight system, and in particular to the state agency in charge of local finance – the Local Government Commission (“LGC” or “Commission”).²⁴⁸ North Carolina created the LGC, a statutory state agency, in 1931 in response to local crises that occurred during the Great Depression.²⁴⁹ Although in the seventy-five years since its creation the commission's function has evolved considerably, its basic mission has remained more or less the same: the LGC oversees local government debt and financial management, and ensures that localities make debt payments in a timely manner.²⁵⁰

The LGC utilizes a sophisticated ongoing supervision system and has strong authority to exercise financial control.²⁵¹ The Commission constantly monitors both the financial management and the debt management of local governments. All the local governments in North Carolina (more than 950 in all) must submit semi-annual financial statements to the LGC, and its fiscal management section reviews and assesses the financial condition of each municipality.²⁵² In addition, the local governments must receive the Commission's approval for

²⁴⁶ See, e.g., K. Lee Carter, Jr., *State Oversight of Local Government Finance*, in STATE AND LOCAL GOVERNMENT IN NORTH CAROLINA: THEIR EVOLUTION AND CURRENT STATUS 71, 71 (Charles D. Liner ed., 2d ed. 1995).

²⁴⁷ Mayraj Fahim, *North Carolina Still Influences U.S. Local Government Finance*, CITY MAYORS, Mar. 31, 2005, http://www.citymayors.com/finance/nc_finance.html.

²⁴⁸ North Carolina established the Commission under the Local Government Finance Act, N.C. GEN. STAT §§ 159-1 to -210 (2007).

²⁴⁹ “[During the Great Depression] more local governments in North Carolina defaulted on their debts than [in] any other state in the nation, except Florida.” Fahim, *supra* note 247.

²⁵⁰ Carter, *supra* note 246, at 75.

²⁵¹ The Commission consists of nine members: four *ex-officio* members (the state's treasurer, who also serves as chairman; the state auditor; the secretary of state; and the secretary of revenue), and five appointed members (three members are appointed by the Governor, one by the President *pro tempore* of the Senate, and one by the Speaker of the House). In addition, the Commission employs a staff of about thirty-five associates. The majority of the staff members are individuals with degrees in economics, business, or accounting. *Id.* at 75-76.

²⁵² Richard P. Larkin & Jeff Schaub, *State of North Carolina Local Government Commission: Credit Enhancement Program Review*, FITCH IBCA TAX-SUPPORTED SPECIAL REPORT, Mar. 29, 1999, at 5, available at <http://nira.go.jp/newsj/seisakuf/04/siryoku/08.pdf> [hereinafter *Fitch Report*].

the issuance of all local debt.²⁵³ As part of the approval process, a special section of the LGC determines whether the issuing municipality is financially able to meet the expected debt obligations.²⁵⁴ Upon approval, the LGC participates in the marketing and sale of local debt, and maintains records to monitor and assure the locality's timely repayments.²⁵⁵

In connection with its fiscal monitoring, the Commission pays special attention to seven financial indicators that provide warning signs for potential financial crises.²⁵⁶ The most important indicator measures the localities' general fund balance. The LGC insists that localities have a general fund balance of at least 8% of their yearly expenditures (approximately one month's expenditures), and view a failure to meet this threshold as a sign of economic deterioration warranting state attention.²⁵⁷

When a locality triggers the financial indicators, the LGC takes special notice of the locality's financial affairs. The LGC begins to work more closely with local officials, and tries to help the locality implement better management practices. In the vast majority of cases, the LGC's guidance is enough to steer the distressed locality back to financial stability, but if the locality does not cooperate and its financial deterioration continues, the LGC can take over the locality as a State Financial Board. In these cases, the LGC has the power to take any financial measures it deems necessary to restore local fiscal health and prevent a local default.²⁵⁸

²⁵³ The LGC's debt supervision is not limited to general obligation bonds; rather, it includes all types of debts, such as short-term notes, local revenue debt, and conduit debt. Carter, *supra* note 246, at 76-77.

²⁵⁴ *Id.*

²⁵⁵ *Id.* at 78.

²⁵⁶ Contrary to most municipal insolvency statutes, North Carolina's Local Government Finance Act does not specify any certain financial indicators that trigger the state's intervention. Compare Local Government Finance Act, N.C. GEN. STAT §§ 159-1 to -210 (2007), with authorities cited *supra* note 240. The Act enables the Commission to take over a local government when a locality is likely to default, but it does not detail specific indicators for when a default is likely. N.C. GEN. STAT § 159-36. The LGC, therefore, developed its own indicators. The LGC's indicators not only define when a default is likely, but they also detect signs of financial distress so as to predict forthcoming fiscal emergencies. According to the survey conducted by Kloha, Weissert & Kleine, the LGC uses the following types of indicators: three indicators examine the local revenues and expenditures, two examine the localities' operating position, one examines unfunded liabilities, and one examines legal or technical violations. Kloha et al., *supra* note 126, at 245 tbl.2.

²⁵⁷ See *Fitch Report*, *supra* note 252, at 4. The same information was also conveyed in an interview the author conducted with Dean Cunningham, Senior Fiscal Advisor of the LGC. Telephone Interview with Dean Cunningham, Senior Advisor, The Local Government Commission (June 9, 2006) (transcript on file with author).

²⁵⁸ N.C. GEN. STAT § 159-36.

This supervision system pays off. In 1999, the Fitch IBCA Rating Agency devoted an entire report to the LGC.²⁵⁹ Fitch IBCA reviewed the Commission's supervision measures and examined its impact on the creditworthiness of local governments. Fitch IBCA praised the LGC's work and upgraded the credit rating of the localities under the Commission's supervision, stating:

The frequency and thoroughness of review by the LGC, coupled with its record of assuming fiscal control before stress leads to crisis, provides additional credit strength to most local issuers. In recognition of this "credit firewall," Fitch IBCA will grant credit enhancement of one to two notches on debt rating below "AA" for local government issuers under the supervision of the State of North Carolina LGC.²⁶⁰

Fitch IBCA is not the only rating agency to acknowledge the contribution of the Local Government Commission. In July 2000, Moody's also published a report that connected North Carolina's strong credit rating to the state's ongoing supervision efforts. *The Bond Buyer* described Moody's report as follows:

A special report released by Moody's Investors Service last week found the credit outlook for North Carolina's counties to be favorable, with its local governments experiencing stronger credit quality than others in the nation as a whole. Sean O'Brien, an assistant vice president at Moody's and author of the report, said the role the state's Local Government Commission plays in county finances contributes considerably to their success. Although the LGC does not financially guarantee local government debt commitments, it does provide active oversight of all issuers in the state. Furthermore, if an issuer defaults, the LGC can take over that government's books, O'Brien explained.²⁶¹

Naturally, the localities' improved credit ratings translate into lower interest rates. Harlan Boyles, North Carolina's former state treasurer, estimated that North Carolina's good bond rating translates into interest rates that are fifteen to twenty percent below the national market average.²⁶² For example, North Carolina's local governments sold general obligation bonds with interest rates averaging ninety-five basis points below the national Bond Buyer Index in 2001,²⁶³ ninety-six basis points below the index in 2002,²⁶⁴ and eighty-two

²⁵⁹ *Fitch Report*, *supra* note 252.

²⁶⁰ *Id.* at 1.

²⁶¹ Tedra Desue, *Moody's: North Carolina Counties Come out on Top*, BOND BUYER, July 12, 2000, at 4.

²⁶² Christensen, *supra* note 231.

²⁶³ N.C. DEP'T OF STATE TREAS., THE STATE TREASURER'S ANNUAL REPORT FOR FISCAL YEAR 2001-2002, at 20 (2002), available at <http://www.nctreasurer.com/NR/rdonlyres/6C7A2B49-6C4C-4B2C-B801-755C3D3D89B7/0/20012002AnnualReport.pdf> [hereinafter STATE TREASURER'S ANNUAL REPORT 2001].

basis points below the index in 2003.²⁶⁵ The lower interest rates in turn translate into considerable savings. As a result of the lower interest rates, local governments in North Carolina saved a total of \$53.5 million in 2001,²⁶⁶ \$108 million in 2002,²⁶⁷ and \$100 million in 2003,²⁶⁸ on interest payments on general obligation bonds alone (assuming they would otherwise sell the bonds according to the average interest rates).²⁶⁹ Certainly, these figures are much higher than the costs of maintaining the Local Government Commission,²⁷⁰ and they show the economic benefits of implementing proactive state monitoring.

It is interesting to compare in this context the achievements of North Carolina's statute to the achievements of municipal insolvency statutes in other states. Evidence suggests that municipal insolvency legislation makes a positive contribution to the fiscal health of local governments in other states as well. The Advisory Commission on Intergovernmental Relations, for example, concluded that the performance of local governments in states that had a supervisory system over municipal finance is considerably better than their counterparts in states that lack such a supervision system.²⁷¹ Similarly, a more recent study conducted by Jane Beckett-Camarata suggests that municipal

²⁶⁴ N.C. DEP'T OF STATE TREAS., THE STATE TREASURER'S ANNUAL REPORT FOR FISCAL YEAR 2002-2003, at 35 (2003), available at <https://www.nctreasurer.com/NR/rdonlyres/2B0622CE-7918-4B2B-A8AD-BBEC663846CA/0/03AnnualReport.pdf> [hereinafter STATE TREASURER'S ANNUAL REPORT 2002]

²⁶⁵ N.C. DEP'T OF STATE TREAS., THE STATE TREASURER'S ANNUAL REPORT FOR FISCAL YEAR 2003-2004, at 29 (2004), available at <https://www.nctreasurer.com/NR/rdonlyres/40A3C119-EC61-49BF-8669-7F08716A5BEB/0/NCTRPT0304LOWREV.pdf> [hereinafter STATE TREASURER'S ANNUAL REPORT 2003].

²⁶⁶ STATE TREASURER'S ANNUAL REPORT 2001, *supra* note 263, at 20.

²⁶⁷ STATE TREASURER'S ANNUAL REPORT 2002, *supra* note 264, at 35.

²⁶⁸ STATE TREASURER'S ANNUAL REPORT 2003, *supra* note 265, at 29.

²⁶⁹ The savings are calculated over the life of the bonds sold, assuming the local governments would have paid the average interest rate as determined by the national Bond Buyer Index.

²⁷⁰ The Commission's staff consists of a mere thirty-five members, suggesting an operating cost of far less than \$50 million. See Carter, *supra* note 246, at 75.

²⁷¹ The effectiveness of these and other State programs designed to assist municipal units in or near severe financial crisis varies widely. Nevertheless, in states with court or administrative assistance, the performance of municipal units under stress seems considerably better than those in states in which no provisions have been made for state review, approval or supervision. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, CITY FINANCIAL EMERGENCIES: THE INTERGOVERNMENTAL DIMENSION 79 (1973). The Advisory Commission reached the same conclusion in its 1985 report. ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, *supra* note 13, at 5 ("A review of the cases of financial emergencies in local governments occurring over the 1972-83 period, generally confirms the findings in the 1973 . . . report that financial management problems are the principal cause of emergencies, and that state actions are the most appropriate means of preventing and treating them.").

insolvency legislation had positive effects on Ohio's local governments.²⁷² She points out that the state's action was necessary for the rehabilitation of Ohio's distressed municipalities, because localities were reluctant to change their ongoing destructive financial patterns without the state's governmental intervention.²⁷³

It seems, however, that no other state has earned the same recognition as North Carolina, and the achievements of the LGC in the credit markets are unparalleled.²⁷⁴ This difference may be due to North Carolina's proactive supervision of local finance. Most states do not spend as much effort on the ongoing monitoring of local financial management, and their agencies are not as professional and sophisticated as the LGC.²⁷⁵ Fitch IBCA points out the importance of North Carolina's proactive "surveillance" system in its credit report:

While the LGC's power to exercise financial control is very substantial, it is the LGC's ongoing fiscal surveillance program that prevents fiscal stress from becoming a crisis for local governments in North Carolina. . . . The proactive involvement of the LGC is, perhaps, the real reason for the Commission's success in fostering good financial operations in North Carolina.²⁷⁶

North Carolina truly has attained remarkable achievements in the area of local government finance, but there is no reason why other states could not adopt the North Carolina model with an equal degree of success. The LGC's accomplishments are not because of any special or unique attributes of North Carolina, so it seems that other states could emulate this model as well.

CONCLUSION

This Article has emphasized the advantages that can result from state intervention in times of local financial distress. I have explored the causes of municipal crises, and I have shown that states – rather than residents or creditors – can better address these causes, rehabilitate cities, and minimize the harmful effects of local financial decline. This Article also suggests that the timing of the state's involvement has considerable importance. To direct the state's involvement to the correct time frame, I have recommended the

²⁷² Jane Beckett-Camarata, *Identifying and Coping with Fiscal Emergencies in Ohio Local Governments*, 27 INT'L J. PUB. ADMIN. 615, 624 (2004) (finding that Ohio's Fiscal Emergency Law "appeared to have a noticeable positive long term effect on 12 of the 15 [sampled] local government's financial performance").

²⁷³ *Id.* at 628.

²⁷⁴ See Carter, *supra* note 246, at 71; Fahim, *supra* note 247.

²⁷⁵ *Id.* ("Of all the states North Carolina has the most extensive state involvement in local government finance, especially in relation to state approval of local government debt management and monitoring of financial conditions.").

²⁷⁶ *Fitch Report*, *supra* note 252, at 4-5.

enactment of municipal insolvency statutes that implement a proactive, *ex ante* state approach.

The advantages of a proactive approach are financial as well as social. As demonstrated by North Carolina, implementing a proactive approach helps localities improve their credit ratings, which results in lower interest rates. The money saved on interest rates can be used for the benefit of the local community, so that the residents will enjoy decreased tax rates and better local services. Further, the proactive approach also helps the state improve local fiscal health. The state's monitoring policies can prevent potential fiscal emergencies, and the state thus minimizes the harm that a potential crisis inflicts on the local community.

To conclude, I wish to return to the excerpt I cited at the beginning of the Article from Bridgeport's bankruptcy case – the testimony of Bridgeport's chief of police.²⁷⁷ In his testimony Thomas Sweeney described Bridgeport as being in the midst of a crisis, especially with regard to the personal security of its residents.²⁷⁸ He spoke of neighborhoods controlled by drug dealers, of inadequate response to emergency calls, and of a severely understaffed police force.²⁷⁹ That said, municipal insolvency legislation is not a magical solution that miraculously improves a city. For the reasons elaborated in this Article, however, I believe that such legislation can make sufficient difference to warrant some experimentation by the states. The gravity of the phenomena associated with urban poverty – crime, drugs, lack of proper public education, decaying infrastructure – cannot be overstated, and a proactive state supervision system may give cities better financial capabilities to deal with these problems. As we have seen, the benefits of such a system can be considerable.

²⁷⁷ See *supra* note 1 and accompanying text.

²⁷⁸ See *supra* note 1 and accompanying text.

²⁷⁹ See *supra* note 1 and accompanying text.