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POLITICAL WILL AND FISCAL FEDERALISM IN MUNICIPAL BANKRUPTCY

Clayton P. Gillette*

Abstract: *Municipalities in fiscal distress may seek to adjust debts under Chapter 9 of the Bankruptcy Code either because they are truly destitute or because they lack the political will to adopt affordable tax increases. Local officials of municipalities that enter bankruptcy proceedings nevertheless retain political authority over municipal fiscal affairs. The decision to enter bankruptcy, however, may have significant financial consequences for other municipalities or for more centralized levels of government. Those externalities induce central governments to consider bailouts for distressed municipalities. In order to avoid moral hazard problems, central governments typically impose harsh restrictions on local officials as a condition of bailout. This dual system of rescue for distressed municipalities -- bailouts and bankruptcy -- permits local officials to threaten to file under Chapter 9, and thus to impose costs on central governments, unless the latter modify the conditions of bailouts. In this article, I suggest that allowing bankruptcy courts to impose tax increases serves to neutralize the strategic behavior of local officials, and thus encourages localities to internalize the costs of their activities in a manner more consistent with the tenets of fiscal federalism.*

After Orange County's unfortunate investment in derivatives in the 1990's caused substantial losses to the local treasury, residents had the opportunity to facilitate exit from bankruptcy by enacting a 10-year half-cent increase in the county sales tax. They declined. They apparently preferred that losses be borne by holders of debt secured by Orange County revenues, which, in the absence of a tax increase, could prove insufficient to pay debt service.¹ In 2008, the city of Vallejo, California filed for bankruptcy in order to reject collective bargaining agreements, the costs of which constituted \$79.4 million of its \$95 million budget.²

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¹ Mark Baldassare, *When Government Fails* 151-160 (1998).

² *In re City of Vallejo*, 408 Bankr. Rep. 280, 287 (2009). The city has recently proposed a plan under which it would pay unsecured creditors between five and 20 percent of their claims. See Randall Jensen, *Vallejo Plan Would Give Unsecured Creditors 5 to 20 Cents on the Dollar*, *The Bond Buyer*, January 19, 2011, available at http://www.bondbuyer.com/news/vallejo_california_unsecured_creditors_bankruptcy-1022294-

The court noted that the city council had consistently refused to seek electoral approval for tax increases, even though Vallejo had the lowest sales tax in its geographic area.³ Last summer the mayor of Harrisburg, Pennsylvania declared that the city would default on a scheduled \$3.3 million bond payment. To the argument that the city could instead have cut services, the mayor responded, “[t]o disrupt [services] because we can’t make a bond payment would just be unconscionable. And as a leader I couldn’t do it.”⁴

These refusals of fiscally distressed municipalities to accept higher taxes or reduced services (I will refer to them collectively as “tax increases”) to satisfy obligations that they have come to regret have multiple plausible explanations.⁵ They may reflect actual fiscal incapacity to pay existing obligations. Tax increases, that is, could be self-defeating because any such effort will generate sufficient exit by current firms and residents that net revenues will actually decline.⁶ Alternatively, failure to fund obligations could be the consequence of an absence of political will rather than of fiscal incapacity. Refusal to accept tax increases may result from residents’ justifiable indignation that political officials incurred obligations in the locality’s name notwithstanding reasonable expectations that their costs would ultimately exceed municipal benefits. Both debts incurred to fund capital projects that have proven burdensome (an incinerator in the case of Harrisburg) or agreements to provide generous pensions to public employees arguably fall within this category. Baldassare reports that substantial opposition to

1.html?ET=bondbuyer:e2782:2060276a:&st=email&utm_source=editorial&utm_medium=email&utm_campaign=B
B_intraday_011911.

³ In re City of Vallejo, 2008 WL 4146015 at *10, *12 (Bkrcty.E.D.Cal.).

⁴ Romy Varghese, Harrisburg Surrender, Wall Street Journal September 8, 2010.

⁵ The examples above are not exhaustive of recent efforts to avoid debt. Residents of Mount Clemens, Michigan defeated a proposal to increase tax rates in November 2010, notwithstanding the city’s \$1 million deficit. See Nick Bunkley, Debt Rising, A City Seeks Donations in Michigan, available at <http://www.nytimes.com/2010/11/20/us/20michigan.html>.

⁶ See Andrew Haughwout et al., Local Revenue Hills: Evidence from Four U.S. Cities, 86 Rev. Econ. & Stat. 570 (2006).

the Orange County sales tax increase came from residents who viewed it as a means of paying for the “mistakes” of county officials.⁷ While turning the responsible officials out of office may provide a more highly targeted means of chastisement, the binary nature of voting, the low likelihood that the officials of distressed cities will run for re-election, and a frequent perception that officials betrayed the trust of the electorate suggest that residents believe repudiation of onerous obligations is appropriate.

Perhaps less benignly, municipalities that could bear tax increases may refuse to fund obligations because residents regret having taken a risk that subsequently materialized and believe that relief from another source – a more centralized government or creditors themselves – is plausible. Bailout or bankruptcy, that is, may be seen as a viable option to tax increases. Eric Monkkonen’s study of late 19th century municipal defaults, largely precipitated by overinvestment in railroad aid and other “internal improvements,” concluded that localities systematically could afford to avoid default, but preferred to impose the costs of imprudently incurred obligations on creditors rather than to bear them personally.⁸

If municipal distress implicated little more than the relationships between municipalities and their creditors, we might address the issue as a variation on fiscal difficulties suffered by individuals or firms. Indeed, that has been the approach of most of the literature that has considered the provisions for municipal debt adjustment under Chapter 9 of the federal Bankruptcy Code.⁹ In this article, however, I contend that the options available to fiscally distressed municipalities are properly examined under the lens of fiscal federalism, as well as under standard perspectives on debtor insolvency, because the conduct of the municipalities

⁷ Baldassare, *supra* note 1, at 147-148.

⁸ Eric Monkkonen, *The Local State: Public Money and American Cities* (1995).

⁹ See 11 U.S.C. §§ 901-946.

necessarily affects the fiscal stability of more centralized governments. Whether default on municipal debt arises from fiscal incapacity or the absence of political will may therefore have implications for the proper role of federal law and federal actors in the face of threatened or actual default.

Specifically, fiscal federalism and the motivation for municipal default have implications for the vexing issue of whether bankruptcy courts can or should require tax increases for residents of municipalities that seek to adjust their debts under Chapter 9. Several years ago, Professors McConnell and Picker proposed that bankruptcy courts do indirectly what they could not do directly by using the authority to reject or confirm a municipal debt adjustment plan in order to induce the debtor municipality to levy taxes on its residents, even if the same court had no authority to order the same increase.¹⁰ The McConnell/Picker suggestion was part of their broader claim that municipal bankruptcy proceedings should more closely resemble bankruptcy proceedings that relate to firms, including grants of power “to force politically unpopular, but sensible, decisions such as elimination of municipal functions, privatization, and changes in tax law,”¹¹ or to force more efficient forms of municipal organization.¹² Others subsequently disagreed, though primarily with the solution, rather than with the problem of constraining municipalities from strategically using bankruptcy to avoid the claims of creditors.¹³ Omer Kimhi, for instance, would restrict the scope of bankruptcy to avoid holdout problems and leave efforts at rehabilitation to state political and financial processes,¹⁴ while Kevin Kordana would

¹⁰ Michael W. McConnell and Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. Chi. L. Rev. 425, 474 (1993).

¹¹ *Id.* at 472.

¹² *Id.* at 470.

¹³ See Kevin Kordana, *Tax Increases in Municipal Bankruptcies*, 83 Va. L. Rev. 1035 (1997); Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U.L. Rev. 633 (2008).

¹⁴ See Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 Yale J. Reg. 351 (2010).

allow municipalities relatively free to make decisions about the propriety and costs of default, constrained only by marketplace sanctions.¹⁵

Because these analyses treat the potential federal and state means of redress for municipal distress as independent alternatives, they ignore the interactions between them. Bankruptcy, federal, and state rescues or bailouts allocate losses from fiscal distress differently. If debts are adjusted under federal bankruptcy law, creditors bear much of the cost of fiscal distress while municipalities bear no obligation to alter the policies that generated distress. If bailouts occur, creditors are more likely to recover their expected payments; the loss will initially fall on the government that provides funds, although the terms of the bailout may require repayment of funds, reorganization of municipal functions, or both. Even within the realm of bailouts, federal and state governments occupy very different positions with respect to their capacity to dictate terms of relief to distressed municipalities. States exercise plenary authority over their political subdivisions and thus have broad legal authority to create mechanisms to address fiscal distress. Both institutional capacity and principles of federalism suggest that the federal government is less able to dictate or monitor the performance of municipalities.

But the fact that different avenues for dealing with municipal distress impose different costs does not mean that the choice among them in any particular situation will be optimal. To the contrary, the availability of multiple options plausibly allows local officials to act strategically in using or threatening to exploit different avenues of relief. The availability of alternatives allows localities that lack political will rather than fiscal capacity to avoid affordable, if painful, tax increases. That possibility arises from the likelihood that the preferences of local officials over the venue and terms of relief differ from the preferences of more centralized

¹⁵ See Kordana, *supra* note 13.

governments. For instance, if states are relatively well positioned to deal with local fiscal distress, albeit at some cost to local officials, it may be preferable to push localities away from federal bankruptcy and into state programs. But if bankruptcy is a plausible option for distressed municipalities, and a more attractive one than centralized bailouts that constrain local political authority, then local officials may use the threat of bankruptcy to reduce the conditions that states place on a proposed bailout. Indeed, local officials may be imperfect agents of their own constituents and make decisions that serve personal political objectives rather than the interests of either their constituents or a broader social perspective.

The strength of the municipal threat to act strategically depends on the motivations of centralized officials to resolve municipal fiscal distress. Those motivations emanate from numerous sources. Central governments may fear that municipal default will implicate the budgets of other municipalities or of the centralized governments themselves, either because other governments will be required to expend resources to relieve the distressed locality or because distress of one locality is perceived as a signal of imminent distress elsewhere. Ideally, markets would distinguish between distressed and non-distressed entities; nevertheless, there appears to be substantial evidence of contagion from distressed to healthy debtors.¹⁶ Alternatively, centralized governments may intervene out of fear that municipal distress is sufficiently correlated with other economic risks that municipal defaults that are not of themselves problematic would trigger more systemic risks. Thus, for some localities and under some circumstances, markets may perceive municipal obligations as including an implicit guarantee that centralized governments (both the state of which the municipality is a subdivision and, in some cases, the federal government) will take measures necessary to rescue distressed

¹⁶ See, e.g., John M. Halstead et al., *Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets*, 37 *Fin. Rev.* 293 (2004); Mardi Dungey et al., *Contagion in International Bond Markets During the Russian and the LTCM Crises*, *J. Fin. Stab.* 2 (2006).

localities. Failure of the centralized government to satisfy those expectations could then be viewed as further evidence of widespread crisis.¹⁷ Indeed, the problem creates somewhat of an infinite regress, because the very likelihood of centralized intervention induces localities to incur more and riskier debts than would otherwise be the case, hence increasing the likelihood that fiscal distress, and the need for centralized intervention, will emerge. The result, however, is that central governments that need to avoid “fiscal pollution”¹⁸ or systemic risks can be vulnerable to the opportunism of local officials.

It is in this sense that fiscal federalism becomes an important consideration in the resolution of municipal financial distress. As a general proposition, fiscal federalism requires each level of government to internalize both the costs and the benefits of its activities.¹⁹ Centralized governments should, therefore, subsidize decentralized governments only to control negative spillovers of local activity or to induce activities that generate positive spillovers. Concomitantly, decentralized governments should be discouraged from engaging in activities that impose adverse external effects. In at least some cases of fiscal distress, however, – primarily those involving localities that have substantial state or national importance – municipalities can externalize some costs of idiosyncratic choices or local public goods onto more centralized levels of government or creditors. As a result, municipalities have tendencies both to overgraze on the commons of more centralized budgets and to avoid the exercise of political will to satisfy the debts they incur. The current legal structure for addressing municipal fiscal distress may interfere with, rather than advance the objectives of fiscal federalism insofar

¹⁷ See Bethany McLean & Joe Nocera, *All the Devils Are Here*, (2010) (market’s treatment of privately held, but federally chartered government sponsored enterprises allowed them to issue debt as if it was supported by an implicit federal guarantee and induced government ultimately to intervene as if actual guarantees existed).

¹⁸ I thank Eric Posner for the felicitous phrase.

¹⁹ See, e.g., Wallace E. Oates, *Toward a Second-Generation Theory of Fiscal Federalism*, 12 *Intn’l Tax & Pub. Fin.* 349, 351-52 (2005); David A. Super, *Rethinking Fiscal Federalism*, 118 *Harv. L. Rev.* 2544, 2571-72 (2005); Clayton P. Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 *N.Y.U. L. Rev.* 1030 (1983).

as it insulates local decisions from centralized influence and reduces the need for distressed localities to internalize the consequences of fiscal decisions. The result is that while theories of federalism typically focus on the security that decentralization confers against an onerous centralized government, the capacity of subnational governments to exploit the financial strength of more central governments raises the possibility that the latter requires protection from the former. The claim of this Article is that judicially imposed tax increases may be used as a means of providing such protection by reducing the incentives of municipalities to exploit bankruptcy proceedings strategically.

The next section of this article discusses the doctrinal background for bankruptcy. Part II introduces the nature of the fiscal commons and demonstrates how local financial choices implicate federal interests in a manner that justifies federal intervention in the bankruptcy process. Part III explores the federal interest in local fiscal health, including both the local use of the federal fiscal commons and the risk of financial contagion, and possible response of federal and state governments to fiscal distress in decentralized jurisdictions. Part IV develops the claim concerning the incentives of distressed localities strategically to exploit centralized jurisdictions and the capacity of federal bankruptcy courts to neutralize that behavior. Part V adds a brief note on the application of the analysis to the current debate about permitting states to file for bankruptcy under federal law. Part VI concludes.

I. The Doctrinal Background

It is tempting to treat the refusal of distressed municipalities to increase taxes as little more than implementation of an implicit risk allocation in the original bargain between localities and their creditors. Municipal governments, like other borrowers, receive extensions of credit in

return for a promise to repay principal with interest. Typically, municipal bankruptcy is precipitated by actual or imminent default on general obligation debts, in which that promise is secured by the general tax revenues of the debtor municipality.²⁰ But promises to repay are subject to background legal rules and contractual limitations. Even municipalities that have the capacity to pay debts may be able to deploy those terms to avoid repayment. Outside of bankruptcy, some municipal debtors have successfully contended that, under state law, a contractual pledge of their faith and credit, which is typically incorporated into municipal promises to repay debts payable from general taxes, means little more than an obligation to exercise good faith in making payments.²¹ On this understanding, if the locality can make payments only by reducing essential services, then residents arguably prevail over creditors.

Other jurisdictions have proven harsher. The New York Court of Appeals rejected a state-authorized moratorium on payments of New York City notes on the grounds that it conflicted with state constitutional provisions that required debt service to be paid “at all costs.”²² But in an era in which mortgagors on under-water properties are encouraged to mail their keys back to the mortgagee rather than continue to make payments,²³ or distressed corporations obtain federal bailouts, there initially seems little reason to distinguish cities that have been overly optimistic about future revenues when investing in credit default swaps, economic development, or collective bargaining agreements. If the background rules or contractual terms against which

²⁰ See Robert S. Amdursky and Clayton P. Gillette, *Municipal Debt Finance Law* 25-29 (1992).

²¹ See *State v. City of Lakeland*, 16 So. 2d 924, 925 (Fla. 1943) (city’s pledge of “full faith, funds, property, credit and resources . . . does no more, in legal effect, than express an undertaking by the city to be irrevocably obligated, in good faith, to use such of its resources and taxing power as may be authorized or required by law for the full and prompt payment of the principal and interest of the obligation as it becomes due under its terms.” The court’s conception of an “undertaking,” especially modified by the “good faith” limitation, arguably falls short of an absolute promise of payment.

²² *Flushing Natl. Bank v. Municipal Assistance Corp.*, 358 N.E.2d 848, 851 (N.Y. 1976).

²³ See Brent T. White, *The Morality of Strategic Default*, Arizona Legal Studies Discussion Paper No. 10-15 (May 2010).

creditors extended credit do not obligate the debtor to impose tax increases, then no impropriety attaches to a decision to forgo them; instead, that decision only constitutes an exercise of the option created by the bargain, and one for which creditors were presumably paid at the time that the bargain was struck.

A locality might avoid tax increases notwithstanding default, for instance, where it has pledged to use tax revenues for debt service only on satisfaction of certain conditions, even where fulfillment of the conditions lies entirely within the its own discretion. That has been the history of so-called “subject to appropriation” debt, in which municipalities agree to pay debt service for capital projects only if the local legislature makes the necessary annual appropriation for that purpose.²⁴ It might seem peculiar for creditors to grant such latitude to the debtor-municipality, unless the market perceives the promise to consider appropriating funds as tantamount to a commitment to make the necessary appropriations. Investors might view the form of the transaction as necessary to satisfy legal requirements unrelated to the payment obligation, such as the desire to circumvent state constitutional debt limitations by removing a legal, but not a practical obligation to make payment. Investors could reasonably conclude that a locality that initially financed capital projects in this manner would continue to finance the debt, primarily out of concern that it would otherwise jeopardize its return to the capital markets.²⁵

²⁴ See, e.g., *Colleton County Taxpayers Ass'n v. School Dist. of Colleton County*, 638 S.E.2d 685 (S.C. 2006); *Moschenross v. St. Louis County*, 188 S.W.3d 13 (Mo. Ct. App. 2006) (“The agreement in the present case was merely to request annual appropriations for repayment of the bonds, subject to the approval of the county council. Therefore, the performance of the contract depends upon action by the county council before any unconditional indebtedness arises. This is distinguishable from an absolute agreement to incur debt, which has been determined to violate the debt-limitation provisions of Article VI, section 26 of the constitution.”); *Drury v. City of Cape Girardeau*, 66 S.W.3d 733 (Mo. 2002). The New Jersey Supreme Court initially expressed skepticism about the propriety of the practice, noting that the market treated “subject to appropriation” as the equivalent of general obligation debt to which issuers have pledged their faith and credit. *Lonegan v. State of New Jersey*, 809 A.2d 91 (N.J. 2002). But the court subsequently determined that the constitutional debt limitation applied only when the state is legally obligated to make payments. *Lonegan v. State of New Jersey*, 819 A.2d 395 (N.J. 2003).

²⁵ See, e.g., *Lonegan v. State of New Jersey*, 809 A.2d 91, 128 (N.J. 2002) (Stein J., concurring in part and dissenting in part):

But if, as a legal matter no such obligation exists, it is also plausible that localities would lack the political will to incur tax increases for projects that turned out to be inopportune.²⁶ In the absence of a legal obligation to pay the debt, there would be little reason for a court to alter the bargain by requiring a distressed locality to make such appropriations. The situation for municipalities would be no different than that of a mortgagee who discovers that a mortgagor in a non-recourse jurisdiction, i.e., one that disallows personal actions against the mortgagor to recover any deficit between the outstanding indebtedness and the value of the foreclosed home, has decided to cease payments and pay the statutorily designated liquidated damages of the value of the home, notwithstanding financial ability to continue making payments. The perceived failure of political will might cause consternation to future residents when the locality sought to re-enter the credit markets, but fiscal prudence is not the measure of legal obligation.

The defaults that give rise to a municipality filing for debt adjustment under Chapter 9, however, typically involve obligations that allegedly cannot be paid as a financial matter, rather than because of any contractual defense. Where municipalities have pledged their faith and credit to repay the defaulted debts, creditors are likely to insist that tax increases be imposed to permit payments. In the face of municipal recalcitrance, creditor success depends in large part on the background rules of the bankruptcy regime. In theory, a municipal bankruptcy regime could permit judges to overcome any failure of political will and require localities to incur tax

Finally, while appropriation-backed bonds are not considered debt under a strict legal definition, Standard & Poor's considers all appropriation-backed bonds of an issuer to be an obligation of that issuer and a failure to appropriate will result in a significant credit deterioration for all types of debt issued by the defaulting government (emphasis in original)

²⁶ Indeed, that appears to be the issue in current litigation involving a default by the city of Menasha, Wisconsin on bond anticipation notes issued to finance a steam plant. The notes were secured in part by the city's promise to appropriate funds out of its annual general tax levy to pay any deficiency that resulted if the steam plant generated insufficient revenues for debt service. But that promise was subject to annual appropriation from the budget, and the city refused to make the requisite appropriation. The market presumably considers such debts as mechanisms for avoiding constitutional debt limitations, but not a limitations on a general obligation to pay debts, since any locality refusing to make payments would have difficulty in subsequent borrowings. Nevertheless, Menasha apparently called the market's bluff.

increases to pay affordable, if unpopular obligations. As a doctrinal matter, however, the existing bankruptcy regime appears to preclude any such intervention. Section 904 of Chapter 9 explicitly bars the court, without the consent of the debtor, from interfering with the political or governmental powers of the debtor municipality, any of its property or revenues, or its use or enjoyment of any income-producing properties.²⁷ No approval of the court is necessary for the municipality to continue to operate as its political leaders determine, or even to borrow additional funds.

This non-interference principle implies that the objective of Chapter 9 is simply to allow a financially distressed city to restructure its monetary obligations, not to restructure the city government or to liquidate its assets for the benefit of creditors. More implicit signals exist to the same effect. Omer Kimhi has noted that the absolute priority rule, which precludes junior creditors from obtaining any payout in bankruptcy before senior creditors have been fully satisfied, acts as a substantial check on shareholder reluctance to pay creditors in corporate bankruptcy.²⁸ The absolute priority rule requires that shareholders pay the debts of both secured and unsecured creditors in full before they can retain any of their own interest in the firm. Although the absolute priority rule applies in municipal bankruptcy as a formal matter,²⁹ its application in that setting has little of the constraining effect that it imposes in corporate bankruptcies. As Kimhi argues, since municipal residents are not considered shareholders or

²⁷ The relevant provision reads as follows:

Sec. 904. Limitation on jurisdiction and powers of court

Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with--

- (1) any of the political or governmental powers of the debtor;
- (2) any of the property or revenues of the debtor; or
- (3) the debtor's use or enjoyment of any income-producing property.

²⁸ See Kimhi, *supra* note 13, at 652.

²⁹ See 11 U.S.C. § 901 (incorporating into Chapter 9 the absolute priority rule of 11 U.S.C. § 1129(b)(2)).

creditors of the locality, their demands for municipal services can be satisfied prior to creditors' demands for payment without violating the priority of the latter. Residents, therefore, can demand continued operation of fire, police, school, and waste disposal services before any municipal funds are dedicated to creditors. Indeed, the likelihood that judges would refuse to subordinate residents' interests in public services to the demands of creditors may increase localities' ability to obtain concessions from the latter.³⁰ The effect is that municipal bankruptcy serves as a mechanism by which localities can obtain the equivalent of the fresh start available to individuals in bankruptcy, rather than the "efficient reconfiguration of assets" characteristic of corporate bankruptcy.³¹ The underlying assumption appears to be that localities should be preserved in their current form, free from judicial reorganization, notwithstanding that they thereby became financially overextended. Perhaps the underlying rationale is that the alternative of dedicating tax revenues to creditors rather than to municipal activities will dilute residents' incentives to engage in municipally productive behavior and will interfere with municipal officials' efforts to provide the local public goods the provision of which justifies municipal incorporation in the first instance.³² More doctrinally, some suggest that the non-interference principle preserves the constitutionality of a federal bankruptcy law directed at municipalities by minimizing the role of federal actors in matters best left to state consideration.³³

But the apparently clear rule that the court may not require tax increases becomes more opaque once one considers the discretion that a court does have to condition the grant of relief in Chapter 9 on the political will of residents to accept tax increases. Judicial discretion is apparent at various stages of the bankruptcy inquiry. First, only municipalities that are "insolvent" can

³⁰ See, e.g., Martin Shefter, *Political Crisis Fiscal Crisis* 106-107 (1992).

³¹ McConnell and Picker, *supra* note 10, at 468-70.

³² See Kimhi, *supra* note 13, at 653.

³³ See text accompanying notes 52-53 *infra*.

file for adjustment of their debts. Chapter 9 (unlike the rest of the Bankruptcy Code) involves a cash flow test under which a municipality is “insolvent” if it is unable currently or prospectively to pay its bills as they become due. The prospective element of the inquiry allows courts discretion over the extent to which a municipality must deploy revenue raising capacity before it can claim inability to pay its debts as they become due. For instance, the city of Bridgeport failed the “insolvency” test, even though it faced a \$16 million deficit for its current budget year, because it had access to a fund containing bond proceeds that was sufficient to eliminate the deficit.³⁴ Any withdrawals that Bridgeport made from that fund, however, would have had to have been repaid in future years, so that current withdrawals implied subsequent use of the municipal taxing power to fund repayments. The court might have agreed with Bridgeport that failure to provide immediate relief simply deferred to the near future the city’s inability to generate revenues sufficient to meet all its obligations. The court thus could have concluded that the prospective test was satisfied. But the court instead required the prospective default to be “imminent and certain,” and concluded that the current availability of assets precluded satisfaction of that test.³⁵

The second point at which judicial intervention is plausible involves the statutory provision that a municipality seeking the protection of Chapter 9 first engage in “good faith” negotiations with creditors.³⁶ At least one court has considered it appropriate to take into account willingness to increase taxes when evaluating the municipality’s satisfaction of the good faith standard. In *In re Sullivan County Regional Refuse Disposal District*,³⁷ the court concluded that districts composed of multiple municipal members had not entered into good faith negotiations

³⁴ *In re City of Bridgeport*, 129 B.R. 332 (Bankr. D. Ct. 1991).

³⁵ *Id.* at 138. See *In re Hamilton Creek Metropolitan Dist.*, 143 F.3d 1381, 1386-87 (10th Cir. 1998).

³⁶ 11 U.S.C. § 109(c)(5)(B).

³⁷ 165 B.R. 60 (Bankr. D. N.H. 1994).

because the districts failed to exercise their ability to assess their member municipalities for unpaid service fees owed to creditors. Those assessments would have been paid from taxes assessed by the member municipalities on their residents. While the court concluded that Chapter 9 did not require municipal debtors “to demonstrate that they have fully exercised their taxing powers to the maximum extent possible,”³⁸ failure to exercise their assessment authority at all precluded their assertion of good faith.

The third point at which judicial discretion can be exercised, and the focal point of the McConnell/Picker argument, is at the stage of confirming a plan for adjusting municipal debts. Confirmation is permitted only if serves the “best interests of creditors.”³⁹ Even if all classes of creditors do not accept the municipality’s proposal, a court can confirm a plan that is “fair and equitable.”⁴⁰ The “best interests” and “fair and equitable” standards arguably are satisfied only if the amount to be received by creditors under the plan is all they can reasonably expect given the municipality’s circumstances. The relevant circumstances, however, arguably include the fiscal capacity of the debtor to bear additional tax increases. The classic case cited for judicial intervention in order to implement the “best interests” standard in the municipal context is *Fano v. Newport Heights Irrigation Dist.*⁴¹ In that case, a bondholder of a bankrupt irrigation district appealed from a decree confirming a proposed composition of indebtedness. The court concluded that even though the District was insolvent in the sense that it did not have cash on

³⁸ Id. at 78.

³⁹ 11 U.S.C. § 943(b)(7). Other commentators have also noted the judicial discretion about municipal tax increases inherent in determining whether the standard for confirmation has been satisfied. See, e.g., David L. Dubrow, Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?, 24 Urb. Law. 539, 582 (1992).

⁴⁰ 11 U.S.C. § 1129(b)(1), incorporated into Chapter 9 by 11 U.S.C. § 901(a).

⁴¹ 114 F.2d 563 (9th Cir. 1940). *Fano* was cited along with *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415 (1943), in the legislative history of Chapter 9 to elucidate the meaning of the “best interests” of creditors. Commentators disagree on the extent to which those citations should control application of the standard. See McConnell & Picker at 465-466; Kordana at 1060-1066.

hand to pay interest, it was not insolvent “in the bankruptcy sense” as it owned “debt free” assets with a value that exceeded the outstanding indebtedness. Those assets took the form of improvements that the District had purchased with current funds that could otherwise have been dedicated to the payment of debt service. Thus, the court concluded, it would be “highly unjust” to require bondholders to settle for the 2/3 of the face value of the bonds, as provided by the proposed composition. But more to the point, the court concluded that, as a practical matter, the District could have increased taxes to pay debt service, and should have done so rather than impose a loss on bondholders.⁴² McConnell/Picker applaud the result and conclude that the obvious need to interpret the vagaries of “best interests” or “fair and equitable” implicitly authorize judicial rejection of confirmation proposals that exclude affordable tax increases.⁴³

It is notable that in each of these cases the courts that exercised discretion against the municipality have implied that allowing relief under bankruptcy law was contingent on a finding that destitution, rather than a lack of political will was responsible for the locality’s failure to satisfy obligations. If it is inevitable that courts will use their discretion to counter the absence of political will, then it is at least worth considering whether to authorize such investigations directly, that is, to repeal rather than circumvent the strictures of § 904. Explicitly permitting judicially imposed tax increases might overcome objections that federal courts should not do indirectly what they cannot do directly.⁴⁴ Perhaps more importantly, explicit grants would add to the transparency of the process, as courts might more readily articulate their understanding of the locality’s fiscal position if they were acting according to an explicit grant of authority than if they believed that they had to proceed by stealth to deny relief to a strategically motivated

⁴² 114 F.2d at 565-566.

⁴³ See McConnell & Picker, *supra* note 10, at 425.

⁴⁴ Kordana, *supra* note 13, at 1059, n. 116.

locality. None of this denies that courts may suffer from their own biases in evaluating a municipality's financial position. Trying to determine the incentive structure of judicial decision-making is a notoriously difficult task.⁴⁵ But if courts are already engaged in the activity, then short of finding a way either to purify their processes or prevent them from interpreting the conditions of Chapter 9 in light of political will (an interpretation that may be perfectly appropriate), explicit authorization of judicial intervention may as desirable as it is inevitable. Whether that is the case, I suggest below, depends more on the capacity of judicial intervention to neutralize distortions that the bankruptcy process currently invites than it does on concerns about federalism that allegedly underlie the non-intervention principle.

In that regard, it is worthwhile to note two other features of municipal bankruptcy that might affect the incentives of the relevant actors. First, municipal entry into Chapter 9 is conditional on state consent, and that consent must “specifically authorize” the locality to be a debtor under Chapter 9.⁴⁶ That does not mean that the state must act individually with respect to each petition for bankruptcy. A general statute that authorizes localities within the state to enter Chapter 9, with or without conditions, will suffice.⁴⁷ A common, if imprecise test is found in *In re County of Orange*; the purported state grant of authority “must be exact, plain, and direct with well-defined limits so that nothing is left to inference or implication.”⁴⁸ But provisions of state law that specify municipal powers without authorizing filing for federal relief, such as general

⁴⁵ See, e.g., Frederick Schauer, Incentives, Reputation, and the Inglorious Determinants of Judicial Behavior, 68 U. Cin. L. Rev. 615 (2000); Christopher R. Drahozal, Judicial Incentives and the Appeals Process, 51 SMU L. Rev. 469 (1998); Clayton P. Gillette, Lock-In Effects in Law and Norms, 78 B.U.L. Rev. 813 (1998); Jonathan R. Macey, Judicial Preferences, Public Choice, and the Rules of Procedure, 23 J. Legal Stud. 627 (1994); Richard A. Posner, What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does), 3 Sup. Ct. Econ. Rev. 1 (1993).

⁴⁶ 11 U.S.C. § 109(c)(2).

⁴⁷ *In re County of Orange*, 183 B.R. 594, 604-605 (Bankr. C.D. Cal. 1995). See, e.g., Calif. Gov. Code § 53760; Colo. Rev. Stat. Ann. § 32-1-1403, N.J.S.A. § 52:27-40.

⁴⁸ 183 B.R. 594, 604 (Bankr. C.D. Cal. 1995).

grants of home rule, the right to sue or be sued, or to enter into contracts or to incur debt will be inadequate.⁴⁹ About half the states have enacted statutes that appear to satisfy that standard. One state has explicitly prohibited its political subdivisions from using Chapter 9.⁵⁰

The second doctrinal point is that, once state consent has been given, the decision to file under Chapter 9 rests with the locality alone. Creditors may not subject a municipality to Chapter 9 involuntarily and, given the language that a municipality can be a debtor for bankruptcy purposes only if it “desires to effect a plan” to adjust its debts, it appears that a state may not force one of its municipalities into Chapter 9.⁵¹

These restrictions on the availability of Chapter 9 affect the relationship between a distressed municipality and more centralized governments. But the two restrictions work in opposite directions. The first suggests that the state retains complete control over fiscally distressed municipalities, so that the latter cannot act strategically with respect to states by threatening bankruptcy against a state that desires to withhold that option. But the latter suggests

⁴⁹ See, e.g., *In re Allegheny-Highlands Econ. Dev. Auth.*, 270 B.R. 647 (Bankr. W.D. Va. 2001). The language requiring that a municipality be “specifically authorized” to file under Chapter 9, introduced in 1994, altered the previous requirement that a municipality be “generally authorized” to take that action.

⁵⁰ See Ga. Code Ann. § 36-80-5 provides:

§ 36-80-5. Relief from or composition of debts under federal statutes; counties, municipalities, etc., not authorized to file petition for

(a) No county, municipality, school district, authority, division, instrumentality, political subdivision, or public body corporate created under the Constitution or laws of this state shall be authorized to file a petition for relief from payment of its debts as they mature or a petition for composition of its debts under any federal statute providing for such relief or composition or otherwise to take advantage of any federal statute providing for the adjustment of debts of political subdivisions and public agencies and instrumentalities.

(b) No chief executive, mayor, board of commissioners, city council, board of trustees, or other governmental officer, governing body, or organization shall be empowered to cause or authorize the filing by or on behalf of any county, municipality, school district, authority, division, instrumentality, political subdivision, or public body corporate created under the Constitution or laws of this state of any petition for relief from payment of its debts as they mature or a petition for composition of its debts under any federal statute providing for such relief or composition or otherwise to take advantage of any federal statute providing for the adjustment of debts of political subdivisions and public agencies and instrumentalities.

⁵¹ 11 U.S.C. § 109(c)(4).

that once the state has allowed the option, its exercise lies wholly within the discretion of the municipality. The capacity to control that decision invites strategic behavior by the affected municipality. The next sections discuss how the interactions between these restrictions may trigger concerns from the perspective of fiscal federalism and therefore license a more active intervention of federal bankruptcy courts than § 904 permits.

III. Municipal Finance and Municipal Externalities

A. Federal Relief and the Federal Fiscal Commons

Initially, the idea of federal intervention into municipal fiscal affairs seems inconsistent with the conception of municipalities as creatures of the state of which they are political subdivisions. It is the states that can define the scope of municipal powers and thus that can mandate actions to be taken either to avoid or redress municipal fiscal distress. Federal intervention therefore might appear to offend conceptions of federalism that generally exclude state/municipal relationships from federal intrusion. Indeed, in upholding the constitutionality of Congress' extension of federal bankruptcy law to municipalities, the Supreme Court focused on the requirement of state consent.⁵² The House Report on 1995 amendments to Chapter 9 indicated that the limitations of § 904 were constitutionally mandated, and that the section “makes clear that the court may not interfere with the choices a municipality makes as to what services and benefits it will provide to its inhabitants.”⁵³ Others have suggested that the requirement of state consent “ensures the constitutionality of chapter 9.”⁵⁴

⁵² *United States v. Bekins*, 304 U.S. 27 (1938). The Court had earlier declared such an extension unconstitutional. *Ashton v. Cameron County Water Improvement District No. One*, 298 U.S. 513 (1936). It remains unclear whether the *Bekins* decision was motivated more by a change in the statute or in membership of the Court.

⁵³ See Bankruptcy Law Revision, HR Rep No 95-595, 95th Cong, 1st Sess. 398 (1979).

⁵⁴ *In re City of Vallejo*, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009).

Of course, the discretionary provisions I have just discussed imply that, congressional intent notwithstanding, the impropriety of judicial interference is anything but clear. The McConnell/Picker analysis suggests that the sacrosanct status of the non-intervention principle is misguided. Instead, to the extent that we view municipalities as efficient providers for local public goods, a relatively full panoply of bankruptcy remedies that treats municipalities similarly to private firms that provide goods within an operating market – including mandated tax increases – seems perfectly appropriate.⁵⁵

My emphasis here, however, is less on the efficient delivery of municipal services than on fiscal federalism as a basis for justifying rejection of the non-interference principle. We typically think of federalism as encouraging an efficient level of sorting whereby those who share preferences for a particular set of goods and services can gravitate to a jurisdiction that provides them at a tax price that residents are willing to bear.⁵⁶ Fiscal federalism promotes sorting and the efficient delivery of sub-national public goods to the extent that it involves autonomous decision making about revenue raising and expenditures by decentralized states and localities.⁵⁷ The theory implies that financial independence at a decentralized level ensures that centralized policies do not impede satisfaction of local preferences.⁵⁸ But the negative implication is that fiscal federalism precludes decentralized jurisdictions from externalizing costs of their activities or demanding subsidies for goods and services that are enjoyed within the

⁵⁵ One might make a further claim, i.e., that either creditors or residents are in a better position to monitor local fiscal behavior and thus the issue of relief should be structured to make to loss fall on one of those parties (no bailout for creditors if they are in the best position to avoid distress, full bailout for creditors if local residents occupy that position). I have addressed that issue elsewhere. See Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 *Wm. & Mary L. Rev.* 937 (2009). Here, I assume that the centralized governments occupy that role and ask how bankruptcy law affects the manner in which they play it.

⁵⁶ This is the basis for optimal allocation of local public goods in the classic work on the subject, Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 *J. Pol. Econ.* 416 (1956).

⁵⁷ See, e.g., Oates, *supra* note 19, at 352-56.

⁵⁸ See Clayton P. Gillette, *Fiscal Home Rule*, 86 *Den. U.L. Rev.* 1241, 1242-1244 (2009).

locality, unless those subsidies are required to encourage the production of benefits that spill over into other jurisdictions. Any externalization of costs or subsidy of purely local goods would disrupt the efficient delivery of services by other (decentralized or centralized) jurisdictions or (in the case of subsidies) would reduce the accountability of local officials, since there would be little reason for residents to monitor the use of funds that they did not provide. Moreover, fiscal federalism requires hard budget constraints, that is decentralized jurisdictions can neither print money nor borrow without limit.⁵⁹ In effect, the benefits of federalism depend on the exercise of fiscal discipline and that discipline exists only when there is intrajurisdictional congruence of revenues (taxes) and expenditures.

Municipal financial distress involves several externalities that plausibly interfere with these objectives of fiscal federalism. The first is related to the fact that, in the absence of hard budget constraints for localities, the budgets of centralized governments provide common pools from which decentralized governments can draw through debt issuance. Like any commons, centralized budgets are prone to “overgrazing” by those decentralized entities that have access to it, with potentially severe consequences for the central government itself. To the extent that fiscal distress is generated by municipal overextension of debt, the federal government necessarily bears part of the burden. The reason is that municipal debt is somewhat underwritten by the federal government, at least when that debt is sold in the tax-exempt market. The tax-exemption creates a federal subsidy for municipal projects, even if the benefits of those projects are enjoyed solely within the issuing jurisdiction.⁶⁰ Moreover, many observers conclude that the subsidy is an inefficient one insofar as it causes losses to the federal treasury that exceed the

⁵⁹ See, e.g., Oates, *supra* note 19, at 354.

⁶⁰ The Staff of the Joint Committee on Taxation estimated that the tax expenditure value of the exclusion of interest on public purpose state and local government bonds between the years 2010 and 2014 will be \$161.6 billion. See Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014, prepared for the House Committee on Ways and Means and the Senate Committee on Finance, December 15, 2010, at Table 1, p. 51.

savings to the issuing municipalities.⁶¹ The availability of the subsidy provides municipal officials with incentives to incur more and riskier debt than they would if they were paying the full cost, and exacerbates other incentives that officials already have to overextend the locality's credit.⁶²

Overgrazing on the tax exemption is further encouraged by the absence of any need for federal approval before a locality can issue tax-exempt debt and by the absence of any significant federal cap on the related tax expenditures. As I noted above, the hard budget constraints that are essential to fiscal discipline at the decentralized level entail limitations on borrowing. States impose those formal limitations on their political subdivisions, but there is broad consensus that the effect of those doctrinal limitations has been eviscerated.⁶³ Moreover, even local obligations that fall outside of the realm of constitutionally defined "debt" may be eligible for the subsidy of the federal tax exemption.⁶⁴ Statutory restrictions on the availability of the tax exemption in recent decades has addressed this issue, but the availability of tax-exempt financing for projects such as the new Yankee Stadium reveals that municipalities still have access to a federal subsidy for projects beyond basic governmental capital expenditures such as schools and courthouses that

⁶¹ See, e.g., Peter Fortune, *Municipal Debt Finance: Implications of Tax-Exempt Municipal Bonds* 57, in Gerald Miller, *Handbook of Debt Management* (1996).

⁶² Local officials have incentives to issue a greater than optimal amount of debt because they receive immediate reputational and economic benefits from the construction of capital projects, but are less likely to be in office when projects prove unaffordable.

⁶³ On the ineffectiveness of debt limitations, see, e.g., Richard Briffault, *The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 *Rutgers L.J.* 907 (2003); Amdursky & Gillette, *supra* note 20, at 159-221; Robert H. Bowmar, *The Anachronism Called Debt Limitation*, 52 *Iowa L. Rev.* 863 (1967). Widespread judicial acknowledgement that "subject to appropriation" debt, discussed above, falls outside of state constitutional debt limits serves as a prime example of the diluted effect of debt limitations.

⁶⁴ For instance, bonds secured by revenues generated by operation of the facility financed with bond proceeds, such as a toll bridge, typically fall outside of constitutional debt limitations. See Amdursky & Gillette, *supra* note 20, at 181-88. Nevertheless, they would satisfy the requirements for the tax exemption if they were governmentally owned and operated.

one might think the federal government has an interest in underwriting.⁶⁵ Elimination of the tax exemption may be the most direct way to address the issue. But political realities render that solution unlikely.⁶⁶

If local tendencies to become overextended implicate the federal budget, and if fiscal overextension raises the risk that municipalities will avail themselves of bankruptcy, then the federal government has a plausible claim that it should play a role ex post that compensates for its inability to control municipal exploitation of the federal budget ex ante. The ability of municipalities to issue a greater than optimal amount of debt, and then to adjust those debts to the detriment of creditors notwithstanding the capacity to bear tax increases does little to discourage overgrazing on the federal commons. In short, if federalism requires a significant federal interest before federal actors can intervene in matters of municipal finance, the risk of municipal overgrazing on the federal commons alone may satisfy that condition.

B. Centralized Relief and the Risk of Contagion

The second externality of municipal fiscal distress is more complicated but far more important for current purposes. Notwithstanding the absence of federal controls on its amount and purpose, sub-national fiscal distress generates demand for bailouts from more centralized governments. At the extreme, decentralized governments that are deemed essential to national or state health enjoy an implicit guarantee by more centralized governments. Any implicit guarantee obviously assists the debtor municipality in the form of lower interest rates for debt

⁶⁵ See IRS Private Letter Ruling, October 6, 2006, 2006 WL 2848788; IRS Private Letter Ruling, October 13, 2006, 2006 WL 2925866.

⁶⁶ The recent demise of the Build America Bonds program indicates that elimination of the tax exemption for municipal bond interest is unlikely to disappear soon. Bonds issued under that program were issued on a taxable basis, with the federal government providing a subsidy that reimbursed the local issuer for the additional costs that it incurred by virtue of not issuing in the tax-exempt market. The bonds were typically seen as attractive, but the program was allowed to expire at the end of 2010. See William Selway & Brendan A. McGrail, Build America Bonds' End Poised to Batter Muni Market, Bloomberg Business Week, December 23, 2010, available at <http://www.businessweek.com/news/2010-12-23/build-america-bonds-end-poised-to-batter-muni-market.html>.

issuance. But it simultaneously induces risk-taking by municipalities, the downside of which is borne by the guarantor.

Municipal default precipitated by a discrete event that does not signal broader economic risks is unlikely to trigger demands for rescue by either the federal government or the state of which the debtor is a municipality. Most recent municipal defaults have been of this nature, generated by a large tort judgment or the non-viability of a single-purpose public authority such as an irrigation district or hospital district.⁶⁷ But it is plausible that even an idiosyncratic default by a large local government would trigger demands for centralized intervention out of fear that an unresolved default would have contagion effects that threaten the stability of neighboring jurisdictions, the state, or even the nation. Moreover, large numbers of defaults from multiple municipalities of even moderate size could generate calls for centralized intervention in order to limit the consequences of perceived systemic distress.

In theory, contagion would not occur because investors would be able to distinguish financially healthy jurisdictions from distressed ones. But markets, especially one suffering from the relatively low level of disclosure that characterizes the municipal securities market, may lack the efficiency necessary to allow perfect segmentation.⁶⁸ Investors might, therefore, treat the default of a substantial municipality or of multiple municipalities as a signal of new and unfavorable information about systemic municipal fiscal instability. Indeed, given the lessons from the recent fiscal crisis about the interconnectedness of risks, centralized governments might feel some obligation to forestall municipal defaults in order to avoid perceptions of more general fiscal fragility in the economy. Contagion risk, moreover, could materialize even if the market is

⁶⁷ See, e.g., Kimhi, *supra* note 14, at 360.

⁶⁸ On the relative low level of disclosure in the municipal securities market, see Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 *J. Corp. L.* 739 (2009).

incorrect about the significance of a singular default. Contagion is a consequence of a perception that one municipality's default would generate external effects, not that those effects would necessarily materialize. Those perceptions are likely to be fostered by representatives of the distressed locality in their efforts to procure some form of bailout. Notwithstanding resistance to bailouts from non-defaulting jurisdictions, geographically widespread defaults would tend to increase the likelihood of federal intervention, as centralized lawmakers would be more likely to represent jurisdictions that are in or are at risk of default.⁶⁹

The empirical evidence about fiscal pollution from local distress is mixed, but offers some support for the presence of contagion. Gramlich found evidence of contagion from New York's near-default in the mid-1970s.⁷⁰ Kidwell and Trzcinka, however, found that any New York City effect on interest rates was both small and brief.⁷¹ Halstead, Hegde, and Klein found that neighboring jurisdictions suffered an increase in interest rates after Orange County's default, even though that event was caused by a discrete set of ill-advised investments and bondholders ultimately were fully paid.⁷² Stowe and Mahoney concluded that neighboring localities pay a risk premium after a municipal default, though not as large of one as the defaulting municipality.⁷³ Outside of the municipal market, Dungey et al. find some contagion from

⁶⁹ See, e.g., Erik Wibbels, *Bailouts, Budget Constraints, and Leviathans: Comparative Federalism and Lessons from the Early United States*, 36 *Comp. Pol. Stud.* 475 (2003).

⁷⁰ Edward M. Gramlich, *The New York City Fiscal Crisis: What Happened and What Is To Be Done?*, 66 *Am. Econ. Rev.* 415 (1976).

⁷¹ David S. Kidwell and Charles A. Trzcinka, *Municipal Bond Pricing and the New York City Fiscal Crisis*, 37 *J. Fin.* 1239(1982).

⁷² John M. Halstead et al., *Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets*, 37 *Fin. Rev.* 293 (2004);

⁷³ Kristin Stowe and M.T. Mahoney, *The Response of the Debt Market to Municipal Financial Distress*, available at <http://myweb.clemson.edu/~maloney/papers/muni-financial-distress.pdf>.

defaults in international bond markets,⁷⁴ while Ma et al. find little fiscal externality from the LTV default.⁷⁵

The few recent instances of imminent default by major cities provide some additional evidence of fear that contagion sufficient to implicate the federal government would occur. Recall, for instance, that notwithstanding President Ford's much-publicized antipathy towards federal relief during New York City's financial crisis in 1975, the federal government ultimately responded to the city's imminent filing for bankruptcy by extending loans with presidential approval in order to avoid the implications of default. Congressional testimony at the time predicted that a New York City default would increase borrowing costs across the public sector, reduce spending, and increase tax rates.⁷⁶ Shefter concludes that "if New York City had defaulted on its \$11 billion in outstanding debts, serious damage might have been done to the national and international banking systems."⁷⁷ Fuchs similarly concludes that federal relief was forthcoming after the City's near-default affected international bond and currency trading and increased borrowing costs for other municipalities.⁷⁸ New York City may have greater national significance than other cities and thus be better positioned to demand bailouts, but the differences are in degree, not in kind. Recent forecasts of imminent widespread municipal bankruptcy in the face of declining property values and property tax collections frequently

⁷⁴ Mardi Dungey et al., Contagion in International Bond Markets During the Russian and the LTCM Crises, *J. Fin. Stab.* 2 (2006).

⁷⁵ Christopher K. Ma et al., The Resiliency of the High-Yield Bond Market: The LTV Default, 44 *J. Fin.* 1085 (1989).

⁷⁶ See, e.g., Impact of the New York City Fiscal Crisis on the Federal Budget, Committee on the Budget of the House of Representatives, 94th Cong., 1st Session, Oct. 23, 1975 2-22 (Testimony of Otto Eckstein).

⁷⁷ Shefter, *supra* note 30, at 128. See also Jonathan Soffer, Ed Koch and the Rebuilding of New York 117 (2009) ("International pressure and a growing realization that the bankruptcy of the nation's largest city would undermine confidence in the dollar and the U.S. economy, as well as implementation of the control board's fiscal and management reforms and destructive across-the-board cuts, led Congress to pass a 'rescue' package of so-called seasonal loans."). Soffer notes, however, that much of the federal resistance to aid for New York was predicated on a concern that doing so would require rescues for other cities as well. See *id.* at 113, 117.

⁷⁸ Ester R. Fuchs, *Mayors and Money: Fiscal Policy in New York and Chicago* 90 (1992).

include an argument that a federal bailout would be appropriate, if not inevitable.⁷⁹ The European Union's recent eagerness to avoid defaults by relatively small member states such as Greece or Portugal similarly demonstrates that centralized governments have concerns about contagion effects.

In short, rational investors in municipal obligations would expect centralized governments to bail out fiscally distressed localities when the adverse consequences of default due to contagion or fear of systemic risk exceed the centralized bailout costs. The political economy of bailout, however, may induce intervention even before that point is reached.⁸⁰ Local officials may favor federal or state bailouts because they permit localities to meet obligations without immediate use of local funds, while repayment of any bailout funds will occur in the future and thus be a burden to later officials. Local officials are likely to be concerned that the personal price of bailout involves the surrender of their authority over municipal functions.⁸¹ But that bias does not necessarily mean that they will reject bailouts; instead it could mean that local officials with a plausible claim that default will have national effects will prefer a federal bailout. Although any government that bails out the locality is likely to demand concessions as a price of intervention, the federal government may demand fewer concessions than the state, both because the federal government has less legal authority over municipalities and less capacity to monitor them than the state. For example, while the federal Seasonal Financing Act that permitted federal loans to New York City in 1975 required earmarking of city revenues for loan repayment and periodic reporting by the city, the federal government did not seek to take over any of the

⁷⁹ Even at the early stages of what was seen as an impending crisis in municipal debt, Representative Barney Frank explicitly advocated some form of federal guarantee for municipal debt. See Treasury, Fed Eye Guaranty for Munis, available at http://www.bondbuyer.com/issues/118_95/-303539-1.html.

⁸⁰ See Saul Levmore, Coalitions and Quakes: Disaster Relief and Its Prevention, 3 U. Chi. L. Sch. Roundtable 1 (1996).

⁸¹ See Fuchs, *supra* note 78, at 88.

financial affairs of the city.⁸² Repayment of funds to the federal government would likely be deferred to the distant future when current officials are less likely to hold office. Creditors will prefer federal bailouts because they will likely permit full satisfaction of obligations more readily than bankruptcy, which would permit adjustment of debts at the creditor's expense. States might favor federal bailouts because they allow relief without expenditures of state funds. Jurisdictions that anticipate impending fiscal crises of their own might similarly prefer a federal bailout in order to set a precedent of which they could take advantage. Thus, those who favor federal bailouts would tend to come from relatively small, concentrated groups of officials and creditors who had the capacity and interest to organize to obtain relief. All these incentives translate to the state level if appeals for federal bailouts are unavailing. That is, local officials and creditors will seek bailouts from the state, and municipalities within the state that anticipate imminent difficulties of their own will be reluctant to object, since they may want to take advantage of the precedent in the near future.

Organizational advantages could enhance the claims of those who favor bailouts. The jurisdictions that seek bailout would presumably obtain a substantial benefit from centralized intervention, and thus have a very intense preference for centralized intervention. Since fiscal distress tends to be readily observable, distressed municipalities can self-identify in a manner that facilitates collective action in lobbying. Those who object to bailouts would comprise taxpayers from jurisdictions who neither anticipate a need for fiscal relief nor want to dedicate their tax dollars to ostensibly profligate municipalities. But the relatively small per capita expenditure that taxpayers from those jurisdictions would suffer from any bailout is likely to discourage collective action to oppose central intervention. That may especially be the case if

⁸² See Donna E. Shalala and Carol Bellamy, *A State Saves a City: The New York Case*, 1976 *Duke L.J.* 1119 (1977).

the precipitating event is seen as non-repeating so that assisting the victims is not seen as a precedent for subsequent demands.⁸³ This is not to say that the central government will necessarily bail out distressed decentralized governments. It is only to say that, barring some constitutional pre-commitment device, it is essentially impossible for central governments credibly to commit not to bail out insolvent decentralized governments.

C. The Primacy of State Intervention

Even where municipal distress triggers sufficient implications to justify central intervention, however, it is not clear that direct federal intervention is either necessary or the best strategy. Indeed, the federal government has rarely employed bailouts with respect to local governments. In the past several decades, fiscal crises in Philadelphia, Bridgeport, Miami, Orange County, and Cleveland were all addressed without federal fiscal intervention.⁸⁴ Only in New York City and Washington, D.C. did federal bailouts materialize. Instead, states have proven to be the providers of relief, either by advancing payments, extending loans, or appointing financial control boards that could exercise municipal authority. One might contend, therefore, that the risk that municipal default will have substantial federal impact is too small to warrant federal bankruptcy court imposition of tax increases.

But the absence of federal bailout does not entail the absence of federal risk or federal interest in the situations that I have suggested, that is, where risks related to municipal defaults are interconnected with other risks in the economy or where multiple defaults occur

⁸³ See Levmore, *supra* note 80, at 4. Note, for instance, the demands of some that the September 11 Victims Compensation Fund be extended to include victims of the 1993 World Trade Center bombing and the Oklahoma City bombing.

⁸⁴ See, e.g., Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, in Jonathan Rodden et al., *Fiscal Decentralization and the Challenge of Hard Budget Constraints* 35, 59-60 (2003); *Actions Taken by Five Cities to Restore Their Financial Health*, Hearing Before the Subcommittee on the District of Columbia of the Committee on Government Reform and Oversight, House of Representatives, 104th Cong., 1st Sess. (1995).

simultaneously. Direct federal intervention in those situations may be forestalled because states can intervene to staunch the local crisis.⁸⁵ States, after all, are the best first responders to municipal fiscal distress because their authority over their political subdivisions provides them with a broader range of possibilities than is available to the federal government. But the existence of federal interest where municipal default signals more systemic risks means that the federal government should be able to intervene at least to ensure efficient state implementation of its superior control over municipal distress.

The need for federal involvement in state processes is evident from examination of the downside effects of municipal distress on the states. The prospect of state relief exacerbates any incentives that local officials might have for overborrowing as a result of federal tax exemptions or the relatively low probability federal bailouts. Contagion effects are more likely within the more concentrated area of the state, and states will tend to have economies that are less diversified than the federal economy. As a result, a local fiscal crisis is more likely to signal intrastate instability, and thus to induce state intervention, even with respect to municipalities that are small enough to fail from the federal perspective. Local officials, therefore, are more likely to look to state bailouts than to federal ones.

The more intense state concern does not necessarily mean that state rescues will take the form of a free bailout. Rather, states are likely to take measures that range from loans or advances of general state aid to formal takeovers of municipal government.⁸⁶ Indeed, Inman claims that state intervention has typically taken the form of temporary financial assistance rather than the injection of new money.⁸⁷ Nevertheless, from the perspective of local officials the effect

⁸⁵ See, e.g., *Actions Taken*, *supra* note 84.

⁸⁶ See, e.g., *Flor. Stat. Ann. § 218.50; 33-A McKinney's Local Finance Law § 85.80 (N.Y.)*; Note, *Missed Opportunity: Urban Fiscal Crises and Financial Control Boards*, 110 *Harv. L. Rev.* 733 (1997).

⁸⁷ Inman, *supra* note 84, at 60.

of these interventions is largely the same. If funds need not be repaid until the distant future, current local officials who can obtain current relief from financial distress are likely to discount the local effects of the corresponding obligations. That means not only that the incentives that tend towards excessive local borrowing remain in place. It also means, as I develop below, that municipal officials may be more concerned with the current effects of state intervention than on the long-term effects. The terms of the state bailout, therefore, are likely to be driven by interactions between state officials and local officials with very different preferences.

D. The Consequences for Central Governments of Potential Bailouts

Divergent preferences of state and local officials might not warrant federal bankruptcy court attention if the consequences had insubstantial effects on the stability of centralized budgets. But the prospect of bailout is widely viewed as creating moral hazard because it reinforces incentives for localities to incur debt that places on more central governments a risk that they cannot (in the case of the federal government) or do not (in the case of states) control, because they do not effectively limit the amount or type of decentralized debt. This local manifestation of a centrally created moral hazard belies the longstanding assumption in the literature of fiscal federalism that decentralized decision making and interjurisdictional competition will foster fiscal responsibility and efficiency in the delivery of public goods.⁸⁸ Instead, the inability of centralized governments credibly to commit against bailout suggests that subnational governments can distort the fiscal policies of national governments. That conclusion is consistent with recent literature that analyzes how the inability of central governments to control local debt for which it has at least implied responsibility causes substantial overspending

⁸⁸ See, e.g., Oates, *supra* note 19, at 355; Yingyi Qian and Barry R. Weingast, *Federalism as a Commitment to Preserving Market Incentives*, 11 *J. Econ. Persp.* 83 (1997).

and inefficiencies at both national and subnational levels.⁸⁹ Fornasari, Webb, and Zou conclude from an examination of both developed and developing nations that subnational spending and deficits can lead to higher spending and deficits at the national level.⁹⁰ Goodspeed develops a model in which national officials increase consumption, and thus the probability of re-election, by granting bailout transfers to overextended sub-national governmental debtors. The likelihood of such transfers encourages sub-national governments to engage in inefficiently high levels of borrowing.⁹¹ Rodden suggests that Germany's combination of local discretion over borrowing and dependence on the central government for revenue creates an implied guarantee of federal bailouts that induces overexpenditures at the local level.⁹² The effects in the United States may not be as pronounced because states and localities may have more authority over their own budgets. But the possibility that the linkage between local default and national distress is not as great in the United States does not entail that there is no significant effect.

Any effects of municipal bailouts on centralized budgets are likely to be amplified by a variety of factors. First, the rescuing government has less capacity to recoup the benefits of a bailout of municipal corporations than of private firms that the government deems too big to fail. In the latter cases, the government may be able to take back a residual claim in the firm, so that it enjoys the rewards of the rescue effort.⁹³ Since municipal corporations have no residual owners, the most that the federal government can obtain is repayment of funds made available for the

⁸⁹ See Jonathan A. Rodden, *Hamilton's Paradox* (2005); Erik Wibbels, *Federalism and the Market*; Daniel Treisman *The Architecture of Government: Rethinking Political Decentralization* (2007); Erik Wibbels, *Federalism and the Politics of Macroeconomic Policy and Performance*, 44 *Am. J. Pol. Sci.* 687 (2000); Francesca Fornasari et al., *The Macroeconomic Impact of Decentralized Spending and Deficits: International Evidence*, 1 *Annals of Economics and Finance* 403 (2000).

⁹⁰ *Id.*

⁹¹ Timothy J. Goodspeed, *Bailouts in a Federation*, 9 *Intn'l Tax and Pub. Fin.* 409 (2002).

⁹² Rodden, *Hamilton's Paradox* 153-187.

⁹³ See, e.g., *Fed Transfers \$78.4 Billion to Treasury*, available at <http://blogs.wsj.com/economics/2011/01/10/fed-transfers-784-billion-to-treasury-for-2010/>.

rescue effort. Any additional upside to the rescue is enjoyed by the municipality alone.⁹⁴ Nor, in the case of federal bailouts is it likely that the government would be able to extract from the municipality any organizational changes that could prevent further municipal distress, since the powers of municipalities are traditionally seen as dictated by state law.

Second, as Robert Inman suggests, the prospect of bailouts creates a prisoners' dilemma logic; since citizens of the central government must participate in the bailout of any distressed locality, any distressed locality has incentives both to take the risks that generate the need for federal bailouts and then to seek bailouts when those risks materialize, because the cost is shared within the central jurisdiction and helps offset the contribution that taxpayers from the distressed locality make to other bailouts.⁹⁵ Even self-interested residents of a municipality would find it rational to overgraze on the central fiscal commons as long as borrowing and default risk is subsidized.

Finally, local officials already suffer from numerous incentives to incur substantial debt, and the likelihood of bailout can aggravate those incentives towards more risky borrowing. Debt is used primarily to fund capital projects. Many of these projects pose substantial municipal risks because their long-term viability is questionable. Local convention centers, stadiums, incinerators, power plants, water works systems and the like constitute bets about the preferences of future residents, future regulatory regimes, and the future availability of alternative sources for the same good or service that the locality proposes to provide. Local officials, however, are likely to be risk-preferring agents with respect to these choices because the benefits of the project (local jobs, attractive new structures, promises of local economic Nirvana) can be realized in the

⁹⁴ Although, in theory, the federal government could purchase the depressed debt of the distressed municipalities, and plausibly sell that debt at a profit once the local economy stabilized.

⁹⁵ Inman, *supra* note 84; Robert P. Inman, *Transfers and Bailouts: Institutions for Enforcing Local Fiscal Discipline*, 12 *Consti. Pol. Econ.* 141 (2001).

short term, while many of the costs can be deferred to future residents (assuming that future debt costs are not fully capitalized into current property values). As a result, local officials are likely to place even bad bets, because the projects in which they invest will only be recognized as such when they are long out of office, while they receive current benefits from the immediate gains of job creation and civic pride inherent in capital projects.

Local spending of a greater than optimal amount for capital projects is plausible even with respect to good bets. Typically when local voters exercise input on individual capital projects, such as through bond elections, they are limited to a binary vote for or against the issue. They do not have any discretion about project scale. The Romer-Rosenthal hypothesis predicts that voters will approve projects that are overfunded, as long as the overfunding does not exceed the loss that the median voter would suffer if the project were not funded at all. Local officials can, therefore, propose and obtain approval for projects even though the personal benefits of the project outweigh social value.⁹⁶

The result of these effects means that central governments face a difficult choice when local fiscal distress arises. Bailouts create moral hazard and impede efforts to impose fiscal discipline on localities that induce them to internalize the consequences of their decisions. It violates the underpinnings of fiscal federalism by imposing on nonresidents the costs of decisions made solely by local officials. Nevertheless, allowing default can create the type of fiscal pollution that requires even more significant central intervention later and that risks imposing significant costs on centralized budgets. Under these circumstances, one might imagine that the best strategy for the central government would be to provide a bailout, but one accompanied by conditions sufficiently stringent to deter officials from exploiting the central

⁹⁶ Thomas Romer and Howard Rosenthal, *Bureaucrats Versus Voters: On the Political Economy of Resource Allocation by Direct Democracy*, 93 Q. J. Econ. 563 (1979). For an application of the Romer-Rosenthal hypothesis, see Clayton P. Gillette, *Direct Democracy and Debt*, 13 J. Contemp. Legal Issues 365 (2004).

budget. This might mean seizing control of the local budgetary process, as occurs when financial control boards are appointed,⁹⁷ permitting the sale of local assets and the rejection of contracts, or otherwise placing the locality into receivership.⁹⁸ It is in this sense that Kimhi concludes that states occupy the best position relative to residents or creditors to address the consequences of financial distress.⁹⁹

Nevertheless, there is little reason to believe that central governments, especially states, will choose optimally in determining whether or how to respond to a local fiscal crisis. From a legal perspective, the state might lack adequate tools. And even if it possesses those tools, the political economy of fiscal distress may impede the state's ability to deploy them. Take the legal issue first. States may be more restricted than the federal government in the relief that they can provide, at least after fiscal distress has materialized, because legislatively imposed compromises of existing debts could impair the obligation of contracts in violation of the Contracts Clause.¹⁰⁰ The Contracts Clause claim against state intervention may be less compelling than is commonly thought. McConnell/Picker suggest that a state-enacted municipal bankruptcy act as applied to subsequently enacted debts would not violate the Contracts Clause, because the act, as all pre-existing law, would be incorporated into the executed contract.¹⁰¹ Moreover, as McConnell/Picker indicate, the Supreme Court took a pragmatic view of the scope of an unconstitutional impairment in the post-Depression case of *Faitoute Iron & Steel Co. v. City of*

⁹⁷ See Kimhi, *supra* note 13, at 670-672; Note, Missed Opportunity: Urban Fiscal Crises and Financial Control Boards, *supra* note 86.

⁹⁸ See, e.g., Mich. Public Act of 2011, § 23, available at <http://www.legislature.mi.gov/documents/2011-2012/billenrolled/House/pdf/2011-HNB-4214.pdf>; Amdursky and Gillette, *supra* note 20.

⁹⁹ See Kimhi, *supra* note 13, at 664-672.

¹⁰⁰ The Contracts Clause provides that “No State shall . . . pass any . . . Law impairing the Obligation of Contracts” U.S. Const. Art. I, § 10, cl. 1.

¹⁰¹ See McConnell/Picker, *supra* note 10, at 479-481.

Asbury Park.¹⁰² There, the Court upheld against a Contracts Clause claim New Jersey's efforts to convert outstanding debts to bonds payable at a later time and at a lower interest rate. The Court reasoned that there was no effective mechanism by which bondholders could enforce their original obligations. As a result, the state scheme that promised later payment did not impair an obligation that was, as a practical matter, unenforceable. Section 903 of the Bankruptcy Act effectively overrules the specific holding of *Faitoute* by prohibiting states from prescribing a method of indebtedness of a municipality that binds non-consenting creditors.¹⁰³ But the rationale of *Faitoute* seems consistent with other cases that indicate that altering the security for indebtedness will not impair the obligation of contracts if the new security leaves the creditor in no worse position than it would have occupied with the original security. *Post-Faitoute* Contracts Clause jurisprudence that makes it more difficult for governments to modify their own obligations than those of private entities and that require more than localized financial difficulties before impairment is permitted could nevertheless frustrate state compromises of debt obligations.¹⁰⁴ Recent Contracts Clause cases demonstrate that plaintiffs must bear a significant burden in demonstrating that a technical impairment of a governmental contract also rises to the unconstitutional level because it lacks reasonableness or necessity to a governmental purpose.¹⁰⁵

While the limitations imposed on states by § 903 and uncertainty about the consequences of Contracts Clause for state intervention give pause to state efforts to diminish creditor rights, bailouts that assure full payment to creditors provide an unquestioned means by which states can proceed to provide relief to distressed cities. Moreover, there are reasons to favor this form of

¹⁰² 316 U.S. 502 (1942).

¹⁰³ See 11 U.S.C. § 903(1).

¹⁰⁴ See *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977).

¹⁰⁵ See, e.g., *United Automobile, Aerospace, Agricultural Implement Workers v. Fortuno*, ___ F.3d ___ (D.P.R. 2011).

relief over the alternatives of a federal bailout or federal bankruptcy. Relative to the federal government, states, which tend to exercise plenary power over their localities on fiscal matters, stand in a relatively good position to limit localities' capacity to become distressed or to address the situation of those localities that do. Unlike the federal government, and absent any federal or state constitutional restraint on its authority, a state can create, destroy, empower, or disempower localities at will. The existence of statutory schemes to withhold advanced funds, create financial control boards, and essentially place localities in receivership demonstrate that states have exercised their plenary authority to extract substantial concessions from distressed cities in return for state assistance, and thus to produce substantial ex ante effects on local officials who value retaining political power.

It is unlikely, however, that states will use their plenary authority in a manner that optimally imposes fiscal discipline on otherwise profligate localities. There are numerous reasons for state shortfalls in this area. First, the fact that a state bailout signals willingness to rescue local officials whose bad bets create financial distress may make state officials reluctant to entertain demands from even destitute municipalities. That concern may explain some of the efforts that states have made credibly to commit against bailouts of distressed localities. For instance, from time to time, some state constitutions have contained provisions that prohibit bailouts of municipalities.¹⁰⁶ Those provisions, however, have disappeared, again revealing the inability of central governments credibly to commit against bailout.

Second, if major or multiple cities within a state are facing fiscal distress, it is likely that the state faces a similar situation and has limited capacity to assist its localities. Currently, for instance, California, Illinois, and New York are widely reported as being in worse financial

¹⁰⁶ See McConnell and Picker at 442; Inman.

condition than their major cities, and thus have resisted local claims for assistance.¹⁰⁷ Residents of non-distressed cities who face tax increases or service reductions to finance state deficits will likely feel little sympathy for assisting what they perceive as profligate localities within the state.

Third, to the extent that localities incur burdensome obligations due to political pressures, there is little reason to believe that states are immune from similar influences and would therefore act to reduce those obligations. Experience reveals that states and localities enter into negotiations with local officials to determine the scope and conditions of state aid.¹⁰⁸ Indeed, that is precisely what the New York Court of Appeals anticipated would be the consequence of its decision to invalidate the state's moratorium on New York City debt.¹⁰⁹ Political processes, however, reduce the likelihood that bargaining between local and state officials produce an optimal balance, because many of the interests that generate local fiscal excess also have substantial influence at the state level. Some of the pension obligations that threaten to overwhelm New York City's budget, for instance, are a consequence of state-imposed requirements,¹¹⁰ presumably because public sector unions that have proven as effective at the state as at the local level. Political pressures may also allow local officials who wish to protect their domain and who are sufficiently connected to state officials through party politics or otherwise to push back against proposed constraints on local authority as the price of state assistance.

¹⁰⁷ See, e.g., Mary Williams Walsh, *Cities in Debt Turn to States, Adding Strain*, Wall St. J., Oct. 4, 2010; David Wessel, *Local Debts Defy Easy Solution*, Wall St. J., Sept. 23, 2010.

¹⁰⁸ See, e.g., Ester R. Fuchs, *Mayors and Money: Fiscal Policy in New York and Chicago* (1992); Michelle Kaske, *Rendell Urges Harrisburg Against Bankruptcy*, *The Bond Buyer*, June 10, 2010, available at http://www.bondbuyer.com/issues/119_359/harrisburg-1013339-1.html.

¹⁰⁹ See last paragraph of *Flushing*.

¹¹⁰ See, e.g., N.Y. Const. Art. V., § 7; N.Y. Retire. & Soc. Sec. Law Art. 2, Title XII, §113.

Fourth, there is little reason to believe that the state has an interest in ensuring that its localities have an optimal amount of taxing authority. Vertical tax competition constrains the ability of states to tax for their own purposes. Mobile residents and potential residents of the state are likely to be more attentive to their total tax bill than to the breakdown of whether the taxing authority emanates from the local, state, or federal level. Especially during times of financial distress, state officials are likely to attribute every dollar taxable by the local level as a dollar that the state cannot tax.¹¹¹ As a result, states may not confer on localities the full taxing power necessary to escape fiscal distress. Instead, both tax competition and unfunded mandates exemplify Rick Hills' observation that states are likely to expand their jurisdiction beyond the optimal point.¹¹²

Certainly the history of municipal fiscal distress offers little assurance that states will respond with solutions that either optimally control municipal finances. Instead, that history reveals a wide array of responses in which states often defer to local political will and thus – the Contracts Clause notwithstanding – facilitate municipal efforts to reduce the claims of creditors rather than either refusing bailouts or engaging in bailouts that take the form of paying the municipality's creditors. New York State's initial response to New York City's 1975 fiscal distress was to enact a moratorium on actions to enforce the city's outstanding short-term obligations, except for holders who exchanged their notes for an equal principal amount of long-term bonds issued by the Municipal Assistance Corporation for the City of New York. During the Depression, states similarly sought to defer obligations of their cities, e.g., through an

¹¹¹ See Howard Chernick et al., Revenue Diversification and the Financing of Large American Central Cities, available at <https://www.appam.org/conferences/fall/boston2010/sessions/downloads/4549.1.pdf>.

¹¹² Roderick M. Hills Jr., Compared to What? Tiebout and the Comparative Merits of Congress and the States in Constitutional Federalism, in William A. Fischel, *The Tiebout Model at Fifty* 239 (2006).

exchange for bonds of different maturities.¹¹³ In the nation's largest default on municipal bonds, states in the Pacific Northwest did not discourage the 88 municipalities that challenged the validity of contracts under which billions of dollars were due to finance mothballed nuclear power plants.¹¹⁴ Risk shifting to creditors with the state's implicit approval appears to be a time-honored strategy. Monkkonen's history of late 19th century local debt reveals a variety of mechanisms for avoiding volitionally incurred obligations, ranging from claims that the bonds were invalid to state reorganization of debtor municipalities that amounted to repudiation of the pre-existing locality's debt. Monkkonen's analysis leads him to two conclusions. First, "state and local governments frequently colluded against the debt holders' interests" by voting cities out of existence.¹¹⁵ Second, "in general, the determination of defaults was political, not fiscal."¹¹⁶ State officials did not refuse bailouts to impose fiscal discipline on their cities; they did so because they were able to impose losses on bondholders with relative impunity, compared to what they might suffer at the hands of the electorate if they used state funds to rescue profligate local officials.

It is not clear that states would exhibit similar antipathy today. Fear of contagion could lead state officials to be more favorable to creditors than has been the case in the past. But that does not mean that states will provide optimal relief to localities. Political relationships between state and local officials may lead either to too much sympathy for local plight or to the attribution of too much blame. For example, reactions to the current fiscal distress of cities suggest both state concerns that local officials have been too solicitous of public sector labor

¹¹³ See *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942).

¹¹⁴ See *Chemical Bank v. WPPSS* (1983).

¹¹⁵ Monkkonen at 79. See also p. 24 ("the city of Duluth and the Minnesota state legislature used legal maneuvers to cheat the city's bondholders of the early 1870s out of any hope of full debt recovery")

¹¹⁶ *Id.* at 76.

unions and local concerns that the state has hampered attempts to control labor costs.¹¹⁷ Perhaps that should not be surprising, given consistent findings that municipal fiscal distress is itself often a function of political decisions.¹¹⁸ That is not to suggest that states should have full control over the fiscal conduct of localities.¹¹⁹ It is only to suggest that state efforts to resolve municipal fiscal distress are vulnerable to political resistance of local officials, and local officials can exploit that vulnerability. The federal interest in ensuring appropriate resolution of municipal distress suggests that principles of federalism or local autonomy cannot easily be invoked to preclude more centralized intervention to neutralize the consequences of state vulnerability. The next section explores how that vulnerability has particular consequences in bankruptcy.

IV. The Strategic Use of Municipal Bankruptcy

A. Local Incentives to Exploit Bankruptcy

If bailouts are unlikely to impose fiscal discipline on otherwise profligate localities, then one might conclude that a regime along the lines of Chapter 9 provides an alternative safety valve that offers an orderly mechanism for adjusting the debts of distressed municipalities. The costs of default would then be borne by creditors or by the municipality, but the threat of such costs would arguably bring some fiscal discipline to subnational governments as it would induce

¹¹⁷ See Michigan Public Act 4 of 2011; Wisconsin law; David W. Chen, Bloomberg Seeks a Sweeping Overhaul of City's Pensions, N.Y. Times, Feb. 2, 2011, available at http://www.nytimes.com/2011/02/03/nyregion/03pension.html?_r=1&scp=1&sq=bloomberg%20sweeping%20overhaul&st=cse.

¹¹⁸ See Shefter, *supra* note 30; Kimhi, *supra* note 13, at 671-672.

¹¹⁹ Indeed, I have argued to the contrary. See Clayton P. Gillette, Who Should Authorize A Commuter Tax, 77 U. Chi. L. Rev. 223 (2010); Clayton P. Gillette, Fiscal Home Rule, 86 Denv. L. Rev. 1241 (2009).

greater monitoring by creditors.¹²⁰ Perhaps more importantly, under some circumstances, local officials might prefer bankruptcy to bailouts. That conclusion might initially seem anomalous, because a locality that has defaulted on its debts or entered bankruptcy is likely to pay a premium when it returns to the credit markets. But if current local officials predict little need to return to capital markets in the near future and if adversely affected creditors are primarily nonresident bondholders rather than, for example, public employees, current officials are likely (assuming only imperfect capitalization of future interest costs¹²¹) to discount the effects of future higher credit costs in favor of the political benefits of favoring residents. Even if the locality does have to return to credit markets relatively soon, the possibility of a post-bankruptcy premium will not necessarily discourage local officials from filing for relief, since the effects on any one constituent are likely to be minimal. Indeed, because the filing of the bankruptcy petition would impose a stay on collection efforts by creditors,¹²² local officials could also prefer bankruptcy to forestall any legal claims that they increase taxes or reduce services in order to pay creditors. Since § 904 allows local officials to maintain control of taxing and spending decisions during bankruptcy, officials may believe that bankruptcy insulates them from the imposition of obligations that they find politically, if not financially, imprudent.

The most important protection that bankruptcy provides local officials, however, may be shelter from the state. As I suggested earlier, state bailouts are likely to be politically costly to local officials, especially if intervention entails withholding state funds to reimburse advances¹²³

¹²⁰ Creditor incentives for monitoring, however, are low, given that the stakes of any individual bondholder are likely to be too small to warrant monitoring, and institutional creditors can, at lower cost, reduce risk by diversification. See Gillette, *Can Public Debt Enhance Democracy*, supra note 55, at .

¹²¹ This assumption is consistent with the literature. See Vicki Been, *Colum. L. Rev.*

¹²² See 11 U.S.C. §§ 362(a), 901(a) (automatic stay provisions incorporated into Chapter 9).

¹²³ See, e.g., Va. Code Ann. § 15.2-2659.

or formal takeovers by state officials.¹²⁴ Federal officials conditioned the 1975 federal guarantee of New York City debt on the creation of state oversight boards for the city.¹²⁵ In subsequent years, the Secretary of the Treasury explicitly committed to federal aid for the city only if state authority over its finances continued and implicitly threatened that additional loan guarantee legislation was contingent on concessions by city employees that would otherwise have been a subject of bargaining (and political support for) with local officials.¹²⁶ Ed Koch of New York City is quoted as objecting to state control of the city's finances: "if I were the Mayor, I would never have gone along with it: I don't think I could have accepted a state of affairs that made me one-seventh of a mayor."¹²⁷ Nassau County's governing board recently reacted to a financial takeover by a state-created control board by initiating an action to declare the effort unconstitutional.¹²⁸ At least as a formal matter, the combination of the automatic stay and the non-intervention principle in bankruptcy precludes similar assumptions of control.

As I have indicated, however, the risk of contagion and of signaling systemic problems means that a municipal bankruptcy filing is not innocuous from the federal or state perspective. Thus, central government officials might prefer bailouts to municipal default and bankruptcy, certainly where bailout is accompanied by severe restrictions on municipal autonomy that minimize the moral hazard associated with rescue. These different preferences of municipal and centralized officials sets up a strategic game in which municipal officials can make credible threats to impose substantial costs on centralized officials. While the first preference for states might be a bailout with strong concessions from the locality concerning its internal fiscal

¹²⁴ See, Note, Missed Opportunity, *supra* note 86.

¹²⁵ Shefter, *supra* note 30, at 166-167.

¹²⁶ *Id.*

¹²⁷ Soffer, *supra* note __, at 120.

¹²⁸ See *County of Nassau v. Nassau County Interim Finance Auth.*, Index No. 001455-11, Sup. Ct. Nassau Cty., March 14, 2011.

operations, the second preference for the state fearful of contagion would be a bailout with weaker concessions, while the last preference would be a bankruptcy filing that could cause contagion and signal systemic difficulties.

Local officials have quite different preferences. Because local officials wish to retain political authority, their least preferred option will likely be a bailout with strong concessions. Again, local officials may prefer a bankruptcy filing even to weak concessions, because bankruptcy costs can often be externalized. But even if local officials prefer weak concessions to bankruptcy, the plausible argument that they prefer bankruptcy in order to retain political authority over their constituents gives local officials a credible threat to deploy the bankruptcy option unless the state agrees to only moderate concessions. In short, local officials can exploit the preferences of centralized officials for bailout over bankruptcy by threatening to take the latter measure unless centralized officials accede to only moderate rather than severe terms for the former.

Indeed, it is plausible that the state's desire to strategic municipalities explains why only about half the states have enacted statutes consenting to the filing of bankruptcy petitions by their municipalities. That phenomenon might initially seem puzzling because, given the states' incapacity or failure to enact state schemes for adjusting debts that can bind non-consenting creditors,¹²⁹ federal bankruptcy might be the best solution to fiscal distress, even from the state's perspective. At least that may be the case either for truly destitute cities or for situations in which state aid is unavailing. Of course, some states may not have enacted the necessary statutes solely out of inertia. No widespread municipal crisis that might induce legislative action has materialized in the 75 years subsequent to the enactment of federal bankruptcy law governing

¹²⁹ See 11 U.S.C. § 903, which prohibits states from compromising

municipalities. The requirement of specific authorization has existed only since 1994. Before that time, general state provisions, such as home rule grants and the power to sue and be sued may have been thought sufficient. If inertia alone explains the uneven enactment of the necessary legislation, it is plausible that the current crisis could stimulate additional state legislation. The Indiana legislature, for instance, has not heretofore granted the required consent but currently has the necessary bill before it.¹³⁰

There may, however, be more considered reasons for state inaction. States may resist conceding to federal courts the authority to affect municipal finances by confirming debt adjustment plans that could have statewide effects. Alternatively, states might simply maintain that any degree of federal intervention (other than bailouts) in the financial affairs of their municipalities violates constitutional principles of federalism.¹³¹ But perhaps a more important impediment to state consent is the risk that states face from the strategic use of bankruptcy proceedings. Elimination of the municipalities' credible threat, therefore, could lead to more widespread and useful adoption of the bankruptcy option by states that have heretofore resisted granting municipalities that authority.

One might respond that if states actually have this concern we should see more bargaining around the bankruptcy option than we do. Of course, if such bargaining is rare, it may be a consequence of the relative low degree of municipal fiscal distress, and thus opportunities for strategic use of bankruptcy, since the enactment of Chapter 9. More important

¹³⁰ See Indiana Bill Would Allow Municipal Bankruptcy, available at http://westlawnews.thomson.com/Bankruptcy/News/2010/12_-_December/Indiana_bill_would_allow_municipal_bankruptcy/.

¹³¹ States, that is, may retain some of the sense of sovereignty that led the Georgia legislature, after the Supreme Court's decision that permitted a creditor to bring an action against that state under the original jurisdiction of the Supreme Court, to enact a law condemning to death "without the benefit of clergy, any marshal of the United States, or other person, who should presume to serve any process against that State at the suit of an individual." William A. Scott, *The Repudiation of State Debts* 11 (1893).

inferences might be drawn from the interactions of states and localities in those situations where bankruptcy actually seemed plausible. On at least some of those occasions, local officials do appear to have exploited the bankruptcy option. That seems to have been the tactic employed by the mayor of Camden, New Jersey, who apparently filed under Chapter 9 in order to prevent the state from creating an oversight board for the fiscally distressed city.¹³² The bankruptcy threat has reportedly been a focal point of current negotiations between Harrisburg and the state.¹³³ Hamtramck, Michigan has sought state permission bankruptcy to enter bankruptcy and resisted the state appointment of an emergency financial manager.¹³⁴ As I noted above, the New York experience similarly appears to involve the grant of aid to forestall a threatened bankruptcy filing, although it was the federal government rather than the state that provided the necessary assistance. Certainly it is understood that municipal debtors (like corporate debtors) may use the threat of bankruptcy to strike deals with creditors. That arguably was the strategy employed by the emergency financial manager of the Detroit Public Schools when he announced that he was considering using Chapter 9 to restructure the school system.¹³⁵

If states are truly wary of municipal strategic behavior, therefore, they may avoid consenting to the bankruptcy option. States might be more willing to permit the bankruptcy option if they could neutralize the credibility of the municipal threat to exercise the bankruptcy option for strategic purposes. It is at that point that the explicit grant of judicial authority to impose tax increases on bankrupt municipalities becomes useful. Since the source of the

¹³² See, e.g., Laura Mansnerus, All He Wanted Was a Little Respect, N.Y. Times, Aug. 1, 1999; Melanie Burney, N.J. City Files for Bankruptcy, Chi. Sun-Times, July 21, 1999, at 33.

¹³³ See Michelle Kaske, Rendell Urges Harrisburg Against Bankruptcy, The Bond Buyer, June 10, 2010, available at http://www.bondbuyer.com/issues/119_359/harrisburg-1013339-1.html.

¹³⁴ See Kate Linebaugh, Tax Dispute Squeezes Detroit's Neighbor, Wall St. J., Dec. 20, 2010, available at <http://online.wsj.com/article/SB10001424052748703734204576019301978263490.html?KEYWORDS=hamtramck+bankruptcy>.

¹³⁵ See Alex P. Kellogg, Detroit Schools on the Brink, available at <http://online.wsj.com/article/SB124813472753066949.html>.

credible threat is the preservation of local officials' political autonomy in § 904, the ideal remedy is to make the level of local officials' authority inside and outside of bankruptcy more similar. Explicitly allowing bankruptcy courts more discretion over the debtor municipality's financial situation than § 904 currently permits serves that function. Just as states can override local political decisions outside of bankruptcy, so modification of § 904 might allow bankruptcy courts to override those decisions when lack of political will rather than destitution explained local resistance to tax increases. Equivalence of the two situations means that local officials would be more likely to condition the decision to file under Chapter 9 on the destitution of the municipality and actual need for debt adjustment rather than on the exercise of political will or the officials' own comparative political position. Presumably, and subject to some caveats I note below, this change would not deter truly destitute municipalities from taking advantages of the benefits of Chapter 9. The court would have few incentives to impose tax increases on such a municipality, as one can only get so much blood from a stone. The localities that would most likely be deterred from taking the bankruptcy option would be those that lacked the very political will to impose tax increases that one might want to allow courts to overcome, but that they can currently circumvent only by indirection.

B. State Self-Help Against Municipal Opportunism

A potential response is that states can protect themselves against strategic bankruptcy while permitting appropriate filings, so additional judicial authority to accomplish that objective is superfluous. Recall that entry into bankruptcy is conditional on state approval. In theory, therefore, states could restrict the use of bankruptcy by the municipality, and therefore the credibility of municipal threats to externalize significant costs.

If states gave ad hoc consent to bankruptcy filings, that strategy might work. Some states do, in fact, follow a procedure that requires a municipality to obtain the consent of a state official prior to filing a petition under Chapter 9.¹³⁶ Alternatively, the state could oppose the filing in court. Connecticut took just that tack in the bankruptcy of Bridgeport, and its opposition may have been influential in the court's determination that Bridgeport did not qualify for insolvency. Even in those cases, however, the explanations that I provided above for suboptimal responses by states confronted with municipal fiscal distress suggests that states may be concerned about municipal strategic behavior, since several of those explanations focused on the political interactions of states and their political subdivisions. Other states have enacted less restrictive authorizations that leave the bankruptcy filing decision solely within the discretion of the distressed municipality.¹³⁷ Those statutes may reveal a concern that any statutory obstacles that protect against strategic bankruptcies also reduce the availability of Chapter 9 to address situations where it would be useful, but where the statutory conditions are not satisfied or where substantial time would be required to satisfy the prerequisites to a Chapter 9 filing. Thus, it may be rational for states not only to be more receptive to the possibility of Chapter 9 if they could reduce the threat of strategic behavior, but also to opt for general authorization statutes.

C. Limitations on the Judicial Power to Impose Tax Increases

I have suggested that allowing federal bankruptcy judges to impose tax increases on defaulting municipalities that appear to lack political will more than financial resources can serve the dual purposes of vindicating central governments' interest in alleviating local fiscal distress and minimizing local use of bankruptcy for strategic purposes. Of course, this solution assumes

¹³⁶ For instance, Michigan localities can file for Chapter 9 only under the supervision of an emergency financial manager who are appointed to deal with the fiscal distress of a particular municipality. M.C.L.A. 141.1222. New Jersey requires the consent of the state's municipal finance commission. N.J.S.A. § 52:27-40.

¹³⁷ See, e.g., Cal. Gov't Code § 53760; Fla. Stat. Ann. § 218.01.

two characteristics of judicial proceedings, each of which is contestable. First, it assumes that bankruptcy courts have both the institutional capacity and the incentives to distinguish between true destitution and lack of political will, a determination that depends heavily on judicial discernment of the peak of a municipality's revenue hill.¹³⁸ It is by no means clear that courts have the institutional capacity accurately to gauge the current or future financial position of municipalities. The required analysis, however, is not much different from current requirements that the court determine the "insolvency" of the petitioning municipality, since the prospective test inherent in that evaluation also requires the court to determine the future financial status of the municipality.¹³⁹ Indeed, since the court would essentially have to demonstrate that tax increases were affordable before imposing them, an explicit finding to that effect, presumably supported with relevant finding of financial wherewithal, would be preferable to one that was made through subterfuge in the guise of a conclusion that the filing locality was not insolvent.

Second, and perhaps more problematic, allowing courts to impose tax increases opens prospects for more intrusive violations of the non-interference principle. For example, if courts can impose tax increases in bankruptcy in order to optimize tax rates or service levels, why can't the court similarly require that a city council be elected on an at-large basis rather than a district basis in order to reduce the fiscal consequences of logrolling that account for inefficient local expenditures?¹⁴⁰ Once bankruptcy courts become an appropriate arbiter of some aspects of municipal organization, it is more difficult to argue that the shibboleth of "federalism" becomes an adequate response to such questions. Thus, the grant of a right to impose tax increases

¹³⁸ See Haughwout et al., *supra* note 6.

¹³⁹ See text accompanying notes 33-35 *supra*.

¹⁴⁰ See, e.g., Reza Baqir, *Districting and Government Overspending*, 110 J. Pol. Econ. 1318 (2002).

implies exercise of a host of powers in the name of protecting the federal and state interests in local financial health notwithstanding the limited direct role that Congress allocated to the courts.

Of course, the issue may be an empty one. If I am correct about the strategic use of bankruptcy, then the very creation of a judicial right to impose tax increases may decrease the need for its exercise. If only localities that lack political will fall subject to judicial imposition of tax increases, then the availability of that option is likely to strengthen political will. True, some local officials may prefer that judges, rather than they, bear formal responsibility for tax increases, so that courts can be blamed for high taxes and low services. Officials of that mindset may still prefer bankruptcy filings to imposing their own tax increases. But local officials who wish to retain political authority are likely to prefer to retain the discretion over whom to tax and what to cut rather than risk alienating political allies by leaving those decisions in judicial hands. Thus, local officials who perceive the inevitability of tax increases are likely to prefer to fashion the remedy themselves or in political negotiations with state officials rather than have it imposed by courts. That may be all to the good if the state is, indeed, best positioned to reach an overall solution to any locality's fiscal difficulties. Nudging the locality into the state's procedures does not ensure optimal solutions to municipal fiscal distress. As I have suggested, state processes are likely both to be subject to political economy explanations that give either local officials or creditors disproportionate power in working out relief plans and to be indifferent to implications for the federal fiscal commons. But adjustments to bankruptcy law can at least allow states to enter that bargain with less concern that municipalities can credibly threaten to exploit the bankruptcy option.

V. A Note on Strategic Use of Bankruptcy by the States

It is, perhaps, worthwhile to close with a brief note on the current debate about whether Chapter 9 or some equivalent should be expanded to permit states, as well as municipalities, to adjust their debts through some federal statutory scheme.¹⁴¹ Some congressmen have taken up the call and are reported to be drafting legislation that would implement a bankruptcy scheme for states.¹⁴² In this article, I have focused on municipal bankruptcy. But the problems of political will and fiscal federalism obviously affect the federal-state relationship as well as the federal-state-municipal one. Indeed, because states are more likely to fall within the too-big-too-fail category than most cities, the likelihood of federal intervention in the event of state fiscal distress is even greater than in the case of municipal distress. One might point to the counterexample of the federal government's explicit refusal to assume the debts of distressed states in the 1840s. That example, however, seems dated in today's financial environment. One-third of the states had little or no debt, and thus would receive no benefit from federal assumption.¹⁴³ The states, rather than the federal government, typically funded capital projects. According to the Treasury Department, the federal debt in between 1840 and 1842 ranged between \$3.5 million and \$13.5 million,¹⁴⁴ in 1841, each of eight states had debts in excess of \$10 million, with Louisiana reaching \$24 million.¹⁴⁵ The divergence among states and reduced federal debt plausibly limited any contagion effect from the default of a distressed state.

¹⁴¹ See, e.g., David Skeel, Gives States a Way to Go Bankrupt, 16 Weekly Standard, Nov. 29, 2010.

¹⁴² See See Jeb Bush & Newt Gingrich, Better Off Bankrupt, L.A. Times, Jan. 27, 2011, <http://articles.latimes.com/2011/jan/27/opinion/la-oe-gingrich-bankruptcy-20110127>; Mary Williams Walsh, A Path is Sought for States to Escape Their Debt Burdens, NY Times, January 20, 2011, available at http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?_r=1&scp=1&sq=skeel%20david%20bankruptcy&st=cse.

¹⁴³ See Erik Wibbels, Bailouts, Budget Constraints, and Leviathan: Comparative Federalism and Lessons from the Early United States, 36 Comp. Pol. Stud. 475, 494 (2003) (seven of 27 states had zero debt, while two had less than \$1 million in debt).

¹⁴⁴ Treasury Direct, Historical Debt Outstanding – Annual 1791-1849, available at http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histol.htm.

¹⁴⁵ Wibbels, supra note 79.

As a consequence, the federal government cannot and probably should not credibly commit not to bail out states or political subdivisions, when their failure would generate the same kinds of contagion that recent federal rescue of financial institutions was intended to avoid. Credit markets likely apply a positive value to the probability of a federal bailout of states, just as they applied a positive value to the probability of a federal bailout of Fannie Mae and Freddie Mac, notwithstanding the absence of any legal obligation.¹⁴⁶

Bankruptcy along the lines of Chapter 9, therefore, might be a plausible solution for a financially distressed state. But, assuming that any statutory solution embodied the equivalent of the current § 904, it would also create the same strategic possibility in the federal-state relationship as I have discussed above in the municipal relationship. Possible contagion effects of state defaults would cause the federal government to favor bailouts over bankruptcy. Presumably the federal government would prefer any such bailout of a state to be accompanied by commitments to future fiscal discipline, just as the federal government attempted to do in the case of New York City. State officials, on the other hand, would presumably prefer a low level of commitment. Any state bankruptcy law, therefore, should include consideration of the possibility that states could exploit the threat of bankruptcy to extract concessions in a federal bailout, just as I have suggested localities can do and have done in the context of Chapter 9.

VI. Conclusion

From the perspective of fiscal federalism, municipal fiscal distress raises three different problems that implicate municipal bankruptcy. The first is the moral hazard problem that is involved whenever one entity – here more centralized governments – has the capacity and the

¹⁴⁶ See McLean and Nocera, *supra* note 17.

incentive to rescue another entity – more decentralized governments. The second problem involves externalities. Municipal distress imposes significant costs on other jurisdictions, which provides opportunities for strategic behavior. Third, fiscal distress exacerbates agency costs. While rational municipal residents would be willing to exploit federal largesse, municipal officials may exceed both residents' interests in overgrazing and in threatening to impose costs in order to reduce the personal costs of centralized relief. Obviously, these problems are related. The tendency of municipal officials to overextend their localities increases the possibility that some form of rescue will be necessary, and the externalities caused by fiscal distress implies that political pressure will be brought on those governments capable of providing assistance to do so. I have suggested that one prophylactic measure against these distortions is to permit bankruptcy courts more explicitly to impose tax increases. Doing so forces municipalities that would otherwise reject additional financial burdens out of a lack of political will or to extract concessions from centralized governments instead to internalize the costs of their activities. The result would be that local officials would gain less from efforts to shift the avoidable losses of fiscal distress to creditors and would be more likely to accede to optimal agreements with central officials for the resolution of fiscal distress.