Reviving Cities - Legal Remedies to Municipal Financial Crises

Omer Kimhi
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By Omer Kimhi

Abstract

Local fiscal crises are by no means a negligible phenomenon. In the last 30 years a significant number of the nation’s cities have suffered from serious financial strain, and several large and important cities (such as New York, Philadelphia and Miami) have even experienced a full-blown crisis (where they did not have sufficient resources to finance basic public services). In this paper I discuss the legal remedies developed over the years to address local insolvency (the creditors’ remedies, Chapter 9 of the bankruptcy code and state financial boards), and I explain the logic and limits of each remedy. The analysis suggests that the remedy of state financial boards is the most effective response to a local crisis. I describe (using both theoretical arguments and examples of actual cases) the advantages of this remedy, and I explain how I believe it should be successfully implemented in legislation. Using the case study of North Carolina, I show that such legislation can improve local fiscal health and facilitate huge savings on interest rates on a regular basis.

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By Omer Kimhi*

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

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

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

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

¹ In re City Of Bridgeport 129 B.R. 332, 335 (1991). In 1991 Bridgeport, one of the largest cities in Connecticut, suffered from a severe financial crisis, and filed for bankruptcy (Chapter 9 of the bankruptcy code).
examples of this phenomenon.2 Financial crises have had an important impact on the development of cities, and they have affected (and will probably continue to affect) the lives of millions of city residents.3 As the excerpt from the Bridgeport bankruptcy case so bluntly shows, cities that suffer from financial crisis are often unable to provide even basic public services, and their residents may suffer from crime, poor education, and decaying infrastructure.

However, notwithstanding the subject’s importance, at least from a legal perspective municipal insolvency is still very much an uncharted area. There is hardly any legal writing about municipal financial crises, and researchers have not sufficiently explored how the legal system deals (or should deal) with this problem. Those scholars who have addressed this issue have mostly focused on one specific remedy to the local crisis — Chapter 9 of the bankruptcy code (the municipal bankruptcy chapter). They have assumed (either explicitly or implicitly) that municipal insolvency (like corporate insolvency) should be dealt with through bankruptcy law, and have neglected other (better and more common) solutions to the problem.4 In this paper I set out to start filling this gap in the literature. I discuss municipal insolvency as a general phenomenon experienced by American cities, and I present several possible remedies (approaches) to deal with it. My analysis shows that notwithstanding the

\[2\] According to a survey conducted by Beth Hondale in 2003 about a hundred local governments have suffered from a financial crisis in recent years. See Beth W. Hondale, The States’ Role in U.S. Local Government Fiscal Crises: A Theoretical Model and Results of a National Survey, 26 INT’L J. PUB. ADMIN. 1431, 1463-1470 (2003). Hondale’s conclusion about the prevalence of local fiscal crises is also consistent with the writings of several other scholars who have dealt with this subject. See, e.g., Anthony G. Cahill & Joseph A. James, Responding to Municipal Fiscal Distress: An Emerging Issue for State Governments in the 1990s, 52 PUB. ADMIN. REV. 88, 88 (1992) (Cahill & James write: “Relatively less attention, however, has been given to what is an increasingly common phenomenon: municipalities of all sizes which, for a variety of reasons, are failing on a regular basis to balance revenues and expenditure flows.” Id. at 88); WILLIAM J. PAMMER, JR., MANAGING FISCAL STRAIN IN MAJOR AMERICAN CITIES xiii (1990) (Pammer explains that according to several studies a significant portion of the nation’s cities were experiencing some degree of financial strain in the 1970s, and this trend continued (albeit to a lesser extent) in the 1980s and 1990s.)

\[3\] MARTIN SHEFTER, POLITICAL CRISIS, FISCAL CRISIS: THE COLLAPSE AND REVIVAL OF NEW YORK CITY xxix (1985) (Shefter, a leading scholar of the New York fiscal crisis, argues: “Indeed, these episodes [municipal fiscal crises – O.K] occur with sufficient regularity that fiscal crises should be regarded not as aberrations, but as an integral part of American urban politics.” Id. at xixix).

academic focus on the bankruptcy code, a different remedy — state financial boards (on which there is hardly any legal writing) — can address local crises more effectively.⁵

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

In the paper I make the claim that the third remedy — state financial boards (which place the burden of the crisis on the state) — is the most efficient remedy for local crises. The reason for this claim is that the state, as opposed to the residents or the creditors, has the ability to prevent potential crises and to minimize their damages. I show that the creditors and the local residents cannot avoid forthcoming crises, because often the causes of these crises are outside their (and the local officials’) activities.

⁵ One exception to the legal community’s general disregard of state financial boards is a note published in Harvard Law Review in 1996. See Notes, Missed Opportunity: Urban Fiscal Crises and Financial Control Boards, 110 HARV. L. REV. 733 (1996) [Hereinafter “Missed Opportunity”]. (However, even this note mentions the lack of legal research on this subject. The note indicates that, “To date no one has undertaken a systematic study of state boards as a genre of state institutional responses to urban fiscal crises.” Id. at 734 n. 8).
realm of control. The state, on the other hand, has both the legal authority and the political powers to deal with the causes of the urban crisis, and thereby to rehabilitate ailing localities.

The analysis presented in the paper also has important practical implications. Despite the importance of state intervention in times of local distress, only a few states have codified their policy on this issue, and the absence of such codification has often resulted in delaying state assistance to localities in poor financial health. Without a statutory obligation to address local fiscal decline, cities have been left to suffer from financial crises that perhaps could have been avoided with the state’s help. The paper explains why the codification of the state financial boards remedy can mitigate these problems, and details the advantages of such codification to both cities and states. I show not only that such legislation can contribute to the fiscal health of local governments, but also that it can help cities reduce the interest rates they pay on a regular basis. North Carolina’s local governments, for example, save up to $100 million a year as a result of a state supervision system on local fiscal health, similar to the system I propose in this paper. This of course facilitates lower tax rates and better services to local residents.

The rest of the paper proceeds as follows: In the beginning I provide the background for the argument. The first part of the paper explores the causes of local financial decline, and the second part examines the various remedies that the legal system currently offers to deal with this phenomenon. After laying down the necessary foundations, in the third part of the paper I study the adequacy of the different remedies, with special focus on state intervention. I make the claim that state intervention is the most effective remedy for local financial crises, and I explain why the state can deal with local crises in cases where the residents, the creditors and the local officials have failed. In the fourth part of the paper I discuss municipal insolvency statutes, and I demonstrate their advantages through studying the legislation of North Carolina.
1. The causes of municipal financial distress

At first glance it seems that a city’s economic situation should be fairly stable. On the revenue side, most cities’ primary source of income is property tax. Property tax is considered to be a relatively reliable revenue source (less fluctuating than comparable taxes such as income and sales taxes), and municipalities have reasonably good ways of collecting it. On the expenditure side, municipalities usually don’t have large unexpected expenses. They can plan their spending relatively well, and they can use revenue estimates to match their costs with their future income. A municipal financial crisis, therefore, may seem unlikely. Nonetheless, it is not uncommon for American cities to experience even severe financial strain. In the past thirty years, several of the largest U.S. cities have undergone a crisis, and many others have experienced at least some degree of financial distress. In this part of the paper I explain why, notwithstanding their seemingly stable economies, some municipalities do suffer from severe economic difficulties.

A financial crisis does not evolve for one single reason. Rather, a combination of several factors is usually responsible for the decline in a city’s economic status, and different circumstances make one city more financially vulnerable than others. Scholars, however, seem to disagree on the exact nature of these reasons, and especially on their relative importance. Examining the literature on this subject reveals two major approaches. Some argue that socio-economic processes beyond the control of local officials are at the root of the local crisis, while others believe that the local management and the political environment are the real reasons for the financial decline. In the following sections, I present

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6 Property tax debts become a lien on the real property. The property cannot be sold without paying the property taxes in full, and even if the owner of the property does not sell it, the municipality can execute on the property and get the tax debt back.
7 See the references supra note 2. New York, Yonkers, Cleveland, Boston, Detroit, Buffalo, Bridgeport, Philadelphia, Camden, Miami, Orange County, Washington D.C, Pittsburgh, East Saint Louis, Richmond, and Nassau County are but several example of this phenomenon.
8 An exception would be, for example, in a small town with a few dozen residents which faces an unexpected financial shock such as the loss of a personal injury lawsuit or a natural disaster. An example of such a case is the city of Bay St. Louis, which lost a personal injury lawsuit and was ordered to pay the plaintiff $375,000. The city could not afford to pay the plaintiff and filed for bankruptcy.
these two approaches. First I discuss the socio-economic decline approach, and then I discuss the local management approach.

1.1. The socio-economic decline approach. The socio-economic decline approach views external economic and social changes, rather than internal political decisions, as the primary causes of urban crises. This approach attributes municipal financial distress mostly to demographic and structural circumstances that are beyond the control of local officials. Helen Ladd and John Yinger, for example, advocate this view in their book *America’s Ailing Cities*. Their research studies the fiscal health of eighty-six American cities, and as a result of an in-depth analysis they conclude:

“As we measure it a city’s fiscal health, standardized or actual, depends on economic, social and institutional factors that are largely outside the city’s control. Poor fiscal health is not caused by poor management, corruption or profligate spending, and a city government’s ability to alter the city’s fiscal health is severely limited.”

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

1.1.1. The national economy. The national economy goes through different economic periods; some are periods of growth and prosperity, while others are characterized by recession and unemployment. Evidence suggests that local economies, although to a lesser extent than the private and federal sectors, are influenced by these trends in the national economy. The effects of national economic cycles on local governments are understandable: In times of recession economic activity slows down,
and real estate prices decrease. Thus, a municipality’s ability to generate revenues from taxes declines, while municipal expenditures, especially due to welfare costs, tend to increase. When inflation strikes, many times the municipal tax collection (usually property tax) does not catch up, and so the local income lags behind the nominal growth of expenditures (mostly employment costs). Research thus shows that municipal defaults are closely related to the country’s business cycles. The greatest number of defaults have occurred during periods of recession, and these periods have been followed by economic expansion, in which municipalities have also experienced relatively strong growth.13

1.1.2. Suburbanization and population changes. Another important socio-economic cause of cities’ economic decline is demographic changes and suburbanization. Suburbanization is the mass movement of households and firms out of the city and into the suburbs. Usually, it is businesses and middle/upper class residents who leave, and the city is left with a higher percentage of poor residents. Suburbanization then has a double negative effect on a city: First, due to outmigration of affluent taxpayers, the city’s tax base significantly decreases. Secondly, due to the inmigration of a more economically deprived population (which presumably requires more welfare and social services), the city’s expenditures increase. Thus, a vicious circle, which can potentially lead the city into economic crisis, begins: In order to finance the growing expenditures taxes are raised. Higher taxes trigger an outmigration of more corporations and individuals, and so additional taxes are necessary. These additional taxes drive even more residents out, and so on. Moreover, suburbanization causes the city to

14 PAMMER, supra note 2, at 5; IRENE S. RUBIN, RUNNING IN THE RED: THE POLITICAL DYNAMICS OF URBAN FISCAL STRESS 5-7 (1982); JOHN HOWELL & CHARLES STAMM, URBAN FISCAL STRESS: A COMPUTER ANALYSIS OF 66 US CITIES (1979) (Howell and Stamm analyzed the fiscal health of sixty-six mid-sized American cities. They conclude that older industrial cities are the most likely to be in financial trouble). Katherine Bradbury, Anthony Downs & Kenneth A. Small, Some Dynamics of Central City–Suburban Interactions, 70 AM. ECON. REV. 410 (1984).
15 These effects were a major cause of the New York fiscal crisis. (See Donna A. Shalala & Carol Bellamy, A State Saves a City: The New York Case, 25 DUKE L.J. 1119, 1119-1120 (1976)).
lose its agglomeration economies. Middle class residents want to live with their former neighbors and friends, and they follow them to the suburbs. Service industries and cultural activities providers suffer from reduced patronage, and following their former clients, they also move out of the city. This further reinforces the decline of the city, and so forth.16

In the U.S, a major process of suburbanization took place during the 1960s and 1970s. The negative consequences of the suburban development were felt mostly in Northern cities. Unlike cities in the South and in the West, the Northern cities were unable to annex surrounding territories and to thereby recapture the lost population and economic activity.17 Thus, cities like New York, Baltimore, and Philadelphia lost a significant number of jobs and taxpaying businesses, and they suffered from severe fiscal stress.

1.1.3. Intergovernmental policies. Yet a third reason for the local decline is intergovernmental (especially state) policies towards local governments. States have an enormous effect on the local economy, and their actions sometime contribute to local fiscal stress or even to financial crises.

Generally speaking, state involvement in local finances affects both municipalities’ ability to generate revenues and their level of expenditures. On the revenue side, states often control which taxes local governments may collect and the rules under which the taxes are collected, and they also give taxing authority to overlapping jurisdictions (such as counties or districts). In addition, states usually dispense intergovernmental aid, and these funds comprise a significant portion of many localities’ income. On the expenditure side, states decide the public services cities are responsible for, and they

16 Anne Marie Vassallo, Note, Solving Camden’s Crisis: Makeover or Takeover? 33 Rutgers L.J 185, 189 (2001) (Vassallo explains the devastating effects of suburbanization on Camden, New Jersey.)
17 Kamer reports that in the 1960s the five Northern cities she studied failed to annex surrounding territory, whereas seven of the ten Southern cities and seven of the ten Western cities she studied did annex formerly suburban cities and thereby gained 380,000 residents. During the 1970s the Northern cities again failed to annex surrounding territory, but Southern cities annexed approximately 360 square miles, thereby gaining 320,000 residents. KAMER supra note 12, at 27.
determine the level at which these services are provided.\textsuperscript{18} Local fiscal problems thus occur when states assign local governments (especially large cities) too many public responsibilities, and do not give them appropriate taxation tools or transfer sufficient funds to finance the assigned services.\textsuperscript{19}

This was the case with several cities during the 1980s. In the beginning of the 1980s the federal government significantly reduced the aid it offered local governments. This decrease in intergovernmental aid was not accompanied with a corresponding decline in the services local governments were responsible for, and as a result many local governments suffered from fiscal strain.\textsuperscript{20} Robert Inman, for example, lists the lack of intergovernmental support as one of the causes of the Philadelphia financial crisis.\textsuperscript{21}

We can thus see that various socio-economic factors that are beyond the local officials’ realm of control can cause municipal financial difficulties. However, even in the presence of some or all of the socio-economic forces described above, many scholars believe that circumstances internal to the locality are the main reason for financial crises.

\subsection*{1.2. The local management approach.} The local management approach focuses on the municipality’s political and financial management. According to this perspective, it is the distribution of power inside a community and how the city manages its resources that determine its fiscal fate. Advocates of this approach do not ignore the socio-economic processes the city undergoes, and they acknowledge that there are external factors that influence a city’s financial status. However, they make

\begin{itemize}
  \item \textsuperscript{18} JOHN E. PETERSEN, C. WAYNE STALLINGS & CATHERINE L. SPAIN, STATES’ ROLES IN LOCAL GOVERNMENT FINANCIAL MANAGEMENT: A COMPARATIVE ANALYSIS (1979).
  \item \textsuperscript{20} See Ledebur, supra note 10, at \textsuperscript{2}.
  \item \textsuperscript{21} Robert P. Inman, \textit{How to Have a Fiscal Crisis: Lessons from Philadelphia}, 85 AM. ECON. REV. 378, 380 (1995) (Inman compared Philadelphia’s per-resident federal and state aid to that of other cities. He shows that, just like other cities, Philadelphia lost significant federal aid during the 1980s. However, whereas state aid to other cities rose to offset this decline, Philadelphia did not enjoy the same increase. Philadelphians gained only $0.61 for each dollar increase in per-resident state aid gained by other cities. Thus, on balance the city’s position deteriorated.)
\end{itemize}
the claim that the city’s political system is the ultimate factor that determines whether the city will deteriorate into a crisis, or whether it will remain in relatively good fiscal health.

Within the local management approach there are two somewhat opposing views. One view regards the local officials’ skills and competence as the determining factor in the city’s financial fate, while the other (more common) view focuses not on the officials themselves, but rather on the political system in which they operate. I will elaborate on both approaches.

1.2.1. Municipal officials. According to this view, the abilities and skills of municipal officials constitute the determining factor in a city’s financial fate. Incompetent local officials implement unsound financial practices, and these in turn may result in fiscal crisis. Scholars who advocate this approach focus on the distressed locality’s financial disclosure practices. They show that when faced with declining revenues, in some cases local officials do not cut costs, but rather use financial and accounting gimmicks to create the appearance of a healthy locality.22 These tricks enable the officials to continue with high levels of public spending notwithstanding the dwindling revenues, but eventually the economic reality catches up, and a financial crisis develops.23

Joan Martin studied the financial distress of Boston and Detroit, and she argues that in both cases the financial management was a core reason for the cities’ deterioration.24 The cities’ officials constantly overestimated the forthcoming revenues and underestimated the city’s fund reserves problem, and so they justified large spending that had no real connection to the city’s actual economic base. Martin concludes, therefore, that the accumulating deficits came from accounting manipulations that were perpetuated by the local management.25

22 For example, officials use debt proceeds to help the city pay for ongoing (non-capital) expenditures, they recognize revenues the locality still hasn’t collected, or they don’t take into account already accrued expenditures.
23 PAMMER, supra note 2, at 8.
25 Id. at 129.
A view that focuses solely on municipal officials, however, misses a far richer and contextual perspective about the environment in which the officials operate. Often, the accounting gimmicks and short-term thinking are but symptoms of deeper problems that are rooted in the political pressures officials are under. A second, more common view of the local management approach, therefore, focuses on the political environment.

1.2.2. The political environment. The political environment approach focuses not on the municipal officials themselves, whether corrupt or not, but rather on the political system that constrains the officials to make their decisions. Differences in political characteristics, according to this view, can explain why, other socio-economic conditions being equal, certain municipalities enter into financial crisis and others do not. Research on the subject, both in the context of cities and in the context of sovereigns, emphasizes political fragmentation as a key reason for excessive public spending and for the creation of deficits. 26

Political fragmentation measures the degree to which the cost of a dollar of aggregate expenditure is internalized by the individual fiscal decision-maker. 27 The more fragmented the political system is, the more likely the local government will suffer from financial difficulties. Scholarly writing about fragmentation distinguishes between two of its aspects: size and procedure. 28

Size fragmentation is related to the number of social groups that participate in the budgetary process (through their representatives). As the number of participants increases, the total budget

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27 Perotti & Kontopoulos, supra note 26, at 192.

28 This distinction is taken from id. at 192.
expenditure increases as well.29 The reasoning behind this observation derives from the common pool problem. When multiple fragments of the community participate (via their representatives) in the budget decision-making process, each fragment fully enjoys the benefits of its own (successful) budgetary demands, but it shares the costs of those demands with all other residents. Thus, since each group internalizes only a fraction of the costs of its demands, it has an incentive to increase the value of the demands. Due to the fact that all the groups that participate in the process are subject to the same incentive structure, they all increase their budgetary demands, and expenditures are inflated.30 Take for example, the building of public swimming pools. Usually, the costs of the building are taken from the public budget, but the pool is used only by a specific segment of the community: those who like swimming and live relatively close to the pool. The swimmers, therefore, have an incentive to pressure politicians to build larger, more expensive pools.31 They will enjoy the pools’ benefits, while the costs will be shared with the entire community. The same rationale of course applies not just to users of public facilities (such as swimming pools), but also to many other local groups, such as districts, religious groups, racial groups, business firms, etc. Naturally, as the number of groups in the community increases (or in other words, as size fragmentation increases), so do the budgetary pressures. Each group internalizes a smaller fraction of the costs it wishes to impose on the community.32

29 Id. at 195.
30 Assuming n is the number of different groups participating in the budgetary process, then each group internalizes 1/n of the costs of its demands. In a fragmented community, as n increases, 1/n decreases, and so each group internalizes the repercussions of its demands to a lesser extent. The total expenditure, therefore, increases. See id. at 195; Barry R. Weingast, Kenneth A. Shepsle & Christopher Johnsen, The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics, 89 J. POL. ECON. 642, in particular at 653 (1981); Wolff, supra note 26.
31 The example is taken from Wolff, supra note 26, at 5.
32 The effects of the budgetary pressures may not be severe in cases in which the mayor enjoys the support of an absolute majority of the local residents. In these cases the mayor can prioritize the different demands, and she has the power to resist pressures to spend more than the locality can afford. Usually, however, and especially in fragmented localities, the mayor does not govern alone, and she needs to form a coalition in order to take power. Therefore, politically, the mayor is obligated to comply with the demands of the different groups, even those demands the locality cannot afford. The mayor needs to sustain her coalition, and she may do so even at the expense of the locality’s long-term financial health. And indeed, empirical evidence shows that large coalitions and (for nations) large cabinet sizes tend to result in larger deficits and lack of fiscal control. See Ricciuti, supra note 26. Ricciuti provides a literature review of empirical results regarding political fragmentation; see also Wolff, supra note 26.
Furthermore, within a fragmented political environment, interest groups play a very dominant role. Public officials often need their support in order to get re-elected, and so the groups have considerable influence over the government policies (in particular financial policies). Interest groups, however, by definition represent only a certain sector of the community. They promote the group’s narrow interest, sometimes at the expense of the community as a whole. The common pool problem is thus aggravated. In many cases of local crises, perhaps the most important and influential interest groups are the public employees unions. Research conducted by Pietro Nivola shows that the level of unionization among city employees is significantly correlated with local fiscal strain indicators. Nivola explains that due to the city’s political structure, municipal officials cannot resist the unions’ “raid over their treasuries,” and as a result the city enters into a financial crisis.

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

33 Indeed, the more interest groups there are in a locality, the more likely it is that the locality will enter into a financial crisis. See Wolff, supra note 26, at 39.
34 As the head of New York’s sanitation union once said, “We have a natural advantage that no [private sector] union has. We elect our employers.” Cited in Pietro S. Nivola, Apocalypse Now? Whither the Urban Fiscal Crisis, 14 POLITY 371, 376 (1982).
35 Id. at 375.
36 Perotti & Kontopoulos, supra note 26, at 196.
37 See id. (Perotti & Kontopoulos cite Hallerberg & Von Hagen. who emphasize the importance of sequencing the different stages of the budgetary process. See M. Hallerberg & J. Von Hagen, Sequencing and the Size of the Budget: A Reconsideration, CEPR, Working Paper No. 1589 (1997)); see also Reza Baqir, supra note 26, at 1347.
Ester Fuchs demonstrates the importance of the political environment to the development of a fiscal crisis through pointing out the differences between Chicago and New York in the 1970s.\(^\text{38}\) She shows that although the two cities experienced similar socio-economic processes, New York underwent a severe fiscal crisis whereas Chicago stayed in relative financial health. The reason for the different financial fates, according to Fuchs, is the cities’ different political environments. Whereas New York was dominated by multiple interest groups with no one central authority that controlled the budget,\(^\text{39}\) Chicago had a strong party machine that was able to resist budgetary pressures.\(^\text{40}\) Chicago, therefore, was able to respond to the socio-economic changes, while New York spent its way to a fiscal crisis.

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

I have described the two approaches to the causes of municipal financial crises. One approach emphasizes the external socio-economic causes, while the other approach emphasizes the political environment within the locality. Both approaches, however, consider circumstances that municipal officials do not necessarily influence, and when such circumstances (both external and internal) are present, a municipality may become insolvent. In the next part I explore the legal remedies that have been developed over the years to address this situation.

\(^{39}\) Id. at 242-250.
\(^{40}\) Id. at 251-261.
2. The Legal Remedies for Municipal Insolvency

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

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

2.1. The creditors’ remedies. Generally speaking, both in the private and the municipal contexts, when a debtor does not pay its debts in full, its creditors can go to court in order to coerce the repayment of their loan. If the creditors prevail in their lawsuit, they receive a judgment in their favor, and then (to the extent the debtor still refuses to pay) they may use various remedies to enforce the judgment.\footnote{The rationale behind these remedies is that without the means to force debtors to pay creditors back, individuals and institutions would not be willing to extend credit, and the lack of credit would damage the economy as a whole. \textit{See} Lynn M. LoPucki, \textit{A General Theory of the Dynamics of the State Remedies/Bankruptcy System}, 1982 Wis. L. Rev. 311, 315 (1982).} In the private sphere, the enforcement of a judgment usually entails the seizure of the debtor’s assets (“execution”). The creditors may foreclose on the debtor’s real estate, they can physically take personal goods, and they can even require a third party to pay them part of what it owes to the debtor (“garnishment”).\footnote{\textit{See generally} DAVID EPSTEIN, \textit{DEBTOR-CREDITOR LAW IN A NUTSHELL} 46-67 (2nd ed. 1980).} In the municipal context, however, even if the creditors receive a favorable judgment against a locality, their ability to enforce the judgment is very limited.

In most jurisdictions, the remedies of execution or garnishment are largely unavailable to aid municipal bondholders.\footnote{Most jurisdictions make a distinction between “public assets,” which are essential for performance of the localities’ duties (and cannot be executed), and “private [proprietary] assets,” which are not essential for public purposes (and therefore can be executed). In practice, however, the tests courts utilize in order to distinguish between the different kinds of assets are} In some states, the legislature has expressly immunized municipal property
from execution by statute.\textsuperscript{44} In other states courts have reached similar results by interpreting remedial statutes narrowly.\textsuperscript{45} Be the source of the prohibition as it may, most of the locality’s assets are out of the creditors’ reach.\textsuperscript{46} The prohibition on execution encompasses not only tangible assets (such as police cars, streets, or municipal buildings), but also financial assets.\textsuperscript{47} This includes not only funds that are part of the local budget, but also funds such as rent\textsuperscript{48} or insurance proceeds\textsuperscript{49} that localities receive. As long as the funds, regardless of their source, are to be used by the locality to finance its public expenditures, they cannot be reached by the creditors. The rationale for this rule was explained by the Texas Court of Appeals:\textsuperscript{50}

> It is easy to foresee what would be some of the results of an exercise of such a right by creditors of a city. Its revenues, which should be devoted to the accomplishment of the purposes for which it exists as a municipality, would be wasted in the payment of court costs, etc., and it soon would be without means to carry on its governmental affairs. We are unwilling to concede that a right, the exercise of which might be fraught with such consequences to a city, exists in favor of its creditors.\textsuperscript{51}

Due to these limitations, creditors find little comfort in the traditional creditors’ remedies. However, as an alternative, a specific remedy for creditors of municipalities has evolved — a writ of mandamus to collect taxes.\textsuperscript{52} The mandamus to collect taxes is a court order that instructs the locality to levy and collect taxes in an amount sufficient to pay a judgment rendered against a locality.\textsuperscript{53}

\begin{itemize}
\item Extremely vague, and courts have found public characteristics in virtually every municipal asset. The vast majority of municipal assets, therefore, cannot be used by the creditors. See Robert S. Amdursky & Clayton P. Gillette, Municipal Debt Finance Law Theory and Practice 248-9 (1992); McConnel & Picker, supra note 4, at 432-433.
\item Id. at §§ 49:44, note 1.
\item Jeff B. Fordham, Methods of Enforcing Satisfaction of Obligation of Public Corporations 33 Col. L. Rev. 28, 29 (1933); Note, Creditors’ Remedies In Municipal Default, 1976 Duke L.J. 1363, 1369 (1976); Lyon v. City of Elizabeth 43 N.J.L. 158 (1881); American-La France v. Town of Winnfield 184 La. 1043, 168 So. 293 (1936); Board of Councilman of City of Frankfurt v. White, 224 Ky. 570, 6 S.W. 2d 699 (1928).
\item Amdursky & Gillette, supra note 43, at 252; Fordham, supra note 46, at 30-32.
\item Lee v. City of Fairfield, 226 Ala. 70, 145 So. 669 (1933); Klein v. New Orleans, 99 U.S 149, 9 Otto 149 (1878).
\item Ellis v. Partt City, 111 Ala 629, 20 S. 649 (1896).
\item Capps v. Citizens Nat’l Bank 134 S.W. 808 (1911).
\item Also See Estate of DeBow v. City of E. St. Louis, 228 Ill. App. 3d 437, 592 N.E.2d 1137 (Ill. App. Ct. 5th Dist. 1992).
\item The writ of mandamus is generally defined thus: “a command issuing from a court of competent jurisdiction, in the name of the State or sovereign, directed to some corporation, public or private, or an officer of it…requiring the performance of a particular specified duty which results from the official station of the party to whom the writ is directed, or from the operation of law.” See McQuilllin, supra note 44 §§ 51:2.
\item See Albert M. Hillhouse, Municipal Bonds: A Century of Experience 297 (1936); Amdursky & Gillette, supra note 43, at 241; Fordham, supra note 46, at 32.
\end{itemize}
The scope of the writ may vary from case to case, but usually the court instructs the municipality to include a tax levy sufficient to pay the judgment (debts) in full in the next current budget. Pursuant to the mandamus then, the municipality must levy a special tax or increase the rates of the existing taxes, and it transfers the extra tax revenues to the creditors as payment for their claims.\textsuperscript{54} The mandamus thus forces the residents (through tax payments) to finance the municipality’s financial obligations. Note, however, that the court itself does not directly impose the taxes. The writ is addressed to the municipal officers who generally have the authority to levy and collect taxes, and the tax is imposed in accordance with the general state laws and constitution. Thus, the court may not force a locality to increase its taxes above any limits prescribed in the state’s statutes, and the creditors can use only the surplus of the revenues the municipality receives above the amount it needs for the local operating expenses.\textsuperscript{55}

Despite its limitations, however, the mandamus remedy is essentially based on the premise that the residents of a locality should pay for the debts that their locality has incurred. Thus, courts do not allow localities to repudiate their financial obligations when they are (legally and economically) able to collect revenues that can be transferred to the creditors, and localities are expected to maximize their tax-raising capacity before defaulting on their debts. Conceptually, then, the mandamus remedy can be thought of as placing the burden of the local crisis on the residents. They finance the local deficit and settle the local debts with the taxes that they pay.\textsuperscript{56}

2.2. Chapter 9 of the bankruptcy code. The federal bankruptcy code deals with insolvent municipalities in a different manner. Chapter 9 (the municipal bankruptcy chapter) enables insolvent localities to seek bankruptcy protection from their creditors, and it provides them with a breathing spell

\textsuperscript{54} HILLHOUSE, supra note, at 280.
\textsuperscript{55} MCQUILLIN, supra note 44, §§ 49:43; AMDURSKY & GILLETTE, supra note 43, at 244; HILLHOUSE, supra note 53, at 279-280; Defoe v. Town of Rutherfordton, 122 F.2d 342, 344 (4th Cir. 1941); Maryland Casualty Co. v. Leland, 214 N.C. 235, 199 S.E. 7 (1938).
\textsuperscript{56} Massachusetts and some other New England states went even one step further in placing the responsibility for the locality’s obligations on the residents. These states allowed the creditors to execute the residents’ private property in satisfaction of the local debts. This extreme remedy was, however, rejected in most other states. AMDURSKY & GILLETTE, supra note 43, at 250-251.
to negotiate a debt readjustment plan. In this section I briefly discuss the municipal bankruptcy procedure, and especially focus on its unique aspects when compared to corporate bankruptcy.

Perhaps the first difference to remark between Chapter 9 and other bankruptcy chapters is that municipal bankruptcy is not readily accessible to localities. In order to enjoy bankruptcy protection, a locality must meet five threshold requirements, which are different (and more difficult) than the thresholds other debtors face. These thresholds include, *inter alia*, the state’s approval for the bankruptcy filing (which must be express and direct), and an insolvency requirement (the locality must show that it cannot pay its debts when due).

Assuming that these threshold requirements are met, the first step in the municipal bankruptcy process is the implementation of an automatic stay. The stay is implemented at the moment of the bankruptcy filing, and it operates immediately to halt all collection efforts by the creditors. As a result of the stay the creditors can no longer enforce their prepetition claims against the debtor, and they do not receive any payments (principal or interest) from the municipality. Under the auspices of the stay, the municipality and its creditors begin negotiations on a plan of debt readjustment. During these negotiations the municipality enjoys the exclusive right to submit plans of debt readjustment to the court, and the creditors can only approve or disapprove of the plans that the locality submits.

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

58 McConnel & Picker criticize the insolvency requirement set forth in Section 109(c). They argue that it postpones the day of the bankruptcy filing, while the city continues to incur more and more debt at increasing interest rates. This in turn burdens the municipal budget, and ensures that each creditor will receive less in bankruptcy. McConnel & Picker, *supra* note 4, at 456-457.

59 An automatic stay means that the mere filing for Chapter 9 acts as a procedural halt to all judicial proceedings against the municipality. No creditor can commence or continue any legal action in order to recover its debt, and no creditor can get any payment (interest or principal) from the debtor. The automatic stay provided in Chapter 9 has two legal sources. First, Section 362 (11 U.S.C § 362), incorporated into Chapter 9 via Section 901. Second, Section 922, (11 U.S.C § 922). Section 922 broadens the protection afforded under Chapter 9, so that not only is the debtor (the municipality) protected but so also is “an officer or inhabitant of the debtor.”

60 In Chapter 11 the exclusivity period is limited to 120 days, and afterwards the court may accept plans also from the creditors or other interested parties (11 U.S.C § 1121(b)). In Chapter 9 the exclusivity period is not limited in time, and so it
Naturally, this gives the locality great leverage in the negotiations. Not only do the creditors not get any payments (interest or principal) during the period of negotiations (because of the automatic stay), but they also cannot submit debt readjustment plans of their own, and so they are very much in the hands of the locality that controls the process. Localities, therefore, can take advantage of this situation, and they can force the creditors to make concessions that they would otherwise not agree to make.61

To the extent that the locality constructs a plan of debt readjustment, it submits the plan for the court’s confirmation.62 Similar to Chapter 11, Chapter 9 offers two routes for the plan’s confirmation: one requires the approval of all classes of creditors, and the other forces the plan on at least some creditors despite their objection (a “cram down”).63 In both types of confirmation the court examines the suggested plan, and it confirms the plan only when it meets certain conditions specified in the code. Although most of the approval conditions are incorporated from Chapter 11, the application of these conditions to the municipal context is not always successful, and the conditions do not always provide adequate protection to the creditors of the municipality.

Perhaps the best example of this problem concerns the application of the absolute priority rule.64 According to the absolute priority rule, if under the plan of reorganization high priority creditors get less than their full claims, then lower priority creditors must get nothing. In the private context this is an extremely potent protection, because if the shareholders (which are the lowest priority creditors) want to continue to keep their holdings in the company, then all other creditors (including of course unsecured creditors) must be paid in full.65 However, when applied to the municipal context, this protection continues as long as the municipality is in bankruptcy. This distinction is connected to the special nature of the municipality as a debtor. Congress did not want the creditors to submit plans that might influence the internal condition in the locality.

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

62 11 U.S.C § 941

63 11 U.S.C § 1129(a) and 1129(b) are partially incorporated into Chapter 9 via Section 901.

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

65 11 U.S.C § 1129(b)(2).
mechanism is very limited. As opposed to a private corporation, a municipality has no shareholders. The residents (the conceptual equivalent of shareholders) are not considered creditors, and so the locality’s unsecured creditors are the lowest priority creditors under the plan. This means that the municipality can impair the unsecured creditors (pay them less than their full claims), and still continue to render services (give funds) to the residents. The creditors in the municipal context cannot invoke the absolute priority rule (instruct the locality: “pay us in full, or else stop rendering services to your residents”), because residents (as opposed to shareholders) do not have the lowest priority with respect to local funds. Thus, notwithstanding the formal incorporation of the absolute priority rule, unsecured creditors may have difficulties in protecting themselves from plans that harm their basic interests.

If the court finds that the submitted plan meets the conditions set forth in Chapter 9 (albeit weaker conditions than those in Chapter 11), then the plan is confirmed and considered binding upon each and every creditor. The municipality’s prepetition obligations thereafter consist only of the obligations it has assumed under the plan, and the rest of the local debts are discharged. If the court does not confirm the plan (or if the municipality fails to submit a plan), then the court may dismiss the case, and the locality no longer enjoys the bankruptcy protection.

Note, however, that the court’s powers are limited to the confirmation or rejection of the plan as submitted by the locality. According to Chapter 9, the court cannot change the submitted plan, or interfere in any other way in the governmental or political powers of the locality. This is particularly important with regard to tax collections. Whereas outside bankruptcy creditors (using the mandamus remedy) can force municipalities to raise their tax rates, inside bankruptcy the creditors (and the court for that matter) are subject to the tax rates the municipality itself sets. So as long as the municipality is

66 The absolute priority rule applies directly to Chapter 9. Sections 11 U.S.C § 1129(b)(2)(A) and 1129(b)(2)(B) are incorporated into Chapter 9 via Section 901.
67 COLLIER ON BANKRUPTCY ¶ 943.03[01][f] (Alan N. Resnick & Henry J. Sommer eds., 15th edition revised, 2006); McConnel & Picker, supra note 4, at 464.
68 11 U.S.C § 944.
69 11 U.S.C § 930.
70 The court may not interfere with any of the debtor’s political or governmental powers. See: 11 U.S.C § 904.
under bankruptcy protection, the court cannot order a tax increase, whether or not the local income is sufficient to pay the creditors in full. This clearly raises a concern that the locality will not exhaust its tax-raising capacity, and that its revenues will be insufficient to repay its debts.\footnote{Note that in order to confirm the plan, the bankruptcy court needs to be convinced that the plan is in the best interest of the creditors (11 U.S.C. § 943(7)), but in many cases courts have confirmed plans even when the locality did not reach its maximum tax levy capacity. See, e.g., Sanitary & Improvement District Number 7, 98 B.R. 970 (Bankr. D. Neb. 1989); in re Mount Carbon Metropolitan District, 242 B.R. 18, 34 (D. Colo. 1999) (In this case the court refused to confirm the plan, but not due to the best interest of the creditors test). For a theoretical justification of this approach see Kordana, supra note 4 (1997).}

The municipal bankruptcy process thus offers municipalities relatively easy debt relief. Using Chapter 9, insolvent localities can pressure creditors to agree to unfavorable debt readjustment plans, and due to the lack of creditor protection mechanisms they can also force plans on unwilling creditors. Therefore, as opposed to the mandamus (the creditors’ remedies), bankruptcy places the burden of a financial crisis on the creditors. It allows insolvent localities to avoid paying part of their debts, even when they do not maximize their tax-raising capacity.\footnote{William D. Baker, Chapter 9 Bankruptcy: A Haven for Central Arizona Project Districts, 27 Ariz. St. L.J. 663, 674-675 (Baker explains the meaning of municipal bankruptcy filing by Arizona Special Districts in the following manner: “The ruling [that approves the bankruptcy filing – O.K.] gives the District great latitude not to be restricted to the former terms of its general obligation bonds. The District now can suggest and seek confirmation of a plan that would alter and vary those terms, such as changing payment dates, extending maturities, and decreasing interest rates. County officials benefit from the ruling because the ruling removes the threat of a mandamus action brought by a bondholder to seek the levy and collection of sufficient funds to pay principal and interest on the bonds.”)}

The justification for placing the burden of the local crisis on the creditors may be perceived as an insurance justification.\footnote{An “insurance” rationale is often given to the fresh start policy in consumer bankruptcy. Baird, supra note 64, at 34-35; Douglas G. Baird, Thomas H. Jackson and Barry E. Adler, Cases, Problems and Materials on Bankruptcy, 470 (3rd edition revised 2001).} According to this view, without bankruptcy law, in times of local financial crisis, the locality would be forced to increase its tax rates, but the residents of the locality would not enjoy more benefits. They would pay more to the locality, but the tax proceeds would be used for debt service, and not for local public goods. Municipal bankruptcy is designed to prevent this outcome. Using bankruptcy the locality can decrease its debt burden and reduce its local tax rates. The relatively low tax rates promote productivity, improve the local economic performance and help the locality recover.\footnote{McConnel & Picker, supra note 4, at 470.}
underlying assumption, therefore, is that mitigating the city’s financial hardship provides the locality with a fresh start, and enables it to rehabilitate to the benefit of both residents and creditors.

A third approach to municipal insolvency is offered by state financial boards. Although by and large the legal literature has ignored this type of remedy, I will argue that it is the most effective remedy.

2.3. State financial boards and state municipal insolvency statutes. A state financial board is a state agency created in order to help a distressed locality overcome its economic troubles. The board usually oversees the financial affairs of the city during its time of crisis, and it initiates a rehabilitation process designed to help the locality recover. Ideally, with the help of the state board the city is able to address the causes of its financial decline and gradually regain financial stability.75

In most states the decision to form a state financial board is an ad hoc decision. The states do not have clear criteria as to when a board should be established, and the decision often depends on the political circumstances in the state and on the gravity of the city’s economic situation. Usually, states decide to intervene only after a city’s credit rating falls below investment grade, or when the city is unable to finance its operating expenses.76 In a few states, however, the decision to establish a board takes a more systematic form. These states have enacted municipal insolvency statutes that list a set of economic criteria, and when a certain municipality meets one of these criteria (for example, the locality reaches a certain level of deficit), then a state board is established.77

The actions boards take differ from case to case, but notwithstanding the differences some typical characteristics can be found. Usually boards engage in three types of activities: information

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75 Missed Opportunity, supra note 5.
77 See Philip Kloha, Carol S. Weissert & Robert Kleine, Someone To Watch Over Me, State Monitoring of Local Fiscal Conditions, 35 AM. REV. PUB. ADMIN. 236 (2005). A more elaborate discussion of these statutes is provided infra, in the fourth part of this paper.
gathering, debt management, and fiscal management. The first category of activity, information gathering, includes activities such as financial inquiries, auditing, and implementing better disclosure practices. These activities are designed to provide the board with better knowledge of the local financial practices, so that it will be able to address the root of the city’s economic problems. The second category of board activity, debt management, usually involves obtaining additional funds for the city. As a result of the crisis, localities often do not have sufficient funds to pay for their debt and operating expenses, and so the state board supplies the distressed city with interim financing. Usually, the board does not simply transfer funds to the city, but rather facilitates the city’s continued access to the credit markets. The state provides creditors with guarantees for their loans, but it is the city that has to pay back the debts with its own resources. The third category of activity, fiscal management, consists of actions the board takes in order to help the city recover. In most cases the board prepares a plan of rehabilitation, and it oversees the locality’s adherence to the plan that has been formed. The plan obligates the city to take the required actions towards recovery (for example, decreasing the city’s expenditures, increasing taxation, or changing the political environment), and with the implementation of these measures the locality regains its financial stability.

Usually, as soon as the city’s economic condition improves, the board dissolves, and the city’s governance returns to normal. The elected local officials resume their previous posts, and the state no longer takes such an active role in the management of the locality. However, even in those cases where

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79 *Actions Taken by Five Cities, supra* note 76, at 48. The Chicago School Finance Authority, for example, issued four series of bonds primarily to provide financial assistance to the Chicago School Board. The bonds were payable out of dedicated taxes levied on all taxable property in the city of Chicago. See *id.* at 59. PICA, the financial board established for Philadelphia, also issued debt to raise cash for Philadelphia’s operating costs. A PICA “authority tax” was approved in order to pay back the debt, and so the city paid for the debt service from its own resources. See *id.* at 76. A similar financial arrangement took place in New York. See ROBERT W. BAILEY, THE CRISIS REGIME: THE MAC, THE EFCB, AND THE POLITICAL IMPACT OF THE NEW YORK CITY FINANCIAL CRISIS 27-28 (1984).
80 *Actions Taken by Five Cities, supra at* 46, 53. A more detailed discussion of some of the rehabilitation measures state boards can take is provided *infra,* in Section 3.3 of the paper.
the board stays for longer periods of time (such as ten to twenty years), after a few years the board’s role is usually reduced from an oversight to an advisory role.81

3. The superior risk bearer of municipal insolvency

So far I have briefly described the three basic remedies for municipal insolvency. I have detailed the procedures that each remedy prescribes, and I have outlined the rights and obligations that the various remedies assign to the distressed locality. This description, however, also invoked a more conceptual and fundamental difference among the remedies with regard to the way municipal insolvency should be addressed. Each one of the remedies can be viewed as placing the burden of a local financial crisis (or at least a substantial part of it) on a different entity.

The creditors’ remedies place the burden of a crisis on the residents of the locality. Pursuant to a writ of mandamus, a crisis is resolved by imposing additional local taxes on the residents, and so the residents essentially pay with their property for the locality’s budget deficits and overspending. The bankruptcy code, on the other hand, places the burden of the crisis on the creditors. Chapter 9 prescribes a debt readjustment process that is very convenient to the locality, as it allows the locality to shift part of its debt burden to the creditors, even when it does not maximize its tax raising capacity. State financial boards offer a third option for the resolution of a crisis, and they place the burden on the state. The state initiates a rehabilitation process to help the locality, and in the meantime it provides the locality with interim financing to prevent a possible default or bankruptcy filing.

In this part of the paper I examine these three possible approaches to municipal insolvency. I consider which of the three entities — the residents, the creditors, or the state — is the most effective

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81 Id. at 49.
risk bearer of a municipal financial crisis, and in what way a local fiscal distress can best be dealt with.\textsuperscript{82}

I start with the residents.\textsuperscript{83}

3.1. The residents as risk bearers. One option is to place the risk of municipal insolvency on the residents. This means that the municipality is not allowed to default, and it must pay its debts in full from its own resources only.

Supporters of placing the burden solely on the residents argue that it forces the municipality to internalize the full costs of its budgetary actions. They make the claim that a different rule, one that permits the municipality to default or that enables the state to bail it out, would shift part of the municipal expenditures onto third parties (the creditors or the state), and would allow the residents to enjoy the benefit of certain goods and services without seeing their full costs. This would induce the municipality to over-consume, and would create inefficiency.\textsuperscript{84} Placing the risk on the residents, on the other hand, promotes efficient resource allocation. The municipality knows that it (and not the creditors or the state) will pay for whatever the residents consume, and so it is obligated to be fiscally responsible.\textsuperscript{85} Moreover, placing the risk of a local financial crisis on the residents seems justified because the residents can determine the financial policies of the locality through the political process.\textsuperscript{86} They can elect financially responsible public officials, who will keep expenditures at a level the locality

\textsuperscript{82} For analytical purposes, I study each possible risk bearer as if it bears the risk of the crisis alone.

\textsuperscript{83} Compare Kordana, supra note 4. Kordana also discusses the conceptual question of the efficient risk bearing of a municipal crisis. However, he fails to examine the state as a risk bearer, and he presents the residents and the creditors as the only possible options.

\textsuperscript{84} In case of a bailout, the state transfers funds to finance part of the local goods and services. The residents, therefore, do not internalize the full cost of the local goods, and so they have an incentive to over-consume. (See Robert P. Inman, Transfers and Bailouts: Institutions for Enforcing Local Fiscal Discipline, 12 CONST. POL. ECON. 141 (2001); Timothy J. Goodspeed, Bailouts in a Federation, 9 INT’L TAX AND PUB. FIN. 409 (2004)). Correspondingly, in case of bankruptcy filing, the municipality consumes local goods and services with debt proceeds, but it does not repay its creditors back in full. (Compare Kordana, supra note 4, at 1066 (Kordana discusses the moral hazard problem Chapter 9 of the bankruptcy code creates. He then argues that reputation effects can mitigate this problem.))

\textsuperscript{85} Inman, supra note 84 (Inman shows the economic inefficiency that occurs when the residents shift part of the local public costs to the state or to the creditors, and he recommends institutional safeguards to prevent such cost-shifting.)

\textsuperscript{86} Compare Clayton Gillette, Idea and Essay: Kelo and the Local Political Process, 34 HOFSTRA L. REV. 13 (2005) (Gillette emphasizes the strength of the political process in a different context — eminent domain.)
can meet, and they can thereby avoid potential crises. Thus, since the residents are in a position to prevent a crisis, they should also bear the risks of its consequences.

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

The first, *ex ante*, perspective derives from the premise that, despite the political process, residents do not control the locality’s financial situation. It is true that the residents elect the political officials that determine the local fiscal policies, but the elections do not provide the residents with a sufficient tool to prevent (or deal with) a possible crisis. One reason for the residents’ lack of control is simply agency costs. Although the residents elect the political officials, once in office the officials often act in order to maximize their own political interests, rather than the interests of the residents or the locality as a whole. The officials might implement policies that ensure their political survival (or reelection), even when those policies damage the locality’s economic performance and may result in future financial deterioration. These agency costs are aggravated due to the collective action problems the residents suffer from. As a large unorganized group, residents have difficulties monitoring the local officials, and so fiscal policy is often biased in favor of small (yet powerful) interest groups that can offer political support. The officials thus comply with the financial demands of minority interest groups, and they overspend the local resources on the expense of the majority of the residents.87

But even if we assume that there are no agency costs (officials implement policies that fully correspond with the wishes of the residents), still it is not evident that the residents can control the

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occurrence of local fiscal crises. As elaborated in the previous part, the causes of a local crisis are often outside the local officials’ realm of control. The officials can hardly affect the socio-economic reasons that are at the base of the financial decline, and they are part of a political environment that mandates continued spending. Thus, since the local officials themselves cannot prevent a forth-coming crisis, certainly the residents (who exercise their powers through electing those officials) cannot do so. Like the officials, the residents are victims of the external and political circumstances that caused the crisis, with little ability to prevent it.

Placing the burden of a crisis on the residents seems even more problematic when we consider the ex-post implications of such policy. Placing the burden on the residents means that they alone pay for the locality’s debts and operating expenses, and this obligates the locality either to raise the local tax rates and/or cut expenditures on public services. In times of a local crisis, however, both options are undesirable.

First, there is a limit to the level of taxes a government can impose. When taxes are raised above a certain limit (the peak of the Laffer curve), the tax base shrinks, and the revenues the government can collect start to decrease.88 This is especially true with regard to local taxes. When a locality raises taxes, its residents can simply move to a different city, and the locality is liable to lose revenues rather than earn more. Therefore, significant and disproportionate increases in the local taxes usually do not solve fiscal problems, and they may even damage the locality rather than help it recover.89

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

89 In the municipal context the Laffer curve (or the revenue hill) is especially low, because the local residents can relatively easily move away from the locality and stop paying taxes. See Andrew F. Haughwout, Robert P. Inman, Steven Craig & Thomas Luce, Local Revenue Hills: Evidence from Four U.S. Cities, NBER, Working Paper No. 9686, available at http://ideas.repec.org/p/nbr/nberwo/9686.html (Haughwout et al. examined the tax rates of four cities, and they found that three out of the four cities were very close to the peak of their local Laffer curve.)
On the other hand, there is also a limit to the amount of services a locality can cut. Local governments are the main providers of public services in the U.S., and they supply services that are essential to residents’ lives.\(^{90}\) Placing the burden of a crisis solely on the residents may jeopardize the supply of these essential services and severely damage the local community. The crisis can affect the quality of local education, the quality of the public utilities (such as water and sanitation), the safety of the community, and in severe cases it may even cost lives. This situation is not merely theoretical. Bridgeport, Connecticut, for example, at the beginning of the 1990s suffered from a serious financial crisis, which resulted in a severe lack of police personnel. As a consequence, murder cases in the city were not properly investigated, neighborhoods were controlled by drug dealers, and there were not enough police officers to respond even to emergency calls.\(^ {91}\) Another example is that of Chelsea, Massachusetts, also at the beginning of the 1990s. A severe fiscal crisis in Chelsea caused the city’s educational system to collapse. The city had to dismiss at least a third of the public school teachers, and in September 1991 the city could not even afford to open the schools for the new school year.\(^ {92}\)

Thus, in light of the serious consequences of a local financial crisis, and in light of the fact that residents have limited control over its occurrence, risk-averse residents should prefer to purchase “insurance” against a crisis.\(^ {93}\) This insurance would allow municipalities facing a financial crisis to shift costs to third parties — namely the creditors or the state — so that the municipality would be able to continue to function, even in times of severe financial difficulty. Creditors can provide such “insurance” if insolvent municipalities will not be obligated to pay their debts in full. Thus, all municipalities will pay higher interest rates to the creditors, but in return the creditors will bear some of the losses in case a particular municipality falls into hard times and defaults (as we saw, this is the function of bankruptcy

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\(^{90}\) For example, water supply, sanitation, police and fire protection, education and recreational activities.

\(^{91}\) See in re City Of Bridgeport 129 B.R. 332, 335 (1991) (testimony of Bridgeport’s chief of police).

\(^{92}\) Florin Pasnicu, Fiscal Fiasco for Tiny Chelsea, Mass., CHRISTIAN SCIENCE MONITOR, August 9 1991 at 8; Receivership Sought for Bankrupt City, UNITED PRESS INTERNATIONAL, September 6, 1991 at the Domestic News Section.

\(^{93}\) This terminology (“insurance”) is taken from the analysis usually made with regard to individuals in consumer bankruptcy (see references, supra note 73). The situation (in some ways) also resembles the need for the limited liability provided to shareholders of a company. Limited liability, which can be viewed as a kind of a shareholders’ “insurance,” is especially necessary when the shareholders are dispersed and do not have a high degree of control over the company’s affairs.
law). Correspondingly, the state can also provide such insurance. The state can help local governments when they enter into financial difficulties, but in return (presumably) state residents will have to pay more taxes to the state. In both cases, however, the consequences of the local crisis are not borne by the municipal residents alone, because the municipality transfers part of its financial burden to third parties.

The advantage of the state and the creditors playing this role is that they “supply the insurance” to a wide range of local governments. Since they deal with multiple municipalities, they can diversify the risks of a crisis, and offset the damage suffered by one locality with the success of other localities. The residents of a single municipality, on the other hand, cannot diversify the risk among themselves. Faced with a financial crisis, municipal residents will be forced to absorb the entire damage — paying high taxes and receiving poor municipal services.

3.2. Who is the superior risk bearer: the creditors or the state? So far we have seen the problems with placing the risk of a municipal crisis on the residents. Residents, on the one hand, cannot prevent the occurrence of a local crisis; and, on the other hand, they cannot diversify the crisis’s damages. Therefore, I argued, the residents should purchase an “insurance policy” against municipal insolvency, and such insurance can be provided either by the creditors or by the state.

It is important to note, however, that placing the risk of municipal insolvency on either the creditors or the state does not mean that cities and their residents will completely stop bearing the costs of municipal financial distress. On the contrary: if we place the risk on the creditors, then municipalities will have to pay higher interest rates to compensate the creditors for the risk they are taking; and if we place the risk on the state, then state residents (who are also municipal residents) will have to pay higher taxes to the state. The question, therefore, is not which of these two entities — the state or the creditors

94 See Section 2.2, supra; McConnel & Picker, supra note 4, at 470.
95 Kordana, supra note 4, in particular 1096-1106 (1997). (Kordana also makes the claim that on average creditors are wealthier than residents, and wealthier people tend to be less risk-averse (on the margin). Due to the fact that creditors are less risk-averse than bondholders they are superior risk bearers.)
— can better absorb the costs of a financial crisis, but rather which of the two options — increased tax payments to the state or increased interest payments to the creditors — is cheaper. In this section, I argue that the answer to this question is the state. The state is the cheaper insurer of municipal insolvency.

The reason for my claim is that the state can address the causes of the crisis or deal with its consequences better than the creditors. When a locality suffers from financial distress, certain measures are often required in order to help it regain financial stability. The locality needs to reform the tax system, cut labor expenses, increase efficiency, and take other actions designed to reduce the deficit and to enable it to recuperate. The state, as will be elaborated further on, can use its legal and political powers to initiate such rehabilitation measures. It can intervene in the local fiscal affairs and help the locality overcome its financial difficulties.96 The creditors, on the other hand, lack the state’s powers. They cannot implement the required local economic reforms themselves, and they also do not have the requisite legal powers to force the locality to take remedial actions. Therefore, since the creditors are in a worse position than the state to avoid a local crisis or minimize its consequences, it is less efficient to place the burden of the crisis on their shoulders.

An argument can be made, however, that although the creditors do not have the legal authority to force municipalities to implement economic policies, they can affect the local policies through the financial markets. The creditors, after all, control the locality’s most important resource – money, and this control enables them to pressure the local officials into taking the steps that they think are necessary for the locality. Since localities often need the funds that the creditors supply, officials are compelled to follow the creditors’ demands. The creditors set the conditions for extending loans to the locality, and this gives them leverage to force the locality to undergo a recovery process. Moreover, since municipalities wish to pay the lowest interest rates they possibly can on their loans, the credit markets (even when the creditors are dispersed and unorganized) push local officials to improve the local financial condition. The better the local financial condition is, the higher the locality’s credit rating and

96 A more elaborate analysis of the state’s powers in this context is provided infra, in Part 3.3 of the paper.
the lower the interest rates the locality has to pay on its debts. Thus, market forces, instead of legal authority, can steer municipalities in the right financial direction, and urge local officials to take measures to regain (or maintain) the local fiscal health.97

However, despite the strength of the above argument, I believe that creditors’ monitoring is not a sufficient tool to help municipalities address financial crises. The reason is that while the creditors’ pressures are directed at the local officials, the officials themselves may be unable to address the underlying causes of the financial deterioration. The creditors can try to force the local officials to take measures to rehabilitate the locality, but the local officials often lack the legal authority and/or the political powers to take the required actions. In order to better understand this claim, it is important to recall the reasons for municipal insolvency discussed in the previous part of the paper.

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

97 In a private corporation, the creditors are often viewed as monitors of the corporate officials. Especially in small and medium-size firms, banks provide the bulk of the firm’s credit, and so they are able to exercise a great deal of control over the corporate policies, and thereby to discipline the corporate managers. See George G. Triantis & Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 82 CALIF. L. REV. 1073 (1995); Randal C. Picker, Security Interests, Misbehavior and Common Pools, 59 U. CHI. L. REV. 645 (1992) (focusing on secured creditors).
However, even if we subscribe to the second approach, which emphasizes the role of the local political management in the financial decline, it is not clear whether the creditors can cause the local officials to change their financial behavior. As mentioned previously, in many cases the local officials’ fiscal policies are dictated to a large extent by the nature of the political system. A fragmented political environment creates a weak municipal leadership, which is unable to stand strong against budgetary pressures. The problem is that local officials see the political system as a given. They have a limited ability to decrease the extent of political fragmentation, and they may face difficulties when trying to weaken the strength of the interest groups. Therefore, even if we subscribe to this approach to local crises, pressures from the creditors directed at the local officials may also fail to bring a positive change. The creditors can raise the price of credit or even stop lending to the locality altogether, but the local officials are trapped in spending patterns that a political system (which they have problems changing) dictates to them.

Perhaps the best example for the creditors’ failure to stop a city’s financial decline is the crisis in New York City. In this case, the city’s creditors organized a creditors’ group (the FCLG), and the group tried to pressure the city’s officials into changing their financial policies (decreasing labor costs, raising taxes, cutting welfare expenditures, etc.). At first, the creditors met with the city’s officials and tried to persuade them to initiate a rehabilitation process, but when these persuasion attempts failed, the creditors applied drastic sanctions against the city. Interest rates were significantly increased, and at the beginning of 1975 creditors refused to extend the city any more credit. However, even faced with these extreme pressures by the creditors (with the city standing on the verge of financial calamity), New York’s officials did not initiate the required reforms. Clearly they understood the gravity of the city’s financial position, but the political environment did not allow them to take the steps needed for rehabilitation. The city was fragmented, its decision-making process was disorganized and lacked financial planning, and interest groups blocked any possibility for a significant change. Under these
circumstances, even the creditors’ strongest pressures were to no avail. The city needed the state’s intervention.\textsuperscript{98}

Note, that this is not to dismiss the importance of the creditors’ monitoring. On the contrary, I believe that the credit markets have an important role in maintaining the local fiscal health, and that the creditors can (and in certain cases do) help prevent local financial decline.\textsuperscript{99} However, I do argue that since the causes of local financial crises are often out of the local officials’ realm of control, the state’s involvement is warranted. When a municipality suffers from severe financial difficulties (that the creditors and local officials were evidently unable to prevent), the state should step in, and try to assist the locality avoid further financial deterioration. The state, I argue, can take measures that address the causes of local financial crises, and it can help localities regain their fiscal health even in cases where the local officials (and the creditors) have failed.

In the following section I, therefore, discuss the role of the state. I set out to explain the advantages of the state in addressing the urban crisis.

\textbf{3.3. The state as the superior risk bearer.} Up until now my argument has been of a negative nature. I have discussed the difficulties of placing the risk of a financial crisis on the residents and the creditors, and I have explained why both of these parties have a limited ability to prevent a crisis or reduce its damages. In this section, I set out to examine why the state’s intervention is required in times of financial crisis. How can the state address financial crises that municipal officials cannot deal with?

The answer to this question again relates to the causes of municipal insolvency examined in Part 1 of this paper. It was there described how some scholars believe that municipal financial crises are the


\textsuperscript{99} The creditors’ efforts can be successful when the local officials have the powers to address the causes of the financial decline, and when the political system enables them to adequately respond to the economic circumstances at the root of the crisis. However, as we saw in the first part of this chapter, usually the reasons for financial crises (as opposed to less serious financial distress) are beyond the local officials’ realm of control.
result of external socio-economic processes, whereas others focus on the political system and the local management. I argue that whether we adhere to one approach or to the other, the state is in a better position than municipal officials to address the underlying causes of a financial crisis. The reasons for my claim are twofold: First, the state has broader legal authority than municipal officials, and so it can better address the external socio-economic processes. Secondly, the state has the ability to change the political environment in the municipality, and so it is able to decrease the political pressures for overspending. I will now elaborate on these two reasons.

The state can better deal with the socio-economic processes. The starting point for the state’s ability to deal with the socio-economic processes is simply its superior legal authority. According to local government law, municipalities are creatures of the state. States have plenary powers with regard to their localities, and localities have only those powers delegated to them by the state. Most states do allow their local governments some degree of autonomy, but especially in financial matters states tend to limit the local officials’ powers to independently regulate. Therefore, regarding many issues (such as the local tax system, debt issuances, financial disclosure, and annexation of new territories to the municipality) municipal officials do not have the powers that the state has, and correspondingly their ability to address economic changes is limited. Dealing with a crisis involves adapting the urban

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101 Most states have accepted some sort of constitutional amendments that allow local governments to independently regulate local affairs (these amendments are called home-rule amendments). However, notwithstanding the home-rule amendments, the powers of local governments are still limited. First, the amendments usually allow local governments to regulate only in certain defined areas that are generally purely local (often fiscal affairs, such as taxation or debt, are outside the localities’ realm of authority). Secondly, states can still review localities’ regulations, and they can legislate statutes that will trump the local policies. In most cases, therefore, the state’s supremacy has been preserved. For a closer look at local autonomy and the home rule amendments see Advisory Comm’n on Intergovernmental Relations, Local Government Autonomy: Needs for State Constitutional, Statutory, and Judicial Clarification (1993) [Henceforth: “Local Government Autonomy”]; Terrance Sandalow, The Limits of Municipal Power under Home Rule: A Role for the Courts, 48 MINN. L. REV. 643, 658-668 (1964); Briffault, supra note 100, at 9; Frug, supra note 100, at 1116; David J. Barron, A Localist Critique of the New Federalism, 51 DUKE L.J. 377 (2001).

102 LOCAL GOVERNMENT AUTONOMY, supra note 101, at 14.
economy to the divergent socio-economic environment, and this in turn may require the regulation of areas that are not within the local officials’ realm of authority.

The core problem with the socio-economic processes is that they are usually external to the municipality. They involve forces that the local officials can hardly affect, and entities (like the suburbs or the state) that the locality cannot control.103 Addressing the problems caused by socio-economic processes, therefore, requires a comprehensive and overarching solution, and the local officials simply do not have the authority to initiate the required reforms. This is the case both with regard to processes of suburbanization (which involve both the city and its suburbs), and with regard to the intergovernmental relations (which involve the city, the state, and other localities within the state).

Take, for example, crises caused by a process of suburbanization. These crises occur because taxing residents (businesses or individuals) move out of the city, and the city is left with both an increasing level of expenditures and a shrinking tax base.104 Naturally, the solution for this problem cannot come only from regulating the city. The city has only limited resources, and imposing more taxes or cutting more services will not necessarily help. The solution must come from looking at the suburbs and the city together (considering both their interests), and understanding that the suburbs must help the city deal with its economic problems.105 The city, of course, does not have the authority to force its suburbs to share its costs and contribute revenues, but the state, with its plenary legal powers, is able to take the necessary actions.

One measure the state can take is reforming the local tax system, and especially allowing the locality to impose taxes on non-residents (for example, commuter taxes or non-resident income taxes).

103 LADD & YINGER, supra note 10, at 291.
104 At the beginning of the 1990s in Washington D.C., for example, almost half a million non-D.C. residents worked in the city, whereas only 300,000 D.C residents were employed (including 70,000 residents who worked outside the district). This created an enormous pressure on the city’s budget, and was among the causes of the city’s severe financial crisis (which reached its peak in the mid-1990s). Robert P. Strauss, The Income of Central City and Suburban Migrants: A Case Study of the Washington D.C Metropolitan Area, 51 Nat’l Tax J. 493, 512 (1998).
When taxing non-residents (usually suburban residents working in the city), the city is able to broaden its tax base and to extract revenues from those affluent residents who have fled to the suburbs. Through the tax reform the state forces the suburban residents to share the city’s expenses, and it thereby relieves the city of the financial burden it is under. And indeed, in several cases of financial crisis, especially of large cities, states have imposed or increased non-resident taxes.\textsuperscript{106}

Another measure that the state can take is the creation of special districts. Special districts are municipal corporations that provide a service or perform a function for a certain jurisdiction (usually different — larger or smaller — than that of the city). The special districts have the authority to independently collect taxes in their jurisdiction, and using these taxes they finance the services that they provide.\textsuperscript{107} If the district’s jurisdiction includes both parts of the city and parts of the suburbs, then naturally the financial responsibility for the provision of the district’s services (such as waste disposal, health care, or transportation) is shared among the residents of both entities. Thus, by assigning to a special district some of the city’s services, the state can lift some of the financial burden from the distressed municipality.\textsuperscript{108} Ester Fuchs explains that the creation of special districts helped Chicago avoid a financial crisis. She reports that in 1975 more than ten local government jurisdictions supported Chicago’s taxpayers, and several of them had boundaries that also included the city’s suburbs.\textsuperscript{109}

Note that municipal officials do not have the power to take these (and other)\textsuperscript{110} important rehabilitating measures independently. The state is usually the only entity that can enable the city to impose taxes on non-residents, and it is the only entity that can create special districts. The key to the

\textsuperscript{106} In Cleveland, for example, there was an increase of local income tax from 1.5 percent to 2 percent (the Cleveland income tax is imposed also on non-residents working in the city). (\textit{See Actions Taken by Five Cities}, supra note 76, at 65); in Yonkers state legislation established a 0.5 percent income tax rate for non-residents working in the city (\textit{See id.} at 81), and in New York the state increased the transit fares in and out of the city (\textit{See id.} at 72).

\textsuperscript{107} MCQUILLIN, supra note 44, §§ 2.28.

\textsuperscript{108} Fuchs, \textit{supra} note 38, at 192-194.

\textsuperscript{109} Id. at 195-207.

\textsuperscript{110} Another measure only states can take in order to help distressed municipalities is annexation. Liberalizing their annexation policies helped Southern states address local financial crises in the 1970s. Studies show that in the 1970s Northern cities (the snow belt) suffered from financial difficulties partly because their states did not enable them to annex surrounding territories. Southern cities (the sun belt), on the other hand, avoided those crises partly as a result of liberal annexation policies by their states. \textit{See supra} note 17.
resolution of the financial difficulties is, therefore, in the hands not of the local officials but rather of the state.

The state’s involvement is also necessary when changes in the intergovernmental support system contribute to a city’s financial crisis. Placing the burden of municipal insolvency on the state in this context has two advantages: First, the state has the ability, on an \textit{ex post} basis, to decrease the amount of unfunded mandates it imposes or increase the financial support it provides to the distressed municipality.\textsuperscript{111} The state can also assume (in full or in part) the costs of some of the services it previously assigned to municipalities — services that can be more efficiently financed by the state itself.\textsuperscript{112} By decreasing the level of unfunded mandates or by assuming the cost of local services, the state removes part of the economic pressure from the municipal budget and it helps the city rehabilitate.\textsuperscript{113} Secondly, from an \textit{ex ante} perspective, placing the risk of a municipal crisis on the state may reduce the number of unfunded mandates the state imposes on local governments in the first place. If state politicians know that the state has the ultimate responsibility for local fiscal health, they may be more reluctant to throw costs (through unfunded mandates) on the local governments. The state will better internalize the costs of its mandates because in case of a crisis the state would ultimately pay for them.

We can thus see that the state has a better ability than municipal officials to address the socio-economic causes that are at the heart of a municipal crisis. The reason is that in most cases the socio-economic processes are external to the municipality, and so the local officials cannot address them. The

\textsuperscript{111} This is not to suggest that the state should increase the monetary aid to municipalities every time a municipality enters into financial distress. However, when a city becomes financially distressed because it does not receive its fair share of intergovernmental assistance (as in the case of Philadelphia briefly discussed \textit{supra} note 19), the state should interfere. In those cases it is only just that the state will equalize the amount of intergovernmental transfers to the distressed city. See Inman, \textit{supra} note 21, at 380.

\textsuperscript{112} The best example is welfare services. It is widely agreed that state or federal governments can finance income redistributive services more effectively than local governments, because when local taxes finance these services affluent residents simply move to the suburbs. In other words, the scope for local redistributive programs is limited by the potential mobility of the residents, which tends to be greater the smaller the jurisdiction under consideration. See Ronald C. Fisher, \textit{State and Local Public Finance} 586-592 (2d ed. 1996).

\textsuperscript{113} For example, as a result of the New York City crisis, New York State assumed the costs of the higher education system and those costs of the state’s courts system that were, prior to the crisis, borne by the city. See Bailey, \textit{supra} note 79, at 152-154.
state has superior legal powers and it can control a larger geographical boundary. Therefore, the state is capable of taking the actions necessary to help the locality recover.

The state can address the political causes of the crisis. So far we have seen the advantages of the state with respect to the socio-economic causes of municipal crises. However, as mentioned earlier, many scholars believe that the underlying causes of the crises have to do not with external factors but with the local management. According to their view, the political environment, and especially the level of fragmentation, determines the city’s fiscal fate, and so in order to initiate a recovery process the state should address not only external economic circumstances but also political aspects.

In order to better understand the state’s ability to address the political causes of a municipal crisis, it is useful to recall the distinction I made earlier between size and procedural fragmentation. Size fragmentation relates to the number of decision-makers that participate in the budgetary process, and it can be thought of as a form of a common pool problem. As the number of financial decision-makers rises, so do the government’s expenditures, because each decision-maker internalizes a smaller fraction of the costs she imposes on the government.\textsuperscript{114} Procedural fragmentation, on the other hand, has to do with the procedures through which fiscal policy is ultimately decided. If the budgetary process is disorganized and lacks central control, the government tends to spend more and incur additional obligations.\textsuperscript{115} As I have shown earlier, distressed municipalities tend to suffer from both size and procedural fragmentation. On the one hand, they have a large number of groups (including strong interest groups) that create pressure on the local budget. On the other hand, they tend to have a

\textsuperscript{114} Each decision-maker (and the sector she represents) enjoys the full benefits of her budgetary demands, but she shares the costs of those demands with all the other decision-makers (and the populations they represent). Therefore, the more groups there are in a locality, the greater the pressure the locality will be under to overspend. See Perotti & Kontopoulos, supra note 26; Guntram B. Wolff, supra note 26.

\textsuperscript{115} Perotti & Kontopoulos, supra note 26, at 196.
decentralized financial decision-making process, with no single authority to ultimately control expenditures.116

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

Generally speaking, studies have shown that certain budgetary procedures afford better control over spending and enable governments to minimize their deficit. For example, a centralized budgetary process enables the government to restrain its expenditures and to suppress the interest groups’ pressures.117 Empirical research thus suggests that when national governments have a finance minister with strong authority over the budget, they also tend to have lower levels of deficit.118 The same is true with regard to local governments. Reza Baquir, for example, shows that a strong and centralized municipal executive authority, in particular one with veto powers over the budget, can ameliorate the effects of size fragmentation.119 Another procedural way to decrease spending pressures is by splitting the budgetary process into two stages. First, the budgetary frame is determined, and only later (by a different group of people) is the allocation of the budget decided.120 Studies show that introducing this relatively simple procedure helps governments avoid public debt problems and contributes to lower

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116 See supra Section 1.2.2.
117 Reza Baquir, supra note 26, at 1347; Hallerberg & Von Hagen, supra note 26, at 9; Roberto Perotti & Yianos Kontopoulos, supra note 26, at 196.
119 Reza Baquir, supra note 26, at 1347-1351.
120 It is important that the decisions in the two stages be taken by two different groups of decision-makers, because otherwise the decisions in the second stage will affect the outcome of the initial stage. In other words, the size of the budget will be determined (through backwards induction) by the allocations the decision-makers want to take in the second stage.
levels of deficit. The state’s intervention in the local financial affairs promotes changes in exactly these directions: the state centralizes the budgetary procedures (which were previously decentralized), and it splits the budgetary process into two stages.

Usually, these procedural changes are implemented through the creation of a state financial board (henceforth “State Financial Board,” “State Board,” or “Board”). As opposed to the situation in the fragmented municipality, the Board, which is usually comprised of a few individuals (appointed by the governor), centralizes the fiscal decision-making. It determines the locality’s economic policies, oversees its expenditures, and generally makes sure the locality maintains a balanced budget. Perhaps the State Board’s most important authority is its veto powers. The Board can veto the approval of the local budget (or even individual expenditures), and Boards reject budgets when they exceed the distressed locality’s revenue limits. Through centralizing the decision-making process, the Board then mitigates the common pool problem (the size fragmentation) the city suffers from.

In addition, due to the existence of the State Board, the budgetary process is split into two stages. First, the Board sets the maximum level of expenditures that the municipality is entitled to spend, and only then, after the Board has approved the budget’s frame, are the local officials allowed to allocate the funds to purchase the various public goods they wish to provide. Since the Board determines the budget’s frame according to the expected local income, the municipality is forced to spend only its

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123 The rehabilitation of New York City provides an example of this process. Prior to the creation of the State Board (or as it was called in New York, The Emergency Financial Control Board), New York suffered from extreme political fragmentation. It was dominated by a large number of social and political groups, with no one central authority to hold the various groups together. (Martin Shefter, who studied the New York crisis, called this the “pluralistic regime.” SHEFTER, *supra* note 3, at 29-37). The State Board with its broad legal powers (among them, the authority to veto the city’s expenditures and the power to negotiate labor agreements) was able to centralize the city’s political environment, and it saved the city from financial calamity. For an in-depth look at New York’s rehabilitation process, see BAILEY, *supra* note 79.
available resources. Thus, the Board prevents the locality from enlarging its deficit, and can facilitate its rehabilitation in times of financial distress.¹²⁴

The existence of a State Financial Board also diminishes the power of the interest groups in the locality. As mentioned, in a fragmented locality interest groups, and especially unions, have a great deal of influence on economic policies. Local elected officials are very much dependent on the interest groups’ support, and they often give in to their financial demands. A State Financial Board, however, is more capable of confronting the interest groups and resisting their budgetary pressures.¹²⁵ First, a Board is not elected, but rather appointed by the state. As such, many of the benefits that interest groups usually confer upon public officials (such as votes or campaign contributions) are not as relevant to it. With fewer “gifts” to bestow, the power of interest groups to influence the financial decision-makers (the Board members) diminishes. Secondly, free from the need to take into account electoral considerations, a Board is also less vulnerable to interest group pressures. A Board is more likely to stand strong in the face of political threats, simply because it is not concerned with its popularity among the city residents. This advantage is particularly important when confronting the unions. A Board can endure union strikes with much greater strength than local officials, because it is focused on the locality’s long-term economic interests, and not on the next elections.

Due to the interests groups’ diminished power, the Board can better implement retrenchment policies, and especially cut a city’s labor costs. A good example is provided by the city of Chelsea,

¹²⁴ This was the way the State Board created in 1991 to assist the city of Philadelphia operated. A five-year financial rehabilitation plan was approved by the Board, and the Board then made sure that the city strictly adhered to the plan and did not spend more funds than the plan allowed. Bernard E. Andersen, the Board’s chairman, explained in a Congressional hearing: “The city would then be required to submit monthly reports to the board, and the mayor then would be informed that he had 30 days to come up with a plan to balance the budget in the future, that is in the next quarterly report and every quarterly report after that. If over a period of 30 days, I believe, the variance [with the five-year financial plan – O.K] which was established or identified in a quarterly report was not corrected, then the board had the obligation to inform the state of this development and we had the authority to withhold tax revenues, State funds…until such time as the variance was corrected.” (Financial Control Boards, Hearing before the Subcomm. on the Dist. of Columbia of the House Comm. on Gov’t Reform and Oversight, 104th Cong. 57 (March 8, 1995) (statement of Bernard E. Andersen))
¹²⁵ Compare Bailey, supra note 79, at 181-188.
Massachusetts. At the beginning of the 1990s, Chelsea was in a grave financial crisis. One of the important causes of the crisis was the strength of the local unions. Due to the city’s political structure, the unions had a large degree of control over the results of the local elections, and so local politicians were incapable of resisting their demands (or unwilling to do so). The municipality, therefore, spent large amounts of money, especially on labor costs, and a growing budget deficit was created. This situation changed with the creation of a state receivership. As opposed to the elected municipal officials, the state receiver was not politically dependent on the unions, and he was able to break free from their paralyzing grip on the city’s finances. He cut the number of municipal public employees by more than 25%, reduced by 75% the amount spent on overtime, eliminated such employment benefits as unlimited sick leave and overly-generous vacation plans, and implemented plans to increase workers’ efficiency. As a result, within half a fiscal year after his appointment, the state receiver managed to cut the city’s expenses by $5 million (more than 10% of the budget), and within a year the city of Chelsea recovered from a grave financial crisis that had lasted more than twenty years.

We can thus see that even when a financial crisis is caused by the political system the state can take measures to rehabilitate the city. The state can centralize the decision-making power and decrease the level of procedural fragmentation (and hence the effects of the size fragmentation). Note that just as in the Chelsea example, the municipal officials are often unable to independently alter their financial

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126 In 1991 the city had an estimated $9 million dollar deficit in its $48 million budget and the state was already contributing almost 50 percent of the budget. More than a third of the city’s residents earned less than $10,000 a year and tax collections were dropping yearly. See Fox Butterfield, Insolvent Boston Suburb Faces Threat of Takeover, THE NEW YORK TIMES, September 8, 1991, at 18.

127 Overtime was grossly abused (the city spent 5% of its annual budget on overtime), labor contracts contained minimum staffing clauses, department heads were granted life tenure, and departments were generally overstaffed and inefficient. See William Cox, Lessons of Receivership: The Legacy of Chelsea, 9 Gov. Fin. Rev. 21, 22 (1993); Ted Hampton, Chelsea Receiver Trims Finances of a “Tough town” (interview with James F. Carlin), THE BOND BUYER, June 16, 1992 at page 6; Ed Cyr, Thoughts on the Chelsea Receivership, 9 Gov. Fin. Rev. 23 (1993).

128 One example of Carlin’s policy was the renegotiation of the firefighters’ contract. Prior to the receivership, due to the firefighters’ strong political power, Chelsea was one of the most fire-protected cities. It had four fully-functioning fire stations for an area of about 1.8 square miles. Each station was staffed 24 hours a day, and each firefighter enjoyed lucrative working conditions and benefits. Carlin, who did not have to worry about winning the next election, changed this costly situation. He managed to close down two of the stations, and significantly decreased the cost of the firefighters’ working conditions to the municipality. Ed Cyr, supra note 127, at 23.

129 See Id.

practices. They are part of the local political environment, and they are forced to comply with various political demands (especially demands made by interest groups). State intervention may thus be necessary in order to change a distressed locality’s economic behavior and enable it to recover.

3.4 Interim summary: So far I have discussed the advantages of state intervention. The starting point of my analysis was the premise that, perhaps contrary to our intuition, local officials have only a limited ability to address the causes of a local fiscal crisis. They can hardly affect the socio-economic processes that bring the financial decline, and they are part of a political system that often fuels the loss of fiscal restraint. Thus, I argued, since the local officials may be unable to rehabilitate the distressed municipality, then residents and creditors’ pressures on the local officials will also not help. These pressures cannot force the local officials to take actions they are anyway unable to take, and they may render the municipality's fiscal condition even worse. In times of a local crisis, therefore, we need the state’s intervention. The state has both the legal authority and the political powers to address the causes of the crisis, and to assist the locality to rehabilitate.

This rehabilitation goal is perhaps what distinguishes between corporate bankruptcy law (on which Chapter 9 is based) and municipal insolvency law (and the creation of state financial boards). Corporate bankruptcy law is not aimed at the rehabilitation of distressed companies, but rather at the preservation of their going concern value. Chapter 11 enables a bankrupt corporation to continue to function only if it is economically viable, and only if it is in the creditors' best interests to keep it alive. Economically distressed (as opposed to financially distressed) corporations are “sent” to liquidation, so that they will give way to more successful and innovative companies. This evolution

131 H.R. REP. NO. 95-595 at 263 (1978)
132 THOMAS JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 2 (1986) (Jackson Writes: “Bankruptcy law can and should help a firm when it is worth more to its owners alive than dead. That is a far cry, however, from saying that it is an independent goal of bankruptcy law to keep firms in operation”); Douglas Baird & Thomas Jackson, Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy 51 U. Chi. L. Rev. 97 (1984).
("survival of the fittest corporations"), it is argued, increases the total wealth in the society.\textsuperscript{133} The law of municipal insolvency, however, should be different. A municipality, as opposed to a private corporation, is not created in order to generate profits. Its purpose is to provide public services to its residents, and it has an obligation to continue providing these services even when facing economic difficulties. Local economic failure does not justify leaving the residents without education or police, and the competition among localities should not cast away localities (and residents) that were left behind. The solution to municipal insolvency, therefore, must offer a remedy also (and perhaps especially) when a municipality's problems are fundamental, and even when these problems cannot be resolved by the local officials. As I have shown, the best way to achieve such rehabilitation is state intervention.

This analysis explains why state financial boards are the most common remedy to municipal financial crises. States understand that other types of remedies (the creditors’ remedies or the bankruptcy code) do not help a distressed city recover, and they prefer to intervene and assist the city themselves.\textsuperscript{134} And indeed, notwithstanding the legal academia’s focus on Chapter 9 of the bankruptcy code, in practice most municipal crises are resolved with the states’ help. Distressed localities rarely default or file for bankruptcy, and instead the state intervenes in their fiscal affairs. This phenomenon was pointed out by the Standard & Poor’s rating agency in a research report on municipal debt:\textsuperscript{135}

“Bankruptcies are usually not an option. Distressed municipalities in most states do not have a bankruptcy option; it is frequently restricted by law… Distressed municipalities will typically receive some additional state aid, oversight, or other outside intervention that prevents the dramatic credit deterioration that [municipal] corporations may suffer”\textsuperscript{136}


\textsuperscript{136} Also see David Litvack & Frank Rizzo, Municipal Default Risk, 21 MUN. FIN. J. 25, 32 (2000) (David Litvack and Frank Rizzo, from the Fitch IBCA rating agency, write: “In evaluating the relatively strong performance of the traditional municipal sectors, it is noted that state intervention, in the form of control boards and special state aid appropriations for certain
State Financial Boards have managed to rehabilitate both large cities (such as New York, Philadelphia, and Miami) and small towns (such as Chelsea, Princeville, and the Village of Maywood).

Despite its relative advantages, the problem with the state’s involvement is usually its timing. In the next part, I elaborate on this problem, and I argue for the legislation of municipal insolvency statutes.

4. Municipal insolvency legislation

So far we have seen that the creation of State Financial Boards is the most effective remedy for local insolvency. I have showed the advantages of State Boards, and have explained why state intervention has been successful in rehabilitating cities. However, notwithstanding the advantages of this remedy, in most states it is not properly codified. There is no general statute that determines when a State Board should be created and how the state should get involved in the distressed locality’s financial affairs.137 State intervention is usually done ad hoc, with the state legislature enacting a special statute for each specific crisis event.138

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

137 Kloha et al., supra note 77, at 240 (Kloha et al. conducted a state survey regarding state approaches to local financial crises. They show that only fifteen states use formal indicators to evaluate their local governments’ fiscal positions on a regular basis); see also Anthony G. Cahill, Joseph A. James, Jean E. Lavigne & Ann Stacey, State Government Responses to Municipal Fiscal Distress: A Brave New World for State-Local Intergovernmental Relations, 17 PUB. PRODUCTIVITY & MANAGEMENT REV. 253, 254-255 (1994).

In this part of the paper I, therefore, examine the enactment of municipal insolvency legislation (which codifies the timing and scope of state intervention). First, I elaborate on the need for such legislation, and thereafter I demonstrate its advantages through the example of the state of North Carolina.

4.1. The need for municipal insolvency legislation. Generally speaking, states can take two types of approaches with regard to their involvement in local financial crises: a proactive (ex-ante) approach or a reactive (ex-post) approach. The proactive approach aims to monitor the municipal financial activities and to help local governments avoid a financial crisis before it actually occurs. The state supervises the fiscal affairs of local governments on a regular ongoing basis, and it intervenes more extensively when local governments show the first signs of economic decline, so as to prevent further financial deterioration. The reactive approach, on the other hand, deals with a crisis after it occurs. It usually takes place only when a city is close to default, and the state’s activity is targeted to solving the specific financial emergency and preventing the consequences of a possible default.139

Although the advantages of proactive state intervention are apparent (it is able to help cities avoid potential crises, and it can save cities from the damages associated with crisis events), most states take a reactive approach.140 State Financial Boards are often created too late, and cities are forced to undergo severe financial difficulties before they receive the required assistance.

The reason for this “late intervention” is rooted in the political interests of state and local officials. These officials often do not have the incentive to help ailing cities, and they prefer to ignore the situation (as much as they can), rather than to deal with it.

139 Kloha et al., supra note 77, at 236-237; Berman, supra note 76, at 57.
140 Hondale, supra note 2, at 1461 (Hondale conducted a survey regarding the role of states in local government fiscal crises. She concludes that states are usually not aware of local governments’ fiscal crises before they occur, and even when they are aware of impending crises they tend not to avert them. Only once a crisis has occurred do the states get involved, in many cases through state financial boards); Kloha et al., supra note 77 (presenting a survey that shows that only seven states use a proactive approach in their legislation. Among these states are North Carolina, New Jersey, Ohio, Pennsylvania, New Hampshire, Maryland, and Florida).
State officials are often reluctant to spend the costs associated with a local rehabilitation process. The state does not have unlimited resources, and investing state funds in the recovery of a distressed locality comes at the expense of other state objectives — some of which may be more politically attractive to the state officials. The state officials’ reluctance to initiate a recovery process may be especially acute due to fragmentation in the state legislature. State politicians often represent a certain municipality or geographical area, and they strive to maximize the utility of their own constituency (rather than the welfare of the state or of other localities).  

A state-funded recovery process, however, is generally perceived to serve the narrow benefit of the distressed locality. The funds are taken from the general state budget, and it appears as if most constituencies (other than the distressed locality) do not profit from the locality’s rehabilitation. State politicians, therefore, have an incentive to reject investing state resources in recovery processes for localities that they do not represent, and state intervention is thereby delayed.

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

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143 Chelsea, Massachusetts provides a good example. In Chelsea both the Board of Aldermen and the unions lobbied in the state legislature to prevent the establishment of a receivership. They argued that the situation did not warrant such a drastic measure, and expressed doubts about whether an “outsider” receiver could solve the city’s problems. See Brian McGrory, *Chelsea Receivership Asked; Weld Takes Unprecedented Step for Fiscally Ailing City*, THE BOSTON GLOBE, September 6, 1991 at Metro/Region Section, page 1; Brian McGrory, *Legislative Panel Backs Chelsea Receivership*, THE BOSTON GLOBE, September 8, 1991 at Metro/Region Section, page 1.
How then can state intervention (in a timely fashion) be achieved despite the political interests of both state and local officials? One possible solution is the legislation of a general municipal insolvency statute. Such a statute establishes a general state policy with regard to local financial distress, and it determines the timing for the state’s actions and the authority that the State Board would possess.

To do this, the statute specifies several financial indicators, the presence of which signals the occurrence of an incipient financial crisis. In case the indicators are “activated” (that is, in case the locality’s financial condition meets the criteria set by the statute), state intervention is warranted, and the state is obligated (by the statute) to intervene and prevent further financial deterioration. For example, the statute can set a certain maximum level of local deficit (e.g., X% percent of the total budget). The state monitors the local finances, and if a locality reaches the specified level, then a process of state intervention commences. The general legislation, therefore, can promote the implementation of proactive state involvement in local affairs. Pursuant to the legislation, the local financial condition is constantly monitored, and using the indicators the state is able to determine more effectively when to intervene. In essence, therefore, the function of the municipal insolvency legislation is to determine the correct timing of the state’s intervention. It directs the state’s involvement to a time frame that is, on the one hand, not too early (before there is any financial justification for the state’s actions), but on the other hand also not too late (after a full blown crisis has already developed).

In the following section, I detail the advantages such a statute can bring to states and local governments. However, before describing the advantages of the legislation, a preliminary question is in

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144 For a survey of the indicators used by the different states see Kloha et al., supra note 77. For examples of specific sections in municipal insolvency statutes specifying the indicators see Municipalities Financial Recovery Act, P.S Tit. 53 § 11701.201 (the Pennsylvania municipal insolvency statute); Municipal Fiscal Emergency Act, Ohio Rev. Code Ann. § 118.03 and 118.022 (the Ohio statute); Nev. Rev. Stat. Ann. § 354.685 (the Nevada statute).


146 Municipal insolvency legislation also helps local governments protect their local autonomy. The existence of a state insolvency statute renders the criteria for the state’s action more objective, and it forces the state to prove the existence of these criteria before it intervenes in the local affairs. This enables better judicial review of the state actions, and it decreases the chances of arbitrary interventions (motivated perhaps by the political agenda of state officials).
order: Why should state politicians agree to implement a proactive policy in a general statute when, as we have seen, they do not have an incentive to implement such a policy ad hoc (without a statute)? How does municipal insolvency legislation overcome the incentives of the local and state officials that I discussed earlier in this section? The advantages of the general legislation in this context are twofold:

First, as opposed to an ad hoc state intervention, municipal insolvency legislation is enacted behind a kind of “veil of ignorance”. At the time the municipal insolvency statute is enacted no one knows which local government will experience economic difficulties, and so potentially the legislation can benefit each and every locality (if and when it will encounter municipal financial distress). The generality of the statute, therefore, enables the state legislators to evaluate it in a more objective manner. Politicians do not consider whether it is in their interest to help a certain locality that currently suffers from financial difficulties, but rather they consider whether the method of proactive state intervention is generally more beneficial.\textsuperscript{147}

Secondly, and perhaps even more importantly, the legislation can reduce the local governments’ cost of capital. The implementation of municipal insolvency legislation sends a signal to the credit markets, and especially to the credit rating agencies: the state shows that it is committed to preventing local crises, and that it will not let its municipalities default. Thus, the state essentially reduces the risk associated with the local debt, and the creditors in turn reward this move with lower interest rates. Since a proactive municipal insolvency statute can potentially reduce the interest rates of many local governments in the state, state and local officials may find it worthwhile to support it.\textsuperscript{148}

\textsuperscript{147} I do not make the claim that a general municipal insolvency statute is legislated free of political interests. Municipal officials, local unions, and other interest groups certainly lobby with regard to these statutes, and the pressures from the different groups in the state do affect the outcome of the legislation. However, I do argue that due to the generality of such a statute, ad hoc political considerations do not play such a dominant role in the state’s decisions. Such a statute reflects the state’s position on the way municipal insolvency should be addressed in general, and it is less connected to the political interests and circumstances of a particular crisis.

\textsuperscript{148} Compare Dennis Epple & Chester Spatt, \textit{State Restrictions on Local Debt: Their Role in Preventing Default}, 29 J. PUB. ECON. 199 (1986) (Epple and Spatt developed a model to explain state restrictions on local debt. They argue that a default of one local government may affect the interest rates of other local governments in the state as well, and that as a result local governments (those that do not wish to default) have an interest to maintain their state’s reputation for the enforcement of local debts. Since a debt limit reduces the number of localities that are prone to default, various local governments in the state benefit from it and support it. The same logic applies here. Proactive municipal insolvency legislation promotes the state’s
In the next section, I demonstrate this claim through a case study of North Carolina. North Carolina implements a proactive model of state intervention, and this policy enables its local governments to enjoy huge savings in interest rates.

4.2. The advantages of state intervention. North Carolina is considered by many a model state in terms of local government finance. It has the largest number of top-rated (AAA-rated) local units in the country, and its localities enjoy the confidence of the credit markets and are charged low interest rates, even when compared with equally-rated municipalities from other states.149

The success of North Carolina’s localities is usually attributed to the state’s oversight system, and in particular to the state agency in charge of local finance: the Local Government Commission (henceforth, the “LGC” or the “Commission”).150 The LGC is a statutory state agency created in 1931 as a reaction to local crises that occurred during the Great Depression.151 Although in the seventy-five years since its creation the commission’s function has considerably evolved, its basic mission has remained more or less the same: the LGC oversees local government debt and financial management, and it ensures that debt payments are made in a timely manner.152

To achieve this goal, the LGC utilizes both a sophisticated ongoing supervision system and a strong authority to exercise financial control.153 In terms of ongoing supervision, the LGC constantly monitors both the financial management and the debt management of local governments. All the local

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reputation for the enforcement of local debts. It thereby reduces the interest rates local governments have to pay, and it benefits all local governments.)


150 The Commission was established pursuant to the Local Government Finance Act, N.C. GEN. STAT § 159-1 to 159-210. The Act details the Commission’s powers and way of operation.

151 During the depression more local governments in North Carolina defaulted on their debts than in any other state in the nation, except Florida. Fahim, supra note 149.

152 CHARLES D. LINER, STATE AND LOCAL GOVERNMENT RELATIONS IN NORTH CAROLINA: THEIR EVOLUTION AND CURRENT STATUS 75 (2d ed. 1995)

153 The Commission is comprised of nine members: four ex-officio members (the state’s treasurer, who also serves as chairman; the state auditor; the secretary of state; and the secretary of revenue), and five appointed members (three members are appointed by the governor, one by the president pro tempore of the senate, and one by the speaker of the house). In addition, the Commission employs a staff of about thirty-five associates. The majority of the staff members are individuals with degrees in economics, business, or accounting. Id. at 75.
governments in North Carolina (more than 950) are required to submit to the LGC semi-annual financial statements, and the fiscal management section reviews the reports and assesses the financial condition of each municipality.\textsuperscript{154} In addition, the local governments are required to receive the LGC’s approval for the issuance of all local debt.\textsuperscript{155} As part of the approval process, a special section of the LGC determines whether the issuing municipality is financially able to meet the expected debt obligations, and the LGC is also involved in the marketing and sale of local debt.\textsuperscript{156}

In connection with its fiscal monitoring, the Commission pays special attention to seven financial indicators that provide a warning sign for forthcoming financial crises.\textsuperscript{157} The most important indicator is the one measuring the localities’ general fund balance. The LGC insists that localities have a general fund balance of at least 8\% of their yearly expenditures (approximately the expenditures for one month), and if the fund balance falls below 8\%, the LGC takes it as a sign of economic deterioration, which warrants special state attention.\textsuperscript{158}

In case the financial indicators are triggered, the LGC takes special notice of the distressed locality’s financial affairs. It begins to work more closely with the municipal officials, and it tries to assist the locality in implementing better management practices. In the vast majority of cases, the LGC guidance is enough to steer the distressed locality back to financial stability, but in case the locality does not cooperate with the LGC and its financial deterioration continues, the LGC can take over the locality.


\textsuperscript{155} The LGC’s debt supervision is not limited to general obligation bonds; rather, it includes all types of debts, such as short-term notes, local revenue debt, conduit debt, etc.

\textsuperscript{156} The issuances are approved in the LGC’s Authorizations and Negotiated Bond Sales Section. See, \textit{LINER}, supra note 152, at 76.

\textsuperscript{157} As opposed to most municipal insolvency statutes, North Carolina’s Local Government Finance Act does not specify any certain financial indicators that trigger the state’s intervention. The Act does enable the Commission to take over a local government when a locality is “likely to default,” but it does not detail specific indicators as to when a default is deemed likely. The LGC, therefore, developed its own indicators. The LGC’s indicators not only define when a default is likely, but they also detect signs of financial distress so as to predict forthcoming fiscal emergencies. According to the survey conducted by Kloha et al., the LGC uses the following types of indicators: three indicators examine the local revenues and expenditures, two examine the localities’ operating position, and two measure unfunded liabilities. \textit{See Someone To Watch over Me}, supra note 77, at 245.

\textsuperscript{158} \textit{See Fitch Report}, supra note 154, at 4. The same information was also conveyed in an interview the author conducted with Dean Cunningham, Senior Fiscal Advisor of the LGC. Telephone Interview with Dean Cunningham, Senior Advisor, The Local Government Commission (June 9, 2006). A memo of the interview is available from the author.
(as a State Financial Board). In these cases, the LGC has the power to take any financial measures it deems necessary to regain the local fiscal health and to prevent a local default.\footnote{159 The Local Government Finance Act, N.C. GEN. STAT § 159-36.}

This supervision system pays off. In 1999, the Fitch IBCA Rating Agency devoted an entire report to North Carolina’s Local Government Commission.\footnote{160 \textit{Fitch Report, supra} note 154.} Fitch’s analysts reviewed the supervision measures implemented by the LGC, and they examined the LGC’s impact on the creditworthiness of local governments. The report praised the Commission’s work, and as a result Fitch formally upgraded the credit rating of local units under the Commission’s supervision. The report states:\footnote{161 \textit{Id.} at 1.}

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

Fitch IBCA is not the only rating agency that acknowledges the contribution of the Local Government Commission. In July 2000, Moody’s also published a report that connected North Carolina’s strong credit rating to the state’s ongoing supervision efforts. \textit{The Bond Buyer} described Moody’s report as follows:\footnote{162 Tedra Desue, \textit{Moody’s: North Carolina Counties Come out on Top}, \textit{THE BOND BUYER}, July 12, 2000, at 4.}

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

Naturally, the improved credit ratings transform into lower interest rates. Harlan Boyles, North Carolina’s former state treasurer, estimated that North Carolina’s good bond rating translates into

\footnotesize{\textsuperscript{159} The Local Government Finance Act, N.C. GEN. STAT § 159-36.} \textsuperscript{160} \textit{Fitch Report, supra} note 154. \textsuperscript{161} \textit{Id.} at 1. \textsuperscript{162} Tedra Desue, \textit{Moody’s: North Carolina Counties Come out on Top}, \textit{THE BOND BUYER}, July 12, 2000, at 4.
interest rates that are fifteen to twenty percent below the national market average.\textsuperscript{163} Thus, for example, in fiscal year 2001 North Carolina’s local governments sold general obligation bonds with interest rates averaging 95 basis points below the national Bond Buyer Index,\textsuperscript{164} in fiscal year 2002 96 basis points below the index,\textsuperscript{165} and in fiscal year 2003 82 basis points below the index.\textsuperscript{166} The lower interest rates in turn translate into considerable savings. In 2001, for example, local governments in North Carolina saved (in total) $53.5 million dollars;\textsuperscript{167} in 2002 they saved $108 million dollars;\textsuperscript{168} and in 2003 they saved $100 million dollars,\textsuperscript{169} on interest payments on general obligation bonds alone (assuming they would otherwise sell the bonds according to the average interest rates).\textsuperscript{170} Certainly, these figures are much higher than the costs of maintaining the Local Government Commission, and they show the economic benefits of implementing proactive state monitoring.

It is interesting to compare in this context the achievements of North Carolina’s statute to the achievements of municipal insolvency statutes in other states. Evidence suggests that municipal insolvency legislation makes a positive contribution to the fiscal health of local governments in other states as well. The Advisory Commission on Intergovernmental Relations, for example, concluded that the performance of local governments in states that have an administrative agency that supervises local finances is considerably better than in states that lack such a supervision system. The states with such a system manage to help localities recover from financial difficulties, and to prevent defaults on local


\textsuperscript{167} \textit{State Treasurer’s Annual Report 2001}, supra note 164, at 20.

\textsuperscript{168} \textit{State Treasurer’s Annual Report 2002}, supra note 165, at 35.

\textsuperscript{169} \textit{State Treasurer’s Annual Report 2003}, supra note 166, at 29.

\textsuperscript{170} The savings are calculated over the life of the bonds sold, assuming the local governments would have paid the average interest rate as determined by the national Bond Buyer Index.
debt. A more recent study, conducted by Jane Beckett-Camarata, also suggests, albeit specifically regarding the Ohio statute, that the municipal insolvency legislation had positive effects on Ohio’s local governments. She points out that the state’s action was necessary for the rehabilitation of Ohio’s distressed municipalities, because localities were reluctant to change their ongoing destructive financial patterns without the state’s governmental intervention.

However, it seems that no other state has earned the same recognition as North Carolina, and the achievements of the LGC in the credit markets are unparalleled. The reason for this difference may be rooted in the efforts North Carolina invests in the supervision of local finance. Most states do not spend as much effort on the ongoing monitoring of local financial management, and their agencies are not as professional and sophisticated. Fitch IBCA points out the importance of North Carolina’s proactive “surveillance” system in its credit report:

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

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

171 THE ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, CITY FINANCIAL EMERGENCIES: THE INTERGOVERNMENTAL DIMENSION 79 (1973) (The report concludes, “The effectiveness of these and other state programs designed to assist municipal units in or near severe financial crisis varies widely. Nevertheless, in States with court or administrative assistance, the performance of municipal units under stress seems considerably better than those in States in which no provisions have been made for State review, approval or supervision.”) The same conclusion was reached in the Commission’s 1985 report. THE U.S. ADVISORY COMM’N ON INTERGOVERNMENTAL RELATIONS, BANKRUPTCIES, DEFAULTS AND OTHER LOCAL GOVERNMENT FINANCIAL EMERGENCIES 5 (1985) (The report reads: “A review of the cases of financial emergencies in local governments occurring over the 1972-83 period generally confirms the findings in the 1973 report that financial management problems are the principal cause of emergencies, and that state actions are the most appropriate means of preventing and treating them.”)


173 Fitch Report, supra note 154, at pages 4-5.
5. Conclusion

This paper has emphasized the advantages that can be derived from state intervention in times of local financial distress. I have explored the causes of municipal crises, and I have shown that states (as opposed to residents or creditors) are able to address these causes, rehabilitate cities, and minimize the damages of the local decline. The paper also suggests that the timing of the state’s involvement has considerable importance. In order to direct the state’s involvement to the correct time frame, I have recommended the enactment of municipal insolvency statutes that implement a proactive state approach.

The advantages of a proactive approach are financial as well as social. First, as demonstrated by the case of North Carolina, implementing a proactive approach helps localities enjoy lower prices for raising credit. The money saved on interest rates can be used for the benefit of the local community, so that the residents will enjoy decreased tax rates and better local services. Second, the proactive approach also helps the state improve the local fiscal health. The state’s monitoring actions can prevent potential fiscal emergencies, and the state thus minimizes the damages that are caused to the local community as a result of a potential crisis.

To conclude, I wish to return to the excerpt I cited at the beginning of the paper from Bridgeport’s bankruptcy case – the testimony of Bridgeport’s chief of police. In his testimony Thomas Sweeney described Bridgeport in the midst of the crisis, especially with regard to the personal security of its residents. He tells of neighborhoods that are controlled by drug dealers, of emergency calls that are not responded to properly, and of a police force that is severely understaffed. Clearly, municipal insolvency legislation is not a magical solution that can miraculously make things in a city better. However, for the reasons elaborated in this paper, I believe that it can make some difference, and states may wish to at least try implementing this approach. The gravity of the phenomena associated with urban poverty (such as crime, drugs, lack of proper public education, and decaying infrastructure) cannot be overstated, and a proactive state supervision system may give cities better financial
capabilities to deal with these problems. As we have seen, the benefits of such a system can be considerable.