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Democracy and Debt

ABSTRACT. Recent state and municipal budget crises have generated a great deal of consternation among market participants and policymakers; they have also led scholars to debate the merits of bailouts or other forms of debt relief. This Essay considers why the mechanisms that were supposed to control state and local fiscal behavior ex ante have not worked. In the aftermath of the state and municipal debt crises of the nineteenth century, states adopted a series of constitutional reforms intended to constrain state and local fiscal behavior. In addition, the debt markets and the Tieboutian market in jurisdictions should theoretically prevent states and municipalities from overspending. Neither the fiscal constitution in the states nor the markets have prevented state and local fiscal difficulties, however; indeed, they have arguably contributed to those difficulties. Nevertheless, much of the current debate over bailouts and state bankruptcy reprises the longstanding skepticism of ordinary state and local political processes. This Essay argues that this distrust of local democratic decisionmaking is unwarranted, that efforts to constrain fiscal politics are destined to fail, and that the solution to state and local fiscal crises is largely a matter of politics and not a matter of institutional design.

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ESSAY CONTENTS

INTRODUCTION

Debt crises loom large throughout the world. This Essay examines a particular subset of government debtors: states and localities. As legislatures across the country wrestle with multibillion-dollar budget deficits, the possibility of state or municipal defaults has preoccupied officials and frightened investors.[1] Several cities have filed for bankruptcy in the last year,[2] and some scholars have advocated that states also be permitted to declare bankruptcy.[3] The fiscal health of states and cities has become a central concern of policymakers.

Recent debates about local and state fiscal health have been surprisingly ahistorical, however. Even if the current budget crises are more consequential than what occurs in normal economic downturns (and there is some doubt that they are),[4] we have been here before. In the nineteenth century, state and municipal debt crises were quite real. Public overinvestment in infrastructure (especially railroads) and a series of economic shocks precipitated state and

1. *See, e.g.*, Editorial, *A Growing Gloom for States and Cities*, N.Y. TIMES, Aug. 13, 2011, http://www.nytimes.com/2011/08/14/opinion/sunday/a-growing-gloom-for-states-and-cities.html; Charles Riley, *Muni Bond Fears Run Wild*, CNNMONEY, Jan. 14, 2011, http://money.cnn.com/2011/01/14/markets/bondcenter/municipal_bonds/index.htm; Jake Zamansky, *Should Investors Be Concerned About Their Muni Bond Portfolios?*, SEEKING ALPHA (Jan. 24, 2011), http://seekingalpha.com/article/248279-should-investors-be-concerned-about-their-muni-bond-portfolios ("Investors are scared, and have withdrawn more than $22 billion from muni bond mutual funds since the end of October."); *60 Minutes: State Budgets: Day of Reckoning* (CBS television broadcast Dec. 19, 2010), *available at* http://www.cbsnews.com/video/watch/?id=7166293n.

2. As of this writing, four general purpose local governments have filed for bankruptcy in 2011: Jefferson County, Alabama; Harrisburg, Pennsylvania; Central Falls, Rhode Island; and Boise County, Idaho. Kelly Nolan, *Largest Municipal Bankruptcy Filed*, WALL ST. J., Nov. 10, 2011, http://online.wsj.com/article/SB10001424052970204224604577028491526654090.html. Harrisburg's petition was recently rejected by a federal bankruptcy court on the grounds that the city council was not authorized to file. *See* Sabrina Tavernise, *Judge Rejects Harrisburg's Bankruptcy*, N.Y. TIMES, Nov. 24, 2011, http://www.nytimes.com/2011/11/24/us/harrisburgs-bankruptcy-filing-is-rejected-by-judge.html.

3. *See, e.g.*, David Skeel, *Give States a Way To Go Bankrupt: It's the Best Option for Avoiding a Massive Federal Bailout*, WKLY. STANDARD, Nov. 29, 2010, http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html [hereinafter Skeel, *Give States a Way To Go Bankrupt*]; David A. Skeel, Jr., *States of Bankruptcy* (Univ. of Pa. Law Sch. Pub. Law & Legal Theory Research Paper Series, Research Paper No. 11-24, 2011), http://ssrn.com/abstract=1907774 [hereinafter Skeel, *States of Bankruptcy*]. For an opposing view, see E.J. McMahon, *State Bankruptcy Is a Bad Idea*, WALL ST. J., Jan. 24, 2011, http://online.wsj.com/article/SB10001424052748704881304576094091992370356.html.

4. *See* Iris J. Lav, *Unbreakable Bonds*, N.Y. TIMES, Mar. 20, 2011, http://www.nytimes.com/2011/03/21/opinion/21lav.html (arguing that predictions of a municipal debt crisis are overblown).

local fiscal failures. In 1841 and 1842, nine states defaulted on their obligations, and hundreds of municipalities defaulted throughout the second half of the century.[5] Public services were reduced and infrastructure projects had to be scuttled, state and municipal property had to be sold off, and in some cases bondholders never got paid. The political response was equally swift: in an effort to rein in wayward legislatures and city councils, states embraced constitutional debt limitations, balanced budget mandates, public-purpose requirements, and other restrictions on debt and spending. The nineteenth century witnessed the rise of the "fiscal constitution" in the states.[6]

We have not yet approached anything like the default rate of the nineteenth century. Nevertheless, the recurrence of state and local budget crises suggests that the fiscal constitution and other mechanisms that purport to discipline state and municipal finances have not achieved their aims. In this Essay, I offer reasons why. I argue that efforts to constrain states and municipalities in the name of good fiscal policy have often led to poor fiscal policy and that the discipline provided by the debt markets is at best partial and at worst counterproductive. More broadly, I question whether the goal of "fiscal discipline" is itself achievable. Even the most sensible, honest, and scrupulous state or local government cannot avoid the business cycle, the reality of economic boom and bust. Efforts to discipline states and local governments assume that profligacy is their central problem and that some external coercive force is necessary to restrain them. I argue against this view.

This Essay has three parts. Part I describes two potential mechanisms of fiscal discipline—the fiscal constitution and the market—and shows how both are informed by the assumption that the problem of municipal and state debt is a problem of overspending. Part II explains why neither mechanism can succeed. As for the fiscal constitution, it severely limits the ability of states and localities to respond to economic downturns,[7] leads governments to adopt indirect and inefficient means of funding services, and fails to depoliticize budgetary decisions, instead merely shifting ideological fights to the courts or

5. *See* RICHARD BRIFFAULT & LAURIE REYNOLDS, CASES AND MATERIALS ON STATE AND LOCAL GOVERNMENT LAW 817 (7th ed. 2009); ERIC H. MONKKONEN, THE LOCAL STATE: PUBLIC MONEY AND AMERICAN CITIES 25-26 (1995). Monkkonen reports that there were approximately 941 municipal bond defaults between 1854 and 1929, with a peak of 111 in 1898. Bond defaults rose by orders of magnitude during the Great Depression, peaking in 1935 with 3251 defaults. *See* MONKKONEN, *supra*.

6. David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2549 & n.21 (2005); *see* Richard Briffault, *Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 911-12 (2003).

7. Super, *supra* note 6, at 2609-11.

to other political arenas. As for the market, it tends to reflect the underlying business cycle. In good times, states and localities are encouraged to take on debt. In bad times, greatly needed financing becomes unavailable. Furthermore, though cities and states may be inclined to follow market signals, they often have limited room to maneuver: their hands are tied by macroeconomic and constitutional constraints. The relative impotence of states and cities suggests that the problem of profligacy is itself a misdiagnosis. Indeed, government spending may be exactly what is needed in a downturn, but both market forces and constitutional constraints require states and municipalities to adopt procyclical policies that undermine fiscal stability and economic growth.[8]

Part III considers proposals for state bankruptcy and describes how they reprise the nineteenth-century effort to overcome the deficiencies of state politics by shifting power away from elected officials. The bankruptcy option is animated by a concern with bailouts and more specifically by a fear of moral hazard. But I argue that moral hazard concerns are overstated. In part, that is because territorially defined, subnational polities are much less responsive to incentives—whether those incentives encourage or discourage profligacy—than designers of institutions sometimes think. That does not mean that states and cities are inevitably badly managed—in fact, the opposite is generally true.[9] It does mean, however, that central governments have a role to play in stabilizing local finances. This suggests that the solution to state and local fiscal crises is largely a matter of politics and not a matter of institutional design.

The political solution to fiscal crisis is complicated, however, for it implicates deeper questions about the relationship between democracy and debt. Debt raises two central difficulties for democratic theory. First, there is the problem of intergenerational equity. Efforts by the current polity to undertake significant financial commitments that bind future polities are troubling. But permitting the future to exercise a veto over present-day tax and spending decisions is also problematic. Indeed, it may be perfectly just and fair for future polities to help pay for long-term investments. Second, there is the problem of governance by capital markets. As David Hume so famously recognized, public debt cedes power to an unaccountable class of financiers, subordinates the citizens' welfare to the creditors', and undermines the independence of the state.[10] Debt is inconsistent with popular sovereignty to

8. David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 766-69 (2010).

9. *See* discussion *infra* notes 65-66 and accompanying text.

10. *See* DAVID HUME, ESSAY ON PUBLIC CREDIT (T. Keys 1817) (1752).

the extent that it allows capital markets to dictate the internal politics of cities and states and to limit their present range of policy choices.

I highlight these tensions not because I can resolve them here but because they suggest why constraining democratic majorities in the name of fiscal discipline is and should be troubling. These tensions have emerged with great force as governments and their citizens throughout the world wrestle with debt crises and austerity reforms in the aftermath of the recent recession.[11] Imminent defaults by member states have induced the European Union to offer bailouts to some nations and contemplate the possibility of additional assistance for others.[12] In the United States, the raising of the country's debt limit and the downgrading of its long-term debt generated a political maelstrom.[13]

Sovereign nations that control their own monetary policy are situated differently from states and localities, which do not have such macroeconomic policy tools at their disposal. Nevertheless, the constitutional setting in which state and local fiscal decisionmaking takes place is relevant to sovereign debt crises, for state and local governments have operated under constitutionalized debt and spending limits for some time. That these governments continue to face debt crises is a lesson about the limits of constitutions. That these governments have nevertheless often met their fiscal obligations suggests that our abiding skepticism of local political processes is unwarranted.

I. DEBT AND DISCIPLINE

Scholars and policymakers tend to emphasize two structural mechanisms for controlling local fiscal behavior: constitutional constraints and markets. State and local governments act against the backdrop of some combination of the two. Of course, representative democracy—citizens' power to elect fiscally prudent agents and decline to elect fiscally imprudent ones—is the chief way to

11. *See, e.g.*, Jackie Calmes & Carl Hulse, *As the Federal Government Hits Its Debt Limit, Lawmakers Spar over Solution*, N.Y. TIMES, May 16, 2011, http://www.nytimes.com/2011/05/17/us/politics/17budget.html; Anthee Carassava, *Greek Farmers Clash with Riot Police*, N.Y. TIMES, Feb. 2, 2009, http://www.nytimes.com/2009/02/03/world/Europe/03greece.html.

12. Stephen Castle & Jack Ewing, *Europe Unifies To Assist Greece with Line of Aid*, N.Y. TIMES, Apr. 11, 2010, http://www.nytimes.com/2010/04/12/business/global/12drachma.html.

13. Binyamin Appelbaum & Eric Dash, *S.& P. Downgrades Debt Rating of U.S. for First Time*, N.Y. TIMES, Aug. 5, 2011, http://www.nytimes.com/2011/08/06/business/us-debt-downgraded-by-sp.html; Eric Dash, *House Panel Plans To Question Rating Agencies over Downgrade Threat to U.S.*, N.Y. TIMES, July 26, 2011, http://www.nytimes.com/2011/07/27/business/economy/credit-rating-agencies-to-testify-before-congress.html.

control local fiscal behavior. But since the nineteenth century, one of the central assumptions about the problem of state and municipal fiscal policy has been that democracy—at least in its majoritarian and representative forms—is a failure.[14]

I will say more about that assumption below, but for now it is enough to point out that constitutional constraints are, by definition, limits on the regular representative political process. The fiscal constitution in the states is a product of a nineteenth-century reaction to state and municipal debt and a twentieth-century movement to restrict taxation. These two movements led to state constitutional constraints designed to limit fiscal flexibility. Forty-one state constitutions include balanced budget requirements.[15] Forty-six states mandate the use of public monies only for public purposes.[16] And three-quarters of the states limit the ability of state and local governments to acquire debt.[17] Many states also have tax uniformity requirements intended to prevent subsidies through selective exemptions.[18] Over thirty states have some combination of constitutional or statutory tax and expenditure limitations (TELs),[19] which can require a legislative supermajority, or a supermajority combined with a public referendum, to approve some or all new tax proposals.[20] Moreover, at least forty-three states limit local governments by placing some restrictions on local property taxation.[21] All these fiscal constraints have been justified as responding to a perceived problem of overspending.

We should be clear about the nature of that problem, however. One possibility is that public officials are engaged in profligate spending in contravention of the public interest because those officials are either corrupt or

14. *See* FREDERIC C. HOWE, THE CITY: THE HOPE OF DEMOCRACY 1-8 (1905) (describing and criticizing this view).

15. *NCSL Fiscal Brief: State Balanced Budget Provisions*, NAT'L CONF. OF STATE LEGISLATURES 3 (Oct. 2010), http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf. Forty-one states either have constitutional or statutory requirements that the legislature pass a balanced budget. Other definitions, such as the requirement that the governor submit a balanced budget to the legislature, lead to a different total number of state provisions. *Id.*

16. Dale F. Rubin, *Constitutional Aid Limitation Provisions and the Public Purpose Doctrine*, 12 ST. LOUIS U. PUB. L. REV. 143, 143 n.1 (1993).

17. Stewart E. Sterk & Elizabeth S. Goldman, *Controlling Legislative Shortsightedness: The Effectiveness of Constitutional Debt Limitations*, 1991 WIS. L. REV. 1301, 1315.

18. *Id.* at 1318-19; *see* BRIFFAULT & REYNOLDS, *supra* note 5, at 667-68.

19. Bert Waisanen, *State Tax and Expenditure Limits—2008*, NAT'L CONFERENCE OF STATE LEGISLATURES (2008), http://www.ncsl.org/Default.aspx?Tabid=12633.

20. BRIFFAULT & REYNOLDS, *supra* note 5, at 700.

21. *Id.* at 699.

beholden to special interests. The main mission of nineteenth-century reformers was to eliminate subsidies to private enterprise—a goal consistent with classical jurisprudence's concern with economic favoritism.[22] Another possibility is that public officials are spending exactly as a majority of their constituents want but that current residents are foisting costs on future residents. This problem of shortsightedness is one that nineteenth-century reformers also sought to correct. A final problem is that local tax and spending decisions might negatively affect outsiders—either neighboring jurisdictions or the state or country as a whole. At the turn of the twenty-first century, we worry about fiscal externalities and, more recently, the possibility of contagion—the potential knock-on effects of a default by a state or a large city.

These are common agency or externality problems, and reformers have long debated how to solve them. Entrenching debt limits in constitutions, limiting the uses to which public monies could be put, and giving courts the role of enforcers were the nineteenth-century solutions. Limiting legislative authority to tax and spend by requiring extraordinary popular consent was the twentieth-century solution.

The second structural solution to this problem of fiscal discipline is the market—either the credit markets or the Tieboutian market in jurisdictions. As to the first, scholars have argued that borrowing costs will create strong incentives for states and localities to exercise fiscal judgment.[23] Assuming that credit rating agencies or the market as a whole can generate accurate predictions (and after the recent failures of rating agencies to correctly assess risk,[24] one might have doubts about that), creditors—and more generally, the bond market—ensure that states and localities will make appropriate fiscal

22. Richard C. Schragger, *The Anti-Chain Store Movement, Localist Ideology, and the Remnants of the Progressive Constitution, 1920-1940*, 90 IOWA L. REV. 1011, 1030-37 (2005).

23. *See* Tamim Bayoumi, Morris Goldstein & Geoffrey Woglom, *Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States*, 27 J. MONEY, CREDIT & BANKING 1046, 1046, 1057 (1995); *cf.* D. Roderick Kiewiet & Kristin Szakaly, *Constitutional Limitations on Borrowing: An Analysis of State Bonded Indebtedness*, 12 J.L. ECON. & ORG. 62, 66 (1996) ("[I]t is the discipline of the credit market that is the real constraint on issuing debt, not the state constitution."); Clayton P. Gillette, *Political Will and Fiscal Federalism in Municipal Bankruptcy* 11 n.26 (N.Y. Univ. Law & Econ. Working Papers, Paper No. 262, 2011), http://ssrn.com/abstract=1793173 ("[A]ny locality refusing to make payments would have difficulty in subsequent borrowings.").

24. Emily Donahue, *SEC Report and Recent Class Action Spell Trouble for Rating Agencies*, AM. BANKR. INST. J., Oct. 12, 2008, at 67 ("Based on the changes the agencies made to their rating methodologies in 2007, it appears that the agencies did not take into account significant differences between the subprime mortgages flooding the market and the traditional mortgages that accounted for most of the historical data relied upon in generating the ratings.").

choices.[25] On this account, the fiscal constitution is a way for governments to credibly commit to exercise fiscal constraint. It is a means of lowering the current cost of credit by limiting the jurisdiction's future borrowing and spending power.

The Tieboutian market works somewhat differently. The incentive for a jurisdiction to be fiscally responsible does not come from capital, but rather from residents and firms through their decisions about where to locate. To the extent that those residents and firms have sufficient information, they will choose jurisdictions that are fiscally sound while punishing (by exiting) those jurisdictions that are overextended. If a state or city wants to win in the jurisdictional competition, it must operate efficiently by providing good services at low cost.[26] Thus, fiscal federalism produces a race to the top: Tieboutian government markets lead to good fiscal outcomes.[27]

Of course, these market mechanisms sit uneasily alongside the fiscal constitution. One does not need the fiscal constitution if either the credit or the intergovernmental market is itself sufficient to impose fiscal discipline on states and local governments. Nevertheless, the fiscal constitution may be a way of signaling a polity's pre-commitment to discipline, especially if the polity has a limited track record.

Finally, the discipline of the market only works if states and localities can and do internalize the costs and benefits of their fiscal decisions. If a locality's fiscal health is mostly a function of circumstances beyond its control or if locals can depend on higher-level governments for aid, then market discipline will have little effect. Fiscal federalists therefore disfavor bailouts.

II. THE FAILURE OF CONSTRAINTS

One might expect that the fiscal constitution and the market together should be sufficient to limit fiscal crises in the states. But it turns out that these two mechanisms often work at cross-purposes. As for constitutional

25. A more general claim is that creditors enhance democratic decisionmaking by forcing states to adopt political reforms that contribute to the transparency, accountability, and responsiveness of government. The strongest form of this argument asserts that the development of western-style representative democracy is in part attributable to creditor demands for institutions that are stable and representative. *See* Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 WM. & MARY L. REV. 937, 941 (2008). These are complex historical claims and depend in part on explaining why credit was extended for so long to monarchs and why capital continues to flow to dictatorial regimes.

26. *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

27. *See* Clayton P. Gillette, *Fiscal Home Rule*, 86 DENV. U. L. REV. 1241, 1242 (2009).

constraints, scholars increasingly argue that they are generally a bad idea—that the cure of the fiscal constitution has often been worse than the disease of overspending.[28] As for the market, the discipline it offers is misplaced. Market signals are often mistimed, and the mechanism for translating bad credit into political cost is highly imperfect. More importantly, the market provides no answers for the cities and states that face fiscal difficulties because of the restructuring of regional and global economies. These issues are related, as the chief concern for states and localities is the same as it has been since the nineteenth century and before: managing boom and bust.

The chief drawback of constitutionalization is that it severely limits the ability of states and localities to respond to changes in economic circumstances. As already noted, the fiscal constitution in many states is a product of a nineteenth-century aversion to debt and a twentieth-century aversion to taxes. This anti-debt and anti-tax fiscal structure sharply constrains the ways in which states and localities can raise and spend monies. It can have pernicious consequences, for states and localities have to fund their services and they will often find indirect ways to do so.

For example, states facing balanced budget requirements will seek to move as much spending "off-budget" as possible. The balanced budget requirement creates an incentive to put off costs or use accounting strategies to hide overruns.[29] The underfunding of state employee pension funds, one of the chief problems animating the current crisis, is one of these strategies.[30] Constitutional or statutory rainy day fund requirements are subject to similar manipulation.[31] Consider also that in states with local property-tax ceilings, cities compete for sales-tax-generating businesses and try to avoid housing. This "fiscalization of land use" induces local governments to zone in ways that distort regional property markets and generate high costs in terms of sprawl

28. Susan P. Fino, *A Cure Worse than the Disease? Taxation and Finance Provisions in State Constitutions*, 34 RUTGERS L.J. 959, 959-60 (2003).

29. Some accounting organizations have made proposals for a uniform accounting procedure that governments can use that will paint a more accurate picture of state and local public finances. Mary Williams Walsh, *A Proposal for Drawing a Clearer Picture of Public Pension Finances*, N.Y. TIMES, July 8, 2011, http://www.nytimes.com/2011/07/03/business/proposal-hopes-to-improve-disclosures-on-public-pensions.html.

30. *See, e.g.*, Karen Paget, *The Balanced Budget Trap*, AM. PROSPECT, Nov. 1, 1996, http://prospect.org/cs/articles?article=the_balanced_budget_trap ("Even in states with strict provisions or a political culture that strongly supports budget balance, a plethora of accounting gimmicks have been devised to reconcile flexibility with nominal budget balance. These include . . . underfunding public employee pension funds . . . .").

31. Gamage, *supra* note 8, at 765-68.

and the unequal provision of local public services.[32] Cities also increasingly depend on fees, intergovernmental transfers, or public-private schemes like tax-increment financing as a means of providing public services. And taxation limitations force states and localities to depend to a greater degree on debt financing—an irony in light of constitutional debt limitations. Meanwhile, those limitations induce states and cities to rely more heavily on special purpose districts or authorities that can issue debt outside of formal constitutional constraints. This "non-debt" debt is often more expensive.[33]

Courts have taken a realist position when it comes to the fiscal constitution, often reading constitutional restraints narrowly in order to allow the government to function, though not so narrowly as to obviate legislatures' need to think creatively. The result has been the judicialization of debt in some states (with judges making distinctions between "good" debt and "bad" debt), the routine avoidance of constitutional debt limitations, and the rise of new (and not always sensible) financing mechanisms.[34] Legislatures generally endorse these avoidance mechanisms through regular legislation or by constitutionally entrenching exceptions.[35]

Fiscal politics is thus state constitutional politics—oftentimes with a supermajority requirement, which gives minority interests effective vetoes. And, as interest groups well know, one can entrench both spending restrictions *and* spending commitments. Some states have constitutionalized their pension commitments or their education spending levels, for instance.[36] Especially in states with a robust initiative process, taxing restrictions coexist with spending requirements, thus limiting the range of revenue and spending options available to legislators. Plebiscitarian or supermajoritarian processes exacerbate that difficulty and are subject to all the usual critiques of such processes.[37] Of course, the purpose of constitutional entrenchment is to raise barriers to state

32. Jonathan Schwartz, Note, *Prisoners of Proposition 13: Sales Taxes, Property Taxes, and the Fiscalization of Municipal Land Use Decisions*, 71 S. CAL. L. REV. 183, 201-04 (1997).

33. Briffault, *supra* note 6, at 919-20, 925-27.

34. *Id.* at 910-27.

35. For instance, although the Alabama Constitution bars state debt, it contains numerous amendments allowing the legislature to issue bonds for specific projects. *See* James H. White, III, *Constitutional Authority To Issue Debt*, 33 CUMB. L. REV. 561, 565-67 (2003).

36. California is one state that has constitutionalized education spending. CAL. CONST. art. IX, § 6. For constitutional commitments regarding retirement plans, see Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 EDUC. FIN. & POL'Y 617, 638-39 (2010).

37. *See* Derrick A. Bell, Jr., *The Referendum: Democracy's Barrier to Racial Equality*, 54 WASH. L. REV. 1 (1978); Julian N. Eule, *Judicial Review of Direct Democracy*, 99 YALE L.J. 1503, 1513-22, 1557-58 (1990).

and local fiscal decisionmaking. The result, however, has often been constrained or distorted budget processes and perennial budget conflict—with no concomitant increase in fiscal discipline.[38]

Does the market work better? Certainly, the participants in the credit markets are capable of making sensible distinctions among government debtors. Thus, bond analysts know that the limits imposed by constitutional debt restrictions are not as important as tax limitations—the revenue-raising capacity of the entity issuing the debt. Moreover, cities and states obviously pay attention to market signals; they are justifiably wary of a poor credit rating. There is no question that the market "works" insofar as it induces the attention of state and local officials.

Nevertheless, the bond market is a fairly crude instrument for enforcing fiscal discipline. It is important to remember that the makers of the market—underwriters, banks, bond counsel, brokers—have an interest in promoting borrowing, especially in economically flush times.[39] And though the myth of perfect markets continues to hold sway in some quarters, it is fairly evident from the recent global downturn that markets do not price in all possible eventualities. By the time the bond market responds to an economic shock, it may be too late. Cities and states will have already taken on significant debt. The short-term interests of market makers may also explain why cities and states can often return to the credit markets even after a default.[40]

But let us assume that the debt markets are not exploitative and that debt can be priced correctly. Even under those circumstances, it is far from clear that states or local governments can take any particular action in response to those prices. This is so for a number of reasons. First, as noted already, constitutionalized fiscal limits often restrict the ability of states and localities to make adjustments on the revenue side. Another way to say this is that the fiscal constitution creates only a partial fiscal federalism. In particular, localities

38. California is the poster child for these failures. *See* JOE MATHEWS & MARK PAUL, CALIFORNIA CRACKUP: HOW REFORM BROKE THE GOLDEN STATE AND HOW WE CAN FIX IT (2010). For discussion of the failures of state debt limitations, see Kiewiet & Szakaly, *supra* note 23, at 66-71. For discussion of the failures of state balanced budget amendments, see RICHARD BRIFFAULT, BALANCING ACTS: THE REALITY BEHIND STATE BALANCED BUDGET REQUIREMENTS 63-65 (1996).

39. Thanks to Richard Briffault for this observation. For discussion of problems in the municipal debt markets, see, for example, Gretchen Morgenson, *Wall Street's Tax on Main Street*, N.Y. TIMES, Aug. 6, 2011, http://www.nytimes.com/2011/08/07/business/wall-streets-tax-on-main-street.html; and Kelly Shea, *Transparency Problems in the Municipal Debt Markets and Their Effect on Fiscal Condition*, PUB. PURPOSE, Spring 2010, at 1, 14-20, http://www.american.edu/spa/publicpurpose/upload/Transparency-Problems-in-the-Municipal.pdf.

40. *See infra* text accompanying notes 55-58.

cannot tax and spend as they wish; the fiscal constitution means that options that would otherwise be open to them (such as raising taxes) often are not.[41] If the revenue side is closed to them—as it is in states with significant restrictions on local taxation for instance—governments are not capable of making the full range of tax and spending decisions. It is for this reason that some scholars have criticized constitutional limitations on local taxation.[42]

Second, the discipline of the market can only work if local tax and spending policies can affect or at least anticipate changes in macroeconomic conditions. The theory of market discipline assumes that states and localities have some ability to influence or manage economic growth and decline.[43] But this assumption is not well founded. As an initial matter, developmental economists are not confident that they know what induces growth or what factors precipitate decline.[44] And economic geographers have argued that economic development has more to do with the happenstance of initial settlement decisions and path dependency than with capital-favorable policies.[45] On this account, local fiscal discipline is only tangentially related to overall economic health.[46]

On the ground, postindustrial cities and states are wrestling with economic restructuring, as production has shifted away from formerly prosperous cities, regions, and nations. The processes of deindustrialization, suburbanization, and globalization operate on a large scale and are relatively immune to local influence. Meanwhile, the burgeoning costs of healthcare and education—which combined make up half of state budgets and a third of local budgets—are also difficult for states and localities to manage or reduce.[47]

More importantly, boom and bust cycles continue to be features of modern economies. Those cycles unsurprisingly produce both business and government failures. Meanwhile, the fiscal constitution requires state and local budgets to

41. *See* GERALD I. FRUG & DAVID J. BARRON, CITY BOUND: HOW STATES STIFLE URBAN INNOVATION 75-98 (2008); Gillette, *supra* note 27, at 1243-44.

42. *See* Gillette, *supra* note 27.

43. *See* Richard C. Schragger, *Decentralization and Development*, 96 VA. L. REV. 1837 (2010).

44. For a discussion of this literature, see *id.* at 1879-81.

45. *Id.* at 1891-93.

46. HELEN F. LADD & JOHN YINGER, AMERICA'S AILING CITIES: FISCAL HEALTH AND THE DESIGN OF URBAN POLICY 291 (1989) ("As we measure it, a city's fiscal health, standardized or actual, depends on economic, social, and institutional factors that are largely outside the city's control.").

47. *See* Iris J. Lav & Elizabeth McNichol, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm*, CTR. ON BUDGET & POLICY PRIORITIES 19-20 (Jan. 20, 2011), http://www.cbpp.org/files/1-20-11sfp.pdf.

be tightened in recessions—the very opposite of what a countercyclical economic strategy demands. The result is that state fiscal policy exacerbates downturns while cutting services to the most vulnerable.[48] Scholars have suggested federal intervention to stabilize local budgets as a second-best solution to this problem.[49] Others have argued for a wholesale rethinking of state fiscal constitutions.[50]

Policy and constitutional reforms may give cities and states the capacity to respond more readily to market signals, but they do not address whether governments will or should do so. Market discipline is often assumed to produce certain (positive) government behaviors. But there is no reason to believe that interjurisdictional competition races or the pressure of the debt market will induce governments to adopt any particular spending and debt policies.

Consider interjurisdictional competition first. As many theorists have pointed out, the assumptions of the Tiebout model, especially its reliance on perfect mobility, are unrealistic.[51] There are very few jurisdictional settings that can meet those requirements.

But even assuming an idealized model, Hongbin Cai and Daniel Treisman have shown that competition will not necessarily produce fiscally disciplined developmental policies.[52] They argue that jurisdictions that are initially behind in the race for mobile capital may not be induced to adopt such policies without a guarantee that the capital will remain in the jurisdiction.[53] Indeed, those jurisdictions that are behind should rationally favor policies that redistribute to current residents or firms. Cai and Treisman's conclusion is that under conditions of initial jurisdictional heterogeneity, interjurisdictional competition does not generate non-redistributive fiscal policies at all. Poorer jurisdictions give up in the interjurisdictional race for capital while richer jurisdictions continue to invest. This model may partially explain the continuing divergence between rich and poor places, that is, why economic

48. *See* Super, *supra* note 6.

49. *See, e.g.*, Brian Galle & Jonathan Klick, *Recessions and the Social Safety Net: The Alternative Minimum Tax as a Countercyclical Fiscal Stabilizer*, 63 STAN. L. REV. 187 (2010).

50. *See* Super, *supra* note 6.

51. *See, e.g.*, John D. Donahue, *Tiebout? Or Not Tiebout? The Market Metaphor and America's Devolution Debate*, 11 J. ECON. PERSP. 73, 77 (1997) (noting that interstate migration is less than 3% per year, and that individuals move for reasons not related to the performance of current officeholders).

52. Hongbin Cai & Daniel Treisman, *Does Competition for Capital Discipline Governments? Decentralization, Globalization, and Public Policy*, 95 AM. ECON. REV. 817, 825-28 (2005).

53. *Id.*

development tends to occur where development already exists. Rich jurisdictions get richer, pulling capital out of poorer jurisdictions, when neoclassical economics would otherwise predict convergence.[54]

By contrast, the pressure of the debt market is real: borrowing costs do increase as debt levels rise.[55] But as I have already noted, the reputational sanction for failing to pay is surprisingly muted. Commentators have observed that creditors do not penalize defaulting governments with much stringency.[56] Indeed, states that only partially repaid or never repaid their mid-nineteenth-century debts were still able to borrow at relatively reasonable rates ten to fifteen years later.[57] This raises the puzzle of why governments repay their debts at all. The evidence shows that they do, often by taking quite heroic measures.[58]

Scholars writing about sovereign debt have offered a number of theories for why this is so.[59] Part of the challenge is determining how fiscal costs are (or, more pointedly, are not) translated into political ones. One possibility is that creditors participate directly in the policymaking process. No doubt large debtholders have an interest in a jurisdiction's long-term budget decisions and may seek to influence policymakers, for better or for worse.[60] In mature credit markets, however, bondholders are more likely to express their preferences through their buy and sell orders, not through politics.

Thus, when scholars argue that creditors influence policy, they mostly mean that the price of debt influences policy. For the market to provide discipline, however, we must assume that state and local officials will pay a political price as debt service or the heightened cost of borrowing eat into the

54. *Id.* at 828 ("Better-endowed units compete aggressively and drain capital from their poorly endowed counterparts. Poorly endowed units, knowing they will lose, simply give up.").

55. *See* Bayoumi et al., *supra* note 23, at 1057.

56. *See, e.g.*, Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1074-77 (1997).

57. William B. English, *Understanding the Costs of Sovereign Default: American State Debts in the 1840's*, 86 AM. ECON. REV. 259, 269-70 (1996).

58. *See* Kordana, *supra* note 56, at 1074-77. Wenatchee, Washington, for example, is doing everything it can to avoid defaulting on loans it took out to finance the construction and maintenance of a mid-size arena. Ken Belson, *Company's Arenas Leave Cities with Big Problems*, N.Y. TIMES, May 16, 2011, http://www.nytimes.com/2011/05/17/sports/a-companys-small-town-arenas-leave-cities-with-big-problems.html?pagewanted=all.

59. Kordana, *supra* note 56, at 1072-84.

60. *Compare* Gillette, *supra* note 27, at 1261 (arguing that creditors enhance democratic responsiveness), *with* Paul Krugman, Op-Ed., *Rule by Rentiers*, N.Y. TIMES, June 9, 2011, http://www.nytimes.com/2011/06/10/opinion/10krugman.html (arguing that interest-group pressure from creditors has undermined democratic processes).

present provision of public services. Short of a default, however, the increased costs associated with a credit downgrade are unlikely to excite sustained public attention.[61] Long-term debt presents a classic public choice dilemma. Interest payments are spread over time and across a large class of taxpayers. There is little incentive for any one taxpayer or even a group of taxpayers to expend political energy to contest the marginal increase.

Potential defaults or bankruptcies arguably raise different concerns, as a default is highly visible, tends to embarrass current public officials, and often has immediate fiscal repercussions. That being said, the mechanism for translating bad credit into political cost is still quite imperfect. Often, the public officials who pay the political costs of a default are not the ones responsible for the fiscal policies that led to it. And if defaulting cities or states can get back into the credit markets relatively quickly, the long-term political effects of a default will be relatively muted.

Of course, none of this addresses the political morality of the debt market's influence. Even if they are willing and able, should cities and states respond to market signals, particularly at the stage of near-default? When faced with a decision to protect bondholders or citizens, it may be entirely appropriate for a public official to choose the latter over the former. Democratic theory may in fact demand such a preference if the short-term consequences of default are not much more severe than the short-term consequences of massive budget cuts. This may seem unfair to the bondholders, but, as Kevin Kordana has argued, the risk of default is built into the price of their investment, and they are in a better position than citizens to bear it.[62] Moreover, to the extent that the bulk of bondholders are not citizens, they can raise no democratic objection to the decision. This tradeoff has been raised in the international arena, as some have questioned whether the austerity demands induced by creditors are worth it.[63] States and localities may be wondering the same thing.

III. OF BAILOUTS AND BANKRUPTCY

The disciplining approach to state and local debt tends to reflect the view that states and cities are relatively incompetent to manage their fiscal affairs and highly likely to impose costs on other jurisdictions or future generations. The current debate about bailouts and bankruptcy raises each of these themes,

61. *But see* Dash, *supra* note 13 (discussing U.S. debt downgrade).

62. Kordana, *supra* note 56, at 1097-99.

63. Mark Weisbrot, Op-Ed., *Why Greece Should Reject the Euro*, N.Y. TIMES, May 9, 2011, http://www.nytimes.com/2011/05/10/opinion/10weisbrot.html.

for it reprises the long-running concerns about the efficacy of state and local democracy. Those concerns are predictably cyclical. After an economic crisis, institutional reformers shift power: from local governments to state legislatures, from legislatures to the people, or from politically accountable actors to politically insulated ones. But those institutional reforms are often found to be unsatisfactory, after which power is often shifted again in the ongoing quest for an institutional solution.[64]

This cycle of centralization and decentralization is animated first by the myth of mismanagement—the assumption that, without oversight, states and cities will manage themselves into default. But this skepticism of local competence is not warranted. Even during the heyday of the urban machines in the nineteenth century, as Jon Teaford has persuasively argued, the perception that cities were abysmally managed was unsupported by the facts.[65] The nineteenth century arguably witnessed the worst of state and municipal corruption. But it was also a time when the great industrial cities managed phenomenal growth rates and produced significant advances in public health and welfare. Even then (as now) municipal and state bonds were viewed as conservative investments. That is because municipal and state defaults are extremely rare and certainly less prevalent than bond defaults by corporations.[66]

That is not to say that mismanagement does not occur—the pathologies of the state and local budgeting process are well known.[67] But the solutions to those pathologies have always been unsatisfying. Thus, almost immediately after the nineteenth-century debt crisis led to a restriction of city powers, institutional reformers initiated home-rule movements to protect local autonomy—a reflection of their dissatisfaction with state legislatures' fiscal intermeddling.[68] Similarly, the judicial avoidance of debt limitations and the dilution of public purpose requirements over the last eighty years reflect a

64. Schragger, *supra* note 43, at 1865-74.

65. JON C. TEAFORD, THE UNHERALDED TRIUMPH: CITY GOVERNMENT IN AMERICA, 1870-1900, at 306 (1984) ("The moral image of city government remained bleak even while the municipal ledgers told a different story.").

66. Paul Sullivan, *The Risks and Returns of Municipal Bonds*, N.Y. TIMES, Apr. 9, 2010, http://www.nytimes.com/2010/04/10/your-money/10wealth.html ("The reality is that municipal bonds have a historically minuscule default rate."); *see also* Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 699 (1995) (noting that between 1983 and 1988 the municipal bond default rate was 0.7%, while the corporate bond default rate was 1.1%).

67. *See, e.g.*, Sabrina Tavernise, *Harrisburg Finds Itself in Uncharted Financial Waters*, N.Y. TIMES, July 20, 2011, http://www.nytimes.com/2011/07/21/us/21harrisburg.html.

68. *See* TEAFORD, *supra* note 65, at 105-11.

political consensus that constitutional entrenchment makes for poor fiscal policymaking.[69] More recent movements to remove tax and spending limitations in state constitutions reflect the same dissatisfaction. The current conversation about bailouts and bankruptcy is thus only the most recent iteration of a long-running debate. And the major themes again are local mismanagement and distrust of the local and state political processes.

The allergy to bailouts encompasses both themes, as the main concern of those who oppose bailouts is that they generate moral hazard. The conventional story is that bailing out cash-strapped states and cities fails to punish them for their profligacy.[70] But the moral hazard objection to bailouts is likely overstated. First, as was already noted, states and cities tend to pay their debts even in the absence of formal coercion. There is no real mechanism to "foreclose" on defaulting governments or force them into bankruptcy, and it is not possible to "liquidate" a state or effectively attach municipal or state property. Even after governments have waived any available immunities, creditors' remedies are extremely limited. If moral hazard were such a pervasive problem, we would expect much more opportunistic behavior and—more importantly—much less lending to governmental entities.[71] But we do not see either. The evidence clearly shows that lenders continue to lend and governments continue to pay back their debts "in spite of the lack of any severe or coordinated debtor punishment."[72]

Second, the concern that a bailout will incentivize opportunistic behavior seems misplaced when local, state, and federal finances are already so intertwined. States and cities are not even remotely fiscally autonomous and certainly not autonomous in the way that idealized accounts of fiscal federalism presume. Intergovernmental transfers and direct federal outlays to state and local governments and to state and local residents are the norm in our federalism.[73] Those transfers are so significant as to make the worry about a one-time bailout seem odd. The federal government is already the primary fiscal backstop for individual citizens. It is not clear why we would see an increase in strategic behavior by states and localities if that fiscal intervention took the form of a bailout.

69. *See* Briffault, *supra* note 6, at 910-14.

70. *See* Kordana, *supra* note 56, at 1068-69.

71. *See id.* at 1067-69.

72. *Id.* at 1085.

73. *See, e.g.*, U.S. CENSUS BUREAU, FEDERAL AID TO STATES FOR FISCAL YEAR 2009 (2010), *available at* http://www.census.gov/prod/2010pubs/fas-09.pdf.

Moreover, the no-bailout view implicitly assumes that higher-level governments have little to no responsibility for local fiscal difficulties.[74] But the federal government encourages states and municipalities to take on debt by providing a tax exemption for municipal bond interest. At the same time, federal and state policies shift costs downward via unfunded mandates or tax cuts—both of which require states and localities to assume a greater share of the fiscal burden. It stands to reason that state and federal officials have little incentive not to impose funding obligations on lower-level governments unless they have to take responsibility on the back end for the fiscal stresses they cause.

Again, a bailout is not particularly remarkable if the fiscal health of states and localities is already dependent on and vulnerable to central government fiscal decisions. Indeed, the intertwined nature of national, state, and local finances means that solving a political process problem at one level of government might contribute to a different problem at another level of government. Elected officials have incentives to impose political externalities downward. If we treat local governments as fiscally autonomous in order to force them to make hard choices, other political actors in the system will be inclined to shift as many of those choices onto them as they can.[75] And the last one holding the bag may be the least able to lift it.

A different objection to bailouts is that the moral hazard to be avoided is on the lending side, as investors anticipating a bailout will be too aggressive in extending credit. But the uncertainty of the rescue and its terms may be enough to prevent overlending. The few bailouts of cities that have occurred have been accompanied by fairly severe terms—terms that can include some pain for creditors. Recall that despite President Gerald Ford's initial objection (as memorialized in the famous headline: "Ford to City: Drop Dead"),[76] New York City did in fact receive $2.3 billion in short-term loans from the federal

74. The no-bailout position also implicitly assumes a contestable distribution of fiscal responsibilities between the local, state, and federal governments.

75. One recent example took place in New York, where the state legislature passed a property tax cap for localities. The cap diminishes the ability of local governments to raise revenue without corresponding funding from the state to make up the difference. *See* Thomas Kaplan, *Senate Passes Cuomo's Property-Tax Cap*, N.Y. TIMES, Jan. 31, 2011, http://www.nytimes.com/2011/02/01/nyregion/01cap.html.

76. Frank Van Riper, *Ford to City: Drop Dead*, DAILY NEWS (N.Y.), Oct. 30, 1975, at 1; *see also* Richard Pérez-Peña, *Hugh L. Carey, Who Led Fiscal Rescue of New York City, Is Dead at 92*, N.Y. TIMES, Aug. 8, 2011, http://www.nytimes.com/2011/08/08/nyregion/hugh-carey-who-led-fiscal-rescue-of-new-york-city-dead-at-92.html (discussing the "Drop Dead" incident in detail).

government to prevent the City from defaulting in 1975.[77] No one would contend that New York's bailout signaled that investors should increase their exposure to city debt; in fact, the large banks holding the bulk of New York's notes had to accept less favorable repayment terms. Nor did the bailout induce cities and states to go on a spending spree, in part because its terms were suitably stringent,[78] but also because local elected officials are not inclined to lead their communities up to the edge of default.

The more plausible objection to bailouts is a democratic one. When the fiscal choices made by one state or city affect the fiscal health of other states or cities, there must be some democratic justification. Assuming that higher-level governments are not contributors to local fiscal stress (and, as I have said, that is questionable), poorly run cities or states should not impose costs on better-run cities and states. That a city or state default threatens contagion—the collapse of the national credit markets—perhaps makes bailouts inevitable but democratically troubling.

This is not a unique problem, however. The federal government has not only injected cash into private enterprises to save the automobile, banking, and mortgage industries, but has in the past injected cash to stabilize foreign sovereigns.[79] The standard by which we judge the normative attractiveness of state and local bailouts should not be any higher. Certainly any bailout terms would be set by Congress, which, for all its flaws, is likely to demand something substantial in return. The existing institutional constraints thus seem well suited to minimize the democratic objection to the bailout itself.[80] The question is whether Congress should have additional power to regulate the fiscal decisions of states as a way of preempting bailouts in the future. That kind of intervention is very troubling to those who worry about state sovereignty.

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77. *See* Roger Dunstan, *Overview of New York City's Fiscal Crisis*, 3 CAL. RESEARCH BUREAU NOTE, no. 1, at 1, 5-6 (1995), *available at* http://www.library.ca.gov/crb/95/notes/V3N1.pdf; Pérez-Peña, *supra* note 76.

78. For a description of the terms of the New York City bailout, see Dunstan, *supra* note 77, at 5-6.

79. Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627, 1638 (2006) (discussing the "$50 billion U.S.-led rescue package" of Mexico).

80. Indeed, a more significant concern from the perspective of democratic theory is that the conditions of assistance will be so onerous as to undermine local self-government. Michigan residents have recently filed a lawsuit claiming that their underlying right to local self-government is being violated by the governor's imposition of emergency managers on fiscally strapped local governments. *See* Monica Davey, *Michigan Residents Sue over Law on Emergency Management of Struggling Cities*, N.Y. TIMES, June 22, 2011, http://www.nytimes.com/2011/06/23/us/23michigan.html.

Scholars have naturally looked to bankruptcy for a solution.[81] At the outset, it is questionable whether the fiscal health of state and local governments is so poor that they need an opportunity to file for bankruptcy. Some commentators have pointed out that state and local debt remains within the historical ranges of the last three decades. The same is true for interest payments as a fraction of state and local spending: roughly 4% of state and local spending today goes toward interest on debt, which is in line with the average rate in the 1970s and early 1980s and is much less than the 6.5% state and local governments were devoting to interest payments in 1987.[82]

Assuming states and local governments are in near-default positions, however, there is still reason to doubt the efficacy of the bankruptcy option. To the extent that we worry about moral hazard (and as I have said, there are reasons to believe that concern is overblown), bankruptcy does not solve it—at least on the debtor's side.[83] Like bailouts, bankruptcy erases debt without making a distinction between poor management and bad luck. The advantage of bankruptcy, according to those who advocate it, seems to be that it is *not* a bailout and that it can force fiscal decisions that would be politically unpalatable otherwise.[84]

The resort to bankruptcy replays the institutional move embodied in the fiscal constitution: shift decisionmaking up the scale of government. In this case, a federal bankruptcy judge would have some authority to reorganize city or state debt at the stage of near-default. Of course, the bankruptcy option at the back end will create incentives on the front end. Thus, depending on the structure of the imagined bankruptcy law, bankruptcy may be an indirect way for Congress (through judges) to regulate state and local fiscal practices.[85] Or the bankruptcy option will shift power within the state, possibly from the legislature to the governor, depending on who is authorized to seek bankruptcy

81. *See* Steven L. Schwarcz, *A Minimalist Approach to State 'Bankruptcy,'* 59 UCLA L. REV. (forthcoming Dec. 2011) (stating that "bankruptcy law is an obvious mechanism of debt relief").

82. Lav & McNichol, *supra* note 47, at 9-10. *But see Blood on the Table, Money in the Bank*, ECONOMIST, July 7, 2011, http://www.economist.com/node/18928863.

83. Kordana, *supra* note 56, at 1085.

84. Skeel, *Give States a Way To Go Bankrupt*, *supra* note 3; Skeel, *States of Bankruptcy*, *supra* note 3.

85. Advocates of a federal law of state bankruptcy are unabashed about this intention. *See* Skeel, *States of Bankruptcy*, *supra* note 3, at 9-18 (describing how a federal bankruptcy law would alter state officials' and political actors' incentives and help to "establish[] more coherent" state budgetary priorities).

protection for the state, who will negotiate its terms, and what kinds of legislative authorization might be required.[86]

Like other institutional innovations, however, it is likely that the bankruptcy option will be unsatisfying. Currently, the Bankruptcy Code seems to be of limited use. Cities can already access bankruptcy if their states allow, but very few cities do so.[87] Perhaps this is because the Code does not contemplate the kinds of reorganizations that are possible on the private side and thus does not help cities grapple with their underlying economic woes. For example, in many cases, redrawing municipal boundaries or reconfiguring the municipalities' status would be advisable. Disincorporation would allow fiscally-strapped cities to become part of a larger taxing entity—in most cases, the surrounding county.[88] But the Code does not permit judges to order such involuntary dissolutions, nor would it appear to be consistent with local autonomy to permit them to do so.[89] State receiverships for municipal debt crises may thus be more appropriate, as the state has the ability (if not the will) to address the structural harms that lead to local fiscal crises in the first place.[90]

As for states, the imposition of a federal judicial solution is also likely to have limited effect.[91] As an initial matter, it should be noted that treating the state as a monolithic debtor is misleading. State agencies, state pension funds, local governments, and state and local public authorities all issue different forms of debt, some of which are formally backed by the state and many of

86. *See id.* at 30 (proposing that Congress vest the authority to propose a restructuring plan directly in the governor).

87. Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351, 359 (2010).

88. *See* Michelle Wilde Anderson, *Dissolving Cities*, 121 YALE L.J. (forthcoming 2012), *available at* http://ssrn.com/abstract=1919768.

89. Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 481-85 (1993).

90. *See* Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633 (2008). As noted above, the receivership option raises its own democratic concerns. *See* Davey, *supra* note 80.

91. *See* Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 896 (2012) ("[B]ankruptcy's likely contributions are limited and often hinge on a set of questionable assumptions."); Richard Hynes, State Default and Synthetic Bankruptcy (Dec. 7, 2011) (unpublished manuscript) (draft on file with author) (noting that states "don't need to file for protection under the bankruptcy code to realize most of the benefits of 'bankruptcy'–a single proceeding that binds all creditors"). *But see* Schwarcz, *supra* note 81 (advocating a minimalist approach to state bankruptcy); Skeel, *States of Bankruptcy*, *supra* note 3.

which are not.[92] State bankruptcy proposals tend not to appreciate these differences. More importantly, a federal law of state bankruptcy will have little traction unless the powers of the bankruptcy judge are well beyond what principles of federalism would seem to allow. No state can be forced into bankruptcy, and it is unlikely a state would volunteer with the knowledge that a judge could force legislative action. In any case, few commentators believe that bankruptcy courts should be empowered to order states to raises taxes or repudiate or amend their constitutions.[93] Even if a judge could do so, it is not at all clear that a state would comply.[94] A detailed federal bankruptcy law that dictates the terms of state restructuring would constitute a serious alteration of the federal-state relationship.

Allowing Congress or an unelected judge to make state-level fiscal decisions at the bankruptcy stage will not be particularly effective either. Bankruptcy will not exercise much disciplinary force on creditors unless bankruptcy is worse than a default—a possibility that is already calculated into creditors' investments. It will also not exercise much disciplinary force on cities and states unless Congress or bankruptcy courts establish fairly interventionist guidelines. And those guidelines will be as much subject to politics, judicial manipulation, and special interest pleading as the states' fiscal constitutions have been. Like the institutional reforms that came before it, bankruptcy is a means of shifting institutional scales to accomplish substantive political ends. The politicians know this. As recent debates illustrate, policymakers understand that the bankruptcy question is really about the relative sanctity of existing and future state employee benefits and pension obligations.[95]

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92. See Hynes, *supra* note 91, for this point.

93. The same political and constitutional concerns that limit bankruptcy judges in municipal bankruptcy filings would almost certainly limit bankruptcy judges in state bankruptcy filings. Thus, a bankruptcy judge would likely be unable to regulate state expenditures, to allow creditors to seize public or private property within the state, or to allow creditors to get a lien on future state taxes or revenues. *See* McConnell & Picker, *supra* note 89, at 429-45. It is also doubtful that a federal bankruptcy judge could order states to levy new taxes. *Cf.* Kordana, *supra* note 56, at 1096-1106 (arguing that allowing such an order would also be inefficient).

94. It is unlikely states would be eager to enroll in a federal bankruptcy program. A majority of governors currently opposes such a plan. *See* Press Release, Nat'l Governors Ass'n, NGA Statement Regarding Bankruptcy Proposals for States (Jan. 25, 2011), http://www.nga.org/cms/home/news-room/news-releases/page_2011/col2-content/main-content-list/nga-statement-regarding-bankrupt.html.

95. McMahon, *supra* note 3; *see also* Mary Williams Walsh & Abby Goodnough, *A Small City's Depleted Pension Fund Rattles Rhode Island*, N.Y. TIMES, July 11, 2011, http://www.nytimes.com/2011/07/12/business/central-falls-ri-faces-bankruptcy-over-pension-promises.html. For a discussion of the politics of a federal law of state bankruptcy, see

It is quite difficult on democratic grounds to justify allowing a judge to impose particular fiscal ends unless the political pathologies of the local and state budgeting process are so wide and deep that coercion outside elective politics is required. And thus we return to the distrust of local, representative democracy. If it is true that cities and states will invariably engage in giveaways to vested interests and rarely take into account future generations, then our ongoing efforts to design institutional checks on their authority would be warranted—even if that effort is likely to fail.

But I do not see an inevitable political failure. Local, state, and national politics are characterized by an almost obsessive concern with excessive spending and debt; elections are won and lost on the electorate's assessment of the relative fiscal probity of the candidates. And voters, like creditors, are usually able to tell the difference between fiscal irresponsibility and economic bad luck, punishing the former more than the latter.[96]

Within this context, bankruptcy may provide strategic benefits for particular political actors. For example, state and city officials may use the threat of bankruptcy as a tool in their negotiations with public sector unions,[97] or as a way of inducing higher level governments to provide aid; city officials may seek bankruptcy protection as a means to prevent a hostile state takeover.[98] But institutionalized debt relief of whatever kind still leaves untouched the existing fiscal regime and the underlying structures that have led to fiscal distress in the first place.[99] Better to revisit the structural defects in the state's fiscal constitution, both on the spending and the revenue sides. Better yet to debate the merits of bailouts, with all their political and fiscal

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Adam Levitin, *Bankrupt Politics and the Politics of Bankruptcy* 36-38 (Georgetown Univ. Law Ctr. Pub. Law & Legal Theory Working Paper Series, Research Paper No. 11-127, 2011), http://ssrn.com/abstract=1898775.

96. *Cf.* Kordana, *supra* note 56, at 1077 (describing how creditors can differentiate between opportunistic and nonopportunistic behavior).

97. Recent court decisions have suggested that cities and states may no longer need to threaten bankruptcy to lower pensions, as governments in Colorado and Minnesota legally reduced pensions without filing for bankruptcy. Mary Williams Walsh, *Two Rulings Find Cuts in Public Pensions Permissible*, N.Y. TIMES, June 30, 2011, http://www.nytimes.com/2011/07/01/business/01pension.html.

98. For a sympathetic account of one city's use of bankruptcy in this way, see Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEV. J. 625, 626 (1995). For a skeptical account, see Gillette, *supra* note 23. Gillette's proposal to permit bankruptcy judges to impose tax increases so as to "neutralize the strategic behavior of local officials," *id.* at 1, has been rejected by Kordana, *supra* note 56, at 1096-1106.

99. *See* Levitin, *supra* note 95, at 3-4.

implications.[100] Gerald Ford claimed that his initial opposition to bailing out New York City cost him the presidential election.[101] More recently, national politicians have paid a political price for supporting bailouts associated with the Troubled Asset Relief Program.[102] That there are political costs and benefits is as it should be.

CONCLUSION

Institutional designers continue to seek mechanisms that will constrain fiscal politics, be they constitutions or markets. The effort is unlikely to bear fruit. First, there is the problem of boom and bust. Public-side investments can and do go bad, especially when they coincide with a downturn in the business cycle. And large-scale changes in the economy will affect government finances in ways that have little to do with irresponsible spending. The modern social welfare state seeks to ameliorate booms and busts with monetary policy, regulation of finance, large-scale tax and transfer programs, and nationwide social insurance. Subnational governments do not have these kinds of tools at their disposal, and thus the central government has an important role to play in assisting those governments.

Second, while institutional reforms will shift political power among and between state and local actors, they ultimately do not depoliticize tax and spending choices. The fiscal discipline of constitutional constraints can only work if state constitutional politics is different in kind from state fiscal politics. But it is not. And the market can only work if its signals are accurate and states and localities have the will and capacity to respond to those signals. None of these conditions holds to a significant degree. Institutional reforms seem only to exacerbate existing political pathologies, and the constraints adopted in the shadow of past crises are not well-matched to present challenges. Indeed, the

100. Anna Gelpern prefers "bailouts with strings" rather than bankruptcy for states. *See* Gelpern, *supra* note 91, at 940; *cf.* Adam Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 442-43, 501-07 (2011) (arguing that bailouts are inevitable and that they should be structured to maximize political accountability).

101. Andy Bechtel, *Memorable Headlines: Ford to City: Drop Dead*, EDITOR'S DESK (Apr. 6, 2009, 10:22 AM), http://editdesk.wordpress.com/2009/04/06/ford-drop-dead-headline.

102. Seth E. Masket & Steven Greene, When One Vote Matters: The Electoral Impact of Roll Call Votes in the 2010 Congressional Election 12 (2011) (unpublished manuscript), http://static.usnews.com/documents/whispers/104076.pdf.

experience of states with balanced budget requirements is a cautionary tale for those who have renewed the call for constitutional reform at the federal level.[103]

This should lead us to think about the idea of fiscal discipline differently. I have argued that an approach to the behavior of subnational territorial jurisdictions that assumes "discipline" is possible is incorrect and misguided. That being said, I began this Essay with the assumption that constraining elected officials so that they act consistently with the public good is the problem to be solved. But this raises a question about ends. What constitutes "fiscal discipline" is really a debate about what the public good requires. For some, all state and local redistributive spending is by definition "undisciplined": taxing and spending should mimic what a private market in analogous goods would produce. For others, states and localities have a significant role to play in producing public goods and ameliorating inequality.

I do not resolve that debate here. It is enough to point out that it is contested and contestable. What is evident from the history of the fiscal constitution, however, is that political actors will deploy institutional reform as a means of pursuing substantive political ends. The institutionalist's conceit is that certain forms of constitutional entrenchment can shape political choices toward some consensus goal.[104] But this is likely too optimistic a story. The consensus goal is elusive and the view that particular institutions have a constraining effect relies on a distinction between law and politics that has been repeatedly discredited.

As for the market, I began this Essay by noting the fraught relationship between democracy and debt, sovereignty and fiscal restraint. Capital markets are obviously useful tools for governments. But democratic theory favors citizens over bondholders. Sometimes their respective interests will coincide; other times they will not. How to ensure public, democratic rule when capital is highly mobile is a question that is beyond the scope of this Essay.[105] Nevertheless, it is important to remember not to confuse access to the debt

103. *See* Jennifer Steinhauer, *Republicans Set Sights on Balanced Budget Amendment*, N.Y. TIMES, Aug. 5, 2011, http://www.nytimes.com/2011/08/05/us/politics/05budget.html; *see also* BRIFFAULT, *supra* note 38, at 63-65 (criticizing balanced budget proposals).

104. *Cf.* John Joseph Wallis & Barry R. Weingast, *Dysfunctional or Optimal Institutions?: State Debt Limitations, the Structure of State and Local Governments, and the Finance of American Infrastructure*, *in* FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY 331, 334 (Elizabeth Garrett, Elizabeth A. Graddy & Howell E. Jackson eds., 2008) ("The institutional structure [of U.S. state and local governments] is not perfect, but nonetheless, on balance, it is quite positive. . . . State and local governments issue huge amounts of debt each year, and yet very few fail to make good on their bonds.").

105. I address this question more directly in Schragger, *supra* note 43.

markets with democratic legitimacy. When the bond market becomes a despot, we have lost the balance between democracy and debt.

While we know that representative institutions at the state and local level are far from perfect, fiscal responsibility has been more the norm than the exception. The reason cities and states have paid their debts during normal economic times is not because the fiscal constitution or the market have prevented profligacy but rather because we have a mature, decentralized political system that holds elected officials accountable more often than is sometimes assumed. Local and state taxpayers are attentive to tax and spending decisions. Moreover, in the post-New Deal state, large-scale infrastructure and social insurance spending are now the province of the federal government, a government that has the capacity to engage in monetary policy. These features of our current federalism have been in place for some time. To the extent that there are "solutions" to state and local debt crises, they already exist.