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THE FORDHAM SYMPOSIUM ON THE LOCAL FINANCE PROJECT OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK: AN INTRODUCTORY ESSAY

*Eugene W. Harper, Jr.**

Background

On March 24, 1979, this Journal sponsored a symposium at the Fordham Law School to discuss a report entitled "Proposals to Strengthen Local Finance Laws in New York State,"[1] ("Proposals") which had recently been published by The Committee on Municipal Affairs of the Association of the Bar of The City of New York. This volume is an edited record of the proceedings of that symposium.

The Committee undertook its study of state laws affecting local finances in New York in the wake of the near financial collapse of New York City. The city's financial difficulties raised the question whether or not the basic constitutional and statutory provisions regulating local finances in New York State needed thorough re-examination. In the summer of 1977, the Committee, then chaired by George Dwight, Esq., of Richards & O'Neil, secured foundation grants to support its Local Finance Project, which aimed to conduct a study of the borrowing, budgeting and disclosure practices of localities in New York State, and to propose particular constitutional and legislative measures relating to these practices.[2] A set of proposals was drafted by the Committee's Subcommittee on Local Finance, chaired by Evan A. Davis, Esq., of Cleary, Gottlieb, Steen & Hamilton, with the assistance of a full-time project director, Kenneth F. Hartman, Esq., currently Associate Counsel for Municipal Affairs in the New York State Department of Audit and Control. In May, 1978, a conference was held at Cornell University to discuss

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1. Committee on Municipal Affairs of the Association of the Bar of the City of New York, *Proposals to Strengthen Local Finance Laws in New York State*, 34 THE RECORD 58 (Jan./Feb. 1979, No. 1/2) [hereinafter cited as *Proposals*]. The text of the constitutional amendment and legislation set forth in *Proposals* is included as an Appendix to this volume.

2. *Proposals, supra* note 1, at 59-60.

the Committee's draft proposals, and in November, 1978, the Committee distributed a report containing the Proposals in final form.

The Fordham symposium was held in order to promote discussion and evaluation of the Committee's Proposals by experts in the field of local finance and to provide a record for further study by the legislative and executive branches of state government. Invited to participate in panel discussions were members of the bar specializing in the law of local government and local finance, members of the academic community with similar expertise and interest, and past and present public officials who have participated in shaping the contours of local finance law in the state.

The format of the symposium was based on the Committee's presentation of its Proposals, which include three principal recommendations: 1) to revise the Local Finance Article of the state constitution, 2) to make "full disclosure" the policy of the state in local finance matters, and 3) to provide for state oversight and enforcement of a proposed balanced-budget requirement for local governments. Panel discussions were held on each of these three topics. At each panel, a principal paper was delivered, followed by comments from the panelists, at least one of whom was a Committee member, and by floor discussion.

This volume contains the principal papers prepared for the symposium, in the order in which the Committee presented its Proposals, and an edited version of the panelists' comments. The principal papers were prepared by Richard L. Sigal, Esq., of Hawkins, Delafield & Wood, who discussed the Committee's proposed constitutional amendment; by Thomas Currier, Esq., of Dewey, Ballentine, Bushby, Palmer & Wood, who addressed the Committee's recommendations concerning disclosure; and by Donald H. Elliott, Esq., of Webster & Sheffield, who analyzed the Committee's proposals for fiscal monitoring. This volume also contains two student comments—a short constitutional history of local finance in the state, and an analysis of the effect of state constitutional debt limits on the finances of New York City.

This introductory essay summarizes the Committee's Proposals, the full text of which appears in an Appendix to this volume, and comments on the Proposals and the responses that emerged from the Fordham symposium.

I. Proposed Local Finance Article

The Committee's most significant recommendation is for a revision of article VIII of the state constitution concerning local finance.[3] The Committee suggests a major shift in emphasis—in place of the specific limits and detailed rules for local finances found in the existing article, the committee's proposed draft would substitute a number of "fundamental principles" intended to govern local finance practice in the state.

The "fundamental principles"[4] identified by the Committee would operate to limit the power of local governments in matters of local finance while removing limits on the power of the legislature in such matters, except with regard to tax limits. Under the Proposals, local governments would be required to pledge their faith and credit for all (including self-liquidating) debt and to appropriate or provide for the payment of all debt; to maintain balanced budgets; and if they issue short-term obligations, to do so only in anticipation of taxes or revenues (*i.e.*, not deficits) or bond proceeds (*i.e.*, not "roll-overs"). The Proposals would remove local government debt limits from the Constitution itself, and would permit the legislature to set these debt limits for local governments. Moreover, the proposed revision would permit the legislature, without maximum limits, to determine periods of probable usefulness which continue to constrain the term structure of local government debt.

The Committee's Report asserts that if courts are charged with applying these basic principles, instead of the particularized provisions of current article VIII, constitutional limitations will be enforced more effectively.

In addition to the shift in emphasis entailed in relying upon basic principles, the Committee proposes particular revisions to the pattern of constitutional limitations. First, the Committee would revise the so-called "gifts and loan" provision of article VIII.[5] The current "gift and loan" provision flatly prohibits local governments from giving or lending their money, property, or credit, but then sets forth a list of specific exceptions to this general rule. The Proposals reaffirm this general prohibition but would permit the legislature to

3. *Id.* at 60-63, 82-92.
4. *Id.* at 83.
5. *Id.* at 84-87.

authorize local governments to make such gifts or loans for a "public purpose." The Committee claims that this revision of the "gift and loan" provision would eliminate the need for what it characterizes as extraconstitutional financing mechanisms and would relax what it views as undesirably rigid constitutional restrictions on cooperation between the public and private sectors in the area of economic development.

Second, in an effort to strengthen control over local government debt limits, the Committee proposes the removal of debt limits from the constitution itself, and a requirement that the legislature set general debt limits.[6] The debt limits, however, are not to be set as a percentage of real estate valuation, as article VIII currently requires, but as a function of local government revenues, a standard the Committee considers to be a more realistic measure of ability to pay. The Committee's proposal would exclude from these limitations only self-liquidating debt (which would, however, be secured by the general revenue powers of the local government) and voter-approved debt, and would thus include within these limitations such obligations as long-term leases and "moral obligation" debts. To check continuing increases in debt limits, the Proposals require approval by two sessions of the legislature before any increase in general debt limits may become effective.

In sum, the Committee's proposed Local Finance Article would remove constitutional limitations on legislative power, thereby permitting the legislature (1) to expand the range of purposes for which local governments may incur debt and (2) to increase the extent to which such debt may be incurred. In contrast to the proposed removal of constitutional limits on legislative power, the Proposals tend to restrain local governments in a variety of ways—localities would be commanded to balance budgets, to restrict short-term debt, and in every case, to pledge their faith and credit and pay debt.

In his paper,[7] Mr. Sigal criticizes the Proposals on several grounds. First, he suggests that the Committee, under the guise of *corrective* action, proposes to revise the "gift and loan" provision

6. *Id.* at 89.

7. Sigal, *The Proposed Constitutional Amendments to the Local Finance Article: A Critical Analysis, infra* at 29.

principally to pave the way for *new* action—increased public involvement in the private economy. He contends that the "gift and loan" provision of article VIII has worked essentially as intended and that the abuses catalogued by the Committee in its report were mainly aimed not at circumventing the "gift and loan" provision, but at circumventing debt and tax limitations. The "gift and loan" provision has in fact served as an impediment to the lending of public money or credit to private corporations, and this, he implies, is precisely why the Committee seeks its elimination.

Second, even if it were appropriate and wise to use public funds to stimulate economic development in the private sector, a point that he does not concede, Mr. Sigal criticizes the method by which the Committee has chosen to accomplish this goal. Mr. Sigal would prefer a straightforward constitutional declaration that public funds may be spent and public credit lent to stimulate private economic development, and he would supplement this declaration with constitutionally mandated standards and requirements. He suggests that the existing article XVIII provisions dealing with housing and urban renewal may serve as a model, although he recognizes that the undue complexity of article XVIII ought to be avoided. In support of his position, Mr. Sigal contends that it is unwise for the Committee to retain the language of the "gift and loan" provision supplemented by an exception for gifts and loans for a "public purpose," for two reasons. First, it is redundant because judge-made fundamental law already requires, even in the absence of a specific constitutional mandate, that all public funds be expended for a "public purpose;" and second, it is unclear in light of precedent whether or not all the economic development measures the Committee may have in mind would pass muster under the judge-made "public purpose" test. Mr. Sigal is careful not to urge amendments eliminating the "gift and loan" provision or, for that matter, authorizing borrowing for economic development, including investment in private entities; he recognizes the questions raised as difficult issues, but would leave ultimate judgment to others.

Third, Mr. Sigal strongly disagrees with the Committee's proposal to require local governments to pledge their faith and credit for every debt instrument, *i.e.*, to make every debt instrument of local government a general obligation. He believes it is futile for the Committee to attempt to constrain local governments in this fash-

ion because this constraint would only encourage the creation of public authorities to avoid the required pledge. Further, he believes that any prohibition of revenue financing would be undesirable because the market test for revenue bonds is, in his opinion, a particularly effective constraint itself. Finally, he suggests that this proposal is doubly wrong when it is coupled with an effective elimination of the "gift and loan" provision, for, in his view, it might jeopardize the ability of local governments to borrow for services that he views as essential. He fears that local governments, under pressure from private economic interests, would be tempted to use their borrowing capabilities to promote private economic development rather than to serve essential public functions.

Mr. Sigal's paper contains two final points that deserve comment. He considers the retention of the constitutional requirement that first revenues be set aside for the payment of debt service in the event a municipality fails to appropriate funds to be of little practical importance for bondholders. Instead, he would prefer a special tax levy for debt service segregated from the general fund. Finally, he suggests that it would be appropriate to consider the question of whether or not to abandon both constitutional debt limits and constitutional tax limits.

Following Mr. Sigal's paper is a lively discussion of the Proposals,[8] involving Edward Kresky, Vice-Chairman of the Municipal Assistance Corporation, Professor Stephen Lefkowitz of Columbia Law School, and Donald J. Robinson, Esq., of Hawkins, Delafield & Wood. Mr. Kresky recounts his experience with constitutional revision during the Rockefeller administrations and comments, in light of this experience, on both the Committee's proposals and the work he sees ahead in implementing them. Professor Lefkowitz and Mr. Robinson, as members of the Committee, defend the Committee's work against Mr. Sigal's spirited criticism.

The Proposals, as well as Mr. Sigal's paper, acknowledge that the concept of "public purpose," whether it is explicit in the constitution or derived by judges, is a fundamental limitation on the exercise of legislative power. One question left somewhat unresolved by the discussions at the symposium is whether or not the concept of "public purpose," a demonstrably open-ended concept like "due

8. *See* Discussion, *infra* at 53.

process," "equal protection," or "general welfare," may be given content for purposes of explaining or guiding legislative action. A closely connected question, of course, concerns the role of the courts in delineating the scope of this concept as it operates as a purported limitation on the exercise of legislative power.

Currently, the effect of state law, in its constitutional and judge-made manifestations, is that public funds are required to be spent (and public credit lent) for public purposes, subject to a kind of categorical presumption, made explicit in the constitution, that to permit gifts and loans of money, credit or property by local governments will not, except in specifically enumerated cases, serve public purposes. The Committee's Proposals indicate its belief that this approach is unsound. The rationale for the Proposals is that such gifts and loans can serve public purposes and ought to be permitted when they do; and that the normal political processes at the state level, constrained by the availability of judicial review, can be entrusted to keep local government activity within proper bounds.

Mr. Sigal is more skeptical. He suspects that the "gifts and loans" provision has basically succeeded in limiting public sector involvement in the private sector and that this, in the long run, serves the public interest. If the line between public and private sectors is to be crossed, he would prefer a specific constitutional provision marking the bounds of the planes on which the public and private sectors are permitted to overlap, *e.g.*, housing, economic development. Mr. Sigal questions whether the normal political processes can be trusted, for he fears that the public sector may be drawn into the private sector through these processes, with results that will not be in the long-term best interests of the state.

When the public sector is drawn into the private sector through, for example, the gift or loan of public credit, the result is a *subsidy* for the activity involved. That activity is thereby made in some respect more profitable to those who undertake it than would otherwise be the case, and thus, more resources are drawn to it. The policy question with its obvious legal consequences is: when, in theory at least, is a subsidy for a public purpose? The answer turns on the content of the open-ended concept "public purpose," and in this connection lawyers indeed have a rich literature, for judicial opinions analyzing when particular governmental acts constitute a public purpose are not hard to find. The problem lies in organizing

the varying factual circumstances from which the cases arise, the language of the opinions, and the actual decisions into a theoretically coherent pattern that can provide both an explanatory and a normative framework for public policy. Although such a study, even limited to New York, is beyond the scope of this essay, it is possible to make certain tentative suggestions.

The disparate elements of the concept "public purpose" might fairly be arranged around two central notions: that of *efficiency,* in its broad allocative sense of maximizing the value of all resources, and that of *equity,* in both its substantive sense of distributive justice and its procedural sense of due process. The former concerns the size of society's "pie," as it were; the latter concerns both the size of each person's slice and the procedures for determining the size of each slice. In short, it might be said that a "public purpose" is served by government action that obtains the efficient use of resources (again, not in the narrow sense of technical, least-cost-per-unit efficiency, but in broad sense of maximizing value, taking account of all costs, including social costs) and divides the fruits of those resources in an equitable manner.[9] Although the requirements of efficiency and equity may at times coincide or substantially overlap, there is an obvious tension between the two; and much, if not all, public involvement in the private economic sector can be explained (or evaluated) in terms of how society is willing to (or ought to) resolve this tension.

If one views the discussion of whether or not to revise the "gift and loan" provision in this context, the question for legislators is when does a state subsidy enhance efficiency without creating undue substantive or procedural inequities. However the legislature may decide this question, the second of our original questions remains—what is the role of the courts in reviewing a legislative action when the concept "public purpose" is the constitutional restraint?

In answer to the first question, economists tell us that the private sector allocates resources most efficiently under circumstances in which competitive markets, trades or exchanges exist or are easily

9. For a similar theoretical analysis of the concept "public interest" by an economist with an interest in legal institutions, see B.A. WEISBROD, J.F. HANDLER AND N.K. KOMESAR, PUBLIC INTEREST LAW: AN ECONOMIC AND INSTITUTIONAL ANALYSIS 4-29 (1978).

arranged. In such circumstances, it would be unwise, under efficiency criteria, for the government to intervene by subsidizing private economic activity, for example, through the gift or loan of credit. When markets work, subsidies are inefficient and should be avoided.

There are, however, circumstances in which the private sector might fail to allocate resources efficiently—circumstances of "market failure."[10] These circumstances are frequently said to include instances of *natural monopoly*, where the cost of providing additional units of the goods or services in question continues to decline, so that a single firm is the most efficient provider. They are also said to include *public* or *collective-consumption goods*, where once the good is provided at all, it is, like national defense, more efficiently made available to all without charge, either because exclusion is too costly or impossible, or because, if one person's consumption of the "good" does not reduce another's, does not "cost" anything, it would be inefficient to charge a positive price. Under circumstances of market failure owing to the presence of natural monopoly or public goods, governments commonly provide the good or service directly (*e.g.*, police protection, aerial spraying of mosquito breeding areas, a lighthouse) or strictly regulate the provision of these goods or services (*e.g.*, public utilities). Both types of government involvement are aimed at enhancing efficiency; neither raises particularly difficult state constitutional issues. Markets fail, however, for other reasons and economists have identified additional interrelated instances of market failure relevant to the question of public involvement in the private sector—*external effects* and *transaction costs*. In the event of this sort of "market failure," a case can be made, on *efficiency* grounds, for government subsidies.

If an activity generates beneficial *external effects, i.e.*, benefits to "third parties" who themselves bear no corresponding costs of the activity, many economists believe that a government subsidy, which could well take the form of a gift or loan of money, property or credit, would actually enhance efficiency, by correcting for the market's failure adequately to reward the activity in question. If these external or "spillover" benefits remain uncompensated,

10. Bator, *The Anatomy of Market Failure*, 72 Q.J. ECON. 351 (1958). *See also* Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141 (1979).

"true" demand for the activity—represented by the price "third-party" or "free-riding" beneficiaries would pay not to be excluded from the spillover benefits—is not reflected in the market, and there is a resulting under-investment in the activity.[11]

Thus, for example, a subsidy to encourage a private developer to transform a blighted area into an urban environment with magnificient architecture and other amenities benefiting many surrounding landowners and residents, perhaps even the entire municipality, may serve a public purpose grounded in efficiency. This is so because without the subsidy the developer may choose instead to develop the property in a manner that would lower his own costs and increase his own, instead of the municipality's, return. Likewise, a private firm may not wish to invest resources, as a pioneer economic development firm, in a blighted area with an untrained workforce, for by training workers, who are themselves mobile, the pioneer firm may bestow uncompensated benefits on other (competing) firms if the newly trained workers then seek other employment. A government subsidy might be justified in this case, on efficiency criteria alone, in effect to capture for the pioneer firm the fruits of its original investment in "human" capital.

The reason why the market is often unable accurately to reflect the demand for external benefits is that *transaction costs* involved in transmitting information about demand from potential consumer-beneficiaries to potential producers are too high.[12] This is particularly apparent in situations giving rise to "free-rider" problems, *i.e.*, where it is too costly or impossible to exclude non-paying beneficiaries who have no incentive to disclose their true demand. In these situations, corrective action by governments in the form of subsidies can operate to enhance efficiency.[13] This is so because the political process can serve as a surrogate market for reflecting the direction and intensity of the consumer-voter demand for external benefits that was not reflected in the market and the subsidy can serve as a surrogate price increment for compensating the producer

11. For a comprehensive analysis of the "free-rider" problem, see M. OLSEN, THE LOGIC OF COLLECTIVE ACTION (1965).

12. The seminal article directing the attention of legal scholars to the problem of transaction costs is Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

13. For my views on the efficacy of subsidies in another context, see Schwartz & Harper, *The Regulation of Subsidies Affecting International Trade*, 70 MICH. L. REV. 831 (1972).

of external benefits. As a result, the public purpose in enhancing (overall) efficiency can be achieved. Thus, to the extent that the concept of "public purpose" is grounded in the notion of efficiency and the current "gift and loan" is intended to insure that public action in the long run serves a public purpose, the current provision does not seem to correspond with its own purpose.

In this market-oriented view of the political process a good legislator is just as sensitive to non-market, consumer-voter demand as a good entrepreneur is to consumer demand in the private sector. But this view of the process may ultimately take us too far. Under this view, the political process, over time, in a continuum of votes and vote-trading in the legislative arena, reflects both the direction and the intensity of *all* consumer-voter preferences, which are themselves grounded in self interest. It follows that, unless we derive some norm (perhaps a moral norm) that is *independent* of the preferences of individual voters, the actual results of this process are interchangeable with the concept "public purpose." Accordingly, "public purpose" becomes no less (and no more) than an aggregation or calculus of private purposes as registered and measured in the political market. The concept of "public purpose" would then cease to be a limitation on legislative action because the accumulated results of legislative actions, over time, define the concept "public purpose." It follows that there is no room for judicial review of the substance of legislative acts, so long as the formal requirements of enacting legislation have been met. Although the *results* of "rational basis" review of the substance of legislative acts suggest that this level of review actually provides no judicial scrutiny, there seems to be a consensus among lawyers that judicial review ought to be, and is, more substantial than purely formal review of the process.[15] And this leads us to the second central notion of the concept "public purpose," the notion of equity.

The notion of equity has two components: (1) that of justice or fairness in the distribution of resources or wealth, and (2) that of justice or fairness in the processes (for purposes of our discussion, the *legislative* processes) by which this distribution is decided. The

14. For a full elaboration of this view of the political process and the function of constitutional rules, see J.M. BUCHANAN & G. TULLOCK, THE CALCULUS OF CONSENT (1962).

15. *See* Michelman, *Political Markets and Community Self-Determination: Competing Judicial Models of Local Government Legitimacy*, 53 IND. L.J. 145 (1977) [hereinafter cited as Michelman].

balance of this section suggests how a concept of "public purpose" that entails this notion of equity, as well as the notion of efficiency, may serve as a meaningful restraint on legislative action by allowing for judicial review with more bite than review of the purely formal requirements of the process of enacting legislation and, at the same time, remain reasonably consistent with the market-oriented view of the political process outlined above.

Legislative acts that redistribute wealth from the more to the less fortunate would serve a "public purpose" grounded in distributive justice. The current "gift and loan" provision in effect recognizes this, *e.g.*, by excepting gifts to charities from its prohibitions. The Committee's proposal would make straightforward redistributive measures even less complicated. But the prohibition itself may serve a distributive function, in the context of the market-oriented view of the political process developed here, by preventing an effective redistribution from the less to the more fortunate. The "gift and loan" provision could in principle be based on the idea that, because inequitable wealth distribution affects the ability of different individuals and groups to register the direction and intensity of their preferences in the political process, there is a risk that through the political process the more fortunate will extract an unfair share of benefits from the less fortunate. In this view, to prohibit subsidies in the form of gifts or loans of public money or credit, even though these subsidies may frequently be efficient, may be more desirable in the long run than continually to risk the unacceptable consequences that an initial unfair distribution of wealth is likely to produce.

It must, however, be recognized that the outright prohibition of efficient subsidies, even in the interests of distributive justice, may involve substantial social costs. The Committeee recognizes this in recommending the effective elimination of the outright prohibition. Its recommendation, however, raises the question of how long-run concerns for distributive justice may continue to be recognized, and the answer must be found in the concept "public purpose" included in the recommended provision. But this raises an additional question—how should the judicial branch construe the concept "public purpose," standing alone as a restraint on legislative action, in a manner that recognizes the concern for distributive justice just described without substituting its own conception of distributive jus-

tice for that of the legislative branch?

In disputes over gifts or loans of public money or credit it is not immediately apparent how a court could invoke any level of strict scrutiny of legislative acts that derives solely from the concept "public purpose," without making an independent judgment—independent, that is, from the calculus of private judgments reflected in the political process—about how resources ought to be distributed in the first place. To invalidate social and economic legislative acts on the basis of that judgment would be to return to (discredited) *Lochner*-era judicial review. Although this mode of judicial review may well have been resurrected in cases where so-called "fundamental rights" are involved, "fundamental rights" would rarely, if ever, be involved in "gift and loan" cases.[16] This sort of judicial review would not be reasonably consistent with either the view of the political process discussed here or the consensus among lawyers about the appropriate scope of review. Thus, at this point, it may be said that the Committee's proposed revision, by substituting the concept "public purpose" for the flat prohibition of the "gift and loan" provision, has effectively removed a check on legislative power (assuming, of course, that it has, as Mr. Sigal asserts, operated as a check on legislative power) that may in principle have been grounded in equity, in order to increase legislative power to enhance efficiency. So stated, the trade-off involved could well have presented a more difficult policy choice than the Committee's Report indicates. However, the trade-off involved is not so clear-cut for three reasons. First, it is uncertain how effective the "gift and loan" provision has been. Second, it is not at all clear that the core justification for the provision may be found in considerations of distributive justice. Finally, even if the provision has been effective and is partly grounded in distributive justice, we may justify a meaningful judicial review based on the concept "public purpose" that is also consistent with both the conventional view of the appropriate scope of judicial review and a market-oriented view of the political process. To see how this might be done, it is useful to turn to the *process* component of the notion of equity discussed here, which is, as we

16. For a refreshing view of the problem of invalidating legislation on the grounds that "fundamental rights" are at stake, see Ely, *Forward: On Discovering Fundamental Values*, 92 HARV. L. REV. 1 (1978). ("We like Rawls, you like Nozick. We win, 6-3. Statute invalidated.")

have seen, derived from the concept "public purpose."

The idea that the legislative process itself ought to be fair in allocating resources for purposes of efficiency and in distributing wealth for purposes of equity is closely related to the foregoing discussion of distributive justice but is ultimately separate and distinct. This is so because the process itself may be inherently biased in favor of, or against, certain individuals or groups for reasons that are unrelated to an existing, unfair distribution of wealth.

For example, if certain individuals are able, through some form of organization, to *aggregate* or *concentrate* their wealth, they may also be able to influence the political process more effectively than may (otherwise similarly situated) individuals, whose wealth is more dispersed. In this case, the actual direction and intensity of individual preferences may not be reflected in the political process. This is the sort of problem, a "government failure" analogous to a "market failure," that may really worry Mr. Sigal when he expresses fear that local governments may choose to subsidize private economic interests instead of providing essential services.[17] It is also the core justification of the current "gift and loan" provision: to prevent inherent biases in the representative political process from working unfairly in favor of certain individuals or groups. In other words, because governments, like markets, may sometimes "fail," the "gift and loan" provision may in the long run insure that the process works fairly, even at the cost of precluding efficient subsidies. But this view of the "gift and loan" provision provides us with an interesting twist. If the core justification of the provision is to be found in concerns about process, and by implication only incidentally in concerns about distributive justice, perhaps the principal aim of the provision may be accomplished without continuing the prohibition of efficient subsidies. That is to say, if courts may closely scrutinize the *process* by which gifts or loans of public money or credit are made, deriving their power from the concept "public purpose" developed here, there may be firm justification for removing the flat "gift and loan" prohibition from the constitution and relying instead on the concept "public purpose" to restrain legislative action. Under this view, the concept of public purpose may restrain legisla-

17. For a recent theoretical analysis along analagous lines, see Wolf, *A Theory of Nonmarket Failure: Framework for Implementation Analysis*, 22 J.L. & ECON. 107 (1979).

tive acts in a way that is reasonably consistent with both the model of the political process developed here and a consensus about the appropriate scope of judicial review.

The manner in which the United States Supreme Court invokes strict scrutiny to protect "discrete and insular minorities" from the actual results of the normal political process is similar to the process-oriented review described here.[18] To the extent the normal political process reflects the direction and intensity of individual and group preferences, it does so over time through a series of bargains and vote-trades and compromises, as all individuals and groups, through their representatives, participate in this process. If a particular group, and derivatively the individuals comprising that group, is denied the chance fully to participate in the give-and-take of this process—if this discrete and insular group is *always* in the minority—the direction and intensity of the preferences of its individual members will not in fact be accurately reflected through the process. Under these circumstances, the court will invoke strict scrutiny, because the process itself may be *unfair,* having denied full access to some individuals and not to others similarly situated. It may moreover be *inefficient* because all individual preferences are not registered, measured and reflected in the results of the process.

The structure of analysis of "discrete and insular minorities" in the political process is parallel to the structure of analysis of inherent biases in the political process. The latter suggests that the political process may, for different reasons, fail to account for the direction and intensity of individual preferences. It further suggests that in reviewing legislative action, with "public purpose" as the only restraint, courts may be best equipped to identify the flaws inherent in the process. More precisely, courts would closely scrutinize the process of deciding which person or firm, under what conditions, may receive a subsidy in the form of a gift or loan of public money or credit. Courts would do this by testing whether or not, in the delegation of powers to local governments, procedures, standards and guidelines are sufficient to account for biases in the normal political processes. In light of this test, the legislature would be constrained to insure that standards and procedures account for the

18. *See* Ely, *Toward a Representation-Reinforcing Mode of Judicial Review*, 37 MD. L. REV. 451 (1978).

biases likely to give rise to abuse. This kind of judicial scrutiny is consistent with, and in fact, is designed to reinforce, the view of the political process described here. It is also consistent with conventional notions of the appropriate scope of judicial review, for courts are institutionally well-equipped to undertake a review of challenges to the adequacy of procedures.

We may now summarize what the Committee's proposed revision may accomplish in light of our analysis of the concept of "public purpose." Close judicial scrutiny, on "public purpose" grounds, of the process of giving or lending public money or credit may achieve what the current "gift and loan" provision principally seeks to achieve without prohibiting efficiency-enhancing subsidies. This latent inefficiency in the current provision may well be the cause of the continuing assault on its strict application which has shaped and may continue to influence its meaning over time in our system of common law adjudication of public law issues.[19]

There should be virtually no "public purpose" review of the allocative efficiency or distributive justice of legislative acts in the area of "gifts and loans" for the political process is the appropriate forum for arriving at these substantive decisions. This essay suggests that it is difficult to justify even "rational basis" review of legislative judgments of public purpose on substantive grounds if one accepts the market-oriented view of the political process described here. Finally, if the legislative history supporting a proposed revision of the "gift and loan" provision clearly delineates the concept of "public purpose," there should be no need either to define the concept explicitly in the constitution or to list specific conceptions of a public purpose, *e.g.*, certain types of housing or economic development, in the document. There would, of course, be no need for the curious syntax of the Committee's proposed revision, but then again, as Professor Lefkowitz indicates in the panel discussion, the political process may sometimes have its irrational demands.

II. Proposed Disclosure Legislation

The Committee's disclosure proposals[20] place responsibility for

19. For a full elaboration of an economic theory of the common law process, see Rubin, *Why is the Common Law Efficient*, 6 J. LEGAL STUD. 51 (1977); Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977). *See also* Michelman, *supra* note 15, at 146-47.

20. *Proposals, supra* note 1, at 92-101.

disclosure in connection with the offer and sale of local government securities at the state level rather than at the federal or local level. They are designed to provide full and accurate disclosure of local government finances to voters, investors, and the media. The proposed legislation would accomplish this objective by requiring local governments to prepare narrative, readable documents for the purpose of disclosing both the problems facing them and the plans local officials have devised to meet those problems. Further, local governments throughout the state will be required to prepare uniform financial reports.

The Proposals rely on three elements to meet the Committee's goal of full and accurate disclosure: 1) a disclosure document (the "official statement") to provide investors with information in connection with the offer and sale of local government obligations, 2) summarized periodic reporting (the "summary annual report") and 3) timely independent examination of financial practices and accounts. At the state level, primary responsibility is placed in the office of the state comptroller.

Specifically, the Committee has proposed an amendment to the Local Finance Law requiring an "official statement" to be filed by local governments prior to the sale of their bonds or notes in a format designated by the comptroller. In devising the format of this disclosure document, the comptroller is required to consider disclosure guidelines promulgated by the Municipal Finance Officers Association [MFOA]. Under certain circumstances, the comptroller may exempt localities from this filing requirement.

The Proposals would also amend the General Municipal Law to require the filing of a new report. This report, the summary annual report, would contain information currently required to be reported as well as a narrative discussion of material facts, trends, and other information not currently reported. To eliminate duplication of effort and reduce expense, the Proposals allow the information in the new summary annual report to be incorporated by reference in subsequent official statements.

Finally, the Committee's proposal would amend the General Municipal Law to require the comptroller to examine unaudited summary annual reports, or as an alternative, to permit local governments to submit independently audited reports.

Mr. Currier's paper[21] surveys the various methods for encouraging financial disclosure in connection with the offer and sale of state and local government securities and compares the Proposals with those found in recent federal proposals and the MFOA Guidelines. He concludes that the Committee's proposals, though less effective than uniform national standards for protecting investors in a national market, are not demonstrably inadequate to this task. He believes that when the costs of federal intrusion into the affairs of state and local government are taken into account, the Committee's proposals are preferable to federal regulation.

Protecting investors, Mr. Currier points out, is not the only aim of the disclosure proposals. The state has an important interest in protecting its own access, and the access of its municipalities, to national credit markets. This, he asserts, gives the state such an immediate and compelling interest in regulating municipal disclosure that state regulation is preferable to regulation by any agency of the federal government.

In the discussion that follows, Professor John C. Burton of the Columbia University Graduate School of Business disagrees. Addressing himself both to the Committee's disclosure proposals and to its fiscal monitoring proposals which are discussed in the next section of this essay, Professor Burton suggests a number of changes in the Committee's approach. He argues that regulation should be national and that the Securities and Exchange Commission [SEC] would be the appropriate regulatory body. He further criticizes the Committee for ignoring the responsibilities of underwriters, for failing to come to grips with the difficult distinctions between budgeting (including capital budgeting) and accounting concepts, for not providing for sufficiently timely reporting for large municipalities, for not dealing at all with the problems of internal financial and accounting standards to be used in a comptroller's examination, and, finally, for not requiring that municipalities qualifying for exemption from a comptroller's examination use generally accepted accounting principles.

Mr. Robinson, who also participated as a Committee member in the panel discussion of the proposed Local Finance Article, agrees

21. Currier, *Mandating Disclosure in Municipal Securities Issues: Proposed New York Legislation, infra* at 67.

with the concept of protecting investors with some nation-wide standard for disclosure, but feels that this can be adequately handled if the different states adopt the MFOA Guidelines. He also indicates that a nation-wide scheme for regulation administered by the SEC would increase the cost of issuing debt without sufficient corresponding benefits.

Defending the Committee, Roswell B. Perkins, Esq., of Debevoise, Plimpton, Lyons & Gates, compares the experience of a corporate securities lawyer in creating disclosure guidelines to fitting a Neanderthal into a tuxedo, a metaphor many bond lawyers will no doubt find enchanting. Responding to Professor Burton, he argues that it is simply unrealistic to expect disclosure devices in local finance to reach the level of sophistication normally expected in corporate finance. The Committee therefore decided to propose attainable goals and workable methods, which, in the course of his talk, Mr. Perkins describes and explains. He disagrees strongly with Professor Burton's suggestion that the SEC be granted regulatory powers over the offer and sale of local government securities; he is worried not only about the implications of such a system for traditional notions of federalism, but also, on a more practical level, that "some little town in Nevada might have to send its comptroller down to deal with the Office of Municipal Disclosure in Washington, D.C." each time it wishes to bond for, say, a firehouse.

The discussion of the problem of disclosure in connection with the offer and sale of local government securities is made especially difficult by two dimensions of the problem: the economic and the political. Divorced from the political, the economic problem of disclosure would be to devise a system of legal rules that would be likely to produce the *optimal* amount of information so that the market (in this case, the market for local government securities) would function fairly and efficiently. It is useful to recall from our discussion of public purpose that the two concepts, fairness and efficiency, may mean the same thing in the market context. The optimal amount of information, of course, need not be "perfect" information or "full" information. Once it is recognized that information is costly to produce, the "optimal" amount of information becomes the amount that is cost-justified. So long as the additional cost of producing the information is exceeded by the additional benefits derived, production of information is cost-justified. The term "cost"

is used here to include all costs—not just out-of-pocket expenses, but the real costs involved when, for example, liability rules create disincentives to otherwise desirable activity.

The economic dimension of the problem of disclosure is sufficiently complex in its own right to merit the considerable attention it has been paid, not only in the law of securities regulation,[22] but in the law of contracts[23] and products liability[24] as well. But any serious treatment of the problem of disclosure as it relates to the offer and sale of local government securities must also consider the political dimension of the problem. An examination of the political dimension of the problem requires a theoretical inquiry, because the nature of the polity may be significantly different from the nature of the firm. It also requires a practical inquiry because the United States Supreme Court has recently revitalized at least one aspect of the concept of federalism by invalidating federal regulation of certain local government activities and because the Court has traditionally extended special protection under the first and fourteenth amendments to political expression. To disentangle the various strands of the economic problem, to shape them into a coherent theory of regulation, and then to demonstrate the extent to which considerations of federalism and political liberty might change or even transform this theory is, needless to say, a study well beyond the scope of this introductory essay. It may be useful in this context, however, to sketch the course such a study might take.

I believe such a study would begin by attempting to unravel the economic problem, *i.e.*, to devise a system of legal rules that would lead to the optimal level of investment in the production of information, particularly in connection with the offer and sale of local government securities. There is a rich literature on the general subject of the economics of information that has only recently found its way into the discussion of legal rules, mainly in analysis of the law of contracts, products liability and consumer protection. This analysis deals with the basic economic problem of disclosure, unencumbered

22. *See* H.G. MANNE, ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES (1969). *See also* H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 62-139 (1979) for a recent criticism of the SEC's failure to take account of economic analysis in devising disclosure policy.

23. *See* Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978).

24. *See* Note, *Promoting Product Quality Information: A Proposed Limited Antitrust Exemption for Producers*, 30 STAN. L. REV. 563 (1978).

by considerations of corporate structure and responsibility. The point here is that it may be better to begin basic theoretical work on the problem of municipal disclosure by applying this analysis to the problem than to begin such work by simply incorporating principles of corporate securities law. This is particularly so if an analysis of the political dimension of the problem would lead in an entirely different direction from the analysis of corporate problems. Since work on the problem of disclosure in the local government area is in its early stages—the Neanderthal has not as yet been outfitted—it seems to be important to get the theoretical framework right.

Stripping down the economic dimension of the problem would require a number of complex issues to be addressed before the disclosure regime might safely be reconstructed. For example, in devising a legal framework for encouraging optimal investment in the production of information, what would be the function of liability rules, and of concepts like privity, materiality, reliance, causation and *scienter*? Should granting property rights in information, which is the functional equivalent of permitting *non*-disclosure, ever be permitted in the issuance or trading of local government securities? Does it make a difference how information is acquired—whether private or public resources are spent in its acquisition? To what extent does a public "full" disclosure regime reduce the incentive privately to acquire information in a more efficient fashion? How should standards of care for public officials be developed that are consistent with the policy goal of providing optimal information and the policy goal of encouraging public service? To respond to these, and many other questions is, however, to attempt to solve only one dimension of the problem. The problem, in its political dimension, is perhaps as difficult.

At the threshhold institutional level stands the tenth amendment to the United States Constitution, which, according to *National League of Cities v. Usery*,[25] may prohibit federal regulation under the Commerce Clause that unduly interferes with the integral governmental functions of local governments. Unraveling *National League of Cities* is a job in itself,[26] but the case neverthe-

25. 426 U.S. 833 (1976).

26. *See* Tribe, *Unraveling* National League of Cities. *The New Federalism and Affirmative Rights to Essential Government Services*, 90 HARV. L. REV. 1065 (1977). *See also* Kaden, *Politics, Money, and State Sovereignty: The Judicial Model*, 79 COL. L. REV. 847 (1979).

less indicates the current Court's interest in preserving a considerable degree of state and local autonomy when essential services—the services normally financed by issuance of local government obligations—are involved. If federal regulation of local government securities will impose costs as high as some of the panel members indicate, it might impermissably invade the protected zone of state and local autonomy.

The more intricate problem, however, seems to involve the special constitutional protection accorded political expression. Especially when problems of local government are severe enough to warrant great concern over the problem of disclosure, the notion of what constitutes materially accurate information for a reasonably prudent investor begins to clash with the notion of what constitutes free and open political discussion, debate and disagreement. As anyone who has worked on disclosure documents during the troubled period of New York City's financial crisis may attest, the clash can be tangible and tense. The costs of producing the optimal amount of information, if those costs are measured in terms of political liberty, may become very high indeed.

The political dimension of the problem of disclosure thus involves a curious reversal of the issues in *First National Bank v. Bellotti.*[27] That case involved the right of a private, corporate entity to unfettered political expression, presumably in the economic interests of its stockholders, in the face of a regulatory regime imposed to achieve ends that were political at the core. Involved here is the right of a public, governmental entity to unfettered political expression, presumably in the political interests of its citizens, in the face of a regime imposed to achieve ends which are economic at the core. The differences between the nature of the firm and the nature of the polity may well affect any assessment of the regulatory regimes.

In sum, there is a need for a comprehensive study of the economics and politics of the problem of disclosure in connection with the offer and sale of local government securities. The Committee's Proposals are fundamentally correct in that they seek cost-justified methods of producing information, constrained by a sense that the concept of federalism and the social costs of imposing liability on public officials are important considerations.

27. 435 U.S. 765 (1978). *See also* Anderson v. City of Boston, 75 Mass. Adv. Sh. 2297, 380 N.E.2d 628 (1978), *appeal dismissed*, 99 S. Ct. 823 (1979).

III. Proposed Fiscal Monitor Legislation

The Committee also drafted legislation to implement the balanced budget requirement found in its proposed Local Finance Article.[28] The draft legislation grew out of a commitment to three principles:1) that monitoring should be increasingly rigorous as financial difficulties become more severe, 2) that the state comptroller should set standards for what constitutes a balanced budget, and 3) that the comptroller should have authority to go to court to compel compliance with local finance laws and regulations.[29] Underlying all of these principles, of course, is the notion that the state has important responsibility for monitoring local finances.

The Committee's proposal requires all local governments to submit annual budgets to the state comptroller, and requires local governments that have incurred substantial deficits to submit these reports on a quarterly basis. The Proposals rely on *ad hoc* future legislative action to establish emergency financial controls in cases of impending financial crisis.

The Committee's proposed legislation grants the state comptroller plenary power for setting standards for reporting and accounting. It further authorizes the comptroller to seek judicial enforcement of the balanced budget requirement found in its proposed Local Finance Article, although the Committee seems to focus more on the practical leverage this power gives to the comptroller than on the discretion this power seems to give to the courts.

Mr. Elliott's paper[30] examines the Committee's proposals on fiscal monitoring in light of the monitoring systems employed in Pennsylvania (which imposes reporting requirements on local governments, but does not permit state supervision of local budgeting) and in New Jersey (which imposes strict state supervision and control over local budgeting). He criticizes the Committee's proposal for granting enforcement powers to the judiciary and would instead prefer a system in which the comptroller had an administrative remedy. He also favors legislative sanction for "standby" financial control boards which could be convened by the state comptroller.

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28. *Proposals, supra* note 1, at 101-05.

29. *Id.* at 64, 101-05.

30. Elliott, *Proposed Fiscal Monitoring Legislation in New York, A Comparative Analysis, infra* at 109.

The ensuing discussion is dominated by those in the public arena. James L. Magavern, Esq., counsel to State Comptroller Edward V. Regan, indicates his doubts about whether regulations in this area will ever be able to restrain public officials in the face of political realities. He suggests that perhaps the comptroller has been granted too much power by the Committee's proposals, and as an alternative, would consider establishing an "ongoing financial review process in local government" with quarterly review responsibilities.

James A. Brigham, Jr., New York City's Director of the Office of Management and Budget, confined his remarks to the balanced budget requirement. Mr. Brigham endorses the constitutional requirement, but recommends that the proposed legislation adopt specific standards and require the state comptroller to mandate generally accepted accounting principles for local governments. He would allow the comptroller to permit justified exceptions to these principles for limited periods but he would not permit the comptroller to require exceptions to generally accepted accounting principles.

Finally, John C. Bender, Esq., General Counsel to the Financial Control Board for New York City and a member of the Committee, defends the Committee's decision to maintain what he describes as a flexible approach to fiscal monitoring. Mr. Bender disagrees with Mr. Magavern's suggestion for a simple solution to budgetary review and comments on the intricate interplay between the concept of a balanced budget and the standard of generally accepted accounting principles. In conclusion, he offers some observations, influenced by his recent experience in the work of financial monitoring, on the prospect of state monitoring of such local matters as taxes *per capita,* debt *per capita,* and operating expenses *per capita.*

If the financial crisis in New York City accomplished nothing else, it underscored the financial interdependence that exists between the state and (at least some of) its municipalities. The fact of this interdependence is important for deciding the weight one wishes to accord principles of home rule in evaluating proposals for state supervision of local government borrowing and finance.

A few states, such as New Jersey and West Virginia, exercise substantial control over local government finance, and some exercise no control at all. The great majority of states exercise some

fiscal controls falling short of complete supervision. The Committee's Proposals would place New York in this latter group.[31]

In the context of fiscal emergency, particularly in light of New York City's preeminence among the state's municipalities, the proposed control mechanisms appear a reasonable balancing of home-rule interests and state-wide concerns. State controls do not, however, come totally without cost. To grant state officials the power to require local officials to correct budgetary or reporting deficiencies risks encouraging state involvement in substantive affairs at the local level and, by inference, injecting state political considerations into local matters. It is here that even the more desirable aspects of home-rule autonomy may in the long run be jeopardized.

An interesting issue, which the Committee's Report deals with mainly by implication and which was not discussed at the symposium, is whether or not in an age of metropolitan interdependencies the principles of home-rule have become anachronistic, even with respect to matters other than financial reporting and budgeting. The problem is particularly acute when matters traditionally regarded as purely local in nature, like garbage collection, begin to involve substantial external effects, *i.e.*, when a municipality's method of dealing with a particular problem imposes substantial costs or bestows substantial benefits on other municipalities. It is in this type of situation that some form of regional governmental unit—for special or even general purposes—may be a fair and efficient way of providing services and regulating activities. The Proposals properly provide for the creation of this new form of local government.

IV. Conclusion

The Committee's Proposals are an important set of recommendations for making local finance law in New York more effective. The Fordham symposium was held, and this volume undertaken, in order to encourage further study and work toward this end. Evan Davis, who was chairman of the subcommittee that prepared the Proposals, has also recommended the creation of a new State Temporary Commission, the principal function of which would be to

31. *See* ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, CITY FINANCIAL EMERGENCIES: THE INTERGOVERNMENTAL DIMENSION 32-33, 63, 70-71 (1973).

study the issues and prepare recommendations. Creation of this Temporary Commission would be a logical step in the continuing effort to improve local finance law in the state.