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Citizens Versus Bondholders

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CITIZENS VERSUS BONDHOLDERS

*Richard C. Schragger**

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INTRODUCTION

I own municipal bonds: Lowell, Massachusetts general obligation bonds; New York Metropolitan Transit Authority Bonds; revenue bonds issued by the Philadelphia Water and Wastewater Authority; some bonds issued by the city of Virginia Beach. I also live in the city of Charlottesville, Virginia, own a home and pay property and other local taxes there.

As a bondholder, do I pay attention to Lowell’s, Philadelphia’s or New York City’s fiscal behavior? Do I know what these cities and public authorities are doing with my money? Could I tell you whether those bond issuers are good, bad, or indifferent managers?

Similarly, as a resident and citizen of Charlottesville, do I pay attention to the city’s fiscal behavior? Do I have any idea what Charlottesville’s budget is? (I do, but only because I teach local government law.) Could I tell you whether the city is a good, bad or indifferent manager?

In both these roles — as a bondholder and as a citizen — my incentive and capacity to monitor local government is limited. It is not nonexistent, but it is quite crude. Assuming that is true, what are the institutional mechanisms that encourage local governments to keep

* Professor of Law, University of Virginia School of Law. This Essay is expanded from remarks presented at the *Cooper-Walsh Colloquium*, “Big Problems, Small Government: Assessing the Recent Financial Crisis’ Impact on Municipalities,” held at the Fordham Law School on November 11, 2011. Thanks to Clayton Gillette for providing the excellent paper to which this Essay is a response, to the organizers and participants for a stimulating conference, and to Risa Goluboff for reading prior drafts.

their fiscal houses in order? Moreover, in these times of fiscal distress, what are the implications of favoring bondholders or citizens when local governments come under fiscal stress and cannot pay their bills? Who should bear the risk of a default—citizens through tax hikes or bondholders through losses? And can the appropriate allocation of priority at the default stage help to prevent local fiscal distress in the first place?

These are centrally important questions as cities and other local authorities experience financial crises in the aftermath of the recent economic recession.¹ These are also the questions that Professor Clayton Gillette asks in his contribution to this Colloquium.² Gillette ultimately concludes that bondholders are in a better position to monitor the fiscal health of local governments and should thus be charged with the risk of default when financial trouble comes along.³ He further argues that by placing the risk on bondholders, the chances of local fiscal distress will be reduced.⁴

I am somewhat less sanguine. I agree with Gillette that bondholders should be charged with the risk of municipal default, though my reasons are slightly different than his. I am also less sure than he is that such an allocation of risk will serve to prevent fiscal crises *ex ante*. And, unlike Gillette, I think that some judicial ambiguity as to the allocation of risk is not a bad thing.

In fact, Gillette's article has convinced me that neither bondholders nor citizens are particularly good monitors of local fiscal probity. If this is true, then it presents a puzzle. As Gillette observes, municipalities have significantly lower default rates than do their private-side counterparts.⁵ Why do cities have such low default rates? Why do they generally keep their fiscal houses in good order?

Gillette's article raises a second puzzle as well. He observes that nineteenth century state courts and state legislatures were relatively sympathetic to cities and their citizens, often invalidating creditors' claims and placing losses at the feet of bondholders.⁶ Twenty-first century state courts and legislatures have yet to make their sympathies fully known, but the assumption that bondholders must be paid

1. See, e.g., Monica Davey, *Darker Nights as Some Cities Turn Off Lights for the Savings*, N.Y. TIMES, Dec. 30, 2011, at A11.

2. Clayton Gillette, *Bondholders and Financially Stressed Municipalities*, 39 FORDHAM URB. L.J. 639 [hereinafter Gillette, *Bondholders*].

3. *Id.* at 677.

4. *Id.*

5. *Id.* at 665–66.

6. *Id.* at 642–43. The United States Supreme Court was less so. *Id.* at 644.

seems to dominate discussion of local fiscal crises. This raises the following question: why were state courts and state legislatures relatively sympathetic to cities and citizens in the nineteenth century and why do public officials appear to be much less sympathetic to cities and citizens now?

Part I addresses the question of municipal monitoring, arguing (though for different reasons than Gillette) that bondholders are the appropriate bearers of the risk of municipal default. Part II explains why this allocation of risk is unlikely to have any significant *ex ante* effects on local fiscal discipline. Indeed, I have argued elsewhere and argue here that “fiscal discipline” is not the central problem for local governments; their fiscal woes originate elsewhere.⁷ Part III then addresses the two puzzles raised by Gillette’s article. I suggest reasons unrelated to creditor or citizen monitoring for why local governments generally do not default. I then argue that the currently fashionable functional arguments for paying off creditors are not particularly convincing and that the choice between citizens and bondholders is ultimately a political one.

I. MONITORING AND RISK BEARING

Gillette’s argument is straightforward: legal rules allocating the risk of default as between bondholders and citizens should make the choice that will induce the party that is better able to monitor local fiscal conditions to undertake that monitoring.⁸ Bondholders are better positioned to monitor local fiscal decisions, either through the bond issuance process or by demanding *ex ante* compensation in the form of higher interest rates.⁹ Therefore, when a default occurs and courts must make a decision about who gets paid (and how much), judges should favor citizens over bondholders.¹⁰ In practical terms, courts should be more willing to impose losses on bondholders than to demand that a defaulting city raise taxes or decrease services.¹¹

7. Richard C. Schragger, *Democracy and Debt*, 121 YALE L.J. 860, 885 (2012).

8. Gillette, *Bondholders*, *supra* note 2, at 657.

9. *Id.* at 656.

10. *See id.* at 677.

11. *Id.* at 641 n.21. *But cf.* Clayton Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 281 (2012) [hereinafter Gillette, *Political Will*]. In *Political Will*, Gillette argues that bankruptcy courts should order local governments to impose tax increases to pay off creditors. *Id.* at 53. He claims that municipalities will otherwise use bankruptcy strategically to renege on debts and that such a strategic use of bankruptcy generates negative externalities. *Id.* at 41–46. Gillette’s argument in *Political Will* is in some tension with his claim that

I share Gillette's view that bondholders should bear the risk of default, but I am not certain that it is because they are better monitors *ex ante*. Indeed, problems of monitoring bedevil both citizens and bondholders.

As Gillette points out, citizen monitoring is difficult because citizen preferences are heterogeneous and the burdens and benefits of local policies are unequally distributed. The central problem is that there is no consensus on what a citizen should be monitoring *for*.¹² Because a city is not a profit-making enterprise, its performance cannot be measured by a specific financial return. Moreover, citizen preferences depend significantly on citizens' time horizons. It may not be in the interest of present citizens to monitor in ways that are beneficial to future citizens. Current debt spending, for instance, might be supported by current residents even if future residents would oppose it.

The free rider problems that Gillette points out are also difficult to surmount; any one citizen has little incentive, little expertise, and little time to monitor local fiscal health. This problem is exacerbated by the mobility of the American populace; local citizens are unlikely to monitor the long-term fiscal stability of a local government if they are not going to be there very long.¹³ And finally, monitoring of local fiscal health is of limited usefulness when the economic health of any particular locality is dependent upon wider regional or national economies. Citizen monitoring of local fiscal behavior will be ineffective if local fiscal health is driven by developments that are beyond the local government's control.

Of course, citizens have an interest in ensuring that local officials are not running the municipality into the ground. If that interest can be leveraged and free rider problems can be overcome, then monitoring might be possible. William Fischel has theorized that homeown-

citizens should be favored over bondholders as a way of enhancing monitoring. Further, his claim that municipalities will act strategically is mostly anecdotal. Municipal bankruptcies are quite rare. Kevin Kordana has argued that municipalities are unlikely to act strategically and observes that municipalities make every effort to pay their debts despite the lack of formal sanctions for default. See Kevin Kordana, *Tax Increases in Municipal Bankruptcy*, 83 VA. L. REV. 1035, 1074-75 (1997). Moreover, the bond market seems unconcerned with strategic defaults, as municipalities continue to be able to borrow at relatively low rates. *Id.* at 1075. If strategic defaults were a real concern, we would arguably see many more municipal bankruptcies and much less lending to municipalities. *Id.* at 1077.

12. Gillette, *Bondholders*, *supra* note 2, at 659.

13. Indeed, in Tiebout's theory, local citizens will not actively monitor at all. Instead, they will simply vote with their feet. See Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956).

ers in smaller jurisdictions can assess the performance of their government by treating their home values as a barometer of fiscal health. If local government performance is capitalized into home values, then “homevoters” can easily vote their interest in the stability of their property values.¹⁴ If the value of residents’ homes increase, the city is doing well; if those home values decrease, the city is doing poorly.

The difficulty is that while homeowners undoubtedly have a strong interest in maintaining the value of their homes, home values turn out to be a fairly inaccurate (and even misleading) barometer of local fiscal health. The recent housing bust provides some evidence that house values often have little to do with economic fundamentals.¹⁵ It certainly provides evidence that house values often have little to do with any particular local government’s fiscal policies. Local house values are often a result of factors outside the immediate control of local governments.¹⁶

Moreover, homeowner-based monitoring can be pernicious. Fischel’s homevoters might be eager to adopt policies that improve home values in the short term while sacrificing long-term fiscal stability, particularly in boom times. Indeed, one could argue that it was a nation of homevoters writ large that exacerbated local fiscal crises by demanding policies that artificially inflated house prices.¹⁷

Gillette argues that bondholders are better positioned to assess local fiscal health. Individual holders of bonds are not likely to monitor; the free rider and information problems are likely insurmountable. But Gillette claims that even if the owner of a single municipal bond is not equipped to monitor, institutional gatekeepers like banks, credit ratings agencies, insurers, underwriters, and large investors generally have the incentive and capacity to keep an eye on local investments.¹⁸

14. WILLIAM FISCHEL, *THE HOMEVOTER HYPOTHESIS: HOW HOME VALUES INFLUENCE LOCAL GOVERNMENT TAXATION, SCHOOL FINANCE, AND LAND-USE POLICIES* 4 (2001).

15. See, e.g., Brent Ambrose et al., *House Prices and Fundamentals: 355 Years of Evidence* (Jan. 12, 2011) (unpublished manuscript) (on file with author); Burnside et al., *Understanding Booms and Busts in Housing Markets* (Jan. 2011) (unpublished manuscript) (on file with author).

16. Jan K. Brueckner et al., *Subprime Mortgages and the Housing Bubble*, 71 J. URB. ECON. 230, 230 (2012).

17. See, e.g., *Viewpoints: The Mortgage Interest Deduction*, HUD.GOV, <http://www.huduser.org/portal/periodicals/em/spring11/highlight4.html> (last visited Feb. 2, 2012).

18. Gillette, *Bondholders*, *supra* note 2, at 670–76.

Gillette's assessment is replete with caveats, however.¹⁹ He recognizes the obvious limitations of ratings agencies and other market actors and observes that the interests of bond market makers are not always benign.²⁰ Market makers are interested in selling debt and will take advantage of both issuers and buyers, selling products of dubious quality to both sides — “trafficking in the shame of the cities.”²¹ And investors often make mistakes, underestimating the risk of exogenous shocks and overestimating the probability of repayment during flush times. Moreover, while the price of municipal debt may reflect the underlying credit-worthiness of the entity issuing the debt, it also reflects the comparative attractiveness of other kinds of investments. The market may be full of lemons. Gillette is going to have a great deal of difficulty persuading readers who experienced the recent recession — caused in large part by mispriced debt — that institutional actors will serve as responsible gatekeepers.

But even if bondholders could monitor, why would they do so when they can diversify instead?²² Monitoring is costly. Diversification reduces those costs. If bondholders act as prudent investors, they will assume some failure rate and build that into the range of their investments. And they can buy and sell their debt readily. Citizens are differently situated. They cannot diversify to any real degree. Their home is often their biggest asset and it is located in one jurisdiction.

This inability to diversify is the central difference between citizens and bondholders. The gap between them is not their respective capacities to monitor, but their respective capacities to bear risk. Citizens cannot readily hedge against downside risk; bondholders can.²³

Kevin Kordana makes this point in an important article arguing that bankruptcy courts should approve reorganization plans that do not impose tax increases on citizens but do impose some loss on bondholders.²⁴ Bondholders are more appropriate risk bearers, he argues, not because they are better monitors of local fiscal health, but

19. *Id.* at 664–70.

20. *Id.* at 671, 675.

21. *Id.* at 675 (quoting A. M. HILLHOUSE, MUNICIPAL BONDS 254–55 (1936)).

22. Gillette recognizes this in his colloquium contribution, see Gillette, *Bondholders*, *supra* note 2, at 665, and elsewhere, see Clayton Gillette, *Can Public Debt Enhance Democracy?*, 50 WM. & MARY L. REV. 937, 979–80 (2008) [hereinafter Gillette, *Public Debt*]. Nevertheless, he seems to discount it.

23. Lee Anne Fennell has written at length about this problem, and has suggested mechanisms to solve it. See Lee Anne Fennell, *Controlling Residential Stakes*, 77 U. CHI. L. REV. 143, 153–65 (2010).

24. Kordana, *supra* note 11, at 1039.

because they have been paid *ex ante* to assume the risk.²⁵ He further argues that imposing the costs of default on citizens is inappropriate and inefficient. As Kordana observes, it makes little sense to charge current residents for commitments that past residents may have undertaken.²⁶ He notes that local residents change over time and thus there is little relationship between risk-creators and risk-bearers.²⁷ He further argues that raising taxes can be inefficient, as it may induce taxpayer flight and undermine the municipality's ability to recover from fiscal distress.²⁸ Finally, Kordana asserts that bondholders are better positioned to absorb economic shocks by pricing those eventualities into the interest rate they charge.²⁹ The interest rate and diversification are the appropriate ways for creditors to protect against financial loss.³⁰ There are no equivalent mechanisms for citizens. For that reason, it makes little sense to charge residents of fiscally strapped cities in order to pay off bondholders.

II. PREVENTING LOCAL FISCAL DISTRESS

I do not think that Professor Gillette would quarrel with the basic thrust of this argument.³¹ Gillette, however, makes an additional claim. He argues that assigning the risk of default to bondholders will help prevent local economic distress in the first place.³² Bondholders will protect their investments by putting pressure on local governments to act more responsibly.³³ And local governments will respond, in part because their borrowing costs will increase if they do not.³⁴ The debt markets will provide fiscal discipline.

This view assumes Gillette's assertion that bondholders be willing and able to monitor effectively—a questionable claim, as I have argued. It also requires that bondholders be able to translate their concerns into political pressure and that local officials have the will and capacity to respond to that pressure.

25. *See id.* at 1097–99.

26. *Id.* at 1101.

27. *Id.* at 1101–02.

28. *Id.* at 1102–04.

29. *Id.* at 1100–01.

30. *Id.* at 1099–1101.

31. *But cf.* Gillette, *Political Will*, *supra* note 11, at 53 (advocating compelled tax increases in bankruptcy).

32. Gillette, *Bondholders*, *supra* note 2, at 677.

33. *See also* Gillette, *Public Debt*, *supra* note 22, at 985 (making a similar argument).

34. *Id.* at 984–85.

Certainly the bond markets, via the ratings agencies, can pressure governments to address their debt problems—though ratings downgrades seem to occur well after governments are already in fiscal trouble.³⁵ If lenders are willing to lend even to dubious projects (as they seem to be willing to do during economic booms), the market is not going to exert much of a disciplining force.

Moreover, public officials have to be willing and able to respond to the market's negative signals. It is true that as borrowing costs increase, taxpayers may have to pay more, leading them to protest. But borrowing costs depend on a host of factors that may have little to do with current officials' mismanagement. The connection between officials' actions and creditor concerns can be quite tenuous, even opaque to voters.³⁶ And because increases in borrowing costs are distributed among large populations of taxpayers and paid over many years, the marginal increased cost to any one taxpayer is unlikely to excite sustained political attention.

More importantly, as Gillette recognizes, the interests of citizens and creditors will not always or even usually overlap. If local officials are appropriately responsive to local voters, they will ignore creditor demands that are inconsistent with those interests. It is also possible that local officials will be *too* responsive to the demands of the bond market, thus diserving the local electorate. Either way, there is significant misalignment between creditor preferences and appropriate political action. Indeed, because citizens will have varied preferences, what constitutes appropriate political action will always be contested. Relying on the narrow interests of creditors to serve as a proxy for the local common good is highly problematic.

Finally, even if local public officials want to respond to creditor demands, they might not be able to do so. The view that bondholders can monitor for good local fiscal outcomes assumes that local governments assert substantial control over their economic and fiscal fates. But there are good reasons to be skeptical about this assumption. First, local governments have little control over large-scale boom and bust cycles, which are a feature of modern economies. In-

35. Consider that Greece, which has essentially defaulted, was selling debt with only a modestly higher interest rate than its peer nations just two years ago, and that ratings agencies did not downgrade Greek debt until relatively recently. See Julie Creswell & Graham Bowley, *Ratings Firms Misread Signs of Greek Woes*, N.Y. TIMES, Nov. 30, 2011, at A1. Gillette notes how ratings agencies failed to anticipate New York's financial crisis in the 1970s. See Gillette, *Bondholders*, *supra* note 2, at 672–73.

36. Schragger, *supra* note 7, at 874–75.

deed, state laws restricting debt, mandating balanced budgets, and limiting taxes and expenditures tend to exacerbate economic downturns because they prevent states and localities from engaging in countercyclical spending.³⁷ Second, local governments are compelled by state mandates to provide certain services. Unlike firms, cities cannot restructure those basic obligations. They cannot get out of the business of providing schools and minimum levels of health care and welfare services to their constituents. Third, there are often structural reasons for local fiscal failure, including the loss of a large job-creating industry or the precipitous decline in property values brought about by events beyond the localities' control. In the United States, formerly robust industrial cities are facing fiscal failure not primarily because of mismanagement (though there has been some) but because deindustrialization, suburbanization, and globalization have sidelined their once prosperous economies.

I do not mean to argue that mismanagement never occurs or that a mature bond market can never distinguish between good and bad debt during normal economic times. A well-functioning municipal bond market can and does influence government borrowers, for better and for worse.³⁸ Nevertheless, the bond market's influence is unlikely to change city outcomes in significant ways.

If mismanagement is a concern, however, then maybe the legal rules should differentiate between different kinds of fiscal distress. In the nineteenth century (and sometimes the twentieth) state courts often denied creditors relief by invalidating municipal bonds for large-scale infrastructure projects that failed.³⁹ Courts seemed to be eliminating venal deals *ex post*, often responding to popular outrage over the commitment of public monies to oversold private schemes.⁴⁰ As Gillette points out, there are many ways to muddy the Constitution's Contract Clause and state constitutional equivalents, which otherwise seem to require that municipal debtors meet their commitments to

37. *Id.* at 872–73.

38. For example, John Yinger has argued that municipal bond ratings can act as a form of redlining. He provides evidence that ratings agencies practice discrimination against places with a certain racial or ethnic composition. See John Yinger, *Municipal Bond Ratings and Citizens' Rights*, 12 AM. L. & ECON. REV. 1, 3, 6–8 (2009).

39. See ERIC H. MONKKONEN, *THE LOCAL STATE: PUBLIC MONEY AND AMERICAN CITIES* 22 (1995). For additional citations, see Gillette, *Bondholders*, *supra* note 2, at 640–53.

40. MONKKONEN, *supra* note 39, at 72–77; Gillette, *Bondholders*, *supra* note 2, at 5.

their creditors.⁴¹ Even while asserting the sanctity of creditor contracts, modern-day courts have introduced significant ambiguity into the question of when and how a bondholder must get paid.⁴² Gillette is somewhat dismayed at this ambiguity. He would prefer clear rules, even if they disfavor bondholders.⁴³

But ambiguity has its virtues. By invalidating certain debt offerings in the nineteenth century, courts were telling bondholders that they would not be allowed to take advantage of municipal borrowers and drain municipal coffers. Perhaps nineteenth century courts also recognized that municipalities were less mismanaged than unlucky. The economic crises of the nineteenth century precipitated failures throughout the country.⁴⁴ Saddling citizens with non-dischargeable debt and forcing them to raise taxes to pay off bondholders—who had often taken advantage of relatively opaque municipal political processes—was both unjust and inappropriate. It also could create incentives for lenders to over-lend.

The same could be said today. Some ambiguity in the rules of priority allows courts to distinguish between bad luck and bad management, giving government debtors some way to restructure their debts during economic cycles over which they have little control—when they are mistaken but not corrupt or incompetent. The uncertainty also requires market makers, insurers, and investors to take responsibility for venal deals.⁴⁵ At the same time, it allows the court to charge the debtor city when it appears that it is acting strategically, or when its citizens are in a position to afford to pay off the debt.

III. WHY THE PREFERENCE FOR BONDHOLDERS?

At the end of the day, creditors have limited formal remedies in the face of municipal defaults. Gillette notes that certain states give priority to bondholders and mandate payments out of segregated

41. Gillette, *Bondholders*, *supra* note 2, at 640–53.

42. *See id.* at 653–54.

43. *Id.* at 654–55.

44. *See* RICHARD BRIFFAULT & LAURIE REYNOLDS, *CASES AND MATERIALS ON STATE AND LOCAL GOVERNMENT LAW* 817 (7th ed. 2009).

45. Consider that Jefferson County, Alabama's recent bankruptcy filing has precipitated a lawsuit against the County's lead underwriter, JP Morgan, on the grounds that it misled the County and investors. *See* Mary Williams Walsh, *Bankruptcy Filing Raises Doubts About a Bond Repayment Pledge*, N.Y. TIMES, Dec. 23, 2011, at B1. Indeed, as Gillette points out, the Securities and Exchange Commission entered into a settlement with the underwriter in 2009, requiring it to pay significant penalties. *See* Gillette, *Bondholders*, *supra* note 2, at 44 n.160.

funds.⁴⁶ But it is difficult—if not impossible—for creditors to seize municipal property or compel tax increases.⁴⁷ Nevertheless, creditors still lend to municipalities and municipal borrowers still make concerted efforts to repay. Municipal borrowers' historical default rates are remarkably low compared to their private-side counterparts.⁴⁸ Absent extreme economic circumstances, relatively few cities go bankrupt.

The relative fiscal probity of local governments raises a conceptual puzzle. If neither bondholders nor citizens are very good monitors of local fiscal health, what accounts for the low rate of defaults among municipalities? There is also an historical puzzle. In the face of significant numbers of municipal defaults in the nineteenth century, state courts often invalidated bondholder claims.⁴⁹ During the present economic crisis, when only a handful of cities have defaulted, the rhetoric (if not practice) of bondholder inviolability seems much more robust. Why?

Neither puzzle can be answered at length here, but I can venture some hypotheses. As to the puzzle of low defaults, it may simply be that governments, unlike firms, do not raise revenue primarily through the sales of goods and services, but rather through the collection of taxes. In a society in which the public generally complies with tax laws, taxes are a fairly stable source of revenue absent a large exogenous shock like a depression. The property tax, in particular, is a fairly stable source of revenue for local governments in most states.⁵⁰

Of course, tax monies are not always spent wisely. One has to explain why citizens do not spend lavishly on short-term benefits and why local officials do not simply line their own pockets. These questions are not unique to municipalities, however. Presumably the existence of a mature political system and basic electoral accountability prevents the worst excesses. Separation of powers, a judiciary that enforces criminal laws against fraud, and an active and independent press may also be preconditions for fiscal responsibility.

That being said, basic checks and balances and “good government” do not sufficiently explain the low rates of municipal failures. American cities grew dramatically between 1880 and 1930—a time when

46. Gillette, *Bondholders*, *supra* note 2, at 647–49.

47. See Kordana, *supra* note 11, at 1058 & n.110.

48. See Gillette, *Bondholders*, *supra* note 2, at 665–66; Kordana, *supra* note 11, at 1099.

49. Gillette, *Bondholders*, *supra* note 2, at 642–43.

50. See BRIFFAULT & REYNOLDS, *supra* note 44, at 649–50.

municipal governments were often dominated by political machines and cities were arguably at their most corrupt.⁵¹ Local economic health is not impervious to bad government, but it does not seem to turn on it.⁵² Corrupt local officials can preside over periods of robust city growth and honest local officials can preside over periods of decline.

Indeed, the presence of good government institutions does not explain the industrial cities' rise, nor does the absence of good government institutions explain their decline. During the second half of the twentieth century, many rust belt and older cities have lurched from fiscal crisis to fiscal crisis, while other, newer cities have boomed.⁵³ Deindustrialization, white flight, disinvestment, and concentrated poverty have undermined many old-line cities as population has moved south and west.⁵⁴ The process by which this has occurred seems to have relatively little to do with the relative fiscal discipline of particular cities or the relative effectiveness or ineffectiveness of monitoring.

The paucity of full-scale municipal defaults—at least in the latter half of the twentieth century—might instead be attributed to the emergence of the federal government as a stabilizing force. The federal government serves two roles with respect to sub-federal jurisdictions. First, the federal government plays an important regulatory role, policing the credit markets (at least to some extent) and limiting (if not eliminating) corruption. Second, the federal government has taken on the bulk of redistributive spending. Local governments receive direct aid from the federal government. More important is the aid that flows to individuals through federal social welfare programs. The rise of the social welfare state means that economic downturns do not necessarily lead to economic collapse. The boom and bust cycle is ameliorated by large-scale national social welfare spending.⁵⁵

So perhaps municipal borrowing is fairly staid because the likelihood of catastrophic municipal failure is fairly constrained. Cities occupy territory, they have the power to tax, they exist within a robust

51. See Richard C. Schragger, *Decentralization and Development*, 96 VA. L. REV. 1837, 1871–72 (2010) (discussing literature on urban corruption and growth).

52. See *id.* at 1871, 1879–81; see also Richard Schragger, *Rethinking the Theory and Practice of Local Economic Development*, 77 U. CHI. L. REV. 311, 323–31 (2010).

53. For a discussion, see JON C. TEAFORD, *THE TWENTIETH-CENTURY AMERICAN CITY* 141–46, 158–60, 169 (2d ed. 1993).

54. See, e.g., DOUGLAS RAE, *CITY: URBANISM AND ITS END* XIV–XV (2003).

55. See generally David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2648 (2005).

federal system, and the modern social welfare state backstops their local economies. Decline certainly occurs, but it is not often precipitous. Failures occur when declining tax revenues cannot keep up with increased costs. This mismatch can happen when a particular infrastructure project goes bad⁵⁶ or when mismanagement occurs, but it is also often a result of the long-term and dramatic restructuring of the global economy.⁵⁷

This leads to the second—historical—puzzle. In the nineteenth century, state legislatures and state courts were often inclined to absolve localities of debts incurred in the heat of economic booms. In the twenty-first century, however, there appears to be a different trend. Local fiscal distress has more often been treated as a moral failure on the part of municipal officials and the public discourse of austerity seems to favor bondholders over citizens.

The assumed sanctity of bondholder commitments requires explanation, especially in light of the political imperatives faced by local elected officials, who would presumably favor citizens over bondholders. One possibility is that municipalities fear being shut out of the credit markets altogether. There is also a genuine fear of contagion. Localities fear that a default will reduce their ability to borrow in the future, and state officials are eager to avoid local defaults or any whiff of municipal bankruptcy for fear that borrowing costs will rise for other localities and for the state as a whole.

But while there is some evidence that interest rates increase for all borrowers in reaction to a default,⁵⁸ the contagion claim is likely overstated.⁵⁹ First, there is evidence that municipalities are able to access

56. See *Money Up in Smoke: An Incinerator Brings Pennsylvania's Capital Close to Fiscal Ruin*, THE ECONOMIST (Oct. 29, 2011), <http://www.economist.com/node/21534811>; Joe Songer, *Alabama County Files for Largest Municipal Bankruptcy*, USA TODAY (Nov. 9, 2011, 11:26 PM), <http://www.usatoday.com/money/economy/story/2011-11-09/alabama-county-bankruptcy/51146416/1>.

57. See RAE, *supra* note 54, at 363–67.

58. See Tamim Bayoumi et al., *Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States*, 27 J. MONEY, CREDIT & BANKING 1046, 1047 (1995).

59. The contagion literature in the municipal borrowing context is limited and somewhat mixed. Some have found evidence of contagion, others have not. For a summary, see John M. Halstead et al., *Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets*, 39 FIN. REV. 293, 297 (2004). Halstead et al. found that municipal bond funds experienced abnormally low returns in the eight-day period after the Orange County bankruptcy was announced. *Id.* at 299. The authors took this as evidence of contagion, at least for the short time period immediately surrounding the bankruptcy. *Id.* at 313; see also MARK BALDASSARE, *WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY* 244–46 (1998) (arguing that the Orange County bankruptcy raised borrowing rates for cities through-

the bond market relatively soon after a default and at reasonable rates.⁶⁰ Indeed, there is evidence more generally that the financial markets do not penalize sovereign defaulters very severely at all.⁶¹ Second, the bond market seems to be able to distinguish among municipal borrowers, even if crudely. Despite the recent filing of the largest municipal bankruptcy in United States history and recent predictions that the recession would trigger municipal defaults on a massive scale, the 10-year borrowing cost for top-rated states and local governments is at its lowest in a decade.⁶² Short of a panic, the bond market seems to be able to accommodate and domesticate municipal defaults.⁶³

The concern for moral hazard has also been a common explanation. Fiscally strapped cities should pay their debts because they need to be incentivized to remedy their wayward ways, to feel the consequences of their actions. But maybe a kind of Victorian morality is at

out California). Orange County's fiscal crisis was precipitated by its treasurer's decision to invest its funds in the highly unregulated derivatives market, so its lessons might have limited applicability to fiscal crises brought about by other events. On the private side, studies have examined whether one firm's bankruptcy affects other firms within the same industry. Studies have found a negative effect, no effect, or a positive effect. See Ken Cyree & Philip Tew, *Is Bankruptcy Risk Systematic? A Look at the Short Selling Data 4–10* (unpublished manuscript) (draft on file with author). If municipalities are in competition with one another for investment dollars, one can imagine certain municipalities benefitting from the bankruptcy filing of a competitor city.

60. William B. English, *Understanding the Costs of Sovereign Debt: American State Debts in the 1840's*, 86 AM. ECON. REV. 259, 269 (1996); see also Kordana, *supra* note 11, at 1074–77; Schragger, *supra* note 7, at 874.

61. See Kordana, *supra* note 11, at 1077.

62. See Michael McDonald, *Banks Cash in on Whitney's Muni-Default Scare*, BLOOMBERG (Dec. 14, 2011, 12:01 AM), <http://www.bloomberg.com/news/2011-12-14/default-defying-muni-rally-shows-dimon-departs-from-whitney-as-banks-buy.html>.

63. In prior work, Gillette argues that the problem of contagion provides a reason to allow bankruptcy courts to order municipalities to raise taxes. See Gillette, *Political Will*, *supra* note 11, at 48–50. He has also argued in this colloquium and elsewhere that bond markets can monitor effectively and thereby enhance democratic accountability. See Gillette, *Bondholders*, *supra* note 2, at 665–70; Gillette, *Public Debt*, *supra* note 22, at 942–43. The contagion claim seems to be in tension with the monitoring claim. If bond markets are easily susceptible to the financial swings that bring good debtors down with bad debtors, then the markets are not providing very effective monitoring. Indeed, if contagion is a dominant problem in bond markets, then the relative fiscal discipline of local governments is not going to matter very much. Every local government debtor will be treated as if it were the most recent defaulter.

work here, more than a concern about moral hazard.⁶⁴ Remember that there is moral hazard on the lenders' side as well. Keeping commitments to bondholders may encourage them to over-lend. If bondholders are in a better position to bear risk — as Gillette and Kordana both argue — then making them absorb losses rather than forcing citizens to incur costs will better avoid the problem.

A different (and more likely) explanation for the punitive attitude toward municipalities is hostility to public employee unions⁶⁵ or a more general hostility to redistributive spending. The payment of bond interest appears to be a neutral, even unavoidable expenditure. But it is not. The decision by a fiscally strapped locality to pay off bondholders — to avoid a default or prioritize creditors in a bankruptcy proceeding — is often a decision to renege on pension commitments or reduce spending on municipal personnel or social services.

Paul Peterson famously argued that political interest groups at the municipal level tend to coalesce around developmental rather than redistributive spending.⁶⁶ It may be that repaying bonds that primarily pay for local infrastructure is more palatable than keeping the municipality's pension commitments or providing social services. It is also plausible that bondholders and bond market participants are simply more politically influential than public employees and social service recipients.

The political gap between cities and state legislatures also plays an obvious role in the current practice of austerity. In her contribution to this Colloquium, Michelle Wilde Anderson criticizes Michigan's punitive emergency manager law, which permits the governor to replace officials of fiscally strapped local governments with appointed managers.⁶⁷ Thus far, four cities and three school districts have emergency managers, and three cities (including Detroit) are under con-

64. Cf. James Surowiecki, *Living By Default*, THE NEW YORKER, Dec. 19, 2011, at 44 (comparing the lack of moral outrage to the strategic bankruptcy of American Airlines with the moral outrage in response to strategic defaults by homeowners).

65. Charges that public employee unions have contributed to local fiscal distress have become commonplace. See, e.g., E.J. McMahon, *State Bankruptcy is a Bad Idea*, WALL ST. J., Jan. 24, 2011.

66. See PAUL E. PETERSON, CITY LIMITS 131–49, 182 (1981).

67. Michelle Wilde Anderson, *Democratic Dissolution: Radical Experimentation in State Takeovers of Local Governments*, 39 FORDHAM URB. L.J. 577 (2012); see also Lyle Kossis, *Examining the Conflict Between Municipal Receivership and Local Autonomy*, 98 VA. L. REV. 26 n.180, 29 n.196 (forthcoming Sept. 2012) (draft on file with author).

sent agreements with Financial Review Teams.⁶⁸ Many of these jurisdictions are predominantly African-American, and likely to vote Democratic, and there is little political cost when Republican governors and legislators take a disciplinary approach to their finances.

Forcing cities to pay their bondholders is a way of restricting a city's budgetary options. This explains why cities might favor bankruptcy, which allows them to seek protection from creditors and avoid painful cuts in public services,⁶⁹ or avoid a hostile state takeover.⁷⁰ This effort may be resisted by state legislators, who would rather control local fiscal outcomes through a state appointed receiver. States, unlike localities, may also be more inclined to placate the credit markets, either because state officials worry about spillover effects or because bankers exercise more power than do local citizens at the state level.⁷¹

It would be surprising if the choice between creditors and citizens was *not* driven by politics. What is notable is how often governments choose creditors. Cities often make heroic efforts to avoid default, cutting services significantly in order to meet their debt service.⁷² After declaring bankruptcy, Orange County, California continued to pay off its general obligation debt.⁷³ In Rhode Island, the bankrupt city of Central Falls continues to pay its general obligation debt holders after the passage of a state law that gives bondholders a lien on the city's tax receipts.⁷⁴

Jefferson County—which includes the city of Birmingham—has, by contrast, stopped paying its bondholders.⁷⁵ It has taken advantage of the protections provided by the Bankruptcy Code. A lawyer for the County recently stated, “Jefferson County made a very different

68. See *Emergency Manager Information*, MICH. DEP'T OF TREAS., http://www.michigan.gov/treasury/0,1607,7-121-1751_51556-201116--,00.html (last visited Apr. 24, 2012). See also e-mail from Michelle Wilde Anderson to author (Jan. 27, 2012) (on file with author).

69. See Dorothy Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEV. J. 625, 635–37 (1995).

70. See, e.g., *id.*; Sabrina Tavernise, *Judge Rejects Bankruptcy in Harrisburg*, N.Y. TIMES, Nov. 24, 2011, at A27.

71. See Brown, *supra* note 69, at 631.

72. See Kordana, *supra* note 11, at 1037, 1072.

73. Walsh, *supra* note 45.

74. Gillette, *Bondholders*, *supra* note 2, at 651; see also Walsh, *supra* note 45.

75. Walsh, *supra* note 45.

decision than Rhode Island did . . . Rhode Island put bondholders ahead of its citizens, and Jefferson County is not going to do that.”⁷⁶

CONCLUSION

The choice between citizens and bondholders is not a technocratic one. And, as a descriptive matter, whether courts or legislatures prioritize citizens or creditors will reflect current political alignments. That makes sense. Debt crises throughout the country (and the world) are not merely economic crises, they are political ones.

That being said, it seems exactly right to charge bondholders with the cost of a municipal default. Bondholders are not better monitors than citizens, but they are more appropriate risk-bearers.

Indeed, my contention here is that privileging citizens over creditors will have little effect on local fiscal health *ex ante*. The same is true of the reverse. The primary effect of the choice is distributional. That is because incentivizing “fiscal discipline” is a distraction. In thinking about mechanisms to prevent future municipal fiscal crises, the decision of whom to charge with the cost of default comes too little and too late. Cities are not failing because of lack of monitoring. We have to look instead at the larger social, economic, technological, legal, and political reasons for city decline and fiscal failure.

76. *Id.* (quoting a bankruptcy lawyer representing Jefferson County).