

Financial Control Boards and Municipal Fiscal Crises

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The financial crisis has generated significant speculation that numerous municipalities will default on their obligations to bondholders and pensioners, increase taxes to pay for outstanding obligations, or substantially reduce service levels. Indeed, municipalities of significance, such as Harrisburg, Pennsylvania and Jefferson County, Alabama have filed for bankruptcy, though at least some of those are less attributable to general fiscal conditions than to idiosyncratically inopportune investments.¹ Other municipalities have considered bankruptcy or taken first steps in that direction.² But even if municipal fiscal distress is widespread, the availability of the bankruptcy system to address it is severely constrained. The current form and costs of municipal bankruptcy make Chapter 9, the relevant provision of the Bankruptcy Code, inhospitable to general purpose municipalities.³ In any event, bankruptcy is unavailable to a substantial number of municipalities. The Bankruptcy Code permits a municipality to enter bankruptcy only if the state of which it is a political subdivision has “specifically authorized” it to file the requisite petition for relief, and only about half the states have enacted the relevant statutes. Many of those states that do permit municipalities to file for bankruptcy do so only if additional prerequisites are satisfied, including the receipt of explicit permission from state

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¹ Harrisburg’s brief bout with bankruptcy was precipitated by an investment in an incinerator that was financially infeasible. Jefferson County’s bankruptcy was precipitated by investments in derivatives that ultimately led to criminal prosecutions.

² See, Jennifer Medina, In California, City Teeters on Brink of Bankruptcy, N.Y. Times, Feb. 29, 2012, available at <http://www.nytimes.com/2012/03/01/us/stockton-calif-moves-closer-to-bankruptcy.html> (discussing possibility of bankruptcy by city that would be largest ever to file).

³ See Municipalities in Peril: The ABI Guide to Chapter 9 33-37 (2010).

officials.⁴ Finally, bankruptcy courts have interpreted Chapter 9's requirements for bankruptcy, such as insolvency and state authorization, narrowly to disqualify some municipalities that have filed for relief.⁵

State imposition of obstacles to municipal bankruptcy filings may reflect a conviction that the state itself occupies the best position to address municipal fiscal crises.⁶ Certainly states have the legal capacity to intrude into municipal fiscal affairs in ways that might exceed federal authority. While the federal government may be constrained by federalism and Tenth Amendment restrictions,⁷ states enjoy plenary power over their political subdivisions, and have historically used their authority to intervene in municipal fiscal affairs through mechanisms that range from extending loans to displacing elected local officials. During the current fiscal crisis, multiple states have increased their control over distressed localities. As of this writing, Michigan has appointed emergency financial managers for four of its municipalities and is in negotiations with officials of Detroit that could lead to appointment of an unelected manager for that city.⁸ Rhode Island placed the City of Central Falls into receivership prior to its filing for bankruptcy, and has more recently done the same with respect to East Providence.⁹ New York State has appointed financial control boards for Nassau County, Erie County, and Buffalo, while the New York City Financial Control Board retains at least formal existence. The state had previously created a financial control board for Yonkers, and press reports suggest that additional

⁴ See, e.g., Calif. Gov. Code § 53760;

⁵ See, *In re City of Bridgeport*, ; *In re City of Harrisburg*, 2011 WL 6026287 (Bkrtcy.M.D.Pa.).

⁶ See, e.g., Omer Kimhi, Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem, 27 *Yale J. Reg.* 351 (2010).

⁷ See *National League of Cities v. Usery*, ;

⁸ They are the Detroit Public Schools, Benton Harbor, Ecorse, and Pontiac. See http://www.michigan.gov/treasury/0,1607,7-121-1751_51556-201116--,00.html.

⁹ See *Gov Taps Trooper to Oversee EP's Budget*, available at http://www.wpri.com/dpp/news/local_news/providence/ri-to-name-overseer-to-handle-ep-finances.

cities in New York face similar fates.¹⁰ Springfield, Massachusetts was supervised by a financial control board from 2004 through 2009.¹¹ These phenomena continue earlier efforts to intervene in the fiscal affairs of distress political subdivisions. Pennsylvania established the Pennsylvania Intergovernmental Cooperation Authority to address Philadelphia's financial difficulties in the early 1990s, and has appointed a coordinator to oversee a municipality's fiscal affairs in 25 municipalities since the 1980s.¹² New York State created the Municipal Assistance Corporation of the City of New York, the New York City Financial Control Board, and the Office of Special Deputy comptroller for New York City to address New York City's fiscal situation in the 1970s.¹³ Congress created a financial control board for Washington, D.C. in the mid-1990s.

The forms of state intervention and the concomitant consequences for the governance structure of the locality vary substantially, though few forms of state assistance come cheaply to the assisted municipalities. In some jurisdictions, oversight boards may provide little more than opportunities for facilitating financial assistance from the state, combined with recommendations that minimally interfere with existing local structures.¹⁴ More intrusively, an overseer may also exercise authority to approve or disapprove budgets or exercise other powers traditionally allocated to elected officials.¹⁵ These powers, which might seem largely ministerial, can in substance significantly alter the structure of local decision making, as oversight committees make clear the limited budgetary options that they will approve. The Nassau County Interim

¹⁰ See Danny Hakim, Deficits Push N.Y. Cities and Counties to Desperation, N. Y. Times, March 10, 2012, available at <http://www.nytimes.com/2012/03/11/nyregion/deficits-push-municipalities-to-desperation.html?scp=2&sq=cities%20desperation%20buffalo&st=cse>.

¹¹ http://www.springfield-ma.gov/COS/control_board.0.html.

¹² Eric Scorsone, Local Government Financial Emergencies and Municipal Bankruptcy 6, available at <http://www.senate.michigan.gov/sfa/publications/issues/localgovfin/localgovfin.pdf>.

¹³ See Robert W. Bailey, The Crisis Regime 23-46 (1984).

¹⁴ See, e.g., R.I. Stat. § 45-9-3 to -17 (2011).

¹⁵ See R.I. Code § 45-9-3(d).

Finance Authority recently rejected a proposed budget submitted by the County on the grounds that it contained “risky” approximations of revenues and cost savings that would have to be eliminated before the budget would be acceptable.¹⁶ Robert Bailey suggests that although the Municipal Assistance Corporation created during the New York City fiscal crisis of the 1970s “did not remove [Mayor] Beame from office, the MAC Act did seem to remove the office from Beame.”¹⁷ In other situations, the state may condition bailouts in ways that seriously constrain the discretion previously delegated to local officials. For instance, Virginia law requires the state to advance funds necessary to pay general obligation bonds of localities that are in imminent danger of default, but also requires the state to withhold funds otherwise payable to the assisted localities until the amount of the payment has been recovered.¹⁸

State intervention frequently involves more direct interference with the fiscal or political organization of the municipality. State law frequently authorizes the appointment of some form of receiver, financial control board, or emergency financial manager (I refer to them collectively as “FCBs”) to advise on, regulate, and frequently direct the fiscal affairs of distressed localities.¹⁹ The range of activities undertaken by FCBs may be quite broad. Michigan municipalities retain independence, subject to little more than advisory intervention, as long as they can pass a series of stress tests. But a Michigan municipality that fails those tests is vulnerable to gubernatorial appointment of an emergency manager “to act for and in the place and stead of the governing body and the office of chief administrative officer” of a distressed locality.²⁰ The relevant statute

¹⁶ See, e.g., *County of Nassau v. Nassau County Interim Finance Authority*, 920 N.Y.S.2d 873 (N.Y.

¹⁷ Robert W. Bailey, *The Crisis Regime* 139 (1984).

¹⁸ See Va. Code ; R.I. Code § 45-12-32.

¹⁹ See, e.g., Note, *Missed Opportunity: Urban Fiscal Crises and Financial Control Boards*, 110 Harv. L. Rev. 733, 734-35 (1997).

²⁰ M.C.L.A. § 141.1515. Currently, four Michigan municipalities operate through an emergency financial manager.

prohibits the governing body and chief administrative officer of any locality placed in receivership from exercising any of their statutory powers without the written approval of the emergency financial manager, and the compensation and benefits of those officials is terminated.²¹ Rhode Island grants a state appointed receiver for a municipality “the right to exercise the powers of the elected officials” and provides that the “powers of the receiver shall be superior to and supersede the powers of the elected officials.”²² A 1991 law that placed Chelsea, Massachusetts in receivership eliminated the position of mayor and reduced the role of other elected officials to an advisory one.²³ New York State has tailored FCBs for specific localities, such as New York City, Nassau County, and Yonkers, but has systematically granted each FCB the authority “to do any and all things necessary or convenient to carry out [their] purposes.”²⁴

Even where FCBs do not fully displace elected local officials, they frequently are empowered to undertake discrete local functions or to reverse prior decisions by those officials. Perhaps the most notorious such power is the ability to reject existing contracts, often including collective bargaining agreements. For example, the emergency financial manager for the Detroit Public Schools recently imposed a 10 percent wage cut and reordered the financing of benefits for employees.²⁵ Alternatively, FCBs can withhold necessary approvals or funds until elected officials comply with their demands. During the New York City fiscal crisis of the mid-1970s,

²¹ M.C.L.A. § 141.1519a.

²² See, e.g., R.I. Gen. Laws § 45-9-7.

²³ See David R. Berman, Takeovers of Local Governments: An Overview and Evaluation of State Policies, 25 *Publius* 55, 63 (1995)

²⁴ See, e.g., N.Y. Pub. Auth. L. § 3644(14) (McKinney’s).

²⁵ See DPS TO Save \$81.8 Million through 10 Percent Wage Concession, and 80 Percent/20 Percent Cost Sharing for Health Care Benefits and Other Measures, available at <http://detroitk12.org/content/2011/07/29/dps-to-save-81-8-million-through-10-percent-wage-concession-and-80-percent20-percent-cost-sharing-for-health-care-benefits-and-other-measures/>.

the state-appointed Municipal Assistance Corporation, which issued state-backed bonds on behalf of the City,²⁶ withheld bond proceeds in order to ensure that the Mayor cut the municipal budget in accordance with the agency's expectations.²⁷

The broad scope of FCB powers inevitably leads to the claim that, at best, they interfere with local autonomy and, at worst, that they are anti-democratic.²⁸ FCBs are created at the state level and their members are typically appointed by state officials. Members of FCBs may have little or no political experience in the distressed locality and little commitment to retaining long-term relationships with the community. Indeed, in at least some jurisdictions, an existing political role disqualifies individuals from membership on an FCB. The reallocation of local decision making authority that accompanies the designation of an FCB helps explicate Ed Koch's comment that, had he been mayor of New York City, he would not have acceded to the demands of state-created FCBs,²⁹ or Abe Beame's near-resignation rather than accept the budgetary adjustments demanded by the Municipal Assistance Corporation and the New York City Financial Control Board.³⁰

Those intrusions on local autonomy might be less controversial if it were apparent that FCBs ultimately resolve financial distress in a manner that residents come to appreciate. But the

²⁶ Bonds of MAC were not, however, general obligation bonds to which the state provided its full faith and credit. Rather, they involved a "moral obligation," pursuant to which, on the occurrence of certain events the state legislature would consider providing funding the debt. See Robert W. Bailey, *The Crisis Regime* 27-28 (1984).

²⁷ See Seymour P. Lachman and Robert Polner, *The Man Who Saved New York: Hugh Carey and the Great Fiscal Crisis of 1975* 118 (2010).

²⁸ See, e.g., Mike deBonis, *D.C. Still Haunted by Federal Takeover*, *Washington Post*, January 31, 2011, available at <http://www.washingtonpost.com/wp-dyn/content/article/2011/01/30/AR2011013004444.html> (mayor of D.C. referred to control board as a "rape of democracy"); *City Mayor Calls RI Receiver a "Dictator,"* available at <http://www1.whdh.com/news/articles/local/south/12004703320297/city-mayor-calls-ri-receiver-a-dictatorship/>.

²⁹ Jonathan Soffer, *Ed Koch and the Rebuilding of New York* 120 (2009) ("if I were the Mayor, I would never have gone along with it: I don't think I could have accepted a state of affairs that made me one-seventh of a mayor").

³⁰ See Lachman and Polner, *supra* note ___, at 121-22.

long-term effects of FCBs are more equivocal. Hamtramck, Michigan, which had been under state receivership in the 1970s,³¹ has recently requested permission from the state to file for Chapter 9.³² Martin Shefter's preface to subsequent editions of his monograph on New York City's fiscal crisis in the 1970s emphasized that the City had suffered "brushes with bankruptcy" on numerous occasions and that the political alliances that explained the earlier crises had re-emerged.³³ Of course, the absence of recidivism does not mean that FCBs have been successful, though some structural changes imposed by FCBs may have long-term beneficial effects. Instead, the period of fiscal stability that follows imposition of an FCB may be attributable to the emergence of better economic conditions generally than those that prevailed at the when the FCB was created. Even bad budgetary practices may have transparent effects only during economic downturns. Thus, the difficulty of measuring FCB performance at least leaves open the claim that FCB displacement of elected local officials substantially interferes with local autonomy without providing compensating long-term benefits.

As the discussion above suggests, the mechanisms by which FCBs are appointed, operate, and are terminated vary significantly among different states. Implicit in each of these statutory schemes is a perspective on the causes of fiscal distress and on the preferred way to resolve it. That is, one would anticipate that the conditions under which FCBs are created, the powers that they are entitled to exercise, and the circumstances under which they are terminated are linked to the state's perception of the causes of the distress and the need for remedial mechanisms not available as a political or legal matter to elected local officials.

³¹ See ACIR Report at 36-40.

³² See Monica Davey, Michigan Town is Left Pleading for Bankruptcy, N.Y. Times, Dec. 27, 2010, available at <http://www.nytimes.com/2010/12/28/us/28city.html?pagewanted=all>.

³³ Martin Shefter, Political Crisis Fiscal Crisis xi-xv (1991).

Nevertheless, it is difficult to infer any consensus on the sources of or remedies for fiscal distress from the current statutory schemes that create, empower, or terminate FCBs. First, ideally FCBs would be appointed when the underlying causes of fiscal distress were beyond the competence of local officials; but different sources would require the appointment of FCBs under different circumstances. That is, if one thought that fiscal distress was the consequence of demographics only partially within the control of the municipality, one would appoint FCBs under very different circumstances and empower FCBs with very different tools than if one thought that fiscal distress was the consequence of local politics. The differences in existing statutory schemes imply divergent perspectives on the core causes of local fiscal distress.

Second, the current schemes vary with respect to the implicit constituency that FCBs are intended to serve. If FCBs were intended to align the interests of local decision makers with the preferences of local residents, then one might prefer FCBs to take very different measures than if one thought that FCBs were intended to serve the interests of some alternative constituency, such as the state or the creditors of the distressed municipality. This inconsistency is not necessarily a negative. The causes of and remedies for municipal fiscal distress are complicated issues and it should not be surprising that different jurisdictions take different approaches to the definition and resolution of the problem. Indeed, the reaction to fiscal distress may be emblematic of the benefits of a federal system that permits experimentation in order to allow evolution of optimal solutions to common, but complex problems.

At some point, however, it is appropriate to consider whether the various solutions have, in fact, produced benefits or whether the variety of proposals simply represents the intractability of the underlying issues or a pervasive mismatch between the source of the problem and proffered remedies. In what follows, therefore, I examine some alternative theories of fiscal

distress and investigate the extent to which the statutory schemes for FCBs map onto those theories. I then investigate the implicit objective functions of FCBs and discuss whether the experience of various FCBs is consistent with one or more of those plausible goals. These discussions take place against a background in which FCBs necessarily interfere with decisions made by elected officials of the locality. It is in this sense that they may be questioned as “anti-democratic” or at least as undermining local autonomy. I begin, therefore, with an investigation of the defense of FCBs against the claim of interference with local affairs.

I. FCBs and Local Autonomy

Critiques of FCBs typically begin with assertions that they are, at best, disrespectful of local autonomy and, at worst, anti-democratic. Michelle Wilde Anderson, for instance, maintains that recent statutory suspensions of elected officials in favor of state-appointed ones amount to “de facto dissolution” of the cities themselves.³⁴ She also notes that the democratic deficit conferred by state takeovers has a socioeconomic bias: in Michigan, four of the local governments with an emergency manager in place (not counting Detroit) are majority minority and all have poverty rates substantially above the national average.³⁵ Democracy, on this account, anomalously becomes something only for those who can afford it.

In this part, I contend that the theoretical case against FCBs based on a democratic deficit is misguided. In theory, FCBs can effectively enhance democratic decision making by inducing budgetary decisions consistent with the interests of affected constituents. That is not to say, however, that FCBs are appropriate. It is only to say that arguments for their invalidity must arise from arguments other than an alleged inherent inconsistency with ideals of local democracy or

³⁴ See Michelle Wilde Anderson, *De Facto Dissolution*, *Ford. J. Urb. L.* (forthcoming).

³⁵ *Id.* at __.

principles of local autonomy. I later argue, however, that the antidemocratic argument may have greater traction because, as a practical matter, FCBs are unlikely to satisfy the conditions necessary to ensure that their decisions are, in fact, aligned with constituent interests. But that practical argument is very different from one that asserts that FCBs are necessarily inconsistent with local democratic governance. In particular, the ways in which FCB decisions vary from the interests of constituents may be quite different from the ways in which the decision of elected officials vary from those interests, and any claim of inconsistency depends substantially on contestable definitions of the relevant “constituents” that each body is intended to serve.

As a purely technical matter, the imposition of an FCB appears inexorably inconsistent with principles of local autonomy simply because local decisions are being made by individuals who have not been locally elected. Certainly that is the case where FCBs not only augment, but displace elected officials. But that conclusion relies on two assumptions, either of which may not hold generally, and most probably does not hold in a fiscal crisis. The first is that the decisions of local officials that are scrutinized or overridden by an FCB reflect the preferences of local residents. If that is not the case, then while FCBs may constrain local decision making as a formal matter (that is, by subordinating decisions of local officials), local autonomy may be preserved if FCBs make decisions that are consistent with residents’ preferences. The second assumption is that state intervention to constrain local autonomy is inappropriate in the context of municipal fiscal distress. Even jurisdictions that have strong conceptions of local autonomy elevate state interests in some circumstances, typically classified as matters that are of state, as opposed to local concern. State involvement, therefore, should be less controversial where the fact and degree of intervention fall on the “state” side of the admittedly hazy state/local divide.

Local constituent preferences are also implicated less where FCBs have a limited function, whether that means that their decisions amount to recommendations rather than mandates or that they operate only within a limited subset of local affairs. The anti-democratic nature of FCBs may also be contingent on the circumstances under which they are appointed and the duration of their existence. The court in the Bridgeport, Connecticut bankruptcy proceedings, for instance, concluded that the state’s appointment of an FCB did not usurp local authority contrary to a state prohibition on special legislation because the purpose of the statute was to enhance the city’s capacity to issue debt and did not affect “Bridgeport’s authority to conduct day to day operations.”³⁶ Even an intrusive FCB is less objectionable if its operates only with respect to the financial affairs of the municipality, only when the normal political processes for taxing and spending threaten fiscal crisis, and only until those processes recover.³⁷ If FCB members can enter the fray on a temporary basis, resolve budgetary imbalances, and return – like Cincinnatus – to the fields that they previously plowed, the fact that they are not formally elected may do little damage to the principles of democratic governance. That may particularly true in the typical case in which the distressed locality has an urgent need for capital and the potential sources of a capital infusion – either the state or the capital markets – distrust the current local leadership.³⁸ If the alternative to transferring authority to unelected officials is the demise of the locality, then it is unclear that residents would object to the transfer as anti-democratic, at least if the transferee were considered capable of creating fiscal stability that ultimately redounded to the residents’ benefit.

³⁶ In re City of Bridgeport, 128 B.R. 688, 699-701 (D. Bankr. Conn. 1984).

³⁷ See Financial Control Boards: Hearing Before the Subcomm. on the District of Columbia of the H. Comm. on Government Reform and Oversight, 104th Cong. 4-5, 38-39 (1995); Actions Taken by Five Cities to Restore Their Financial Health, Hearing Before the Subcommittee on the District of Columbia of the Committee on Government Reform and Oversight, House of Representatives, 104th Cong., 1st Sess., 2 (1995) (hereinafter “Actions Taken”).

³⁸ Id. at p. 41.

The second assumption of the “anti-democratic” critique is that FCBs cannot serve the preferences of residents more accurately than elected officials. At first, the notion that appointed officials can be better proxies than elected ones for local preferences seems oxymoronic, since the objective of local elections is presumably to allow residents to register their preferences. But the binary nature of voting, the capacity of interest groups to influence decisions of officials, and the standard collective action problems that enable officials to act in a manner inconsistent with constituent interests all suggest that there can be substantial gaps between the policies preferred by local residents and those pursued by elected officials.³⁹ More to the point, the very appointment of an FCB typically implies that elected local officials of the locality have failed to pursue the interests of their constituents. Instead, the existence of fiscal distress sufficient to require imposition of an FCB presumably indicates that local officials have provided goods and services that a majority of local residents do not prefer or are unwilling to pay for at the level that officials have contracted to provide. Fiscal distress that results from some exogenous shock may justify state aid or even a municipal bankruptcy filing because one-off events that disrupt a municipal budget may be remedied by debt adjustment that allows the municipality to avoid the catastrophic consequences of an idiosyncratic event.⁴⁰ But bankruptcy is less suited to remedy the kind of systematic misfeasance that FCBs are intended to redress, since nothing in Chapter 9 entails restructuring municipal governance structures or displacing the roles of elected officials. To the contrary, Chapter 9 prohibits direct interference by the court with the functions of elected officials.⁴¹ In the idealized Tiebout world of efficient provision of local public goods, the threat

³⁹ See Clayton P. Gillette, *Local Redistribution and Local Democracy* (2011).

⁴⁰ See Omer Kimhi, *supra* note 1, at 360-61.

⁴¹ Section 904 of the Bankruptcy Code provides:

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

of exit would constrain local officials from offering bundles of goods and services inconsistent with residents' preferences.⁴² But outside that world, the capacity of officials to direct expenditures towards avenues of political support may entail deviations from resident preferences with electoral impunity. To the extent that FCBs are intended to restore local financial outcomes that would be implemented if the Tiebout assumptions of perfect mobility could be realized, one end result of democratic governance may exist, notwithstanding that the process for achieving that objective varies from traditional democratic governance insofar as decision makers are not elected. In short, FCBs may instantiate substantive versions of democracy that require compliance with majoritarian preferences, even if they violate procedural versions of democracy that require majoritarian election. Of course, to the extent that the substance of democratic government includes procedural rights of self-governance – including the right of elected officials to err – FCBs nominally represent antidemocratic tendencies.⁴³ But given the contestable nature of democracy, the possibility that FCBs can correct substantive deviations from idealized democratic results at least dilutes the claim that FCBs are antithetical to democratic governance.

Consider next the possibility that any FCB deviation from local preferences is appropriate in order to satisfy state interests that properly trump concerns for local autonomy during periods of fiscal crisis. States appoint FCBs because local fiscal distress is perceived as creating a risk of contagion in which other localities and perhaps the state itself will bear the costs of local

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

11 U.S.C. § 904.

⁴² See, e.g., Robert P. Inman, *Transfers and Bailouts: Institutions for Enforcing Local Fiscal Discipline*, 12 *Consti. Pol. Econ.* 141 (2001).

⁴³ See, e.g., Robert A. Dahl, *Democracy and Its Critics* 163-175 (1989).

insolvency or profligacy. For instance, the statutory scheme for resolving the Orange County bankruptcy began with a recital that “[i]t is in the interest of the state and all public debt issuers within the state to enable the County of Orange to finance an acceptable plan of adjustment in order to improve the credit standing of California public debt issuers and to preserve and protect the health, safety, and welfare of the residents of the county and the state.”⁴⁴ There is at least some empirical evidence that such contagion exists, and anecdotal evidence that states perceive the possibility of contagion and intervene to prevent it.⁴⁵ New York State’s intervention in New York City’s fiscal crisis in the 1970s was largely motivated by concerns that a state default would inevitably follow from a City default.⁴⁶ The recent unsuccessful efforts by Alabama to forestall the state’s most populous county from declaring bankruptcy was largely attributed to the consequences of default for the rest of the state.⁴⁷ In short, some diminution of local autonomy may be necessary in order to protect the autonomy of neighboring localities or the state. If that is the case, however, then it is difficult to contend that the principle “autonomy” or democratic decision making has been violated, except to the extent that one reaches the anomalous conclusion that local democracy entails the ability to impose preferences on other local or centralized entities.

Finally, local fiscal distress frequently involves the inability to satisfy obligations previously incurred by the locality’s democratically elected officials and, in many instances,

⁴⁴ Calif. Gov. Code § 30400(a).

⁴⁵ For a general discussion of contagion from default in municipal markets, see Clayton P. Gillette, *Fiscal Federalism, Political Will, and the Strategic Use of Municipal Bankruptcy*, U. Chi. L. Rev. (forthcoming 2012). See, e.g., Inchang Hwang, Frances Haeuck In, & Tong Suk Kim, *Contagion Effects of the U.S. Sub-Prime Crisis on International Stock Markets, Finance and Corporate Governance Conference 2010 Paper*. Available at SSRN: <http://ssrn.com/abstract=1536349>.

⁴⁶ See Seymour P. Lachman and Robert Polner, *The Man Who Saved New York* 131-32 (2010).

⁴⁷ See Mary Williams Walsh and Campbell Robertson, *Just Before Deadline, County in Alabama Delays Bankruptcy Move*, N.Y. Times, July 28, 2011, available at <http://www.nytimes.com/2011/07/29/business/economy/alabamas-jefferson-county-postpones-a-decision-on-bankruptcy.html?scp=1&sq=alabama%20county%20bankruptcy%20before&st=cse>.

approved by the electorate. The ability to incur obligations as a function of local autonomy might mean little if it did not also entail the ability of creditors to enforce them. To the extent that FCBs fulfill that role, they may also be seen as acting in accordance with the democratic functions of a local government.

II. The Apolitical FCB

Even as these justifications for FCBs diminish the concerns that they are inherently anti-democratic, they raise an alternative set of issues that revolve around the objective that FCBs are intended to serve. If the justifications for FCBs entail efforts to ensure the efficient provision of services to residents, neutralization of negative spillovers, and capital flows, then one might expect the statutory schemes through which FCBs are appointed and operate would be directed to those objectives. An examination of the statutory schemes, however, reveals an imprecise fit between the causes of fiscal distress and the proposed remedies. At best, the misfit between causes and proposed remedies could be attributable to the multiple and potentially conflicting explanations for fiscal distress. A legislature might appoint an FCB and allocate one set of powers to it given one understanding of the causes of fiscal distress, while a quite different threshold for appointment and a different set of powers would be appropriate given an alternative rationale for state oversight. At worst, the misfit between causes and proposed remedies could be a function of the use of fiscal distress to accomplish objectives that are not wholly related to the underlying fiscal situation at all. Thus, I next turn to the different arguments for state intervention and an examination of the fit between those arguments and the statutory provisions governing FCBs.

A. The FCB as Expert

At least some of the justifications for FCBs imply that they should possess an apolitical character. This may be the case either because 1) the perceived cause of fiscal distress is a lack of fiscal sophistication by elected officials so that expert, rather than political, assistance is necessary to remedy the situation; or 2) normal politics is itself the perceived cause of fiscal distress so that apolitical managers are necessary to make decisions that are politically infeasible. Begin with the “expertise” explanation. Where fiscal distress is a consequence of either widespread and demographic changes that alter the local economy or discrete exogenous shocks, it is unclear that imposition of an FCB can improve matters.⁴⁸ As underlying economic conditions change, causing deterioration of the local tax base, service levels and tax rates are necessarily affected.⁴⁹ But those conditions tend to be a consequence of more centralized policies, so appointment of a local FCB is likely to promise little advantage over elected officials. Discrete shocks tend to be a consequence of less predictable events (e.g., large tort judgments or the closure of a major local employer due to industrial shifts) that similarly reflect little on the quality of local decision making. The migration of manufacturing plants that previously provided a substantial tax base for a locality or reduced tax revenues due to national recessions can neither be attributed to local jurisdictions nor systematically redressed by shifting local political leadership to an appointed board.⁵⁰ Decisions by a state to engage in public projects that remove substantial property from municipality’s tax rolls may generate municipal fiscal distress, but not of the sort for which a remedy lies within the advantage of an FCB.⁵¹

⁴⁸ See, e.g., Philip Kloha et al., *Someone to Watch Over Me: State Monitoring of Local Fiscal Conditions*, 35 *Am. Rev. Pub. Admin.* 236, 237 (2005).

⁴⁹ See Cahill, *supra* note 15 at 261-62 (citing sources).

⁵⁰ See Kimhi, *supra* note ___, at 376.

⁵¹ The decision by the Port Authority of New York and New Jersey and the New Jersey State Highway Department to construct the George Washington Bridge and surrounding roads in a manner that removed large amounts of taxable property from Fort Lee, New Jersey caused substantial financial distress for that locality, but – given those causes – there is little reason to believe that replacement of Fort Lee officials with an FCB would

Perhaps most importantly in the current environment, state law may impose on municipalities requirements related to pension or other post-employment benefits (primarily health care related benefits) that consume a substantial proportion of the municipal budget or prohibit reductions of benefits that were previously granted.⁵² But given the stringency of state law, appointment of an FCB once the problem materializes is unlikely to remedy a problem that arises from more centralized policies.

FCBs may be more appropriate where fiscal distress is attributable to an absence of competence in the controlled municipality for which professional assistance can be a palliative. An early report of the Advisory Commission on Intergovernmental Relations largely blamed municipal financial distress on “unsound financial management” that allowed municipalities to drift into financial emergency, but that could be corrected by improvements in accounting, auditing, and reporting.⁵³ That report recommended state education of local officials about prudent accounting practices and appointment of independent auditors as palliatives.⁵⁴ If ineffective managerial practices foment fiscal distress, then state assistance or requirements in professionalizing operations should have some positive effects that prevent recidivism.⁵⁵ A more recent account of different FCBs concludes that, despite differences in state laws, “they have as a

provide a superior remedy to normal political processes. See Advisory Commission on Intergovernmental Relations, *City Financial Emergencies: The Intergovernmental Dimension* 22 (1973) (hereinafter “ACIR”).

⁵² See, e.g., Ill. Consti. Art. VIII, § 5 (“Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.”) The extent to which clauses such as the Illinois Pension Clause prevents prospective diminution of benefits is a matter of some debate. See Sidley Austin LLP, *Pension Reform Analysis*, available at <http://www.senatedem.ilga.gov/images/pensions/C/SidleyPensionReformAnalysis%2003-10.pdf>. Conflicting views on the issue can be found at <http://www.senatedem.ilga.gov/index.php/component/content/article/108-public-information-brochures/1517-pension-debate>. See also Mary Williams Walsh, *Untouchable Pensions May Be Tested in California*, N.Y. Times, March 16, 2012.

⁵³ *Id.* at 4-5.

⁵⁴ *Id.* at 5.

⁵⁵ See, e.g., Anthony G. Cahill et al., *State Government Responses to Municipal Fiscal Distress: A Brave New World for State-Local Intergovernmental Relations*, 17 *Pub. Productivity & Manage. Rev.* 253, 258 (1994).

common theme the displacement of failing management with individuals who are disinterested and have special expertise .”⁵⁶ Robert Bailey attributes New York City’s adoption of an integrated financial management system to the involvement of businessmen in oversight of the city’s management.⁵⁷ Bailey notes, however, both that other managerial reforms were adopted through amendments to the city’s charter approved by voters and advocated by a state commission rather than the oversight agencies, and that there is substantial skepticism concerning the effectiveness of managerial professionalism.⁵⁸ Certainly some of the more notorious recent examples of fiscal distress involve participation in sophisticated investments that were arguably inappropriate for municipal officials who had limited comprehension of the transactional risks to which they were exposed. Orange County’s bankruptcy followed state deregulation of the investments available to localities, with the consequence that local treasurers took risks to which they were either oblivious or indifferent.⁵⁹ Jefferson County’s bankruptcy filing was precipitated in part by losses incurred on derivatives purchased in an effort to reduce the effects of possible increases in interest rates.⁶⁰ The report of the Detroit Financial Review Team that concluded the city was in “a condition of severe financial distress” as defined in the state’s emergency financial manager statute noted that the city had entered into swaps that

⁵⁶ Harold S. Horwich and Seth J. Pruss, When Political Will is Not Enough: Control Boards in Municipal Finance Restructuring, 32 Mun. Fin. J. 59, 81 (2011).

⁵⁷ Bailey, *supra* note __, at 140-41 (1984).

⁵⁸ *Id.* at 141-42. Bailey concludes even if claims for managerial expertise are overblown, they enhance accountability, prediction, and control in a manner that permits local officials to centralize policy and dilute the effects of independent bureaus. This effect may be more relevant to defragmentation, discussed below, than to pure expertise.

⁵⁹ See Balldasare, *supra* note __, at 75.

⁶⁰ See, e.g., *In re Jefferson County*, 2012 WL 32921*3-*6 (Bkrcty.N.D.Ala.) (“Simplistically and at the behest of former county commissioners, the County believed it could lower the interest on warrants by shifting from fixed rates to adjusting ones. Some of what failed was the structure the so-called experts sold to the county as being able to counteract the impact of an increase in interest rates. . . . Some of those involved in the development and sales of the types of financial instruments used in part by the County for its sewer system’s needs have committed crimes related to what was sold to the County. Others have not been charged with crimes, but have entered settlements with the United States Securities and Exchange Commission where there is no admission of wrongdoing, but payments in the tens of millions of dollars have been made.”)

assumed interest rates would increase. The subsequent decrease in interest rate obligated the city to pay more than \$1.1 billion over the life of the debt, and exposed the city to additional payment in excess of \$280 if downgrades in its credit rating constituted a “termination event” under the terms of the derivative contracts.⁶¹

If the “expertise” explanation underlies the creation of FCBs, then we might expect the statutory schemes to require proficiency in finance, and municipal finance in particular, to be the primary criterion for selection for membership. Moreover, one might infer that the state is acting somewhat paternalistically towards its municipalities and is imposing FCBs primarily to encourage localities to be able to put their financial houses in order rather than to impose a specific substantive solution on them. That is, once expertise is provided, there would be little need for the state to question the locality’s exercise of that expertise in making budgetary decisions.

Several of the statutes that permit imposition of an FCB are consistent with the expertise explanation, insofar as they require that FCB members possess financial expertise, although not necessarily related to the public sector. Michigan requires that an emergency financial manager “have a minimum of 5 years’ experience and demonstrable expertise in business, financial, or local or state budgetary matters.”⁶² California’s statutory plan for appointment of an Orange County trustee included a requirement that the trustee have “recognized expertise in management and public finance.”⁶³ Moreover, the types of action that FCB statutes require of a city often imply that expert assistance is the core function to be provided. The Pennsylvania

⁶¹ See Report of the Detroit Financial Review Team, March 26, 2012, at page 5.

⁶² M.C.L.A. . See also Ohio Rev. Code Ann. § 118.0x (members must have at least five years of experience in public sector).

⁶³ Calif. Gov. Code § 30401 (b).

Intergovernmental Cooperation Authority (“PICA”) perhaps provides the best example of an FCB created to provide expertise, albeit with a series of incentives that suggests that something other than state altruism is the primary motivation. PICA was created in 1991 to address budgetary imbalances in Philadelphia and the city’s lack of access to capital markets.⁶⁴ Members of the authority are expected to have had experience in finance or management.⁶⁵ The statutory scheme requires an assisted city to prepare a five-year financial plan of projected revenues and expenditures subject to PICA review.⁶⁶ PICA is entitled to withhold the proceeds of bonds that it issues on behalf of the assisted city until there is agreement on the plan.⁶⁷ Statutes in other states similarly require review and approval of a locality’s financial plans and contracts, including collective bargaining agreements.⁶⁸ One might interpret these plans as essentially tests of the ability of local officials, under the guidance of outside experts, to engage in long-term budgeting consistent with the ability to make realistic predictions about future revenues. Other common statutory attributes of FCBs imply a preference for apolitical decision making. As I noted above, some states disqualify political actors from membership in an FCB, implying that technocratic skills are to be elevated above partisan ones.⁶⁹

⁶⁴ See Actions Taken at 74-75.

⁶⁵ 53 Pa. Stat. § 12720.202(a)(7).

⁶⁶ 53 Pa. Stat. § 12720.209(d).

⁶⁷ 53 Pa. Stat. § 12720.209(a), (b).

⁶⁸ See Michigan Act, Nassau County Interim Finance Authority Act, § 3669.

⁶⁹ See, e.g., Ill. St. Ch. 50 § 320/x (members cannot have held elected public office in prior two years, and cannot be candidate while serving); Ohio Rev. Code Ann. § 118.0x (members may not have held public office for 5 years prior to appointment, or become a candidate while serving on the FCB); Pa. Stat. Ann. tit. 53 § 12720.202(f) provides: “Except for the Secretary of the Budget of the Commonwealth and the Director of Finance of an assisted city, neither members of the board nor the executive director shall seek or hold a position as any other public official within this Commonwealth or as a party officer while in the service of the authority. Members of the board and the executive director shall not seek election as public officials or party officers for one year after their service with the authority. Members of the authority and the executive director may serve as appointive public officials any time after their periods of service with the authority.”

In practice, however, it is less clear either that expertise is a primary qualification for membership or that provision of management expertise motivates the statutory schemes. The standard of experience in business or management casts a sufficiently broad net that it excludes few plausible candidates for membership on an FCB, notwithstanding that the characteristics that underlie their appointment are more political than vocational. Indeed, the admonition for experience in management may preclude the kind of academic/technocratic background that characterizes appointments of technocrats in Greece or Italy during the current euro crisis.⁷⁰ Those individuals who have been appointed as FCB members have little in the way of common backgrounds, though banking, business, and law seem to predominate. Famously, the original members of the MAC included Felix Rohatyn, a senior partner at the investment banking firm of Lazard Frères. But other members included Simon Rifkind, a former federal judge and law firm partner; the former Secretary of the Department of Housing and Urban Development; a political science professor; the head of New York Telephone; a stock broker; an investment banker; and the head of a New York City based business.⁷¹ Current directors of the Nassau County Interim Finance Authority include representatives from banking, investment banking, law, and finance. The current emergency financial managers of Michigan cities include a former General Motors officer (in charge of personnel administration), turned private equity manager; a former chief financial officer of Detroit; a former city manager and president of a firm providing services to municipalities; and the head of a firm providing statistical services to underwriters of municipal bonds.

Apart from broad stipulations of the criteria for membership the statutory schemes for FCBs do not systematically imply that competence is at the core of fiscal distress. If expertise

⁷⁰ Gelpert at 939.

⁷¹ See Bailey at 27.

were the primary issue, then we might expect FCBs to work with elected officials, that is to educate them and to assist them in implementation of sophisticated accounting and budgeting principles. To some extent, FCBs appear to be designed in a manner that supports that cooperative role. For instance, many statutes that provide for FCBs include local officials or appointees of local officials as members. The special act that created the Bridgeport, Connecticut Financial Review Board provided that its nine members would include the mayor of the city and two representatives appointed by the mayor.⁷² Mayor Beame of New York City appointed three members of the MAC and served as one of seven members of the Emergency Financial Control Board. The inclusion of local officials and their appointees may be intended ensure the continuation of some degree of local autonomy in the presence of an FCB. But it also implies that local officials are intended to benefit from interactions with those who are appointed outside the existing political structure.

But that rosy picture of cooperative may also be breached both in practice and in design. Even where FCBs include elected officials, the relationship between those officials and other members may deteriorate into an adversarial, rather than a cooperative one. The creation of an Emergency Financial Control Board for New York City in addition to the original MAC was predicated at least in part on the perceived inability of the mayor to satisfy requirements imposed by MAC for long-term budgeting and the distrust between the mayor and the banking community.⁷³ In additional, other statutes provide that FCBs effectively displace, rather than to educate or assist, elected officials. Florida's statutory scheme is silent as to the qualifications of members, but local officials were omitted from the oversight boards created for Miami and

⁷² Act of June 9, 1988, 1988 Conn. Laws, Special Act 88-80 §9.

⁷³ See Lachman and Polner at 126-131.

Delray.⁷⁴ As I noted at the outset, the relatively new statutes concerning FCBs in Michigan and Rhode Island provide the most draconian solutions from the perspective of local self-governance, as the appointment of state supervisors in those jurisdictions compels the effective dissolution of elected local bodies, although they retain an “advisory” role in Rhode Island.⁷⁵ California’s proposed appointment of a trustee for Orange County in the event that the County did not file a timely plan of adjustment included a withdrawal of powers from the County Board of Supervisors and delegation of those powers to the trustee.⁷⁶

A strategy of displacement may be intended primarily as an *in terrorem* measure that reduces the moral hazard that arises from any situation in which the state intervenes to bail out a distressed locality. Alternatively, it may provide a penalty default that induces local officials to accept conditions proposed by the state for providing assistance, since the next best alternative for those officials would be the loss of office. Certainly that strategy appears present in ongoing discussions about state assistance to Detroit structured under a statutory scheme that allows state appointment of an emergency financial manager if the city is unable to agree on a financial plan with a state-appointed financial review team.⁷⁷ But to the extent that FCBs displace rather than augment the normal local decision making process, it is more difficult to understand the appointment of FCBs as an effort to enhance the capacities of elected local officials.

A desire for expertise, moreover, should entail that the life of an FCB is not itself within the discretion of the experts. One might be concerned that experts would become entrenched and thus continue in service beyond their point of usefulness. If that were the case, then we might

⁷⁴ See Fla. St. Ann. §218.503(g).

⁷⁵ R.I. Stat. § 45-9-7(c).

⁷⁶ Calif. Gov. Code § 30402.

⁷⁷ See Mich. Act 4, §§ 13, 15(4).

expect to see termination triggered alternatively by a determination of the FCB members that they had fulfilled their objective, or by objective standards that limited the discretion of the FCB, or by a third party's determination that the control period should end. Some statutes do contain those characteristics. Ohio allows a financial supervision commission to expire when the commission or the state auditor determines that specified conditions have been satisfied.⁷⁸ Michigan similarly conditions termination of the control period on the assent of the emergency financial manager and the state treasurer.⁷⁹ Other statutes, however, prolong the life of the FCB based on characteristics that have little relationship to the need for expertise. The most prevalent condition appears to require the continuing existence of the FCB while any of its indebtedness is outstanding.⁸⁰ This condition may be necessary in order to induce prospective bondholders to purchase bonds issued by the FCB for the benefit of the assisted municipality, although the bonds arguably could be guaranteed by some other entity, such as the state, after the termination of an FCB. The effect, however, is to create both a perverse incentive for FCB members to issue additional bonds in order to maintain their position (reminiscent of Robert Moses' issuance of bonds to continue the life of public authorities after the costs of constructing their projects had been paid⁸¹) and potentially to allow continuation of the FCB long after termination of an emergency. In either case, the lifespan of the FCB seems detached from the expertise explanation for its existence.

Of course, perhaps the demand for "expertise" does not entail highly specialized accounting or managerial skills as much as the exercise of judgment that engenders more trust from potential creditors and employers that they are willing to commit to incumbents. To the

⁷⁸ Ohio Rev. Code § 118.27(B).

⁷⁹ Mich. Comp. L. Ann. § (section 24).

⁸⁰ See, e.g., New York, New Jersey, Pennsylvania,

⁸¹ See Robert Caro, *The Power Broker*.

extent that the fiscal distress reflects current cash crises and the inability to raise capital, the introduction of “expertise” may be a proxy for altering the budgetary process because local decision making proceeds in a manner that imperils the interests of those who would otherwise make capital contributions to the locality. That distrust may be the result of perceived incompetence, but may also arise from a concern about the local decision-making process. The apolitical structure of FCBs may be able to address that issue because of the decision making structures allowable to FCBs, wholly apart from the technical qualifications of their members. It is to that issue that I next turn.

B. The FCB as an Agent of Defragmentation

1. Fragmentation and Fiscal Distress

Rather than externally imposed adverse economic conditions or an absence of expertise, an alternative explanation for municipal economic decline lies in politics. On this theory, FCBs are appropriate when excessive spending and burdensome debt has been a consequence of the structure of local decision making that local officials have proven unwilling to alter. Budgetary structures might generate fiscal distress when they accommodate the demands of well-organized, politically preferred groups by diluting the possibility of effective opposition from more diffuse taxpayers. That may occur, on the demand side, if interest groups can initiate requests for projects that return net benefits for their members, notwithstanding that they produce net costs from the perspective of the municipality, in a context where potential opponents are unlikely to intervene. That might occur, for instance, where a multi-member decision making body, such as a city council, consists of representatives elected from separate districts, and members defer to the expenditure preferences of their colleagues who seek net benefits for their districts, subsidized by local residents at large. While it might be in the interests of the locality to have the

decision making body reject projects that generate net costs, no member will desire to risk his or her own preferred projects by voting against those that generate net benefits within some other district. In short, budgetary imbalance is a consequence of fragmentation in the budgetary process.⁸²

Alternatively, fragmentation may occur on the supply side if public expenditures can be made by bureaucrats who have substantial discretion over their budgets. Decision makers who have the capacity, for instance, to enter into long-term arrangements may commit the future resources of the municipality without the obligation or the authority to generate offsetting revenues. Bureaucrats and elected officials with budgetary discretion have incentives to provide inefficient benefits either to maximize their budgets or to induce electoral support or post-public service opportunities.⁸³ In the case of either demand-side or supply-side fragmented decision making, the consequences may be nonsalient when the local economy is growing so that its effects are shrouded by higher revenues or when the benefits conferred are to be realized largely in the future, such as by grants of long-term tax abatements or pension benefits. In either of those cases, local officials can escape immediate accountability for behavior that is politically useful to them but that generates net negative effects on the municipal budget. The capacity of localities to fund deficits through borrowing relaxes budget constraints that might otherwise promote fiscal discipline.⁸⁴ In short, fiscal crises arise when local officials allow the normal political competition among interest groups for scarce resources to be diluted by evading

⁸² For general treatments and literature reviews, see, e.g., Roberto Ricciuti, *Political Fragmentation and Fiscal Outcomes*, 118 *Public Choice* 365 (2004).

⁸³ See, e.g., William A. Niskanen, Jr., *Bureaucracy and Representative Government* (1971). Tests of Niskanen's theory of bureaucracy has generated a bit of a cottage industry, though results are inconclusive. See, e.g., . Of course, it is plausible that some municipal officials act in a manner consistent with the theory and some do not, and that it is those officials in the first category whose municipalities are more frequently in fiscal distress.

⁸⁴ See Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, in Jonathan Rodden et al., *Fiscal Decentralization and the Challenge of Hard Budget Constraints* 35, 50-51 (2003)

budgetary constraints that have the effect of limiting claims on the local treasury. The Madisonian dream of public interest emerging from offsetting factions is then supplanted by what Richard Stewart has termed “Madison’s Nightmare” of factions dividing an expanded pie in which each group receives an enlarged slice.⁸⁵ Moreover, fragmentation not only explains the evolution of fiscal distress; it can also explain the incapacity of local officials to extract themselves from adversity once it materializes. The same political forces that induce or that profit from the initial grant of inefficient benefits from the municipal budget also constrain officials from reducing those grants after their impact on the local budget becomes salient.

The concerns for fragmentation and the use of FCBs to control its effects are consistent with Martin Shefter’s and Charles Morris’ analyses of the New York fiscal crisis in the 1970s⁸⁶ and Ester Fuchs’ explanation for the different fiscal histories of New York and Chicago. Shefter attributes the New York fiscal crisis of the 1970s to the prior efforts of many mayors to maintain their political coalitions by directing municipal funds to projects that would assist the component groups. Expenditures to some subgroups, however, did not substitute for expenditures to other groups. Rather, both existing and new groups received expenditures which were financed with borrowed funds rather than tax increases.⁸⁷ For instance, as relatively poor racial minorities attained power in 1960s New York, expenditures for services that were highly utilized by that group increased substantially more than other expenditures. Shefter reports that expenditures for welfare services increased 940 percent between 1961 and 1976, while open enrollment for the City University of New York required an increase in expenditures of 1224 percent for higher education during that period. At the same time, expenditures for police, fire, sanitation, and

⁸⁵ Richard D. Stewart, *Madison’s Nightmare*, 57 U. Chi. L. Rev. 335 (1990).

⁸⁶ Martin Shefter, *Political Crisis Fiscal Crisis* (1992); Charles Morris, *The Cost of Good Intentions: New York City and the Liberal Experiment* (1980).

⁸⁷ *Id.* at 105-24.

education (other than higher education) increased 277 percent, 217 percent, 178 percent, and 304 percent respectively.⁸⁸ Shefter contends that public sector unions protected the interests of current members at a time when pressures existed to increase the number of nonwhites on the municipal payroll.⁸⁹ As a result, the size of the municipal workforce increased almost 50 percent between 1961 and 1975, and the average cost per employee almost tripled.⁹⁰

Morris provides a more benevolent story in which expenditures in New York City increased in the period before the fiscal crisis in order to satisfy philosophical and political objectives rather than as a sop to powerful interest groups. Morris argues that neither the underlying motivations for nor amounts of expenditures to particular groups were idiosyncratically high in New York.⁹¹ Rather, they were indicative of national movements in favor of public sector unionization and the expansion of welfare services for the relatively poor (for which New York City bore a disproportionate cost relative to other cities). Nevertheless, Morris also notes that politics and a desire to obtain electoral support explained expansion of the police and sanitation forces and use of financial gimmicks to make the costs of labor agreements less transparent.⁹²

Fuchs tells a complementary story about the relative ability of Chicago to withstand New York's fate in the 1970s. She suggests that mayors in cities with strong party systems are able to set the fiscal agenda without fear that resisting demands from interest groups will cost them electorally. Mayor in cities with weak party systems, on the other hand, are susceptible to interest group demands, which typically require distribution of a disproportionate share of the

⁸⁸ Id. at 114.

⁸⁹ Id. at 117.

⁹⁰ Id.

⁹¹ Morris, *supra* note 26, at 171-94.

⁹² Id. at 144.

local budget to their constituents.⁹³ New York, on her account (and that of Sayre and Kaufman in their well-received *Governing New York*), suffers from the latter. New York mayors, she contends, have historically ignored the revenue-side implications of expenditure decisions, with the exception of when fiscal crisis materializes.⁹⁴ Chicago, Fuchs, contends, avoided New York's fate in the 1970s because a strong party system controlled by the mayor effectively eliminated other points of access for political demands and thus weakened interest groups by defragmenting the budgetary process.⁹⁵ Chicago's fiscal stability declined only when reformers ascended to the mayoralty, simultaneously reducing the role of the party and the centralization of budgetary decisions. As access points to the budgetary process increased, city council members were able to develop their own fiscal agenda. One measure of the financial consequences is that Chicago bonds were downgraded in 1984, and recovery occurred only when the mayor was able to use patronage and programs congenial to large segments of the electorate in order to establish an autonomous basis for political support.⁹⁶ Similar arguments are implicit in recommendations by Haughwout and Inman to reorganize central city public finance by replacing ward-based politics with at-large politics, requiring cities to elect an at-large mayor, and conferring on the mayor broad agenda setting and veto authority.⁹⁷

This is not to say either that 1) strong, unitary authority (either party or individual mayors) will necessarily generate fiscal responsibility, or 2) interest group pluralism necessarily generates fiscal irresponsibility. With respect to the risks of centralization, there is substantial evidence that monopolized authority generates its own costs. Trounstine concludes that

⁹³ Ester R. Fuchs, *Mayors and Money* 238-39 (1992).

⁹⁴ *Id.* at 242-44.

⁹⁵ *Id.* at 251-54.

⁹⁶ *Id.* at 255-56.

⁹⁷ See Haughwout, Andrew F. and Inman, Robert P., *Should Suburbs Help Their Central City?*. Brookings-Wharton Papers on Urban Affairs 45, 79 (2002).

expenditure decisions by monopolistic leadership within cities – both traditional machine monopolies and reform monopolies – tend to spend a disproportionate share of the budget on members of their governing coalition and on core constituents at the expense of the general public.⁹⁸ Glaeser and Shleifer identify extreme cases of the phenomenon in which monopolists spend funds in a manner that affirmatively encourages exit by non-coalition members.⁹⁹ Monopoly in these cases typically means the absence of political competition, but the same effect is plausible where centralized officials face few checks from other centers of decision making. Thus, while fiscal control may correspond to financial stability for the local budget at a whole, the stable point does not necessarily correspond to optimal expenditures from the perspective of local welfare.

Nor does interest group proliferation necessarily lead to fiscal distress. The possibility that interest groups will not compete, but will instead support (or at least not oppose) each other's demands emerges from the presence of nebulous budget constraints and the indifference of public officials to inefficient expenditures because they are spending public money rather than their own and because their personal compensation (both monetary and intangible) is not based on efficient expenditures. But even profligate local officials presumably face some, if fuzzy, budget constraints in the form of tax or debt limitations, monitoring by political opponents, good government groups, or state officials concerned about contagion effects of local fiscal distress.

Nevertheless, the consistent stories of the New York fiscal crisis at least give pause to any claim that fragmentation is unrelated to the relaxation of local fiscal discipline. One might conclude that Shefter, Morris, and Fuchs have simply told a story about New York (which,

⁹⁸ See Jessica Trounstein, *Political Monopolies in American Cities* 139-71 (2008).

⁹⁹ See Edward L. Glaeser and Andrei Shleifer, *The Curley Effect: The Economics of Shaping the Electorate*, 21 *J. L. Econ. and Org.* 1 (2005).

understandably, is the subject of more analysis of its fiscal distress than any other municipality), or at most of other large cities. For instance, Ferreira and Gyourko find that partisan politics has a much lower effect on the size of government at the local level than at the state or federal level, and one might conclude that since partisan politics translate into a greater need to use government expenditures to keep a winning coalition together, we should expect less linkage between fragmentation and budgetary difficulties at the local level.¹⁰⁰ But the conclusions in the New York studies are also consistent with more general findings in the political economy literature that the size of local government increases with the size of a legislative body (because enhanced logrolling in large bodies increases expenditures), and that local officials have incentives to propose more costly projects than those preferred by the median voter.¹⁰¹ For instance, Baqir's study of approximately 2,000 local governments reveals that increases in the size of the legislative body is associated with an increase in the size of government.¹⁰² Baqir also concluded that, while shifting from a district system to an at large system did not affect the result, concentration of budgetary powers in a strong mayoral system did. An additional political district in the average city is associated with a budgetary increase of approximately \$0.72 million.¹⁰³ Inman provides supporting evidence of budgetary effects of constituent service. He demonstrates that movement to a city council more representative of the demographics of their

¹⁰⁰ Fernando Ferreira and Joseph Gyourko, Do Political Parties Matter? Evidence from U.S. Cities, NBER Working Paper No. 13535 (October 2007).

¹⁰¹ Thomas Romer and Howard Rosenthal, Bureaucrats versus Voters: On the Political Economy of Resource Allocation by Direct Democracy, 93 Q. J. Econ. 563 (1979).

¹⁰² Reza Baqir, Districting and Government Overspending, 11 J. Pol. 1318 (2002).

¹⁰³ Id. at 1319. Baqir's study was published in 2002 and used budgetary data from the early 1990s. See Barry R. Weingast, Kenneth A. Shepsle, and Christopher Johnsen, The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics, 89 J. Pol. Econ. 642 (1981).

constituents translated into a 23 percent increase in nonlabor spending, and that the spending was for neighborhood services rather than poverty services.¹⁰⁴

Moreover, the alternative explanations for fiscal distress cannot be fully segregated from political fragmentation. One cannot, for instance, treat demographic shifts or job losses independently of fragmentation, because one reason why tax-paying firms and individuals may exit is to avoid paying taxes that reflect the cost of deals made with interest groups from which the emigrants receive insufficient benefit.¹⁰⁵ Similarly, the absence of budgetary or financial controls may be less a function of ignorance of sophisticated accounting mechanisms than of a desire to obfuscate expenditures in order to perpetuate appropriations that might be viewed skeptically by the electorate if more transparent procedures were in place. It would, for example, be difficult to complain that New York City lacked financial expertise in the 1970s; instead, it appears that officials were involved in deliberate efforts to mask deficits and expenditures.¹⁰⁶

Finally, it is plausible to draw at least weak inferences about fragmentation from the fact that large localities rather than small ones tend to require FCB assistance. (“Require” may be a loaded term here. It is plausible that a relatively small jurisdiction could suffer the same fiscal distress as a larger jurisdiction, but the state would not intervene because the spillover effects of a small jurisdiction’s distress are insubstantial. Perhaps the current appointment of an emergency financial manager for Ecorse, Michigan (population 9,500) serves as the appropriate

¹⁰⁴ See Robert P. Inman, *How to Have a Fiscal Crisis: Lessons from Philadelphia*, 85 *Am. Econ. Rev.* 378, 382 (1995). It is plausible that historic underrepresentation of residents would mean that there were greater neighborhood needs to be met when representative city councilors were elected. Thus, the increase in expenditures did not necessarily mean that the financed projects were wasteful. Nevertheless, the increases suggest that constituent service becomes a focal point for representatives that motivates political deals with financial implications.

¹⁰⁵ See, e.g., Congressional Budget Office, *Fiscal Stress Faced by Local Governments* 3 (December 2010) (emphasizing that “political dynamics” play an important role in the structural budget imbalances that can cause fiscal distress).

¹⁰⁶ See CBO at 3; SEC Study

counterexample.) To the extent that a need for expertise underlies fiscal crisis, one might expect just the opposite, because large municipalities should have a larger pool of financial talent from which to draw. Serving public functions is likely to generate greater reputational benefits in large localities than in small ones. Small localities may be more likely to suffer fiscal crisis due to exogenous shocks, since their budgets are sufficiently small that they can be substantially disturbed by events – such as damages in a tort suit or the departure of a major employer – that would not dramatically implicate the budget of a larger locality. But, again, those shocks do not warrant the imposition of state oversight. If large municipalities are relatively susceptible to oversight, it may be due to the fact that their residents have a more heterogeneous set of preferences for local expenditures than small localities, and thus have more groups with the kinds of discrete interests that allow for fragmented decision making.¹⁰⁷

2. FCB Statutes and Political Fragmentation

If political fragmentation is the major cause of fiscal distress that warrants the imposition of an FCB, then we would expect to see the statutory frameworks for those bodies reflect the conditions and reduction of fragmented decision making. In fact, the statutory frameworks for FCBs have an uneasy relationship with the fragmentation explanation. In theory at least, FCBs possess two characteristics that diminish fragmentation. First, the appointed nature of FCBs renders them less vulnerable to the entreaties of multiple interest groups since FCB membership is not conditioned on the support of politically influential local constituents. Berman quotes an assistant receiver for Chelsea to the effect that a new contract that reduced benefits for firefighters “was only possible because the receiver did not have to run for re-election and face

¹⁰⁷ See Clayton P. Gillette, *Local Redistribution and Local Democracy* (2011).

the wrath of an organized, focused opposition.”¹⁰⁸ Commonly FCBs have the capacity unilaterally to impose fiscal constraints that might be unacceptable to local officials who require the political support of groups that benefit from fiscal largesse. Perhaps the most celebrated or notorious power involves authority to reject contracts, including collective bargaining agreements with public sector unions.¹⁰⁹ More frequently, FCBs can reject proposed budgets or items within budgets, approve or disapprove new contracts, and freeze wages of public employees. The disqualification of political actors from FCB membership in some jurisdictions betokens not only a preference for expertise, but also a desire to avoid inclusion of those who have participated in the allocation of public funds to discrete interests.

Second, to the extent that there is a relationship between multi-member logrolling or bureaucratic discretion and the size of government, the relatively small statutory size of FCB’s should reduce expenditures. FCB’s may consist of as few as one person, as is the case of the financial emergency manager position in Michigan or the receiver in Rhode Island, and membership appears rarely to exceed single digits in number. That appears to be true even for cities with large legislatures. The FCBs for Chicago’s School District and Philadelphia consisted of five members; Cleveland, Yonkers, and the New York City Emergency Financial Control Board consisted of seven, and the New York City Municipal Assistance Corporation had nine members.¹¹⁰ Centralized decision making through the FCB may have similar effects on fragmentation to the extent that decisions override legislative or bureaucratic regimes with multiple points for expenditures. Bailey attributes to the movement from a strong mayor/legislative council (actually, at the time, two legislative councils – the Board of Estimate

¹⁰⁸ Berman, *supra* note , at 64.

¹⁰⁹ See, e.g., Il St. Ch. 65 § 5/8-12-17(c); M.C.L.A. § 141.1519(1)(k); R.I. Gen. Laws Gen.Laws 1956, § 45-9-9.

¹¹⁰ *Actions Taken by Five Cities* at 50.

and the City Council) to a mayor/FCB model a reversal of the fiscally destructive prior “devolution of allocative decision making to the bureaucracies, reinforced by unionized employees.”¹¹¹

Other statutory criteria for FCB membership commonly reflect concerns about fragmentation. While some statutes eschew membership by political officials, others include the mayor of the assisted municipality. It is plausible to explain that phenomenon as evidence of the “expertise” justification for FCBs, since incumbents, if incompetent, may benefit from interactions with experts. Moreover, if one believes that mayors are likely complicit in the distribution of disproportionate benefits to interest groups, then inclusion of the incumbent appears to be an odd source of defragmentation. If, however, one concludes that mayoral complicity has been motivated primarily by the need for electoral support from multiple interest groups, then it is plausible that including the incumbent in a body that can act without fear of electoral redress, either by using other board members as “cover” or by bypassing resistant local legislators in order to impose policies, allows the mayor both the capacity and the incentive to internalize the interests of the locality at large while simultaneously minimizing the claims of antidemocratic state intervention into local affairs. Indeed, during discussion the possible state takeover of Detroit, there was been some speculation that the mayor was seeking to have himself appointed as the financial emergency manager should one become necessary.¹¹² That would have the effect of centralizing decision making authority into a single elected official while simultaneously displacing the elected city council.

¹¹¹ Bailey, *supra* note , at 146-47.

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Finally, statutory authority in at least some jurisdictions empowers FCBs to alter or avoid expenditures that tend to be associated with groups that are typically associated with the exercise of political influence, such as public sector unions. New York City's fiscal crisis in the 1970s stands as an exemplar. Certainly there were demands that the city cut its overall budget substantially, and the EFCB was entitled only to review budgets for imbalances, but not to interfere with legislatively enacted expenditures and priorities. But in practice, review of budgets implicated particular expenditures, and the demands for alterations in specific expenditures were echoed in the federal government's conditions for providing assistance.¹¹³ As indicated above, Michigan's new emergency financial manager statute explicitly permits the rescission of collective bargaining agreements. Less harshly, the Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class, which was enacted in 1991 to relieve Philadelphia from financial distress, allowed fulfillment of existing collective bargaining agreements, but required that new agreements be approved by the Authority.¹¹⁴

Statutory requirements that controlled municipalities adopt long-term plans are also consistent with the fragmentation explanation for fiscal distress. Plans that fix budgets over multiple years reduce the variability of annual expenditures, and thus induce groups to compete for fixed pool of funds rather than to accede to mutual division of an expandable budget pie. For instance, the requirement in Pennsylvania that the controlled city provide a five-year financial plan of revenues and expenditures¹¹⁵ may cabin the city's capacity to favor particular groups on an ad hoc basis, and the enhanced budgetary transparency could reduce the costs of monitoring by competing interest groups. The consequence can be to increase accountability, as organized

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¹¹⁵ 53 Pa. Stat. § 12720.209(d).

interest groups have incentives not only to demonstrate the relative utility of their proposed projects, but also to expose the disutility of proposals that compete for the same dollars, even if not for the same project.

Nevertheless, the fit between statutory authority and defragmentation is highly imperfect. Even FCB statutes that facilitate reduction of existing debt burden (perhaps by issuing new debt), reject existing collective bargaining agreements, or shift decision making responsibilities about those choices to individuals or boards who do not have electoral accountability do little to address the political causes of fiscal distress over the long term. FCB statutes generally impose no structural requirements on local decision making past the relevant control period. It is, of course, plausible that short-term changes in local financing are “sticky,” so that once they are installed by the FCB, they remain in place even when the FCB period expires. In this sense, the creation of institutions that affect budgetary decisions may be more important than approval or rejection of specific expenditures. But the inability of FCBs to demand structural changes may provide at least partial explanation for the evidence of recidivism once FCBs terminate. Yonkers, for instance, emerged from a control period in 1978, but an FCB was reimposed when the city faced fiscal distress again in 1984. The city’s fiscal position may have been adversely affected by housing desegregation orders and penalties that disrupted the budget. Even the move to a “strong mayor” has not alleviated budgetary instability, and the city has recently retained a former lieutenant governor and head of a task force on governmental fiscal crisis in an effort to find solutions.¹¹⁶ New York City (in collaboration with the state) has reverted to rolling over current obligations in a manner reminiscent of the inattention to debt limitations that contributed

¹¹⁶ See Hakim, *supra* note 9.

to the fiscal crisis of the 1970s.¹¹⁷ That other localities have not had FCBs reimposed does not necessarily mean that there has not been recidivism in the practices that generate fiscal distress. Instead, it may mean that until the most recent widespread fiscal difficulties, the practices that generate distress have been affordable.

But my point in demonstrating the lack of fit between fragmentation as a cause of fiscal distress and the limited statutory authority of FCBs is most emphatically not to claim that FCBs should have more statutory authority to impose conditions that directly reduce fragmentation of the political process. One could imagine statutory conferral of additional authority to restructure local governmental institutions, such as by allowing the FCB to impose a strong-mayor form of government or to reduce the number of districts from which the local legislature was represented. The grant of any such authority would dramatically alter the conception of an FCB from the Cincinnatus model of resolving otherwise intractable fiscal difficulties through short-term circumvention of the political process to more permanent interference with local autonomy. But there is little reason to believe that structural choices made by FCBs would optimally balance the costs and benefits of competing models of institutional design. FCBs can perhaps provide a stopgap mechanism provides short-term assurances against budgetary excess, sufficient to attract new capital from either the private market or the state. More permanent implementation of institutions that might facilitate defragmentation, however, implicate more contestable propositions and tradeoffs over which reasonable people could disagree and thus that are perhaps better resolved by normal politics or by Tieboutian mobility than by purportedly apolitical bodies. It is, for instance, by no means clear that alteration of the political structure of the locality to implement strong mayor forms of government or to reduce the number of legislative

¹¹⁷ See *Local Government Assistance Corp. v. Sales Tax Asset Receivable Corp.*, 813 N.E.2d 587 (N.Y. 2004).

districts returns unqualified benefit. Strong mayoral systems may crowd out political opposition and allow entrenchment that ultimately diminishes interest group competition.¹¹⁸ Relatively large representative bodies may enhance participation and induce better representation of minority groups. Logrolling is not necessarily negative-sum, especially for groups too small to achieve their agenda in a majoritarian system without an opportunity to become part of a winning coalition.¹¹⁹ Similarly, think of proposals to reduce the bargaining power of public sector unions by privatizing city services or by requiring competition between public sector unions and private entities.¹²⁰ The privatization movement has been less of an unqualified success, with some evidence that the political context in which privatization decisions are made reduces the efficiencies that might otherwise be achieved due either to corruption or to the mismatch between the time horizons of the letting public officials and their constituents.¹²¹ Fragmentation may also be reduced by financing local public goods through user fees rather than general taxes. That choice, however, also entails distributive consequences that compete with any efficiency-enhancing implications and is, again, perhaps less vulnerable to the apolitical characteristics attributed to FCBs. In short, the jurisdiction of even the ideal FCB is properly limited to implementation of fiscal policies that reduce the symptoms of fragmentation without addressing its causes.

III. The Political FCB

I have suggested that the match between plausible justifications for FCBs have an imperfect fit with their statutory authority. I have also suggested that any such mismatch does

¹¹⁸ Trounstine

¹¹⁹ Roderick Hills, *Federalism and Public Choice*

¹²⁰ Inman

¹²¹ See, e.g., Julie A. Roin, *Privatization and the Sale of Tax Revenues*, 95 *Minn. L. Rev.* 1965 (2011).

not necessarily warrant a grant of greater authority to FCBs, because, in theory at least, they are too apolitical to be entrusted with choices among plausible mechanisms for financing local governments that are inherently political. In this section, I take an alternative tack. I suggest that, notwithstanding the presumptively apolitical nature of FCBs that disqualifies them from making decisions that are more appropriately assigned to the political realm, the more compelling characteristic of FCBs that should limit their jurisdiction is that they are *too* political. In short, the conception of the apolitical that enters the fray, resolves fiscal morass by instituting mechanisms for defragmentation and retreats in favor of a revived local democracy defies reality. Instead, FCBs inherently and necessarily make choices among contestable alternatives, and are likely to do so in a manner that reduces the likelihood that their actions are consistent with what I have described as the democratic justifications for their existence.

The inherently political nature of FCBs is evident from the fact that fiscal decisions necessarily entail tradeoffs within the basket of goods and services that any municipality must face, given limitations on the ability to borrow money and prohibitions on printing it. Even FCBs that are statutorily constrained in their capacity to address structural characteristics of the controlled municipality or that are limited to powers of approval or disapproval of the actions of elected officials retain substantial discretion to achieve their own preferences for expenditure reductions, revenue increases, or readjustment of priorities. The authority to approve budgets entails the ability to disapprove them until the expenditures and revenue raising measures that the FCB prefers are adopted by the controlled officials. Indeed, even where the FCB is charged solely with enforcing a balanced municipal budget, it may constrain the choices of political decisions about how to attain stability. The recent decision by the Nassau County Financial Control Board to require the county to rewrite its budget was met with claims that the board was

dominated by Democrats who preferred property tax increases to the tax cuts and wage concessions preferred by Republic elected officials.¹²² Regardless of whether the claims of partisanship were true, the preference for tax increases appears to have been. The act creating the New York City Financial Control Board in the 1970s specifically barred intervention in setting the budgetary priorities of the City. Cuts were mandated, but what was to be cut nominally remained within the mayor's discretion. Nevertheless, Robert Bailey's study of the operation of the FCBs during the crisis reveals that their decisions necessarily affected the "political" decisions that could be made. As Bailey concludes, "[d]ebt was limited, debt service ensured and increased, a wage freeze was imposed, programs for increased productivity were demanded."¹²³

This is not to say that FCBs are acting in bad faith. It is only to emphasize that the decisions of an FCB are inherently political. The issue of FCB compatibility with local autonomy thus becomes more complicated. Recall that I have argued that the democratic case for FCBs depends in large part on the extent to which the FCB is able to create fiscal arrangements that address the risk of contagion to neighboring localities or to the state, or that are more consistent with the preferences of local residents than the budgetary arrangements implemented by displaced elected officials, or that are necessary to attract additional capital that permits the locality to survive a cash crisis. Those justifications assume that FCB members share a readily identifiable objective function that motivates their conduct. But the appropriate objective function is itself unclear. For instance, FCB members could justifiably seek to serve

¹²² See David M. Halbfinger, New York State Seizes Finances of Nassau County, N.Y. Times, January 26, 2011, available at http://www.nytimes.com/2011/01/27/nyregion/27nassau.html?_r=1&scp=1&sq=seizes%20finances%20nassau%20county&st=cse.

¹²³ Robert W. Bailey, The Crisis Regime 49-50 (1984).

the interests of the locality's residents, to serve the interests of the state by avoiding negative externalities of local fiscal decisions, or to serve the interests of municipal creditors by avoiding default. Moreover, even if there is agreement on the appropriate objective function, the same immunity from the demands of interest-group politics that justify FCBs make it more difficult to conclude that FCB members will faithfully pursue the preferred objective. Thus, the question is not whether FCBs can aspire to some apolitical role. Rather the relevant questions are (1) given the inevitably political nature of their decisions, whose interests do FCB members represent, and (2) in the absence of electoral checks, what allegiances (if any) motivate FCB decisions to align with the interests of the constituents they are supposed to serve? The more uncertain we are that the answers to those questions align with the performance of the ideal apolitical FCB, the less we might wish to entrust the necessarily political FCB with broad jurisdiction.

A. Whose Interests Do FCB Members Represent?

We are relatively confident that the objective that elected local officials are supposed to pursue involves the interests of the local electorate. It is for that reason that we may feel it is appropriate to impose an FCB when electoral and Tieboutian constraints on officials' deviation residents' interests appear to have broken down. The failure of local officials to satisfy local interests – whether by misfortune, incompetence, or corruption – might be thought to entail that the FCBs that replace them must serve the same objective of advancing local interests. But the reasons I have delineated above as to why FCBs do not necessarily imply a democratic deficit simultaneously provide alternative interpretations of the appropriate role of these entities. If state creation of an FCB were triggered solely by the failure of local officials to serve local interests, the assumption that FCBs serve the same function would be justified. But it is less clear that local distress, standing alone, is sufficient to warrant state appointment of an FCB

where minimal effects materialized outside the distressed jurisdiction. Rather, one might rationally conclude that the state should leave local distress to local redress, following Mill's admonition that a locality should be allowed to mismanage its own affairs, and that defalcations by local officials are best discouraged or repaired by intramural political and residential markets.¹²⁴

State takeovers, then, are perhaps most appropriately predicated on the externalities generated by fiscally distressed cities. State officials who impose FCBs or who threaten to do so commonly explain their actions in terms of the need to control potential contagion from the potential default of a distressed municipality rather than out of paternalistic concern for the controlled locality's residents.¹²⁵ If that is the case, however, then the appointment of an FCB implies protection of state interests, even if that requires subordination of local interests.¹²⁶ The statutory framework for appointing FCB members in most jurisdictions confirms that view. State officials are typically charged with naming FCB members, and the relevant officials often represent a broad spectrum of the state's political interests.¹²⁷ And because state intervention is frequently triggered by concerns for contagion from the non-payment of the distressed municipalities' debts, the appointment of an FCB typically entails signaling creditors that they

¹²⁴ John Stuart Mill, *On Representative Government*.

¹²⁵ See text accompanying notes 23-25 *supra*.

¹²⁶ See, e.g., R.I. Gen. L. § 45-9-1, which requires a state appointed receiver to act with "due regard for the needs of the citizens of the state and of the city or town, . . . as will best preserve the safety and welfare of citizens of the state and their property, and the access of the state and its municipalities to capital markets, all to the public benefit and good."

¹²⁷ See, e.g., Pa.Stat. Ann. tit. 53 § 12720.202(a) (five members of PICA are appointed by state executive and legislative leaders).

will receive sufficient payment of their obligations notwithstanding the adverse impact on municipal residents.¹²⁸

Initially one might conclude that there is no conflict between the objectives of serving the interests of local residents and those of the state or bondholders, because pursuit of each one depends on ensuring the long-term fiscal stability of the distressed locality. But there are multiple ways of accomplishing the general objective of fiscal stability, and the path chosen may favor one of the affected groups over others. Statutes that demand generation, review, or approval of a financial plan by the FCB say nothing about the mechanisms by which balancing of expenditures and revenues is to be achieved or by which debt burdens are to be resolved. Local residents may prefer that budget balancing occur at the expense of bondholders, who are likely to be composed largely by non-residents, rather than at the expense of higher taxes or reduced services for themselves, or reduced pay and pensions for their neighbors who are public employees. The decision to impose costs on bondholders is not necessarily an effort to externalize costs, since any reputational harm to the locality caused by debt restructuring could cause increases in future interest rates when the locality returns to the capital markets. Thus, resident preferences to impose costs on bondholders cannot be dismissed as pure opportunism. Moreover, although one might conclude that bondholders were not the cause of fiscal distress in the same sense that, for instance, public sector unions that obtained supracompetitive wage and benefit packages may have been, there are also instances in which bond issuances have been sufficiently ridden with scandal that claims for restructuring seem less problematic. For instance, recent negotiations with bondholders of Jefferson County, Alabama's troubled sewer

¹²⁸ See, e.g., Mary Williams Walsh and Michael Cooper, *Faltering Rhode Island City Tests Vows to Pensioners*, N.Y. Times, August 13, 2011, available at http://www.nytimes.com/2011/08/13/us/13bankruptcy.html?_r=1&scp=1&sq=faltering%20rhode%20island&st=cse

project ostensibly generated greater than typical reductions in debt obligations because one of the major banks involved in the transaction had already agreed to settle federal securities charges related to the bonds and had agreed to bear most of the losses resulting from the restructuring.¹²⁹

But even if residents' preferences for imposing the costs of fiscal irresponsibility on bondholders is non-opportunistic, the state may have a different perspective. It may prefer that residents of the controlled city, rather than bondholders, bear the adverse effects of fiscal distress, because bondholder disappointment can impose higher costs on other localities or on the state itself than local resident disappointment. Perhaps the most dramatic recent example of state efforts to favor bondholders involves Central Falls, Rhode Island, a city of 19,000 residents that had previously been placed in receivership by the state. Shortly before the filing of the city's bankruptcy petition in the summer of 2011, the state enacted a statute that required cities to impose ad valorem taxes sufficient to pay general obligation indebtedness.¹³⁰ The receiver for the city contended that the statute required him to pay creditors prior to making pension payments for city workers, and presumably prior to paying for ongoing city services.¹³¹ State officials reportedly defended the statute as necessary to ensure that investors would continue to purchase bonds of Rhode Island and its municipalities.

Other provisions of state law similarly appear to elevate the interests of creditors at the expense of residents of a distressed municipality. For instance, the New York State Emergency Control Board for the City of Yonkers was succeeded by legislation that appointed the State comptroller as the "fiscal agent" for that city. In that capacity, the comptroller was granted the

¹²⁹ See Michael Corkery and Kelly Nolan, Debt Showdown in Alabama, *Wall St. J.*, Sept. 16, 2011, at C2.

¹³⁰ See R.I. Code § 45-12-1.

¹³¹ Michael Corkery, Bondholders Win in Rhode Island, August 4, 2011. See *Moreau v. Flanders*, 15 A.3d 565, 571 (R.I. 2011).

power to approve municipal budgets, control a segregated debt service account, segregate bond proceeds, and approve the issuance of new securities.¹³² The state comptroller was legislatively authorized to exercise these powers until retirement of the bonds issued to cover the deficit that led the state to impose an FCB in the first instance. But those powers were subsequently expanded, not through the legislative process, but instead through bond covenants.¹³³

Even where the objectives of the city and the state do not blatantly diverge, it is plausible that measures taken by an FCB may have substantial long-term negative implications for municipal residents that could be avoided by alternative measures. Efforts to resolve fiscal distress will typically involve some combination of revenue enhancement, cost reduction, and borrowing. Residents might prefer either a different mix among these alternatives than is offered by the FCB, or at least a process that permits the choice among reasonable alternatives to be made by elected officials. For example, in the 1970s, the Municipal Assistance Corporation issued 30-year bonds to support New York City. The bonds were secured by a portion of state sales tax revenue that otherwise would have been available to the city. As those bonds approached maturity, however, the city was in the midst of a new fiscal crisis, which could be partially averted if the funds scheduled to be diverted to payment of the 1970s MAC bonds were instead available to the city. The state responded by creating a new mechanism that effectively allowed rolling over the 1970s debt for an additional 30 years. In effect, the scheme means that New York City residents in the 2030s will be paying the MAC debt incurred in the 1970s.¹³⁴ While one may question whether elected officials in the 1970s would have had a time horizon sufficient to contemplate such a scenario in deciding whether and how much debt to issue at that

¹³² Actions Taken by Five Municipalities at 78.

¹³³ *Id.*

¹³⁴ The New York Court of Appeals ultimately upheld the laws creating the extension. See *Local Government Assistance Corp. v. Sales Tax Asset Receivable Corp.*, 813 N.E.2d 587 (N.Y. 2004).

time, there is at least similar skepticism about the capacity or willingness of MAC officials to engage in that analysis.

Thus, it is plausible that the state and the locality will have very different views about whose interests the FCB is to serve, and the state, by virtue of its plenary authority over its political subdivisions, is likely to prevail. That result may be acceptable where the state and locality are engaged in reasonable if intractable disagreements over the proper priorities of state and local interests. But there is a risk that FCBs serve the interests of the state in more nefarious ways. I noted above that state intervention in local fiscal affairs is most appropriate where local distress threatens contagion. That is simply an application of the general principle of the state/local relationship that limits local autonomy to a sphere of action that does not produce substantial negative externalities. But states have incentives to expand the boundaries of their jurisdiction beyond clear cases of externalities. Indeed, the history of the home rule movement has largely been written as a reaction to state interventions that were largely considered to violate a principle of subsidiarity that would allocate the exercise of a particular power to the lowest level of government capable of internalizing both its costs and its benefits. Constitutional prohibitions on special legislation and on “special commissions” have been viewed as efforts to prevent the legislature from imposing burdens or benefits on localities at the behest of either residents unable to command a majority within the local political process or nonresidents who were able to organize at the state level to constrain localities involved in activities that the nonresidents found distasteful, even if they generated net social benefits. In short, the risk of contagion may be in the eyes of the beholder, and state officials who may favor takeovers of local budgets for political reasons unrelated to the efficient provision of local public goods may

perceive a contagion risk under conditions in which others perceive only highly localized fiscal distress.

It is difficult to evaluate the extent to which the motivations for appointment of an FCB involve politics rather than a concern for contagion that would justify a state takeover. One measure of political motivation might be the party affiliation of the mayor, the governor, and the legislature. I have not found any studies that test whether localities headed by mayors with a party affiliation different from that of the state leadership are more likely to be taken over than localities in similar financial condition but governed by mayors with a party affiliation the same as that of state leaders. There is some anecdotal evidence that FCBs tend to arise when the state house is occupied by a different party than city hall. Harrisburg, Pennsylvania's recent abbreviated foray into Chapter 9 was precipitated by a Democratic council's efforts to resist the imposition of financial reforms by a Republican governor and Republican state legislators.¹³⁵ Although the FRB for Bridgeport, Connecticut was created under a Democratic governor during a time when the city had a Democratic mayor, the previously cooperative relationship between the FRB and the City apparently disintegrated when the city elected a Republican mayor.¹³⁶ When FRB and city officials disagreed on whether to close the city's deficit through tax increases (favored by the state, though (or because) potentially suicidal for the mayor during an election year) or wage concessions and borrowing, the mayor filed for bankruptcy.¹³⁷ The recent extension of powers for emergency financial managers in Michigan occurred after a transition from a Democratic to Republican governor, and Republican capture of majorities in the state

¹³⁵ Paul Burton, Harrisburg Fate in Judge's Hands, Bond Buyer, Nov. 21, 2011, available at http://www.bondbuyer.com/issues/120_224/harrisburg-pa-bankruptcy-1033367-1.html.

¹³⁶ See Dorothy A. Brown, Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty, 11 Bank. Dev. J. 625, 634-35 (1995).

¹³⁷ Id. at 635-37.

senate and house of representatives. Certainly the extension was motivated in part by concerns by the budgetary morass in heavily Democratic Detroit.¹³⁸ (Both Harrisburg and Detroit have also raised issues of whether race plays a role in the state's willingness to intervene in local fiscal affairs.)

One important exception to the claim that partisanship explains the appointment of FCBs is New York City, which was headed by Democrat Abraham Beame Democratic governor Hugh Carey led the effort to create the MAC and the EFCB. But the city's situation may have been so dire, that politics aside, state intervention was uncontrovertibly necessary to avoid municipal bankruptcy and contagion to the state. Even in that situation, however, it is notable that it was the Republican leader of the state assembly who insisted on significantly increased conditions for state assistance and rejected pleas from the City for assistance prior to the creation of the MAC, notwithstanding more sympathetic support from the governor and chief financial officers of the state.¹³⁹ In negotiations about the MAC's powers, Republicans demanded that the board have veto power over city debt issues, that tax revenues be segregated for MAC's use, that the board include state legislative representation, and that limits be placed on city long-term debt.¹⁴⁰ The subsequent Financial Emergency Act, which placed greater restrictions on the city's self-government, was not opposed by the city, but was opposed by Republicans who wanted no state appropriations for the City. The Republican leader of the Assembly apparently voted for the bill only after meeting with Ford Administration officials and representatives of New York banks.¹⁴¹

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¹³⁹ Bailey at 25.

¹⁴⁰ Id. at 26.

¹⁴¹ Id. at 40.

Still, the New York experience indicates that it is difficult systematically to attribute state takeovers to partisanship. A Democrat held the governorship in Pennsylvania when Philadelphia was placed under state oversight in 1991 and Pittsburgh in 1993. Washington, D.C. was placed under a financial control board in 1995,¹⁴² when Republicans held majorities in both the House and the Senate. Nevertheless, the delegate from the District, Eleanor Holmes Norton, initiated the proposal for an oversight board.¹⁴³ The evidence on partisanship as an explanation for unnecessary takeovers of distressed localities, at least as measured by party affiliations at the state and local level, therefore, is somewhat mixed.

But even within political parties, it is plausible that there will be different preferences for the range of state and local authority over local budgets. As Roderick Hills has argued, states have systematic preferences to expand the scope of their jurisdiction by assuming functions that may more appropriately be delegated to decentralized bodies.¹⁴⁴ Any general tendency that states possess to expand their jurisdiction is likely to be exhibited most strongly in the financial area since state control over local budgets not only reduces the risk of contagion from fiscal crisis, but also favors the state in the vertical tax competition that they face with localities.¹⁴⁵ The result for both the appointment and exercise of authority by FCBs is that state officials, who ultimately determine whether and on what terms to appoint an FCB have incentives to perceive a greater risk of contagion than actually exists and to appoint as FCB members individuals who are likely to identify their objective functions more with state goals than with those of the residents of controlled localities.

¹⁴² Public Law 104-8.

¹⁴³ See *Actions Taken* at p.

¹⁴⁴ Roderick Hills, in William A. Fischel (ed.), *The Tiebout Model* at Fifty (2006).

¹⁴⁵ Gillette, *Fiscal Home Rule*.

B. What Do FCB Members Seek to Maximize?

The second question raises equally difficult issues that I will only mention here.

Assuming for the moment that we could identify the appropriate objective for FCBs, why would we believe that FCB members seek to maximize it? That is, when the self-interest of FCB members deviates from the specified objective function, what would constrain their pursuit of the former? Given the absence of electoral accountability, FCB members may, with relative impunity, serve objectives inconsistent with those that they are supposed to serve. This is not to say that FCB members would be corrupt or intentionally deviate from the interests of their intended constituents. It is only to say that they might filter the definition of their constituents, or of how to serve their intended constituents through a lens that deviated from the one expected by the intended constituents themselves.

The source of deviation may vary with respect to different FCB members. Members from the local public sector, such as mayors of controlled municipalities, may have distorted incentives if the specified objective function is to serve the interests of state residents (to whom the public member does not have electoral accountability) rather than local residents (to whom they do have electoral accountability). Members of FCBs appointed from the private sector may have difficulty abandoning the incentives and interests that they bring to their public roles, especially when those roles are prized as providing the knowledge and expertise necessary to remedy the situation created by public officials. But those roles could skew the selection among various alternatives. Felix Rohaytn, an investment banker, was perceived by some as being too lenient on bondholders at the expense of residents. Bailey, for instance, concluded that, under

Rohaytn's leadership, the Municipal Assistance Corporation transformed from serving as an advocate for the city to advocating on behalf of the credit markets to the city.¹⁴⁶

Without electoral accountability, why would we believe that the decisions of FCB members are consistent with the plausible objectives posited for them? Unlike judges, for whom long term of office and repeat play provides a basis for believing that reputational constraints will offset the absence of democratic controls,¹⁴⁷ the temporary nature of FCBs, the relative anonymity of FCB members, and the reduced likelihood that members will be active in multiple FCBs make it difficult to rely on extra-legal sanctions to motivate fidelity to even well-defined objectives. Legal sanctions are similarly unlikely to impose substantial constraints, as the absence of statutory admonitions to implement specific policies or to create priorities among budgetary practices implies deference to the decisions of FCBs.¹⁴⁸ The result is that FCBs can implement their visions of desirable budgetary programs with little in the way of political or legal constraints.

Conclusion

The ideal model of the FCB entails that it will enjoy functional success by addressing the structural causes of fiscal distress (incompetence or fragmentation) and the risk of moral hazard that would otherwise argue against centralized assistance, and attracting necessary capital to a struggling municipality. That model predicts that modifications implemented by an FCB can reduce the risk of recidivism by rejecting both individual expenditures and decision making structures that generated the initial distress. The ideal conception of the apolitical FCB also

¹⁴⁶ Bailey, *supra* note , at 31.

¹⁴⁷ See Posner, etc.

¹⁴⁸ FCB decisions are likely to receive substantial deference from courts. See, e.g., *County of Nassau v. Nassau County Interim Finance Authority*, 2011 WL 1044556 at *18-19 (N.Y. Sup. Ct.).

assumes minimal interference with local democratic practices, and implies that those practices that are displaced were inconsistent with the preferences of local residents as a whole. Under those explanations, the variety of FCB schemes is neither problematic nor undesirable. Indeed, the absence of harmony in the ways in which states address municipal fiscal distress may exemplify the traditional benefits of a federal system in which different regions experiment with different prospective solutions to a common problem in effort to find a panacea.

Nevertheless, state supervision of municipalities through FCBs becomes more dubious if there is little relationship between the root causes of distress and the powers of the FCB, and if FCBs fail to provide long-term, structural solutions to the root causes of municipal fiscal distress. If the FCB repairs the immediate crisis, but political bargains to treat the local treasury as a common pool recur at the conclusion of the control period, the FCB has only provided a stop-gap rather than a remedy for the primary source of fiscal distress.¹⁴⁹ One then must wonder whether the game is worth the candle. But even if one concludes that FCBs in their current form do not offer long-term solutions, the response is not to provide them with greater authority. The theoretical apolitical nature of the ideal FCBs makes them poor candidates for resolving the inherently political issues that distressed localities must face about budgetary tradeoffs. And the practical political nature of their operation means that their unaccountability makes FCBs poor candidates for addressing those same issues in a manner that isn't subject to claims of democratic deficits. The democratic case for FCBs might be stronger if we were confident that they were entrusted with well-defined objectives, such as protecting residents against the risk of contagion that attended default by the distressed locality. But both the appropriate objectives for FCBs and

¹⁴⁹ The point here is quite different from the one made in Note, Missed Opportunities, supra note 2. The author of that Note observed that FCBs did not address regional issues that could adversely affect the financial security of cities and suggested that states create financial reform boards that would restructure urban boundaries. My argument is that internal political interactions, not insufficient regionalization, causes fiscal instability.

the likelihood that they will pursue them are contestable, given the biases of the state that creates them and the uncertainty that FCB members have incentives to pursue whatever objective we define for them.

This is not to say that FCBs should be avoided. The mere change in decision making personnel may provide access to either private or state capital necessary for the survival of distressed municipalities. But the characteristics of FCBs give pause to statutory grants of broad and long-term authority over municipal budgeting or that imply the capacity of FCBs to achieve an optimal balance between the financial interests of the state and those of its political subdivisions.