DEFAULT WITHOUT CAPITAL ACCOUNT: THE ECONOMICS OF MUNICIPAL BANKRUPTCY[1]

Lotta Moberg
Department of Economics
George Mason University, Fairfax, VA 22030 USA

Richard E. Wagner
Department of Economics
George Mason University, Fairfax, VA 22030 USA

ABSTRACT

This paper analyzes the concept of municipal bankruptcy in a comparative framework with commercial bankruptcy. Cities are corporate bodies that continue to exist despite the ever changing identities of the residents. The common designation of cities as municipal corporations suggests an affinity between them and commercial corporations that would offer a bridge between commercial and municipal bankruptcy. Despite this apparent affinity, however, there are significant institutional differences between the two forms of corporation that prevents construction of such a bridge. Commercial bankruptcy allows both creditors and debtors to resolve problems that emerge in consequence of a debt default, and to do so in a generally beneficial manner given the fact of insolvency. By contrast, municipal bankruptcy is a process that benefits some city creditors at the expense of others.

1. INTRODUCTION

These days, news media are full of reporting on governmental financial crises. The specter of default and bankruptcy looms across all levels of government, from small towns to large nations. Commercial corporations enter bankruptcy regularly and it is easy to understand how insolvency and bankruptcy can arise.[2] Companies borrow in the anticipation that the added revenue that capital infusion makes possible will exceed the expense of retiring the debt. In a turbulent world, however, commercial plans sometimes do not work out as their creators anticipated, and the corporation may end up unable to redeem its debt. While bankruptcy may not be the best way for the corporation

---

1. We are indebted to two referees for helping us to strengthen our argument by pointing out places where our argument was unclear and by suggesting paths to achieving clarity.

2. As an etymological note, b*ankruptcy* is derived from Italian *banca rotta*, meaning "broken bench", which may stem from a custom of breaking a moneychanger's bench or counter to signify his insolvency (Loveland, 2012: 4).

to move forward in the commercial world, it is a viable option all the same. A plan can be worked out to restructure the enterprise and unprofitable parts of it can be eliminated. Creditors can be assured of a process that is orderly even if disappointingly unprofitable.

Municipalities are in many ways like commercial enterprises. Cities have a formal similarity to hotels, with paying residents, services, transportation, and public and private spaces (McCallum, 1970; Foldvary, 1994; Wagner 2007, 2012c). Because of their similar structure, cities are often described as municipal corporations. Like their commercial cousins, municipal corporations also experience financial crises. In the United States, they have their own form of bankruptcy provision, denoted as Chapter 9, to complement Chapters 7 and 11 that pertain to bankruptcy by commercial corporations. The resemblance between municipal and commercial corporations thus allows for treating municipal bankruptcy as a special case of commercial bankruptcy. Those similarities, however, are superficial. Once one looks beneath that surface, the institutional differences between municipal and commercial corporations render dubious any facile extension of commercial bankruptcy to municipal corporations. Municipalities are but cousins to commercial corporations. With commercial corporations, there typically exists an active market for shares of ownership and there is at any moment a market value for the corporation. In contrast, there is no direct market for ownership shares of municipalities, so no market value can be established for them.

Commercial bankruptcy is often described as a means of giving everyone in the corporate nexus a fresh start once it becomes clear that they will otherwise be unable to escape their insolvency. For municipal corporations, however, insolvency is often, though not invariably, a product of intentional political conduct. As we will see, municipal bankruptcy therefore leaves unaddressed the institutional sources of fiscal crisis. Municipal bankruptcy offers not so much a fresh start as it creates a fresh source of taxation by imposing a special tax on municipal creditors.

While economic action always follows a universal logic of seeking gain and avoiding loss, the substantive force of that logic plays out differently under different institutional arrangements. In the section that follows, we explore how institutional differences between commercial and municipal corporations affect the nature of their capital accounts and their tendency to incur debt. We explain in Section 3 that municipal insolvency therefore does not carry the same meaning as commercial insolvency. In Section 4, we show that insolvency among municipal corporations is actually an inherent feature of the fiscal commons on which they operate. Democratic governments differ significantly from commercial enterprises in that they have systematic tendencies to push costs off to some future date rather than facing them now. Section 5 points to the weakness of the link between any concept of insolvency for governments

and their propensity to go bankrupt. We thus argue in Section 6 that this means that bankruptcy for municipalities is an inherently illusive concept. We conclude by explaining why municipal bankruptcy can become meaningful only by significant institutional changes in how governments operate.

2. MUNICIPAL CORPORATIONS AND THEIR IMPLICIT CAPITAL ACCOUNTS

While municipalities, like commercial corporations, can become insolvent, bankruptcy has a very different meaning between them due to significant differences in their capital accounts. All corporations have capital accounts in the *de facto* sense of the term, along with a list of assets and liabilities. For commercial corporations, the capital account is real, as illustrated by the existence of a market for ownership shares. For municipal corporations, the capital account is only implicit. Municipalities operate with assets and liabilities, and so must possess capital accounts that achieve balance between the two sides. There is, however, no direct market for ownership shares, which means the capital account is only implicit or imputed and not actual. This difference between actual and implicit capital accounts ramifies throughout a wide range of issues regarding the operation of municipal corporations.

The capital accounts of commercial corporations reveal their net worth. They are created by funds supplied by people who choose voluntarily to become shareholders and owners. This leads to a setting where corporate shareholders tend to agree about the distinction between good and bad corporate performance. With an open market in ownership of corporate shares, there exists at any moment a market value for the corporation that is governed by the willingness of people to buy corporate stock. A significant share of the compensation of corporate executives is also tied in various ways to the changes in market value of corporate stock. Corporate executives will therefore have strong incentives to maximize corporate value, as has been explored both theoretically (Meckling and Jensen, 1976; Fama, 1980; Fama and Jensen, 1983) and empirically (Manne, 1965). In commercial corporations, the interests of shareholders and managers are not in conflict with one another because they share a common interest in efficient corporate operation (De Angelo 1981; Makowski, 1983).

Given the kaleidic nature of economic reality (Shackle, 1972; Shackle, 1974; Wagner, 2012a), it is nevertheless unavoidable that firm executives sometimes make decisions that turn out so badly that they lead to corporate insolvency. A corporation that incurs debt to finance a new construction project will do so under the belief that the project will increase the net worth of the corporation. If the project somehow does not generate sufficient revenue to cover the project's cost, this loss depresses the market value of the corpora-

tion. If no quick remedy is found for this situation, the corporation may end up insolvent and declare bankruptcy.

Municipal corporations can face similar situations, only their capital accounts are implicit and not explicit, and this makes all the difference. With municipal corporations, there are no explicit ownership shares that can be bought and sold, so municipal corporations, unlike commercial corporations, do not have market value. Without market value, it is impossible to tie executive compensation to changes in an enterprise's market value. Therefore, where a commercial corporation might abandon a project that turns out to be unprofitable, a municipal corporation can increase taxes to cover the losses. One rarely if ever sees municipal executives abandoning a project because it has been proven not to be worthwhile. This difference in modes of operation is due at base to the differences in capital accounts. For commercial corporations, the stock market continually yields information about corporate performance. While such information contains variable amounts of noise that prevents the fundamental value from being perceived with full accuracy, no similar information can even be collected about municipal performance.

Unlike a corporation's shareholders and executives, therefore, the interests of residents and public managers often mesh only incompletely. In both cases, an organization is managing many people's money. In a municipal corporation however, the officials deciding how to spend the money are not guided by the incentive to maximize the value of their investments on behalf of their residents. Elections are not a substitute in this regard. They represent what economists would recognize as cheap talk, because a vote is not accompanied by a purchase of a stock whose value is rising or falling. Voters, in contrast to commercial investors, do not place their own skin in the game (Wagner and Yazigi, 2013).

A municipality might sponsor a major construction project that includes a tunnel under a river and an elevated roadway through the center of town. The project is sold to the citizenry under the claim that construction will require $100 million, which is secured by selling bonds. Like many such public projects, the original budget projection might prove to be too low. The project is half-finished and the money is gone. Does this experience mean that it is a bad project that should be abandoned? Perhaps it does. A commercial corporation in this kind of situation might abandon the project to secure its salvage value, recognizing that to continue the project might bankrupt the firm. Municipal executives, however, are not compensated by firm value. They have no significant capital invested in the municipality, and in any case cannot use market signals about firm value to obtain guidance from third-parties about municipal performance.

It would therefore not be surprising to see the city's governing board approving a tax increase or borrowing to support completion of the project. Where a commercial corporation faces insolvency, a municipal corporation can increase taxes. There are of course limits on the ability of any municipality to increase taxes. A city council will not raise taxes to a level where the city becomes depopulated, though falling population was significant in the recent bankruptcies of Detroit and Stockton. It is quite possible that some form of revolt will occur before depopulation runs its course. Nevertheless, the relationship between managers and capital suppliers is looser for municipal corporations than it is for commercial corporations. This looser relationship is a manifestation of the institutional differences in the capital accounts of the two corporate forms.

Municipalities have residents but not shareholders. It would always be possible as an accounting exercise to construct an implicit measure of shareholdings. Ownership shares could be imputed in proportion to taxes paid. Someone who paid twice the tax as someone else would be imputed as having twice the ownership shares. Such a measure of shareholding, however, would be imputed and not actual, in contrast to the situation with commercial corporations. There is no market exchange for the rights to enjoy the public spaces, services and voting rights that are available for municipal residents. The municipal enterprise does not have equity that grows or shrinks according to the economic success of the municipality, and which a person leaving the community can take with her if she so chooses. For a commercial corporation, an excess of revenues over expenses indicates successful operation of the corporation. This is not the case for a municipal corporation. Without transferable ownership and the corporate value that this allows, the notion of a rate of return on equity is undefined, and would at most have implicit existence through some accounting-based effort at imputing such a return.

Because of the differing natures of their capital accounts, corporations run surpluses where many municipalities would run deficits. The corporation can divert some of the extra profits in the form of dividends to its shareholders. Such payments signal that the enterprise has cash to spare, which can encourage people to remain shareholders. If the municipal enterprise has unspent money, municipal executives will often choose to fund new projects or expand existing projects. Returning those funds to taxpayers would be a sign of miscalculation in the need for tax revenue, and hence managerial incompetence, which would offer little positive political return.

Rather than paying dividends, a municipality collects reversed dividends in the form of tax payments. These do not buy taxpayers additional shares of ownership in the municipality, but rather are an imposition that allows a municipality to fund activities that it could otherwise not afford. It can thus conscript capital in a way that corporations cannot. The municipal entity does not

run on its own capital but relies on the cash flow from fees and taxes. The lack of a genuine capital account and the market valuation that it generates reveals the tenuous relationship between corporate and municipal bankruptcy. In an entity without market value, what and whom are bankruptcies for? And what does it in fact mean that a municipality files for bankruptcy?

3. THE AMBIGUOUS NATURE OF MUNICIPAL INSOLVENCY

Bankruptcy has a clear meaning for a commercial corporation because the net worth of the corporation has clear meaning under limited liability. A commercial corporation can have negative cash flow and yet be able to meet its debt obligations by drawing down its capital. If the debt obligations exceed that capital value, however, the corporation will be unable to satisfy all its creditors, leaving bankruptcy as a process for dealing with the situation. Such was the case with Lehman Brothers, which filed the biggest bankruptcy in American history in September 2008, with an unpaid debt of $691 billion. Lehman Brothers was fast approaching balance sheet insolvency as its assets were falling in value. Selling part of its portfolio would only provide a temporary relief from cash-flow insolvency. Bankruptcy became the only way of preventing a conflict-laden scramble among creditors.[3]

Municipal corporations do not operate under limited liability, though such operation would be possible as McCallum (1970) and Foldvary (1994) explain. Rather, municipalities operate with unlimited liability, which makes insolvency an ambiguous condition. To say liability is unlimited is not to say that cities have access to the entire wealth of its residents because those residents can always move elsewhere. The unlimited nature of liability means only that there is no definite point where the city has zero net worth. Such a point can still be reached, and the process of reaching such a point could entail significant depopulation. For instance, Detroit's population fell by about two-thirds from a high of two million in the mid-20th century to the time it filed for bankruptcy in July 2013.

At the time Detroit filed for bankruptcy, its debt was estimated at around $19 billion. The city's bankruptcy attorney Kevyn Orr described its operations as "wasteful after years of budgetary restrictions, mismanagement, crippling operational practices and, in some cases, indifference or corruption" (AP, 2013). Detroit would at the end of the year have $100 million in deferred pension payments (Orr, 2013). In November 2011, Jefferson County, Alabama, which includes Birmingham, declared bankruptcy with $4.2 billion of debt. Much of Jefferson County's bankruptcy has been attributed to a sewer construction project that turned out much costlier than initially expected.

3.http://www.nytimes.com/2008/09/11/business/11lehman.html?_r=2&hp=&adxnnl=1&oref=slogin&adxnnlx=1361127876-WTQFizmb/9+4Xlj6gbG7ig

Detroit and Jefferson County share a similar pattern of conduct: borrowing against a projected rosy future rather than living within a city's means. Municipal officials can overestimate the value of their projects and hence pursue projects that in many people's eyes are not worth the cost. Yet if a municipal corporation makes such a mistake, it need not be insolvent in the sense of a negative value for the city. Residents of a city often enjoy benefits from living there beyond the value they receive from city-supplied services. To the extent this is so, a municipality can increase taxes on residents without inducing significant migration because of the consumer surplus that residents attach to living in that city. To some extent municipal authorities will be able to transform consumer surplus into municipal expenditure (Niskanen, 1971). Municipal residents will leave only when they sense that the quality of life in another municipality is significantly better. The ability of municipal authorities to transform consumer surplus into municipal expenditure is strengthened when governments cooperate on high tax rates to avoid the tax competition that could deprive them of valuable citizens as well as capital (Morriss and Moberg, 2012).

We cannot know whether a municipality in this view is insolvent or not, as one cannot calculate how well a city is truly performing. A company becomes insolvent if its customers do not value its offerings more highly than the firm's cost of producing those offerings. For municipalities, one can measure how much people pay to support local government, but one can only estimate the value of the services that are supplied. Budget deficits are not reliable indicators for appraising municipal performance. Two cities might run identical deficits. One of them uses the extra funds to support a project that benefits most residents. The other wastes the money through poor managerial practices or by building ugly monuments. If these were commercial corporations, the former would be solvent and the latter would find its value plummeting and possibly end up in bankruptcy. As municipalities though, the two appear objectively equivalent when studying their annual budget documents.

A municipality can in other words stay in business despite creating negative net value for many or most of its residents. To the extent that people build personal ties to the local environment and the people with whom they associate, insufficient municipal services and high taxes need not cause a municipality to lose its residents, at least not to the extent that a commercial corporation would lose customers.

4. THE SYSTEMIC FEATURE OF DEMOCRACY AND DEBT

In a democratic system, policymakers have incentives to create positive value for city residents. Yet, democratic institutional arrangements also contain systemic pressures to issue debt in preference to taxation, as Buchanan and Wagner (1977) explain and as Wagner (2012b) extends and amplifies. As

an analytical point of departure, suppose that a city faces a truly hard budget constraint, so that all promises to spend are accompanied by equivalent extractions of revenue. Within this institutional framework, all current expenditures would be financed through current taxation. In addition, all promises of future expenditure are funded by assigning future tax liabilities to current residents, and with those liabilities remaining with current residents even if they move elsewhere.

Within this imagined institutional setting, the replacement of tax finance with debt finance does not soften the city's budget constraint one bit. Ricardian equivalence (Barro, 1974) thus holds as a practical and not just as a theoretical matter. Ricardian equivalence weakens as the budget constraint is loosened so that a city can borrow money without assigning explicit liability for repayment of that debt. Ricardian equivalence recognizes that borrowing is merely future taxation, with the present value of those future taxes being equal to the amount borrowed in the first place. It is an accounting identity with respect to a closed set of people. A municipality however, is not a closed set of people. Its membership changes continually as people enter and leave the city. The ability to borrow relaxes the budget constraint because liability to repay the debt is not assigned to individual members of the city at the time the debt is created.

In contrast, debt in commercial settings rests with the debtor regardless of whether that debtor stays in place or moves far away. Liability for debt is personal, regardless of whether the debtor is a person or a corporation. What we mean by debt being personal is that it represents a specific obligation that is distributed among the shareholders in proportion to their ownership shares. This is not the case with debt issued by municipal corporations or other governmental entities. Liability for municipal debt is not assigned to specific people at the time it is created, but is rather assigned in future years as the debt is amortized. When the debt is issued, the distribution of its liabilities is contingent upon future economic and political circumstances, including changes in tax systems (Buchanan, 1967). For instance, a city that finances its activities wholly by a tax on real estate might subsequently shift half of its financing to a retail sales tax, thereby changing the distribution of liability for debt amortization. A municipal resident may opt for the bond with the expectation that he will pay it later in property taxes, but later find that he bears an increased tax liability due to the change in tax structure.

Even if tax schemes remain the same, the residents of a city do not. This means that a collectively expressed preference for debt financing over tax financing does not imply that the members of the locality believe that borrowing will be beneficial. To illustrate, consider a typical resident of a municipality where a referendum is held on whether to finance a significant program of capital improvement by issuing bonds to be amortized over 20 years when the

alternative is to finance it by an equivalent tax increase. Ricardian equivalence says that these two options are equivalent. For many taxpayers, however, they are not. Ricardian equivalence might hold for a taxpayer who expects to remain in the city for the 20-year period over which the debt is amortized. For a taxpayer who expects to remain there only five years, the bond will be superior to the tax. A systematic tendency toward deficit finance is therefore a natural feature of democratic systems.

We should note that existing institutional arrangements have features that operate to limit the intensity of the preference for deficit finance. The operation of the real estate market creates some personal liability for deficit financing. To illustrate this point, imagine a city that is financed wholly through taxes on real estate and where all voters own real estate. Such a city, in other words, has no tenants. The real estate market would in this case generate personal liability for deficit financing in proportion to a taxpayer's share in the total value of real estate in the city. The taxpayer who leaves the city after five years will find that his or her real estate sells for a lower price the larger the amount of public debt the city has issued.

This illustrative case is, however, far from reality. Cities have many residents who are both tenants and voters, and cities are not financed exclusively by taxes on real estate. Many participants in bond referendums have reasons to support a bond issue over a tax increase because debt finance is personally less costly than tax finance. This can explain why direct voting on bond issuance has not kept municipalities out of bankruptcy. The revenue generated from issuing bonds is generally tied to projects such as new schools that matter more for current residents than do obligations for future debt amortization. Currently, 27 American states have mandated direct elections for issuing municipal bonds. Among those are all of the states with municipalities that have filed for bankruptcy since 2010: Alabama, California, Idaho, Michigan, Pennsylvania, and Rhode Island.[4]

Most municipal decisions regarding debt and taxes take place not through referendums but through proceedings of a city council and similar corporate entities. In many cases, a mayor or the members of a city council will seek to capture present support by making commitments that will come due in the future. One popular tactic is to relax budget constraints by promising more favorable pension terms to city employees, or perhaps significant subsets of such employees. The city of Stockton, for instance, which declared bankruptcy in June 2012, was reported to have accumulated some $900 million of liability in retirement promises. In cases like these, we see a simple template at work: a

4. http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html.

nasty present problem can be obviated by replacing current taxation with taxation at a future date when it is someone else's problem to deal with.

5. INTERNAL AND EXTERNAL SOURCES OF INSOLVENCY

As a conceptual matter, we can distinguish between internal and external sources of municipal insolvency. Internal insolvency traces to the implicit nature of the capital account with which municipalities operate. External insolvency traces to features of the system of governance within which municipalities are embedded. A municipality can become insolvent either through ineffective management or through exogenous changes in its environment. Internal insolvency arises because governmental entities are not capitalized like corporations, which yields a soft budget constraint. While governments have the ability to accumulate contingency funds, the pressures and tendencies of democratic politics encourage the dissipation of such funds (Buchanan and Wagner, 1977). Cost overruns on projects will rarely be covered by contingency funds and will instead often be accompanied by borrowing or increased taxation. Budget deficits also accompany such unforeseen events as cost overruns on projects or situations like floods that require an emergency response (Wolfe, 2012: 561). All the same, recurring budget deficits rarely lead to municipal bankruptcy. Because deficits are more the rule than the exception, they cannot explain why only around thirty municipal bankruptcies occurred in the United States between 1976 and 2009 (Kimhi, 2010: 12). We must therefore look for explanations in municipalities' external environment.

External insolvency arises through the ability of higher levels of government to impose obligations on municipalities. Because cities are creatures of their states, those states can impose costly requirements on local governments located inside their boundaries (Burns and Gamm, 1997).[5] External insolvency can similarly hit commercial corporations through the imposition of regulatory requirements. Whether the insolvent entity is a commercial or a municipal corporation, the source of that insolvency resides in the unanticipated imposition of costly requirements by higher levels of government. External insolvency can also result from unanticipated decreases in support from higher level governments.

For a municipality, a drop in support from the state deteriorates its financial situation if the municipality counted on state support. Because of the nature of politics, such drops can happen suddenly. A great deal of the macrotheoretic literature promotes the idea of governments as acting to stabilize what would otherwise be an unstable economy. Consideration of some elementary principles of political economy, however, gives reason to think that

5. Goodnow (1997) examines municipal home rule as a framework and process through which relationships between states and municipalities are governed.

politics more often operates to generate instability than to promote stability. Within the theory of economic equilibrium, economic patterns are presumed to be stable without changes in what people want, what they know, or in the supply of resources. Even within this set of circumstances, however, literature on public choice and political economy shows how political processes can inject volatility into society. Majority rule is a prominent feature of democratic processes. It is subject to the problem of cyclical majorities (Buchanan and Tullock, 1962), which means that for any motion regarding a budgetary program that enjoys majority support, there are an indefinitely large number of revised programs that could defeat the program in question by a majority vote. Stability in wants, resources, and knowledge is not sufficient to promote stability in fiscal outcomes even though it is sufficient to promote stability in market outcomes.

This is the nature of the environment in which municipal corporations operate. They are not autonomous entities that interact with other entities as economic rationality dictates. Governments can impose action on other public entities, as they are not limited by the market-governing conventions of private property and liberty of contract. New York City experienced this reality in its 1975 financial crisis and subsequent quasi-bankruptcy. Despite its insolvency, the city was rescued from default as state and federal authorities worried about the repercussions of letting such a large city default. Congress even debated signing a special law for such large municipalities (Splitz, 1992; Patchan and Collins, 1976). New York was rescued as the state government stepped in and guaranteed the city's debt (Tung, 2002: 31) and the federal government extended loans to the city (Gilette, 2012: 308). Whether New York City would default was less a matter of the magnitude of its financial distress than it was a matter of politics. A federal bailout has otherwise only materialized in the case of Washington, D.C. Usually it is a matter of state governments stepping in to save its own towns and cities. Yet a municipality cannot know in advance if such help is coming, or whether the assistance might come in the form of loans, bailouts, or a takeover of the municipal government (Id: 310).

Moreover, constitutional limits on the ability of local governments to issue debt are often avoided through legislative exemptions from those limits. For instance, White (2003: 566) explains that when Birmingham, Alabama faced a constitutional debt limit of $406 million, it was able to borrow $556 million due to legislative exemptions for debt to fund schools and sewers. Political entities can create limits, but they can also ignore or avoid them. In this respect, Primo (2007: 109) explains that the American Congress enacted legislation in 1978 that required a balanced budget by 1981, only Congress ignored its own legislation. As Schragger (2012) explains, the control of debt is more a political than a technical problem. Technical problems are clearly involved because budgeting is replete with technical challenge, as Reed and Swain (1996) illustrate. Budgeting requires projections of revenues and expenses,

which are not open to precise calculation in advance. While those projections will be subject to error, we should expect those errors to be random and not systematic. This means that unexpected surpluses should arise as often and be of similar magnitude to unexpected deficits. Yet surpluses are rarely observed. Deficits are the norm, which illustrates that the accumulation of debt is more a political than a technical problem.

High municipal debt is frequently solved simply by governmental transfers. Municipalities routinely receive grants from the state level to cover their expenses (Buettner and Wildasin, 2006). Between 1972 and 1997, almost 30 percent of municipal revenue came from government transfers. This allows local politicians to increase spending without increasing taxes. When a municipality receives more grants, almost two thirds of the extra revenue tends to be used for higher levels of spending rather than lower taxes (Id.: 18).

This municipal support system would supposedly be limited by the fact that all American states except Vermont have balanced budget requirements. That should mean that what a state transfers to one local government must be offset by reduced transfers to other governments, or financed by increased taxation. However, only 37 states actually require the budget to be balanced within one fiscal year. Several of these alleged requirements constitute vague interpretations of statutes. Only California and Massachusetts actually require that the government signs off on a balanced budget (Hou and Smith, 2006). In addition, only expenditures consisting of 50-60 percent of government spending actually need to be balanced. Expenditures on buildings, highways, and land can be financed by debt without affecting any balanced budget requirement (NCSL, 2010). It is therefore no mystery that state budgets generally are not balanced.

In addition, the American federal system allows for interstate transfers of magnitudes large enough that some American states have run deficits of hundreds of billions of dollars over the past couple of decades without the equivalent debt to show for it (*Economist,* 2011). The vague notions of balanced budgets and the ability of higher ranking governments to aid local governments when they deem this prudent means that the fiscal fortunes of municipalities depend not solely on the actions of their own municipal executives, but also on activities of higher levels of government. The weight of plausibility would suggest that the first place to look when municipal insolvency arises is to management of the municipality. Nonetheless, a system of governments surely entails less independence among entities at different levels than the market economy entails independence among corporations. Even if alleged debt limits on the local and state levels are a better constraint than none at all, the incentive of political officials is not to refrain from borrowing and spending today when they know that they can obtain government grants tomorrow.

6. THE TOOTHLESS BITE OF MUNICIPAL BANKRUPTCY

As creditors try to obtain as much value as possible from a failed company, corporate bankruptcy can help them solve this common pool problem. When a company files for Chapter 7 bankruptcy, its assets are liquidated and creditors are paid in an orderly fashion. Bankruptcy can also allow for a fresh start for a company and a reorganization of its debt. A company filing for Chapter 11 bankruptcy remains a going concern, usually with the debtor still in charge of the business and protected for a period from any litigation. If a company is illiquid but solvent, Chapter 11 bankruptcy can help it reorganize its finances and remain in business.

Chapter 9, municipal bankruptcy, is likened with the corporate world's Chapter 11. This was, however, not always the case. After the law was enacted in the wake of the Great Depression and until New York's near bankruptcy in the 1970s, the object of the law was to avoid a holdout problem among creditors. If a debt needed to be restructured, it was always in each creditor's self-interest to claim the rights to her share while the others were forced to agree on a haircut (Kimhi, 2010). Chapter 9 served to protect the process of the debt readjustment agreement and thereby had a fairly limited function (Id.). Since a municipal bankruptcy does not entail dismembering a town and selling off its constituent parts on the market, the old Chapter 9 was merely a law that granted policing to oversee compliance with a restructuring contract.

For a municipal bankruptcy law to allow for restructuring and reorganization of the municipality, solving creditors' holdout problem cannot be its only function. After New York City almost went bankrupt in the rough economic times of the 1970s, the American municipal bankruptcy law was revised. More power was given to the municipality over the debt restructuring procedure, and it received greater protection from creditors when reorganizing its finances (Id.). Bankruptcy thus became a more appealing route for municipalities in financial distress. Chapter 9 is now more akin to Chapter 11 filings for companies, and "is based on the idea of the fresh start rather than the efficient reconfiguration of assets" (Id.: 470), but with an even higher protection for the municipality than for a Chapter 11 company. While a trustee may be appointed to govern a bankrupt company under Chapter 11, Chapter 9 protects the bankrupt government from any interference it its internal affairs. No creditor can demand that a municipality changes its policies so as to put the municipality's assets to more productive use (McConnell and Picker, 1993: 462, 470, 472).

It seems that the model for municipal bankruptcy has come to favor municipalities at the expense of their creditors. A skeptic of the current leniency towards municipalities might hope that further development of the municipal bankruptcy code will eventually yield a bankruptcy model that is suitable for

municipal enterprises. If it was too harsh on municipalities before and too lenient now, the law might eventually find a place somewhere in the middle. However, the political institutions in which municipalities operate create significant analytical distance from commercial corporations. While it is reasonable to describe commercial and municipal corporations as cousins, they surely must be regarded more on the order of second or third cousins than first cousins. A bankruptcy cannot restructure municipal assets so as to increase the market value of the municipality. It does not occur when a municipality is actually insolvent, but rather as a result of political decisions over intergovernmental transfers. A municipality in bankruptcy may be allowed to partially default on its debt, but whatever it thus gains, its creditors lose. In addition, the stained reputation of the bankrupt municipality lowers the value of its residential properties (Kimhi, 2010), to the dismay of its residents.

While corporate bankruptcy can serve both parts of the loan contract, municipal bankruptcy can thus only change the slices of the same or shrinking pie as the law is adjusted for the benefit of one side or the other. The positive effects from restructuring in a corporate bankruptcy are absent. So are the benefits from keeping a corporation as a going concern. If a factory's managers have built up a smooth operation, with collaborative production teams skilled at working with the company's machines, it may be prudent to avoid dismantling the operation. This analogy does not hold for municipal bankruptcies. Neighborhoods and communities will remain with or without it. Grocery shops keep working and people are not told to seek new employment. The municipal bankruptcy code thus cannot be a tool for restructuring the municipal enterprise.

7. CONCLUSION: CAN EXTRAVAGANT PROMISING BE TAMED?

Any politician of a municipality in financial distress would want to receive grants from higher government levels to avoid the stigma that bankruptcy implies. Bankruptcy is generally associated with misery and poverty (Kimh, 2009: 41) so it threatens to place a politician in a bad light. It seems that in a democratic system, a bankruptcy will stain the popularity of office holders. To avoid being voted out of office, politicians should therefore abstain from political prolificacy. Yet, politicians hoping to avoid bankruptcy may still not have an incentive to avoid budget deficits. They want to remain in office however this might be accomplished, and in that pursuit bankruptcy should be avoided. The budgetary reality of municipalities, however, is that politicians can spend more than their tax revenues without becoming insolvent or, thanks to intergovernmental transfers, even incurring a net deficit. As long as they can avert outright bankruptcy, deficit spending is a winning strategy. Democratic politics thus tends to operate with budget deficits. While budget surpluses arise in sporadic instances, they are small in magnitude and of short duration. Often,

any surplus will be a kind of resting point, where funds are being stored until support is marshaled for a new political program.

What can municipal bankruptcies accomplish? Can they ever help tame the extravagant spending promises that are a natural part of democratic processes? Kimhi (2010) proposes to replace bankruptcy with stringent supervision of local finances by a state-appointed officer who would somehow operate independently of political considerations. To similar effect, Gilette (2012) proposes that bankruptcy courts be able to impose tax increases or spending reductions on municipalities. He admits, however, that the courts might actually deteriorate municipal finances further in the process, and notes that there are issues of sovereignty that need to be overcome before granting the courts this power. Such caveats speak against any proposal that would replace the authority of municipal management with another governing authority.

Any real solution for municipal bankruptcy would need to change the nature of municipalities quite radically. Cities may resemble hotels and malls, but they would need to take on fundamental features of such corporations for bankruptcy to be meaningful. Municipalities, as governmental offices generally, operate with capital accounts that weaken fiscal responsibility relative to the truly hard budget constraint that private property and residual claimancy creates. Only a change in the capital account structure could make bankruptcies for municipalities serve the function they do for corporations. Along the lines similar to Sonstelie and Portney (1978) or Boudreaux and Holcombe (1989), for instance, municipalities could be transformed in some fashion into profit-seeking commercial enterprises. Alienable claims to real capital accounts would then replace the implicit accounts of today. Such a transformation would mean a change in the very nature of cities as we know them.

REFERENCES

Associated Press, The (AP) (2013) “Detroit finances bleak, on ‘ill-advised and unacceptable course,’ bankruptcy manager says”, May 13, 2013. Available at http://www.cbsnews.com/news/detroit-finances-bleak-on-ill-advised-and-unacceptable-course-bankruptcy-manager-says/ (last accessed Feb. 6, 2014).

Barro, R. J. (1974) “Are Government Bonds Net Worth?” *Journal of Political Economy*, 82: 1095-1118.

Boudreaux, D. J. and R. G. Holcombe. (1989) “Government by Contract”, *Public Finance Quarterly*, 17: 264-80.

Buchanan, J. M. (1967) *Public Finance in Democratic Process*, Chapel Hill: University of North Carolina Press.

Buchanan, J. M. and G. Tullock. (1962) *The Calculus of Consent*, Ann Arbor: University of Michigan Press.

Buchanan, J. M. and R. E. Wagner. (1977) *Democracy in Deficit: The Political Legacy of Lord Keynes*, New York: Academic Press.

Buettner, T. and D. E. Wildasin. (2006) "The Dynamics of Municipal Fiscal Adjustment", *Journal of Public Economics*, 90: 1115–1132.

Burns, N. and G. Gamm. (1997) "Creatures of the State: State Politics and Local Government, 1871-1921", *Urban Affairs Review*, 33: 59-96.

De Angelo, H. (1981) "Competition and Unanimity", *American Economic Review*, 71: 18-27.

Economist, The. (2011) "Greek Americans: Which American states enjoy the biggest fiscal transfers?" *The Economist*, July 30th 2011, Print ed. Available at http://www.economist.com/node/21524887 (last accessed Apr. 27, 2013).

Fama, E. F. (1980) "Agency Problems and the Theory of the Firm", *Journal of Political Economy*, 88: 288-307.

Fama, E. F. and M. C. Jensen. (1983) "Agency Problems and Residual Claims", *Journal of Law and Economics*, 26: 327-49.

Foldvary, F. (1994) *Public Goods and Private Communities*, Cheltenham, UK: Edward Elgar.

Gilette, C. P. (2012) "Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy", *The University of Chicago Law Review*, 79: 283-331.

Goodnow, F. J. (1997) *Municipal Home Rule: A Study in Administration*, Buffalo, NY: W. S. Hein.

Hou, Y. and D. L. Smith. (2006) "A Framework for Understanding State Balanced Budget Requirement Systems: Reexamining Distinctive Features and an Operational Definition", *Public Budgeting & Finance,* 26(3): 22-45.

Kimhi, O. (2010) "Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem", *Yale Journal on Regulation*, 27: 351-96.

Makowski, L. (1983) "Competition and Unanimity Revisited", *American Economic Review*, 73: 329-39.

Manne, H. (1965) “Mergers and the Market for Corporate Control”, *Journal of Political Economy*, 73: 10-20.

McCallum, S. (1970) *The Art of Community*, Menlo Park, CA: Institute for Humane Studies.

McConnell, M. W. and R. C. Picker. (1993) “When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy”, *The University of Chicago Law Review*, 60: 425-95.

Meckling, W. H. and M. C. Jensen. (1976) “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure”, *Journal of Financial Economics*, 3: 305-60.

Morriss, A. P. and L. Moberg. (2012) "Cartelizing Taxes: Understanding the OECD’s Campaign against “Harmful” Tax Competition”, *Columbia Journal of Tax Law*, 4: 1-64.

National Conference of State Legislatures (NCSL) (2010) “NCSL Fiscal Brief: State Balanced Budget Provisions”, October 2010. Available at http://www.ncsl.org/documents/fiscal/statebalancedbudgetprovisions2010.pdf (last accessed Feb. 6, 2014).

Niskanen, W. A. (1971) *Bureaucracy and Representative Government*, Chicago: Aldine.

Orr, K. (2013) “City of Detroit: proposal for Creditors”, June 14, 2013. Available at http://www.freep.com/assets/freep/pdf/C4206913614.PDF (last accessed Feb. 6, 2014).

Patchan, J. and S. B. Collins. (1976) “The 1976 Municipal Bankruptcy Law”, *University of Miami Law Review*, 31: 287-306.

Primo, D. M. (2007) *Rules and Restraint: Government Spending and the Design of Institutions,* Chicago, IL: University of Chicago Press.

Reed, B. J. and J. W. Swain. (1996) *Public Finance Administration*, 2nd ed., Englewood Cliffs, NJ: Prentice Hall.

Schragger, R. C. (2012) “Democracy and Debt”, *Yale Law Journal*, 121: 860-86.

Shackle, G. L. S. (1972) *Epistemics and Economics*, Cambridge: Cambridge University Press.

Shackle, G. L. S. (1974) *Keynesian Kaleidics*, Edinburgh: Edinburgh University Press.

Spitz, J. J. (1992) "Federalism, States, and the Power to Regulate Municipal Bankruptcies: Who May be a Debtor under Section 109 (c)", *Bankruptcy Development Journal*, 9: 621-642.

Sonstelie, J. C. and P. R. Portney. (1978) "Profit Maximizing Communities and the Theory of Local Public Expenditure", *Journal of Urban Economics*, 5: 263-77.

Tung, F. (2002) "After Orange County: Reforming California Municipal Bankruptcy Law", *Hastings Law Journal*, 53: 1-60.

Wagner, R. E. (2007) *Fiscal Sociology and the Theory of Public Finance*, Cheltenham, UK: Edward Elgar.

Wagner, R. E. (2012a) "Viennese Kaleidics: Why It's Liberty More than Policy that Calms Turbulence", *Review of Austrian Economics*, 25: 283-97

Wagner, R. E. (2012b) *Deficits, Debt, and Democracy*, Cheltenham, UK: Edward Elgar.

Wagner, R. E. (2012c) "Democracy and the Theory of Public Finance: A Polycentric, Invisible-Hand Framework", *Public Finance and Management*, 12: 298-315.

Wagner, R. E. and D. Yazigi. (2013) "Form vs. Substance in Selection through Competition: Elections, Markets, and Political Economy", *Public Choice* DOI: 10.1007/s11127-013-0065-y

White, J. H. III. (2003) "Constitutional Authority to Issue Debt", *Cumberland Law Review*, 33: 561-74.

Wolfe, L. M. (2012) "The Next Financial Hurricane? Rethinking Municipal Bankruptcy in Louisiana", *Louisiana Law Review*, 72: 555-90.

Copyright of Public Finance & Management is the property of Southern Public Administration Education Foundation and its content may not be copied or emailed to multiple sites or posted to a listserv without the copyright holder's express written permission. However, users may print, download, or email articles for individual use.