

# BANKRUPT POLITICS AND THE POLITICS OF BANKRUPTCY

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*The most recent round of state budget crises has resulted in calls to permit states to file for bankruptcy in order to restructure and reduce their financial obligations. This Article argues that these proposals are misguided because states' financial distress is primarily a political problem created by "fiscal federalism"—the financial relationship between the federal government and the states—and exacerbated by political agency problems. Accordingly, state bankruptcy proposals need to be evaluated in political, rather than financial, terms.*

*Bankruptcy can no more remake fiscal federalism than it can fix a firm with an untenable business model. While bankruptcy might provide a tool for mitigating political agency problems, either as a forum for negotiation or as a "penalty default rule" that would encourage political settlements outside of bankruptcy, it is more likely to be used to provide judicial cover for partisan agendas.*

*Attempts to use bankruptcy to solve political problems invite a reevaluation of the "creditors' bargain," the dominant theory of bankruptcy law, which argues that bankruptcy law tries to replicate the bargain that creditors would have made themselves. This Article argues that "contractarian" approaches to bankruptcy are necessarily incomplete because they do not account for the politics of bankruptcy.*

*Instead, this Article sketches out a new theory of bankruptcy law as the dynamic "armistice line" between competing interest groups. Bankruptcy is fundamentally a distributional exercise, and the shape of bankruptcy law is an expression of distributional norms and interest group politics rather than an exercise in economic efficiency. A proper theoretical understanding of bankruptcy must therefore commence from a political, rather than economic, perspective.*

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## INTRODUCTION

State fiscal crises seem to be a near perennial occurrence, but their incidence has become particularly common since the 2008 global financial collapse. In fiscal year 2012, forty-two states collectively closed out \$103 billion in budget shortfalls.<sup>1</sup> In an attempt to cope with budget problems, at least forty-six states have already reduced services, and more than thirty states have raised taxes.<sup>2</sup> The Minnesota state government even shut down for twenty days in the summer of 2011 because the Republican legislature and Democratic governor could not reach agreement on how to close a budget gap.<sup>3</sup>

State fiscal crises emerge during every economic downturn and sometimes in between downturns because state revenues are tied to economic activity and financial markets, whereas state costs are static or even countercyclical.<sup>4</sup> These crises put tremendous political strains on the states and often entail gut-wrenching choices for state legislatures about layoffs, program cuts, and tax increases.<sup>5</sup> Even with three

<sup>1</sup> Elizabeth McNichol et al., *States Continue to Feel Recession's Impact*, CTR. ON BUDGET & POLICY PRIORITIES, 6 (June 27, 2012), <http://www.cbpp.org/files/2-8-08sfp.pdf>.

<sup>2</sup> *Id.*

<sup>3</sup> Monica Davey, *With Signing of Budget, Impasse Ends in Minnesota*, N.Y. TIMES, July 21, 2011, at A13.

<sup>4</sup> See David A. Super, *Federal-State Budgetary Interactions*, in FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY 366, 369-70 (Elizabeth Garrett et al. eds., 2008).

<sup>5</sup> See McNichol et al., *supra* note 1, at 7.

years of budget cuts and tax increases since 2008, many states are still struggling to balance their budgets.<sup>6</sup>

When an individual, firm, or municipality ends up in similar financial distress, bankruptcy is one of several options available as a means of restructuring debt obligations. Yet this option is not available to the states, which at present may not file for bankruptcy.<sup>7</sup>

Prompted by the latest round of state fiscal crises, Professor David Skeel has proposed a plan, based on the Chapter 9 municipal bankruptcy model, to permit states to file for bankruptcy.<sup>8</sup> Prominent Republican politicians have echoed this proposal,<sup>9</sup> and Professor Steven Schwarcz has expanded on it, even drafting a model state bankruptcy law.<sup>10</sup> Professor Anna Gelpern, in contrast, has questioned whether bankruptcy is even a helpful paradigm through which to analyze quasi-sovereign debt problems, as discussions become freighted with the baggage of existing U.S. bankruptcy law.<sup>11</sup>

This Article considers whether bankruptcy or any bankruptcy-type process, regardless of its name, is in fact the right tool for addressing state fiscal crises. Significant constitutional issues lurk in any potential state bankruptcy system, but they lie beyond the scope of this Article, which focuses on the desirability, rather than the constitutionality, of state bankruptcy.<sup>12</sup>

In this Article, I argue that state budget crises are a structural political problem that bankruptcy cannot be expected to fix. Cyclical state budget crises are the inevitable outcome of the interaction between “fiscal federalism”—the financial relationship between the fed-

<sup>6</sup> See *id.* at 1–3.

<sup>7</sup> See Mary Williams Walsh, *A Path Is Sought for States to Escape Debt Burdens*, N.Y. TIMES, Jan. 21, 2011, at A1 (“Unlike cities, the states are barred from seeking protection in federal bankruptcy court.”).

<sup>8</sup> See, e.g., David Skeel, *A Bankruptcy Law—Not Bailouts—for the States*, WALL ST. J., Jan. 18, 2011, at A17; David Skeel, *Give States a Way to Go Bankrupt*, WKLY. STANDARD, Nov. 29, 2010, [http://www.weeklystandard.com/articles/give-states-way-go-bankrupt\\_518378.html](http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html). Professor Skeel has since written expanded, academic versions of his proposal. See David A. Skeel, Jr., *States of Bankruptcy* (Univ. of Pa. Law Sch. Pub. Law & Legal Theory Research Paper Series, Research Paper No. 11-30, 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1907774](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1907774); David A. Skeel, Jr., *State Bankruptcy from the Ground Up* (Scholarship at Penn Law, Paper No. 382, 2011), available at [http://lsr.nellco.org/upenn\\_wps/382](http://lsr.nellco.org/upenn_wps/382) (forthcoming in *WHEN STATES GO BROKE: ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS* (Peter Conti-Brown & David A. Skeel, Jr. eds., forthcoming Aug. 2012)).

<sup>9</sup> Jeb Bush & Newt Gingrich, *Better Off Bankrupt*, L.A. TIMES, Jan. 27, 2011, at A19.

<sup>10</sup> Steven L. Schwarcz, *A Minimalist Approach to State “Bankruptcy,”* 59 UCLA L. REV. 322, app. at 350–52 (2011) (including a “Model Federal Statute for State Debt Restructuring”).

<sup>11</sup> See Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 891 (2012).

<sup>12</sup> On the constitutionality of state bankruptcy, see Thomas Moers Mayer, *State Sovereignty, State Bankruptcy, and a Reconsideration of Chapter 9*, 85 AM. BANKR. L.J. 363 *passim* (2011).

eral government and the states—and states’ legal and political cultures. Due to the U.S. fiscal federalism arrangement, economic downturns result in increased demands for state services at the very time when state revenues are declining. The strains created by fiscal federalism are exacerbated by states’ self-imposed restrictions on countercyclical deficit financing and by political agency problems that encourage spending and tax cuts in good times and “gambling on resurrection” in bad times.

The problems underlying state fiscal distress ultimately concern political structures rather than finances, and they necessitate political, rather than financial, restructuring. Accordingly, bankruptcy makes sense only as a political tool in addressing these problems, rather than as a means of accomplishing financial and legal restructuring.

Bankruptcy, however, is ill-equipped to accomplish political restructuring. It is not an adequate forum for renegotiating fiscal federalism. At best, bankruptcy is a convening and negotiating tool, but it is of limited use because it cannot bring all of a state’s stakeholders to the table. As a negotiation forum itself, bankruptcy offers only convocation of and procedural assistance with creditors—a subset of states’ stakeholders or constituencies. Even then, bankruptcy offers less procedural assistance than it does for individuals or firms because central bankruptcy principles such as having a liquidation baseline for evaluating reorganization proposals (i.e., bankruptcy’s “best interests” test) and enforcing absolute priority (i.e., that no junior creditor or equity holder is paid unless all senior creditors have been paid in full), are inapplicable to states. While a bankruptcy regime could potentially facilitate political negotiations outside of bankruptcy by functioning as a type of “penalty default rule”<sup>13</sup> or punitive alternative to a negotiated solution, bankruptcy would need to be sufficiently unattractive to all negotiating parties for it to function in this manner. It is far from clear that a bankruptcy regime would impose sufficient political costs on the politicians negotiating state budgets to facilitate budget deals. Indeed, bankruptcy might actually discourage negotiations if it offered political gains that could not be achieved in a negotiated solution.

Bankruptcy has never been a tool to deal with structural problems in businesses, and fiscal federalism and political agency problems are essentially structural problems for states. Bankruptcy can reduce financial leverage and restructure debts.<sup>14</sup> It can elimi-

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<sup>13</sup> See *infra* text accompanying notes 166–69.

<sup>14</sup> States, however, have comparatively little financial leverage in the traditional sense. They are primarily cash-flow operations; bond debt financed only 2.3% of state expenditures in fiscal year 2010. NAT’L ASS’N OF STATE BUDGET OFFICERS, FISCAL YEAR 2010 STATE EXPENDITURE REPORT: EXAMINING FISCAL 2009-2011 STATE SPENDING 7 tbl.1 (2011), *available*

nate legacy costs such as bad contracts or tort liability. But bankruptcy cannot fix bad business models. Bankruptcy cannot fix the structural political problems underlying states' budgets any more than it can make a buggy whip maker or typewriter manufacturer profitable. Not surprisingly, state bankruptcy proposals simply do not engage with the sources of state budget problems.

Bankruptcy might conceivably mitigate some of the political agency costs that exacerbate state budget problems, but it could also easily be used as a partisan political tool. The politics of state budget gaps are fundamentally a debate between increasing revenues (generally by raising taxes) and cutting state services and benefits. This debate has strong partisan overtones. While there is a great deal of local variation and nuance, the partisan divide can be roughly summarized as follows. Republicans generally oppose closing budget gaps via tax increases. Instead, they prefer cutting spending, although they sometimes have particular spending functions they wish to shield. Republicans also have a strong interest in cutting compensation to unionized public employees because public employee unions tend to support Democrats.<sup>15</sup> In contrast, Democrats typically prefer to close budget gaps by increasing revenues (usually through progressive taxation) and cutting costs, while protecting certain social welfare programs.

Bankruptcy could be used to force service and benefits cuts that cannot happen in the normal realm of state politics. Under a Chapter 9 model, however, bankruptcy cannot be used to force tax hikes.<sup>16</sup> Thus, Republican politician Newt Gingrich expressed his support for a state bankruptcy option as a tool for enabling the renegotiation of public employee unions' contracts:

I . . . hope the House Republicans are going to move a bill in the first month or so of their tenure to create a venue for state bankruptcy, so that states like California and New York and Illinois that think they're going to come to Washington for money can be told, you know, you need to sit down with all your government employee unions and look at their health plans and their pension plans and, frankly, if they don't want to change, our recommendation is you go into bankruptcy court and let the bankruptcy judge change it, and I would make the federal bankruptcy law prohibit tax increases as part of the solution, so no bankruptcy judge could impose a tax increase on the people of the states.<sup>17</sup>

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at <http://www.nasbo.org/sites/default/files/2010%20State%20Expenditure%20Report.pdf> [hereinafter NASBO 2010 REPORT].

<sup>15</sup> See, e.g., Bob Secter, *Wisconsin Recall Battle Gains Steam*, CHI. TRIB., Jan. 17, 2012, at 1.

<sup>16</sup> See 11 U.S.C. § 904 (2006); Kevin A. Kordana, *Tax Increases in Municipal Bankruptcies*, 83 VA. L. REV. 1035, 1038, 1059–66 (1997).

<sup>17</sup> Doug Halonen, *Gingrich Seeks Bill Allowing State Bankruptcy to Avert Bailouts*, PENSIONS & INVS. (Jan. 10, 2011), <http://www.pionline.com/article/20110110/PRINTSUB/3011099>

The possibilities for a state bankruptcy regime are hardly bounded by Newt Gingrich's vision; one could of course imagine a different type of bankruptcy regime in which tax hikes would be possible, or even mandatory, or in which there are protections for collective bargaining agreements.<sup>18</sup> But part of the appeal of a Chapter 9–modeled state bankruptcy regime is as a partisan sword for Republicans in the tax-hike versus spending-cut debate.

Rather than addressing the causes of state budget crises, state bankruptcy proposals dangle the false hope of fiscal solutions to political problems and offer cover for partisan agendas. Current state bankruptcy proposals leave the root causes of state fiscal distress unaddressed, setting the stage for serial filings by states, much like the airline industry, where massive cuts in labor costs have not fixed a tenuous business model heavily dependent on fuel costs and consumer spending.<sup>19</sup> Whatever limited benefits state bankruptcy might produce, it is wholly inadequate to address procyclical pressures on state budgets that result from fiscal federalism's interaction with state legal and political culture.<sup>20</sup> How to reform the fiscal federalism arrangement or states' legal and political cultures is a topic beyond the scope of this Article, but that is where we must instead look to find real solutions to state budget crises.

The shortcomings of state bankruptcy proposals illustrate the limits of bankruptcy as a tool for dealing with debt problems. Understanding the limitations of bankruptcy helps define what bankruptcy is, just as drawing the spaces around objects, rather than the objects themselves, defines figures on a canvas. Objects can be defined not only as what they are, but also as what they are not.

This Article uses state bankruptcy proposals as a window into bankruptcy theory. The bankruptcy field is surprisingly undertheorized, with only one major attempt to create a unified theory of bank-

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76 (alteration in original) (quoting a November 11, 2010 speech given by Newt Gingrich before the Institute for Policy Innovation).

<sup>18</sup> Cf. Clayton P. Gillette, *Fiscal Federalism, Political Will, and Strategic Use of Municipal Bankruptcy*, 79 U. CHI. L. REV. 283, 327–29 (2012) (proposing that bankruptcy courts be allowed to impose tax increases in municipal bankruptcies in order to neutralize strategic behavior of local officials).

<sup>19</sup> IATA *Economic Briefing: Airline Fuel and Labour Cost Share*, INT'L AIR TRANSP. ASS'N (Feb. 2010), [http://www.iata.org/whatwedo/Documents/economics/Airline\\_Labour\\_Cost\\_Share\\_Feb2010.pdf](http://www.iata.org/whatwedo/Documents/economics/Airline_Labour_Cost_Share_Feb2010.pdf) (breaking out fuel, labor, and aircraft rentals as the three major real operating costs); Joe Brancatelli, *The Sky Gods Can Smile (for Now)*, PORTFOLIO.COM (Aug. 4, 2010), <http://www.portfolio.com/business-travel/2010/08/04/airlines-positive-earnings-reports-belie-dark-trends/> (noting the importance of business and leisure traffic levels for airlines' revenues).

<sup>20</sup> See Brian Galle & Jonathan Klick, *Recessions and the Social Safety Net: The Alternative Minimum Tax as a Countercyclical Fiscal Stabilizer*, 63 STAN. L. REV. 187, 190 (2010) (noting the procyclical fiscal pressures placed on states and the neglect of scholarly attention paid to this problem).

ruptcy. That attempt, emerging from the early law-and-economics literature, has produced a contractarian understanding of bankruptcy known as the “creditors’ bargain.” The creditors’ bargain theory posits that bankruptcy law should try to replicate the bargain that creditors would have made themselves—a bargain that would necessarily involve a maximization of returns.<sup>21</sup> Despite numerous criticisms of the creditors’ bargain theory,<sup>22</sup> no clear alternative unified theory has emerged, and the creditors’ bargain approach continues to dominate the field, if simply for lack of competition.

This Article presents a first step toward a new theoretical understanding of bankruptcy law. It argues that contractarian and procedural approaches to bankruptcy are necessarily incomplete because they do not account for the politics of bankruptcy.

Bankruptcy law must be understood first and foremost from a political perspective. Bankruptcy is ultimately a distributional exercise, rather than a system to maximize returns to creditors, and this characteristic makes it inherently political. The shape of bankruptcy law is an expression of distributional norms (of which the creditors’ bargain efficiency norm is but one) and interest group politics, rather than an exercise in economic efficiency. Special interest provisions in bankruptcy law are thus not a deviation but, like the rest of bankruptcy law, simply an outcome of political bargaining. A proper theoretical understanding of bankruptcy must therefore commence from a political, rather than economic, perspective.

This Article does not aim to present a full exposition of a new, political theory of bankruptcy law. Instead, it lays out the initial roadmap for a fuller exposition of bankruptcy as the “creditors’ armi-

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<sup>21</sup> See generally THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 8–21 (1986) (setting forth basic principles of bankruptcy law and presenting bankruptcy as a system of contracts between creditors); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 831–33 (1987) (advocating for a view of bankruptcy that would preserve in bankruptcy proceedings the rights and relations creditors have outside of bankruptcy law); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain*, 91 YALE L.J. 857, 895 & n.173 (1982) (“As the creditors’ bargain model would suggest, [the] decision [of whether to proceed with liquidation or reorganization] should be made on the basis of which form provides the greatest aggregate dollar-equivalent return from the assets . . .”). The emphasis on the wealth-maximization principle owes much to Richard Posner, who sets forth wealth maximization as an ethical basis for social and economic organization. RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE passim* (1981). It is never entirely clear whether the creditors’ bargain principle is normative or positive. While the creditors’ bargain is a rationalization of current bankruptcy law, its proponents have also identified numerous examples where current bankruptcy law violates the maximization principle. See, e.g., Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors’ Bargain*, 75 VA. L. REV. 155, 156 (1989) (“[P]ersistent and systematic redistributive impulses are apparent in bankruptcy.”).

<sup>22</sup> See *infra* note 194 and accompanying text.

stice”—namely that bankruptcy law represents a dynamic and often messy political “armistice line” between competing interest groups.

Part I of this Article commences with a consideration of the origins and political economy of state budget crises. It emphasizes that the interaction of the current fiscal federalism arrangement and the peculiar political economy of state legislatures sets the stage for cyclical budget crises. The U.S. fiscal federalism arrangement results in unusual financial strains on the states during economic downturns, while states’ legal and political cultures constrain states’ options for dealing with downturns.

Part II examines how the instability in state budgets caused by fiscal federalism metastasizes into budget crises due to a variety of political agency problems, including a moral hazard in state politics and a lack of political resolve and consensus about the appropriate response.

Part III explores the bankruptcy toolbox. It notes that traditional rationales for bankruptcy are a poor fit for subnational governments like states. Instead, another rationale emerges: bankruptcy as a political tool. As a political tool, bankruptcy might be able to mitigate political agency problems, but it could easily become a partisan weapon. Irrespective, bankruptcy cannot fix the structural–political problem underlying states’ budgets any more than it can make a gas lamp maker, cooper, cartwright, wainwright, wheelwright, or telegraph transmitter manufacturer profitable. Bankruptcy is not a solution to every debt problem.

Part IV steps back and asks what state bankruptcy proposals tell us about bankruptcy law. It argues that state bankruptcy proposals show the limits of contractarian approaches to bankruptcy law and that bankruptcy must be viewed first and foremost through a political lens because it is fundamentally a distributional exercise. In so doing, Part IV takes a first step at sketching out a new political theory of bankruptcy law.

## I

### FISCAL FEDERALISM AND STATE FINANCIAL DISTRESS

Every state has its idiosyncratic budget problems, but cyclical state fiscal crises are the inevitable outcome of the interaction between fiscal federalism—the financial relationship between the federal government and the states—and states’ legal and political cultures. The current U.S. fiscal federalism arrangement is hardwired to create cyclical

cal state financial distress.<sup>23</sup> The extent of this distress will vary among states during cyclical downturns. States as a whole, however, cannot escape budget crises during an economic downturn because of the lopsided burdens placed on them by fiscal federalism.<sup>24</sup>

Under the current fiscal federalism arrangement, states are saddled with countercyclical Keynesian spending obligations—both explicit obligations and those implicit in the political compact—but lack the Keynesian borrowing power required to support these obligations.<sup>25</sup> The result of this structural mismatch is budget crises, as

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<sup>23</sup> See Galle & Klick, *supra* note 20 (“[State revenues are heavily] tied to the business cycle, so that budgets get tighter just when the need for countercyclical spending increases.”).

<sup>24</sup> See *id.* at 191 (suggesting ways in which the federal government could attempt to combat this problem).

<sup>25</sup> See JOHN MAYNARD KEYNES, *THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY* ch. 22 (1936) (describing the “Trade Cycle”); David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2605–11 (2005) (discussing the pre-Keynesian nature of state budgets).

It is instructional to compare the U.S. fiscal federalism arrangement with the European Union fiscal federalism arrangement. The Maastricht Treaty establishing the EU vaguely mandates balanced budgets for the member states: “Member States shall avoid excessive government deficits.” Treaty on European Union art. G, art. 104(c)(1), Feb. 7, 1992, 1992 O.J. (C 191) 13 (hereinafter Maastricht Treaty). This is defined as a government deficit to GDP ratio exceeding 3% and a government debt to GDP ratio exceeding 60%. Consolidated Versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, Sep. 5, 2008, 2008 O.J. (C 115) 279, Protocol (No 12), art. 1. There is little in the way of an enforcement mechanism. See Maastricht Treaty art. 104. Instead, the provision is largely aspirational—in 2002, France and Germany were the first states to breach the deficit ratios—but it might have a precatory effect that limits member states’ Keynesian borrowing powers. *The Nine Lives of the Stability Pact: A Special Report of the CEPS Macroeconomic Policy Group*, CTR. FOR EUR. POLICY STUDIES, 4 (2004), <http://www.ceps.eu/ceps/download/948>.

The EU itself has neither Keynesian spending obligations nor Keynesian borrowing power, and neither the EU nor member states are formally liable for each others’ obligations. Maastricht Treaty art. 103. As a practical matter, however, this is no longer the case because of the creation of the European Financial Stability Facility (EFSF)—which is able to issue bonds guaranteed by European Area Member States (EAMS)—and the creation of the European Financial Stability Mechanism (EFSM)—which is able to issue debt guaranteed by the European Commission (EC) and collateralized by the EC’s budget. See generally *About EFSF*, EUR. FIN. STABILITY FACILITY, <http://www.efsf.europa.eu/about/index.htm> (last visited July 16, 2012) (describing the capabilities of the EFSF). On July 11, 2011, the EAMS signed a treaty creating the European Stability Mechanism (ESM), a rescue fund to replace the EFSF and EFSM. *Treaty Establishing European Stability Mechanism (ESM) Signed*, EUR. COMM’N (July 11, 2011), [http://ec.europa.eu/economy\\_finance/articles/financial\\_operations/2011-07-11-esm-treaty\\_en.htm](http://ec.europa.eu/economy_finance/articles/financial_operations/2011-07-11-esm-treaty_en.htm). A modified version of the Treaty was signed on February 2, 2012. *European Stability Mechanism Treaty Signed*, COUNCIL OF THE EUR. UNION (Feb. 2, 2012), <http://consilium.europa.eu/homepage/showfocus?lang=en&focusID=79757>.

The EU does not itself engage in debt issuance (and has no legal mechanism for doing so) and is subject to a strict annual balanced budget requirement. See Robert Ackrill, *The European Union Budget, the Balanced Budget Rule and the Development of Common European Policies*, 20 J. PUB. POL’Y 1, 6 (2000). The European Investment Bank provides project finance, like the World Bank, for projects that further “the EU’s policy objectives,” rather than general funds, while the European Central Bank acts as a liquidity provider, like the IMF or Federal Reserve, via its purchases of EU member government bonds, but

states struggle to come up with spending cuts and tax hikes to close their budget gaps.<sup>26</sup>

The states have Keynesian spending obligations because they are the primary providers of many services to citizens, including education, corrections, health care, disability, and unemployment benefits.<sup>27</sup> Much of this spending is due to unfunded or partially funded federal mandates—costs that the federal government formally or functionally requires the states to incur.<sup>28</sup>

These federal mandates range from education to environmental protection, but welfare and health care programs are the most expensive.<sup>29</sup> Demand for welfare and state-funded health care is also cyclical with the economy. For example, as unemployment rises, so too do demands on the states for partially state-funded welfare benefits,<sup>30</sup> such as unemployment insurance,<sup>31</sup> Temporary Assistance to Needy

not as a Keynesian borrower, as it is a monetary, rather than fiscal, institution. See EMMANUEL APEL, CENTRAL BANKING SYSTEMS COMPARED: THE ECB, THE PRE-EURO BUNDESBANK, AND THE FEDERAL RESERVE SYSTEM 183 (2003); RENÉ SMITS, THE EUROPEAN CENTRAL BANK: INSTITUTIONAL ASPECTS 269–72 (1997); *About the EIB*, EUR. INV. BANK, <http://www.eib.org/about/index.htm> (last visited July 16, 2012).

<sup>26</sup> See McNichol et al., *supra* note 1, at 1–3.

<sup>27</sup> See *id.* at 7.

<sup>28</sup> Under the Unfunded Mandates Reform Act of 1995, enacted as part of the Contract with America, a spending obligation is not a mandate if the federal law allows the state to make up for the cost by reducing other facets of the activity. See Pub. L. No. 104-4, § 421(5), 109 Stat. 48, 51–52 (codified at 2 U.S.C. § 658(5) (2006)) (defining “federal intergovernmental mandate”). Neither Medicaid nor most other programs that play prominent roles in state fiscal crises are mandates under this definition. Given political realities, however, states cannot cut some programs—particularly those that are intergovernmental programs—because the costs to the states would likely be higher if the states attempted to provide the service alone. See Robert D. Behn & Elizabeth K. Keating, *Facing the Fiscal Crises in State Governments: National Problem; National Responsibilities* 3–4 (John F. Kennedy Sch. of Gov’t, Harvard Univ., Research Working Paper No. 04-025, 2004), available at <http://ssrn.com/abstract=563162>. I refer to these programs as “functional mandates.”

<sup>29</sup> There is no definitive costing of federal mandates nor is there a definition of “unfunded mandate.” See ROBERT JAY DILGER & RICHARD S. BETH, CONG. RESEARCH SERV., R40957, UNFUNDED MANDATES REFORM ACT: HISTORY, IMPACT, AND ISSUES 4–12 (2011). The Office of Information and Regulatory Affairs in the Office of Management and Budget puts out an annual cost–benefit analysis of executive agencies’ regulations, but this analysis does not cover preexisting mandates like Medicaid, which is generally regarded as the largest single mandate and is the largest single item for states’ budgets, comprising 22.3% of states’ expenditures in fiscal year 2010. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, 2011 REPORT TO CONGRESS ON THE BENEFITS AND COSTS OF FEDERAL REGULATIONS AND UNFUNDED MANDATES ON STATE, LOCAL, AND TRIBAL ENTITIES (2011); NASBO 2010 REPORT, *supra* note 14, at 11.

<sup>30</sup> See, e.g., Marshall J. Vest, *Arizona Fiscal Issues: The Effects of the Economic Cycle on Government Revenue*, ELLER COLL. OF MGMT. ECON. & BUS. RESEARCH CTR. (Nov. 2009), [http://ebr.eller.arizona.edu/Arizona\\_fiscal\\_issues/economic\\_cyclicality%20\\_government\\_revenues.asp](http://ebr.eller.arizona.edu/Arizona_fiscal_issues/economic_cyclicality%20_government_revenues.asp).

<sup>31</sup> Hannah Shaw & Chad Stone, *Introduction to Unemployment Insurance*, CTR. ON BUDGET & POLICY PRIORITIES (Apr. 16, 2010), <http://www.cbpp.org/files/12-19-02ui.pdf> (“States provide most of the funding and pay for the actual benefits provided to workers; the federal government pays only the administrative costs.”). While unemployment insur-

Families (TANF, the successor to Aid to Families with Dependent Children),<sup>32</sup> Supplemental Nutrition Assistance Program/Employment and Training (SNAP/ET, formerly known as the Food Stamp Program),<sup>33</sup> the Children's Health Insurance Program (CHIP),<sup>34</sup> and most importantly, Medicaid, which accounted for 22.3% of state spending in fiscal year 2010.<sup>35</sup>

Figures 1 through 3 below illustrate states' problems with countercyclical expenses. As Figure 1 shows, total annual unemployment insurance benefit costs rose during and after every economic downturn since 1980, but most dramatically in 2009.<sup>36</sup> Figure 2 shows total unemployment insurance benefits paid annually as a percentage of states' annual aggregate gross revenue.<sup>37</sup> Unemployment insurance benefit payments spike at precisely the time when state revenues decline, resulting in unemployment insurance benefit payments rising from less than 2% to nearly 7% of state budgets. Figure 3 illustrates the annual rate of growth of Medicaid expenditures. While Medicaid expenditures have consistently increased for a variety of reasons, the

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ance is collected into federal and state trust funds, neither has been immune from raids. See, e.g., *NJ Unemployment Insurance Trust Fund Diverted Revenues, Low Balance Threaten Fund's Health*, N.J. POL'Y RES. ORG. FOUND. (2006), <http://www.njprofoundation.org/pdf/ffd0906.pdf>. Moreover, state unemployment insurance trust funds will borrow from the federal government. As of March 7, 2012, twenty-eight states and the Virgin Islands were borrowing for their insurance trust funds. *Unemployment Insurance: State Trust Fund Loans*, NAT'L CONFERENCE OF STATE LEGISLATURES, <http://www.ncsl.org/issues-research/labor/state-unemployment-trust-fund-loans.aspx> (last updated July 13, 2012).

<sup>32</sup> TANF is funded through federal block grants but requires matching state maintenance of effort (MOE) funds in order to retain block grant eligibility. Forty-five percent of TANF expenditures in fiscal 2010 were from state funds. NASBO 2010 REPORT, *supra* note 14, at 30.

<sup>33</sup> The federal government directly funds the SNAP component of SNAP/ET, but the states have a 50% matching contribution requirement for the ET component after they exhaust a substantial grant of federal-only funds. See 7 U.S.C. § 2025(h)(1)–(3) (2006). Many states contribute very little to ET even in good times. States do not appear to increase ET spending in response to increased poverty or SNAP participation. The states also share administrative costs for SNAP with the federal government. FOOD & NUTRITION SERV., U.S. DEP'T OF AGRIC., SUPPLEMENTAL NUTRITION ASSISTANCE PROGRAM (SNAP) STATE ACTIVITY REPORT: FEDERAL FISCAL YEAR 2010, at 11 (2011), available at [http://www.fns.usda.gov/snap/qc/pdfs/2010\\_state\\_activity.pdf](http://www.fns.usda.gov/snap/qc/pdfs/2010_state_activity.pdf) ("The Food and Nutrition Service (FNS) pays approximately 50 percent of State agency administrative costs to operate the [SNAP] program.")

<sup>34</sup> JOINT ECON. COMM., 110TH CONG., WORSENING ECONOMIC CONDITIONS WILL INCREASE DEMAND FOR THE STATE CHILDREN'S HEALTH INSURANCE PROGRAM AND MEDICAID 1 (2008), available at <http://jec.senate.gov/archive/Documents/Reports/01.18.08%20CHIP%20Medicare%20Report.pdf>.

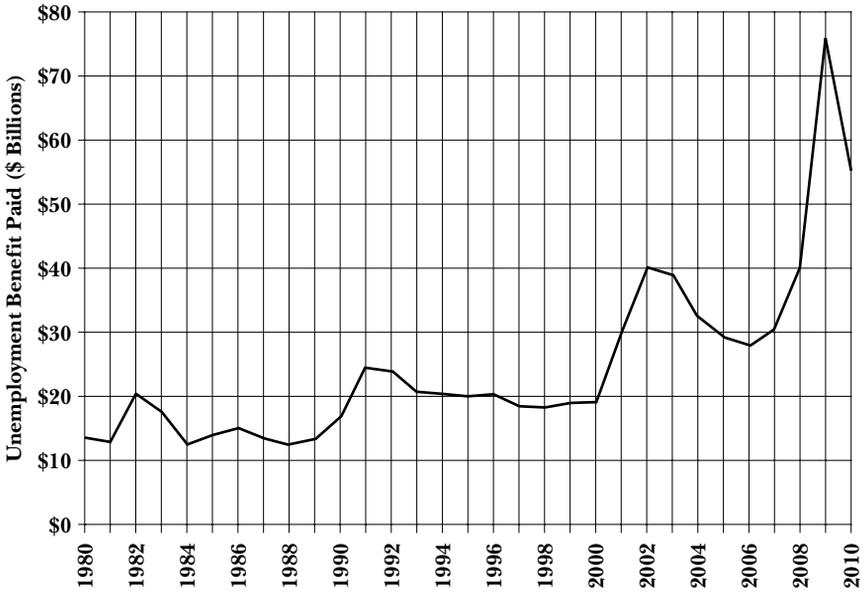
<sup>35</sup> NASBO 2010 REPORT, *supra* note 14, at 11 tbl.5. States are also vulnerable to changes in federal budgeting. See Michael Cooper, *No Matter How Debt Debate Ends, Governors See More Cuts for States*, N.Y. TIMES, July 16, 2011, at A8.

<sup>36</sup> Falling unemployment insurance benefits in 2010 may represent the expiration of unemployment benefits for many of the unemployed.

<sup>37</sup> The discrepancy between the time series lengths in Figures 1 and 2 is because aggregate state revenue data is not readily available before 1992.

rate of growth still corresponds to economic cycles, spiking after the economic downturns in 2001 and 2009.

FIGURE 1: TOTAL ANNUAL UNEMPLOYMENT INSURANCE BENEFITS PAID<sup>38</sup>

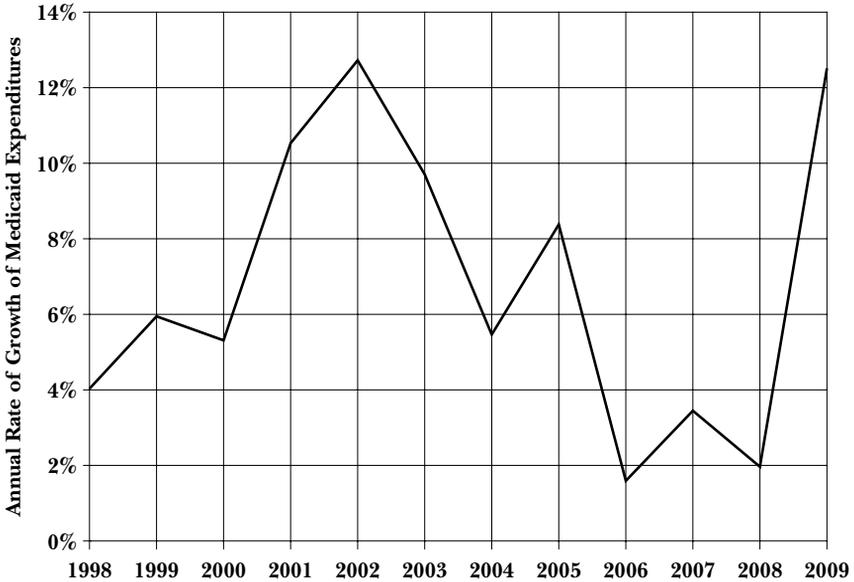


<sup>38</sup> EMP'T & TRAINING ADMIN., U.S. DEP'T OF LABOR, UNEMPLOYMENT INSURANCE FINANCIAL DATA HANDBOOK, available at <http://workforcesecurity.doleta.gov/unemploy/hb394.asp> (reporting column 10, benefits paid, not inflation adjusted). This chart represents unemployment insurance benefit payments. The data does not account for changes in the terms of unemployment insurance or the size of the eligible labor pool. Instead, it is meant merely to show large countercyclical costs for states.

FIGURE 2: TOTAL ANNUAL UNEMPLOYMENT INSURANCE BENEFITS PAID AS % OF STATES' REVENUE<sup>39</sup>



<sup>39</sup> *Id.*; U.S. CENSUS BUREAU, STATE & LOCAL GOVERNMENT FINANCE, HISTORICAL DATA [hereinafter CENSUS BUREAU HISTORICAL DATA], available at [http://www.census.gov/govs/estimate/historical\\_data.html](http://www.census.gov/govs/estimate/historical_data.html) (providing data from 1992 to 2008); U.S. CENSUS BUREAU, TABLE 1. STATE AND LOCAL GOVERNMENT FINANCES BY LEVEL OF GOVERNMENT AND BY STATE: 2008-09, available at <http://www2.census.gov/govs/estimate/09slsstab1a.xls> (providing data for 2009).

FIGURE 3: ANNUAL GROWTH RATE OF MEDICAID EXPENDITURES<sup>40</sup>

States have three possible options when faced with budget shortfalls: (1) increase spending by increasing revenue; (2) increase spending by borrowing funds; or (3) cut costs by reducing services. States face constraints on increasing both their revenue and their borrowing, while reducing services risks exacerbating economic downturns.

States have four major sources of revenue: (1) taxes; (2) federal transfer payments; (3) charges (such as licensing and other fees, tuition, and miscellaneous income); and (4) income from pension and insurance trust fund investments.<sup>41</sup> While the breakdown varies by state, for the fifty states in aggregate, taxes historically represent 43% of revenue, federal transfers represent 23%, various charges represent 17%, and investment income represents 17%.<sup>42</sup> States' revenue has procyclical tendencies, as some types of tax, charges, and investment income depend on the level of economic activity.

States have limited ability to control and increase their revenue. Legal restrictions limit states' control over tax and charge revenue. While states may set their tax rates and the level of charges, many states also have constitutional tax limitations that constrain their abil-

<sup>40</sup> NASBO 2010 REPORT, *supra* note 14 (providing thirteen different reports from 1998 to 2010). While the Medicaid program has changed during this period, the spikes in growth rates are nonetheless apparent.

<sup>41</sup> See CENSUS BUREAU HISTORICAL DATA, *supra* note 39.

<sup>42</sup> *Id.*

ity to raise revenue.<sup>43</sup> Federal law too limits states' ability to raise revenue, by restricting the type of transactions states may tax.<sup>44</sup>

Economic factors also limit states' ability to increase tax and charge revenue. Although states have an in-state monopoly on some services (e.g., issuance of driver licenses for state residents) and are generally not subject to market pressures in pricing the way private firms might be, states are in theory subject to Laffer curve constraints on their ability to tax and charge. The Laffer curve is the economic theory positing that as tax rates rise, so too will tax revenue until the taxation begins to discourage economic activity by rendering it insufficiently profitable relative to untaxed activities, such as leisure, at which point higher tax rates will result in lower revenue.<sup>45</sup> In addition, a jurisdictional competition for residents can also limit a state's ability to tax, as described by economist Charles Tiebout.<sup>46</sup> Thus, if taxes are too high, a state's tax base may shrink, either due to reduced economic activity or fewer economic actors.<sup>47</sup>

Moreover, some types of tax and charge revenues are inherently procyclical, which complicates states' efforts to raise revenue in economic downturns. Income and sales tax revenues, for example, are likely to decline during a downturn if rates are held constant, as the

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<sup>43</sup> See Richard Briffault, *Foreword: The Disfavored Constitution: State Fiscal Limits and State Constitutional Law*, 34 RUTGERS L.J. 907, 915–25 (2003); see also Bert Waisanen, *State Tax and Expenditure Limits—2008*, NAT'L CONF. ST. LEGISLATURES, <http://www.ncsl.org/issues-research/budget/state-tax-and-expenditure-limits-2008.aspx> (last visited July 14, 2012) (reviewing states' taxing and spending limitations).

<sup>44</sup> Super, *supra* note 4, at 369. States cannot generally tax Internet sales absent a sufficient nexus in the buyer's state. Cf. *Quill Corp. v. North Dakota*, 504 U.S. 298, 301–02 (1992) (declaring that *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753, 759–60 (1967), which requires an economic nexus for taxation, is still valid); STEVEN MAGUIRE, CONG. RESEARCH SERV., R41853, STATE TAXATION OF INTERNET TRANSACTIONS I (June 7, 2011), available at <http://www.fas.org/sgp/crs/misc/R41853.pdf> (noting that states are attempting to persuade Congress to change the law to require out-of-state retailers to collect taxes from in-state purchasers). Federal law also limits states' ability to tax the Internet and Internet transactions more broadly. See Internet Tax Freedom Act of 1998, Pub. L. No. 105-277, 112 Stat. 2681 (establishing an initial Internet tax moratorium), amended by Internet Tax Nondiscrimination Act of 2001, Pub. L. No. 107-75, 115 Stat. 703 (extending the moratorium to 2003), amended by Internet Tax Nondiscrimination Act of 2004, Pub. L. No. 108-435, 118 Stat. 2615 (extending the moratorium to 2007), amended by Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat. 1024 (extending the moratorium to 2014).

<sup>45</sup> Jude Wanniski, *Taxes, Revenues, and the "Laffer Curve,"* PUB. INT., Winter 1978, at 3, 3–5.

<sup>46</sup> Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418–21 (1956).

<sup>47</sup> But see Robert Tannenwald et al., *Tax Flight Is a Myth: Higher State Taxes Bring More Revenue, Not More Migration*, CTR. ON BUDGET & POLICY PRIORITIES, 1 (Aug. 4, 2011), <http://www.cbpp.org/files/8-4-11sfp.pdf> (noting that tax increases have little impact on interstate migration). This study does not disprove the Laffer curve or Tiebout competition, but merely indicates that at current tax rates, citizens do not significantly migrate from high-tax to low-tax jurisdictions. *Id.* at 15.

revenue from these taxes depends on the level of economic activity. Property tax revenue is also likely to decline, although it may lag behind the business cycle because of outdated property valuations. Charges may also suffer in downturns, as demand for certain types of licenses or willingness to pay tuition may decrease during downturns. And states may be reluctant to increase tax rates or charges in an economic downturn both for political reasons and for fear of further damaging the state economy. Thus, taxes and charges have limited potential as countercyclical revenue.

States have even less control over federal transfer payments and investment income. Federal transfer payments depend on federal government policy and are generally not countercyclical, except at the margin. Investment income is heavily dependent on the market and is highly procyclical. States therefore have limited ability to increase revenue when the demand for state services increases during economic downturns.

Borrowing is a way of financing countercyclical spending, but states' ability to do so is bound by self-imposed positive legal constraints. Unlike the federal government, every state except Vermont, and arguably Wyoming, North Dakota, and Alaska<sup>48</sup>—states both with no history of deficits and with political cultures strongly opposed to deficit spending—has a balanced budget requirement of some sort,<sup>49</sup>

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<sup>48</sup> Vermont lacks any sort of balanced budget requirement or related fiscal limitation. See U.S. GEN. ACCOUNTING OFFICE, GAO/AFMD-93-58BR, *BALANCED BUDGET REQUIREMENTS: STATE EXPERIENCES AND IMPLICATIONS FOR THE FEDERAL GOVERNMENT* 3 & n.3 (1993) [hereinafter GAO BALANCED BUDGET REQUIREMENTS]. Wyoming does not have an explicit balanced budget requirement, but in practice it is required to balance, as Wyoming's constitution generally prohibits the state from incurring debt beyond the current year's tax revenue absent a popular vote, and it limits state debt other than for public defense or suppression of insurrection to 1% of the assessed value of taxable property in the state. WYO. CONST. art. 16, §§ 1–2; GAO BALANCED BUDGET REQUIREMENTS, *supra*.

North Dakota's constitution contains a general prohibition on debt and requires partial matching of bond debts with revenues, but there is no explicit balanced budget requirement. N.D. CONST. art. X, § 13. North Dakota's executive budget officers, however, consider themselves prohibited from running deficits. NCSL *Fiscal Brief: State Balanced Budget Provisions*, NAT'L CONFERENCE OF STATE LEGISLATURES, 5 (Oct. 2010), <http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf> [hereinafter *NCSL Fiscal Brief*].

Alaska also does not have an explicit balanced budget requirement, but its constitution and statutes effectively require one. *Id.* at 2; see ALASKA CONST. art. IX, § 8 (limiting the incurrence of debt other than for defense and disasters to capital improvements and housing loans for veterans and requiring voter ratification); *id.* § 10 (permitting borrowing in anticipation of collection of revenues but requiring such debt to be repaid before the end of the next fiscal year); ALASKA STAT. § 37.07.020 (2011) (“Proposed expenditures [by the governor] may not exceed estimated revenue for the succeeding fiscal year.”).

<sup>49</sup> Peter R. Orszag, *The State Fiscal Crisis: Why It Happened and What to Do About It*, MILKEN INST. REV., Third Quarter 2003, at 17, 21; INST. FOR TRUTH IN ACCOUNTING, *THE TRUTH ABOUT BALANCED BUDGETS: A FIFTY STATE STUDY* 25 (2009), available at [http://statebudgetwatch.org/50\\_State\\_Final.pdf](http://statebudgetwatch.org/50_State_Final.pdf). For a listing of the constitutional and statutory citations of state balanced budget requirements, see Yilin Hou & Daniel L. Smith, *A Framework*

although stringency varies.<sup>50</sup> Most states also prohibit the carryover of deficits<sup>51</sup> and have debt limits of various types.<sup>52</sup>

While states have found numerous ways to circumvent these requirements,<sup>53</sup> the circumventions are at best short-term fixes.<sup>54</sup> For

for *Understanding State Balanced Budget Requirement Systems: Reexamining Distinctive Features and an Operational Definition*, PUB. BUDGETING & FIN., Fall 2006, at 22, 31–33.

<sup>50</sup> The major variations in balanced budget requirements are whether a balanced budget must merely be proposed, whether a balanced budget must be passed, and whether deficits can be carried over from budget to budget. *NCSL Fiscal Brief*, *supra* note 48, at 2.

There is significant variation in state balanced budget requirements. In forty-four states, the governor must submit a balanced budget. James M. Poterba & Kim S. Rueben, *Fiscal News, State Budget Rules, and Tax-Exempt Bond Yields*, 50 J. URB. ECON. 537, 547 (2001). Only thirty-seven states, however, require the legislature to enact a balanced budget, but revenues and expenditures may vary from it. *Id.* Six of these states require unexpected deficits to be corrected the next fiscal year, while twenty-four prohibit deficits to be carried forward. *Id.* at 547–48. This means that deficits can be run both in the states that only require the submission of a gubernatorial budget (IL, LA, MA, NH, NV, NY) and in those that do not require deficits to be accounted for in future budgets (AK, CA, CT, MD, MI, PA, WI). See Steven M. Sheffrin, *State Budget Deficit Dynamics and the California Debacle*, 18 J. ECON. PERSP. 205, 206–07 (2004).

The federal government briefly had a balanced budget requirement. See *Balanced Budget and Emergency Deficit Control Act of 1985*, Pub. L. No. 99-177, 99 Stat. 1038; *Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987*, Pub. L. No. 100-119, 101 Stat. 754. These Acts provided for automatic sequesters (spending cuts) if the budget exceeded certain fixed deficit targets. The automatic sequesters were held to be unconstitutional because their execution was delegated to the Comptroller General, a legislative branch official. *Bowsher v. Synar*, 478 U.S. 714, 732–34 (1986). Congress enacted a revised version of the legislation in 1987, but the fixed deficit targets proved ineffective and were supplanted by the Budget Enforcement Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388-573 (codified as amended throughout 2 U.S.C. and at 15 U.S.C. § 1022), which instead imposes caps on annual appropriations and requires a pay-as-you-go (PAYGO) budget-neutral process for changes in taxes and entitlements. These provisions have subsequently lapsed and been reinstated, and they have frequently been circumvented. *The 'Paygo' Coverup*, WALL ST. J., June 11, 2009, at A12.

<sup>51</sup> *NCSL Fiscal Brief*, *supra* note 48 (identifying thirteen states that permit deficit carryovers); cf. GAO *BALANCED BUDGET REQUIREMENTS*, *supra* note 48 (identifying twenty-one states that permit deficit carryovers).

<sup>52</sup> ROBERT S. AMDURSKY & CLAYTON P. GILLETTE, *MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE* § 4.2 (1992); see also Robert Krol, *A Survey of the Impact of Budget Rules on State Taxation, Spending, and Debt*, 16 CATO J. 295, 295 (1997) (counting twenty-three states with tax or expenditure limitations).

<sup>53</sup> See INST. FOR TRUTH IN ACCOUNTING, *supra* note 49, at 26–30 (detailing ways in which states evade balanced budget requirements); see also Cheryl D. Block, *Budget Gimmicks*, in *FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY*, *supra* note 4, at 39, 39–63 (describing analogous gimmicks in the federal budget).

<sup>54</sup> The empirical political-science literature shows that budgetary institutions influence fiscal policies. See, e.g., James E. Alt & Robert C. Lowry, *Divided Government, Fiscal Institutions, and Budget Deficits: Evidence from the States*, 88 AM. POL. SCI. REV. 811, 823 (1994) (finding that states with harder balanced budget rules react more promptly to revenue or spending shocks); H. Abbie Erler, *Legislative Term Limits and State Spending*, 133 PUB. CHOICE 479, 479–80 (2007) (finding higher state spending in states with legislative term limits); Signe Krogstrup & Sébastien Wälti, *Do Fiscal Rules Cause Budgetary Outcomes?*, 136 PUB. CHOICE 123, 134–35 (2008) (examining the impact of fiscal rules in Swiss subfederal jurisdictions); James M. Poterba, *Capital Budgets, Borrowing Rules, and State Capital Spending*, 56 J. POL. ECON. 165, 185 (1995); James M. Poterba, *Do Budget Rules Work?* 35–37 (Nat'l

example, because states operate on cash budgets,<sup>55</sup> some states have balanced their budgets by simply not paying obligations during a fiscal year.<sup>56</sup> The obligations remain due, however, and must eventually be paid. Likewise, states have routinely raided their pension funds (which are not subject to balanced budget requirements), but these funds must ultimately be repaid if the state is to avoid defaulting on its pension obligations.<sup>57</sup>

In the end, these gimmicks only delay recognition of budget problems and tend to worsen future budget crises. As a result, states have limited ability to engage in long-term borrowing to meet current expenses, and to the extent they can, law or tradition often limits states' borrowing to capital projects. Because states are more likely to initiate capital projects in flush times than in crises, this borrowing ends up being procyclical.<sup>58</sup>

The result is that states cannot engage in countercyclical Keynesian deficit spending in order to stimulate the economy when private sector spending falls off. Instead, when demands on the federally mandated parts of states' budgets grow during economic downturns, states must either raise taxes (subject to all the complications and limitations previously discussed), cut nonmandated (i.e., discretionary) spending—expenditures on state programs other than for existing debts—or both.

Both responses are politically unpopular and economically counterproductive. Both tax hikes and spending cuts exacerbate economic downturns by reducing aggregate demand.<sup>59</sup> Higher taxes re-

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Bureau of Econ. Research, Working Paper No. 5550, 1996), available at <http://www.nber.org/papers/w5550>; James M. Poterba, *State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics*, 102 J. POL. ECON. 799, 819 (1994) [hereinafter Poterba, *State Responses*]; Jürgen Von Hagen, *A Note on the Empirical Effectiveness of Formal Fiscal Restraints*, 44 J. PUB. ECON. 199, 208–09 (1991) (finding that state budget rules affect the level and composition of state debts); see also Dale Bails & Margie A. Tieslau, *The Impact of Fiscal Constitutions on State and Local Expenditures*, 20 CATO J. 255, 257–58 (2000) (discussing conflict in political science literature between “public choice” and “institutional irrelevance” views of state budget institutions).

<sup>55</sup> INST. FOR TRUTH IN ACCOUNTING, *supra* note 49, at 26. Some states, like California, have repeatedly shifted between cash and accrual budgeting based on what would provide the easiest way to balance the budget. States also use accrual accounting selectively to count future revenues or savings in their current budgets, but not future expenses. *Id.* at 28.

<sup>56</sup> See *infra* text accompanying notes 106–07.

<sup>57</sup> Public pension plans are not guaranteed by the Pension Benefit Guarantee Corporation. See 29 U.S.C. § 1321(b)(2) (2006).

<sup>58</sup> Super, *supra* note 4, at 387–88 (discussing the issuance of revenue bonds at the peak of the business cycle without accounting for future downturns).

<sup>59</sup> Orszag, *supra* note 49, at 22.

duce the funds citizens have to spend, thereby contributing to economic contraction.<sup>60</sup>

Similarly, spending cuts result in layoffs, cancelled contracts, reduced benefit payments, and lower payments to businesses and non-profits that provide direct services.<sup>61</sup> Spending cuts mean that citizens—either as direct-benefit recipients or as employees of the state or affected firms—receive less money from the state and have reduced consumption ability. In addition, many state expenditures are tied to federal matching funds. Therefore, expenditure cuts reduce state services more than they reduce state costs. For example, cutting a dollar of Medicaid expenses will only net a state between 12 and 44 cents of savings, but it will deny the state's residents a dollar's worth of Medicaid covered services.<sup>62</sup> Thus, both tax increases and spending cuts can exacerbate economic woes.

The combination of Keynesian countercyclical spending obligations without Keynesian borrowing capacity means that state budgets are inevitably stressed during a national economic downturn. While countercyclical spending need not be done at a deficit, it often is done so in order to avoid tax hikes or spending cuts during economic downturns. Balanced budget requirements are simply inconsistent with deficit-financed countercyclical spending obligations. At the root of states' budget troubles is a structural problem stemming from the fiscal federalism arrangement, caused more by a mismatch between spending duties and borrowing capacity than state overleverage.

This problem suggests a need to revisit the current fiscal federalism arrangement. U.S. fiscal federalism has an insurance function that provides a partial stabilizing safety net for states against asymmet-

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<sup>60</sup> *Id.* Both spending cuts and tax hikes might affect savings rates before consumption levels, but given the low savings rate for most of the population, spending is likely to be rapidly affected.

<sup>61</sup> McNichol et al., *supra* note 1, at 7.

<sup>62</sup> Jeremy Gerst & Daniel Wilson, *Fiscal Crises of the States: Causes and Consequences*, FED. RESERVE BANK OF S.F. (June 28, 2010), <http://www.frbsf.org/publications/economics/letter/2010/el2010-20.html>. The basis of Gerst and Wilson's calculation is unclear. Under permanent law, Medicaid's matching rate varies from 50% to just under 80%. Social Security Act, 42 U.S.C. §§ 1396b, 1396d(b) (2006). The American Recovery and Reinvestment Act of 2009 temporarily increased that rate, but that provision has expired. Pub. L. No. 111-5, § 5001(a)–(b), 123 Stat. 115, 496–97. A higher rate—at least 75%—applies to services funded through CHIP. 42 U.S.C. § 1397ee. But in general, cutting Medicaid a dollar should yield 20 to 50 cents to the state. *See* § 1396d(b).

ric revenue shocks via tax and transfer flows.<sup>63</sup> It also accomplishes significant interstate and interregional redistribution.<sup>64</sup>

But with state income increasingly reliant on volatile capital markets, states simply cannot sustain both countercyclical federal spending mandates and balanced budget requirements.<sup>65</sup> Either states must jettison their balanced budget requirements and be willing to engage in deficit-funded countercyclical spending, making them true Keynesian entities<sup>66</sup> and giving real effect to their sovereignty, or they must be recognized as mere administrative subdivisions of the federal government—a solution that would obligate federal spending to kick in to fund federally mandated state obligations when the demand for state services rises.<sup>67</sup> Eliminating countercyclical federal spending

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63 See, e.g., Tamim Bayoumi & Paul R. Masson, *Fiscal Flows in the United States and Canada: Lessons for Monetary Union in Europe*, 39 EUR. ECON. REV. 253, 264–65 (1995) (estimating a fiscal federalism stabilization effect of 30%); Charles A.E. Goodhart & Stephen Smith, *Stabilization*, in THE ECONOMICS OF COMMUNITY PUBLIC FINANCE 417 (EUR. ECON. REPORTS & STUDIES No. 5, 1993) (estimating fiscal federalism stabilization effect of 13%); Kenneth Kletzer & Jürgen von Hagen, *Monetary Union and Fiscal Federalism*, in THE IMPACT OF EMU ON EUROPE AND THE DEVELOPING COUNTRIES 17, 20 tbl.2.1 (Charles Wyplosz ed., 2001) (summarizing the literature's estimates for redistribution and insurance effects of intranational transfers in the United States); Jacques Mélitz & Frédéric Zumer, *Regional Redistribution and Stabilization by the Center in Canada, France, the UK and the US: A Reassessment and New Tests*, 86 J. PUB. ECON. 263, 279 (2002) (concluding that fiscal federalism accounts for 10% of the regional stabilization in the United States); Xavier Sala-i-Martin & Jeffrey Sachs, *Fiscal Federalism and Optimum Currency Areas: Evidence for Europe from the United States*, in ESTABLISHING A CENTRAL BANK: ISSUES IN EUROPE AND LESSONS FROM THE US 195, 206–13 (Matthew B. Canzoneri et al. eds., 1992) (estimating that U.S. fiscal federalism produces a combined short-term stabilization and long-term redistribution effect of 33 to 40%); Jürgen von Hagen, *Fiscal Arrangements in a Monetary Union: Evidence from the US*, in FISCAL POLICY, TAXATION AND THE FINANCIAL SYSTEM IN AN INCREASINGLY INTEGRATED EUROPE 337, 337–59 (Donald E. Fair & Christian de Boissieu eds., 1992) (estimating a fiscal federalism stabilization effect of 10%).

64 See Kletzer & von Hagen, *supra* note 63 (summarizing estimates of the redistribution effect of U.S. fiscal federalism, ranging from 7 to 47%); von Hagen, *supra* note 63 (emphasizing the distinction between short-term stabilization and long-term redistribution). Relative to other fiscal federalism arrangements, the United States does not engage in substantial interregional redistribution. German fiscal federalism has a complex, constitutionally mandated redistribution requirement. See Ralf Hepp & Jürgen von Hagen, *Fiscal Federalism in Germany: Stabilization and Redistribution Before and After Unification* 2–3 (Aug. 30, 2010) (unpublished manuscript), available at [http://faculty.fordham.edu/hepp/vHH\\_MZ02\\_Paper\\_2010\\_0830\\_web.pdf](http://faculty.fordham.edu/hepp/vHH_MZ02_Paper_2010_0830_web.pdf).

65 Noncyclical federal spending mandates like environmental protection do not significantly worsen state fiscal troubles other than by taking some fraction of spending off the table for cuts.

66 See Super, *supra* note 4, at 367 (noting that “[s]tate fiscal policy . . . has no analogue to the notion that federal deficits and surpluses at different points in the business cycle can help achieve macro-economic stability”).

67 The federal government did toss a Keynesian bone to the states in the form of the American Recovery and Reinvestment Act of 2009 (also known as “the stimulus”), mainly in the form of increased Medicaid funding and a “State Fiscal Stabilization Fund.” See Pub. L. No. 111-5, §§ 14001–14012, 123 Stat. 115, 279–286. That aid helped states weather budget shortfalls in 2009 through 2011, but there are few funds remaining for disbursement in 2012 and forward. McNichol et al., *supra* note 1, at 7–8.

mandates would not solve all state budget problems. States would still have a problem of cyclical revenue and noncyclical spending activities. Eliminating countercyclical spending obligations, however, would greatly mitigate state budget stress during downturns.

Put differently, to limit the severity of state budget crises, it is necessary to either (1) eliminate unfunded, countercyclical federal spending mandates (basically either requiring federal funding of state-administered programs or relieving states of these obligations); (2) allow the states to piggyback on the federal government's Keynesian borrowing power; or (3) eliminate state balanced budget requirements (a particularly dangerous idea given the numerous political economy problems that encourage deficits, as discussed below).<sup>68</sup> States' current sovereignty limbo is a fail-safe recipe for fiscal crises in economic downturns. Without resolving fiscal federalism's conundrum, states are left with the hard task of choosing what taxes to raise and what services to cut.

## II

### THE POLITICAL ECONOMY OF STATE BUDGETS

While state budget crises ultimately have structural roots in fiscal federalism, they are exacerbated by a moral hazard in state politics. State legislatures and governors do not bear the full cost of their budgetary decisions and are therefore incentivized to engage in riskier fiscal management than they would otherwise. The result is to amplify the cyclicity of state budget crises that already exists due to fiscal federalism.

#### A. Budget Deficits and Budget Crises

To understand the moral hazard in state budget politics, it is first necessary to differentiate state budget crises from budget gaps. A

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<sup>68</sup> Balanced budget rules are a way of addressing politically induced inefficiencies, as they force greater fiscal discipline. Balanced budget rules are also both a commitment and a signaling device. They increase credibility with creditors, who know that future discretionary spending will be cut or future revenue increased in order to pay the obligations owed to them. Balanced budget rules also serve as a type of deductible that mitigates the moral hazard of states counting on a federal bailout. If states have to first make the expenditure cuts or tax increases to balance their budget before turning to the federal government for assistance, they might be less likely to see federal bailouts as attractive insurance for unwise profligacy. But they come at the price of loss of ability to engage in fiscal stabilization over the economic cycle. See JONATHAN A. RODDEN, *HAMILTON'S PARADOX: THE PROMISE AND PERIL OF FISCAL FEDERALISM* 147 (2006); Xavier Debrun & Manmohan S. Kumar, *Fiscal Rules, Fiscal Councils and All That: Commitment Devices, Signaling Tools or Smokescreens?*, in *BANCA D'ITALIA, PUBLIC FINANCE WORKSHOP, FISCAL POLICY: CURRENT ISSUES AND CHALLENGES* 479, 603–08 (2007), available at [http://www.bancaditalia.it/studiricerche/convegni/atti/fiscal\\_policy/Session%203/Session\\_3\\_Fiscal\\_Policy\\_and\\_Budgetary\\_Institutions.pdf](http://www.bancaditalia.it/studiricerche/convegni/atti/fiscal_policy/Session%203/Session_3_Fiscal_Policy_and_Budgetary_Institutions.pdf).

budget gap is only a budget crisis if the budget must be balanced in an acute timeframe. Running a deficit is not, in and of itself, a budget crisis. A budget gap may become a crisis, however, when the legal constraints that limit deficit financing force states to choose between increasing revenue and cutting services in order to close the budget gap. State budget crises arise from the inability (or more precisely, unwillingness) of state legislatures to choose from the unappetizing menu of tax hikes and service cuts necessary to close budget gaps. The problem, then, has two elements: legal constraints on deficit financing and political dysfunction inhibiting states' ability to close budget gaps via increases in revenue or cuts in services. State budget crises are about the unappealing political choices involved in closing budget gaps, rather than any inherently insurmountable financial problem in doing so.

States have greater ability than firms to increase revenue or cut expenses. States can increase revenue by raising taxes (subject only to the Laffer curve) and can cut services without losing revenue or ceasing operation. This means that states are generally capable of balancing their budgets if they have the political moxie to increase taxes, cut services and benefits, or both.<sup>69</sup> Politically, however, state legislators have few incentives to pursue fiscal responsibility.

## B. Political Agency Problems

A vast political economy literature has produced several theoretical explanations for why governments run budget deficits.<sup>70</sup> These explanations include tax rate smoothing, common pool problems and budgetary institutions, strategic deficits, intergenerational redistribution, delay due to distributional conflicts, and opportunistic politicians exploiting voters' fiscal myopia. Not all of these theories easily apply to U.S. states, given the legal constraints on running long-term deficits, although the theories are not without relevance, given states' numerous creative circumventions of balanced budget rules.<sup>71</sup> In addition to these theories, this Article suggests an additional explanation of states' budget problems: a political moral hazard due to the weakness of electoral discipline on spending decisions. All of these theories imply some form of political agency problem exacerbating state fiscal distress.

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<sup>69</sup> See Gillette, *supra* note 18, at 1–2 (detailing municipal unwillingness to raise taxes or decrease services when confronted with budget crises).

<sup>70</sup> For an excellent overview of the theoretical literature on budget deficits, see Alberto Alesina & Roberto Perotti, *The Political Economy of Budget Deficits*, 42 INT'L MONETARY FUND STAFF PAPERS 1, 1 (1995).

<sup>71</sup> See sources cited *supra* note 53.

### 1. *Tax Rate Smoothing*

One explanation for budget deficits is that they are used to ensure intertemporal smoothing of tax rates.<sup>72</sup> If a state's expenses are high in time period one ( $T_1$ ), but will be low in time period two ( $T_2$ ), a balanced budget approach would imply high taxes in  $T_1$  and low rates in  $T_2$ . If the state is seeking to smooth tax rates though, it will run a deficit in  $T_1$ , which it will pay off with the surplus in  $T_2$ . In so doing, it will minimize the distortional effect of taxes. This is not necessarily a political agency problem—politicians may be carrying out exactly what their constituents want—yet it could also easily reflect political agency problems if risk-averse politicians seek to engage in tax rate smoothing so as to avoid tax increases that could affect their reelection chances (and the private benefits that come with elected service).

### 2. *Common Pool Problems and Budgetary Institutions*

Another explanation of budget deficits portrays state legislatures with geographically based representation as suffering from a common pool problem. Individual legislators and committees fully internalize the benefits of their spending decisions (generally focused on their districts), but they bear only a fraction of the total cost, which is spread out over the entire legislature.<sup>73</sup> Similarly, when budgetary authority is dispersed, such as through multiple committees, spending

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<sup>72</sup> Robert J. Barro, *On the Determination of the Public Debt*, 87 J. POL. ECON. 940, 940–41 (1979).

<sup>73</sup> See, e.g., Barry R. Weingast et al., *The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics*, 89 J. POL. ECON. 642, 654, 658–62 (1981) (describing the “Law of  $1/n$ ,” which theorizes that spending increases with the number of legislators).

also increases.<sup>74</sup> Thus, centralized or decentralized budget processes matter.<sup>75</sup>

### 3. *Strategic Deficits*

State budget problems could also be the result of the strategic political use of debt—either to provide cover for spending cuts or to tie future governments' hands. Ronald Reagan's budget director David Stockman coined the term "strategic deficit" to describe an administration policy of running up deficits in order to provide cover for cutting social programs.<sup>76</sup> Several political economics articles have modeled a Stackelberg game<sup>77</sup> in which the party in office runs up debt in order to limit the spending options of its successors, who would be saddled with the debt service.<sup>78</sup> The appeal of such a strat-

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<sup>74</sup> See, e.g., John F. Cogan, *The Dispersion of Spending Authority and Federal Budget Deficits*, in *THE BUDGET PUZZLE: UNDERSTANDING FEDERAL SPENDING* 16, 17 (John F. Cogan et al. eds., 1994) (suggesting that the most important reason for continuous federal budget deficits after World War II was that jurisdiction over expenditures shifted from a centralized congressional committee structure to a decentralized structure). There is a vast literature on how the organization of legislatures leads to inefficient fiscal decisions. See, e.g., JOHN A. FERREJOHN, *PORK BARREL POLITICS: RIVERS AND HARBORS LEGISLATION, 1947-1968*, at 1-12 (1974) (explaining how a decentralized legislative structure promotes economically inefficient decision making); David P. Baron & John A. Ferejohn, *Bargaining in Legislatures*, 83 *AM. POL. SCI. REV.* 1181, 1183-86 (1989) (suggesting that members of the legislature act noncooperatively in choosing strategies to serve their own district); Morris P. Fiorina & Roger G. Noll, *Voters, Bureaucrats and Legislators: A Rational Choice Perspective on the Growth of Bureaucracy*, 9 *J. PUB. ECON.* 239, 251-53 (1978) (explaining that when a demand for a public good surges, incumbent legislators will engage in economically inefficient projects if they are seeking reelection); Kenneth A. Shepsle & Barry R. Weingast, *Political Preferences for the Pork Barrel: A Generalization*, 25 *AM. J. POL. SCI.* 96, 107-10 (1981) (showing that economically inefficient projects can be politically popular); Weingast et al., *supra* note 73.

<sup>75</sup> There are clearly limitations to the power of a common pool explanation of budget gaps. The mismatch between costs and benefits only applies to projects that are particular to individual legislative districts—for example, the construction of a new bridge. These localized benefits are a fairly small part of state budgets. For program expansions, such as Medicaid, corrections, or higher education, most legislative districts get a fraction of the spending and bear a fraction of the costs. Even if there were a mismatch between costs and benefits for legislative districts in most or all of state spending, it would only explain an increase in spending, not a deficit itself (i.e., the failure to pay for the increased spending) as the costs of a tax increase, just like the costs of financing a deficit, would be amortized over all legislative districts, even if the benefits were limited to some.

<sup>76</sup> Greg Anrig, "Strategic Deficit" Redux, *AM. PROSPECT*, Jan. 26, 2010, <http://prospect.org/article/strategic-deficit-redux-0> (discussing Reagan budget director David Stockman's concept of strategically limiting deficits to provide cover for cutting social programs).

<sup>77</sup> In a Stackelberg game, one player, the "leader," moves first, followed sequentially by other players, the "followers," who can observe the leader's action. This gives the leader an inherent advantage because the leader's move limits the followers' options and the leader knows this. See generally HEINRICH VON STACKELBERG, *MARKET STRUCTURE AND EQUILIBRIUM* (Damien Bazin et al. trans., Springer 2011) (1934) (introducing the Stackelberg Leadership Model).

<sup>78</sup> See, e.g., Alberto Alesina & Guido Tabellini, *A Positive Theory of Fiscal Deficits and Government Debt*, 57 *REV. ECON. STUD.* 403, 412-13 (1990) (modeling an economy comprised of two parties that disagree about spending priorities but not spending levels, where

egy increases with the chance that the opposition will prevail in the next election.

Even in states with minimal partisan competition, strategic deficits (to the extent that balanced budget rules can be circumvented) may make sense in the presence of term limits. Running a large deficit increases officeholders' popularity while sticking future officeholders with the bill. The result is to increase the popularity and legacy of the incumbents who may aspire to higher office.

#### 4. *Intergenerational Redistribution*

Budget deficits can result from attempts at intergenerational redistribution, as the present generation spends and passes the bill on to the future generation (assuming no Ricardian equivalence).<sup>79</sup> Again, this redistribution alone does not create a budget crisis unless a balanced budget requirement also exists or the debt burden from the intergenerational redistribution becomes unmanageable.

In the case of states, intergenerational redistribution is a one-way ratchet, as there is no viable means to pass a surplus along to a future generation. While states can accumulate surplus revenues in their general fund balance or pay into a "rainy day" fund, not all have such a fund,<sup>80</sup> and those that do are not secure against political raids when the need is not dire (leaky buckets). Moreover, some states' balanced budget requirements do not permit deficits to be financed by the

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both parties are encouraged to issue debt strategically); Roland Hodler, *Elections and the Strategic Use of Budget Deficits*, 148 PUB. CHOICE 149, 158–59 (2011) (introducing a model in which a conservative incumbent with preferences for low public spending strategically runs a budget deficit to prevent the left-wing opposition candidate from choosing high public spending if elected, and possibly also to ensure his own reelection); Torsten Persson & Lars E.O. Svensson, *Why a Stubborn Conservative Would Run a Deficit: Policy with Time-Inconsistent Preferences*, 104 Q.J. ECON. 325, 339–42 (1989) (modeling two parties that disagree about spending levels, but not priorities, which encourages the low-spending party to issue debt to constrain the high-spending party in the future); Guido Tabellini & Alberto Alesina, *Voting on the Budget Deficit*, 80 AM. ECON. REV. 37, 47–48 (1990) (concluding that under certain conditions, a balanced budget is not a political equilibrium and a majority of the voters favors a budget deficit); see also Stijn Goemmine & Carine Smolders, *Strategic Use of Debt in Flemish Municipalities*, 10 B.E. J. ECON. ANALYSIS & POL'Y 1, 1–7 (2010) (reviewing literature and theories on strategic deficits).

<sup>79</sup> See, e.g., Alex Cukierman & Allan H. Meltzer, *A Political Theory of Government Debt and Deficits in a Neo-Ricardian Framework*, 79 AM. ECON. REV. 713 *passim* (1989) (demonstrating how individual preference for positive debt induced by bequest constraints influences intergenerational redistribution). Ricardian equivalence is a theory that total demand in an economy is unaffected by government's decision to finance spending via debt or taxation as consumers internalize governmental budget constraints. See generally John J. Seater, *Ricardian Equivalence*, 31 J. ECON. LITERATURE 142 (1993) (explaining Ricardian equivalence).

<sup>80</sup> Arkansas, Kansas, and Montana lack rainy day funds. Kim Rueben & Carol Rosenberg, *State and Local Tax Policy: What Are Rainy Day Funds and How Do They Work?*, TAX POLICY CTR., <http://www.taxpolicycenter.org/briefing-book/state-local/fiscal/rainy-day.cfm> (last updated Aug. 12, 2009).

rainy day fund.<sup>81</sup> Functionally, most states maintain rainy day funds at levels that cannot meaningfully cushion even small economic downturns; as of fiscal year 2008, only eight states had rainy day funds that exceeded 10% of the states' annual expenditures.<sup>82</sup>

### 5. *Wars of Attrition*

Budget deficits can also be the result of political stalemates or "wars of attrition"—the delay in dealing with fiscal shocks caused by conflicts between social groups or political parties regarding allocation of the costs (i.e., higher taxes or decreased expenditures) of balanced budgets.<sup>83</sup> In divided governments, wars of attrition can be a particular problem. But even in coalition governments in which all parties want a balanced budget, deficits can result because the demands of maintaining a coalition require all parties to accede to the others' partisan spending interests that predominate over balanced budget interests.<sup>84</sup>

### 6. *Fiscal Illusion and the Political Business Cycle*

The persistence of budget deficits in modern democracies has been a central theme in public choice scholarship.<sup>85</sup> The public choice literature has argued that public deficits are the result of voters suffering from a "fiscal illusion," namely that voters overestimate the benefits of current expenditures and underestimate future tax burdens when analyzing deficit-financed expenditures.<sup>86</sup> Opportunistic politicians seeking reelection for their personal benefits exploit this misapprehension by raising spending more than taxes to curry favor with the "fiscally illuded" voters.<sup>87</sup> Accordingly, countercyclical spending itself contributes to excessive deficits because of its asymmetric application. Politicians will run deficits in a recession but not sur-

<sup>81</sup> *Id.* ("Some states allow withdrawals for any purpose deemed appropriate by the governor or the state legislature, whereas others allow withdrawals only if the deficit is due to a revenue shortfall, and others only if it is caused by unexpected expenditures.").

<sup>82</sup> *Id.*

<sup>83</sup> Alberto Alesina & Allan Drazen, *Why Are Stabilizations Delayed?*, 82 AM. ECON. REV. 1170, 1171 (1991).

<sup>84</sup> See Fabrizio Balassone & Raffaella Giordano, *Budget Deficits and Coalition Governments*, 106 PUB. CHOICE 327, 328 (2001).

<sup>85</sup> See, e.g., JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* 31–39 (1962).

<sup>86</sup> JAMES M. BUCHANAN & RICHARD E. WAGNER, *DEMOCRACY IN DEFICIT: THE POLITICAL LEGACY OF LORD KEYNES* 128–30 (1977); Richard E. Wagner, *Revenue Structure, Fiscal Illusion, and Budgetary Choice*, 25 PUB. CHOICE 45, 47 (1976). The fiscal-illusion argument curiously presages behavioral economics in its emphasis on systematic overestimation of benefits and underestimation of costs by voters (consumers). Strangely, behavioral economics is associated with progressive political thought in consumer finance, but fiscal illusion is associated with conservative (or libertarian) thought in public finance.

<sup>87</sup> See BUCHANAN & WAGNER, *supra* note 86, at 129–30; Wagner, *supra* note 86, at 47.

pluses when the recession ends because fiscally illuded voters reward this behavior.<sup>88</sup> While the fiscal illusion argument has limited application to states because of their legal limitations on deficit financing, it does help explain why states might spend profligately in  $T_1$ , namely as an underestimation of the costs to be paid in  $T_2$ .

A related explanation for deficits can be found in the literature on the political business cycle. While this literature has developed parallel to the public choice literature, its explanation is rather similar: deficits are the result of politicians following expansionary policies in election years in order to curry favor with voters who do not recognize the future price tag of these policies.<sup>89</sup> Both the public choice and the political business cycle literatures emphasize politicians exploiting voter myopia.<sup>90</sup> But voter myopia is hardly necessary given the frictions that exist in electoral systems; elections offer imperfect discipline on politicians' choices on any particular issue, as discussed below.

### 7. *Political Moral Hazard*

In addition to previously discussed, nonexclusive explanations of state budget deficits in the political economy literature, this Article adds an additional, original explanation. This Article argues that even if voters are not fiscally illuded, state spending is skewed by a political moral hazard problem, as voting exercises very imperfect discipline on budgets. The problem starts in good times, before there is a budget crisis. When coffers are flush, states, like firms, face a dual temptation. They can lower taxes and return the surplus to citizens (equivalent to a firm dividending retained earnings<sup>91</sup>) or they can

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<sup>88</sup> Charles K. Rowley, *The Legacy of Keynes: From the General Theory to Generalized Budget Deficits*, in DEFICITS 143, 165–68 (James M. Buchanan et al. eds., 1987).

<sup>89</sup> See, e.g., Alberto Alesina & Jeffrey Sachs, *Political Parties and the Business Cycle in the United States, 1948–1984*, 20 J. MONEY, CREDIT & BANKING 63, 63 (1988); Alberto Alesina, *Politics and Business Cycles in Industrial Democracies*, 8 ECON. POL'Y 55, 55 (1989); André Blais & Richard Nadeau, *The Electoral Budget Cycle*, 74 PUB. CHOICE 389, 389 (1992); Mala Lalvani, *Elections and Macropolicy Signals: Political Budget Cycle Hypothesis*, 34 ECON. & POL. WKLY. 2676, 2681 (1999) (finding in India a reallocation of resources around election time to expenditure categories that would help capture votes); C. Duncan MacRae, *A Political Model of the Business Cycle*, 85 J. POL. ECON. 239, 239–40 (1977); William D. Nordhaus, *The Political Business Cycle*, 42 REV. ECON. STUD. 169, 187 (1975); Kenneth Rogoff & Anne Sibert, *Elections and Macroeconomic Policy Cycles*, 55 REV. ECON. STUD. 1, 1 (1988); Kenneth Rogoff, *Equilibrium Political Budget Cycles*, 80 AM. ECON. REV. 21, 21 (1990). *But see* Adi Brender & Allan Drazen, *How Do Budget Deficits and Economic Growth Affect Reelection Prospects? Evidence from a Large Panel of Countries*, 98 AM. ECON. REV. 2203, 2203–04 (2008) (finding no evidence that deficits help reelection independent of other factors and finding that deficits actually reduce reelection prospects in developed countries).

<sup>90</sup> See Rogoff, *supra* note 89, at 21, 33.

<sup>91</sup> Dividends that render a firm insolvent can be recovered as fraudulent transfers. Kevin J. Liss, Note, *Fraudulent Conveyance Law and Leveraged Buyouts*, 87 COLUM. L. REV.

spend on more discretionary projects (equivalent to a firm reinvesting its surplus).

However, both the tax cuts/dividends and spending/reinvesting routes can be seen as forms of betting on risky projects. If successful, they will yield big payoffs politically and financially. One route bets on low taxes producing the political payoff without state budget troubles. Thus, if taxes are cut and the state's budget holds firm, tax-cutting politicians will reap political benefits.

The other route bets on state spending producing the political payoff without state budget troubles. Thus, if the state engages in more discretionary spending, there too is upside for politicians in the form of patronage employment, benefit transfers, and general goodwill.<sup>92</sup> Accordingly, in good times, states have locked themselves into long-term obligations, such as generous collective bargaining agreements.<sup>93</sup> While the details of these bets differ, the basic substance of both gambles is the same, namely that using rather than saving the surplus will bring political gain and will not result in a future shortfall.

The upside of undisciplined fiscal behavior, either through spending/reinvesting or tax cuts/dividends is quite similar for states and firms. But states face very different downsides than firms. If a firm spends profligately, its share price will plummet, and the firm will become a takeover target or even end up in bankruptcy, where current equity owners will likely be wiped out and management replaced.

In contrast, state legislatures and governors face much less electoral discipline for fiscal profligacy. Electoral discipline is weaker in this context than market discipline. Elections take place at regularly scheduled intervals, which mutes their ability to provide a dynamic response to elected officials' current actions. Elections also typically present voters with binary choices between candidates. Voters then cast their votes based on many factors, with state budget gaps being only one, and candidates' stances on fiscal issues might be outweighed by their stances on social issues, for example. Moreover, blame for budget problems is often shared among multiple politicians, elections are staggered (like those for many corporate boards),<sup>94</sup> and many state legislators are elected from what are effectively "rotten boroughs," "gerrymanders," or "safe seats" in which there is no electoral

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1491, 1496–97 (1987). There is no indication that this would be the case with state tax cuts.

<sup>92</sup> Lowering taxes or increasing services conditions citizens to expect low taxes or high services, which makes it politically harder to unwind these entitlements when there is a budget gap.

<sup>93</sup> See, e.g., Peter Applebome, *In Connecticut, Affluent Image but Fiscal Pain*, N.Y. TIMES, June 30, 2011, at A1.

<sup>94</sup> Query whether the increasing (but still rare) use of recall elections may create more electoral discipline.

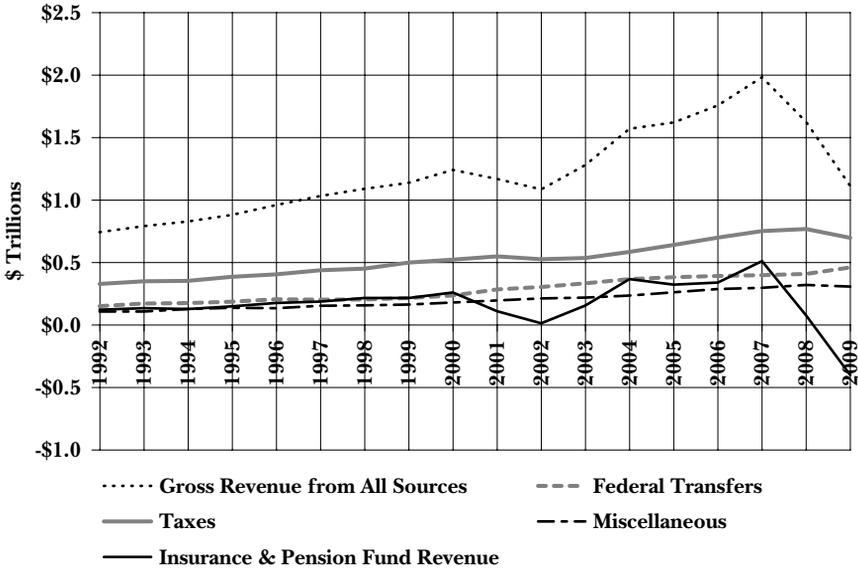
competition. The resulting mismatch between strong upside benefits and limited downside costs encourages state legislators and governors to be undisciplined with budgets and gamble large in good times.

The tendency to gamble via tax cuts or increased discretionary spending in good times is itself exacerbated by the procyclical nature of a major state obligation—pensions. Most state pension plans are defined-benefit plans, meaning that the state is responsible for any shortfall between the market return on employee contributions to the plan and the promised benefit.<sup>95</sup> Thus, the state assumes the risk of investment performance on pension plan assets. If the stock market is up—as it tends to be during boom times—state pension obligations look well funded. When the market falls, however, state pension funding obligations increase at precisely the time that other demands on the state budget increase.

A similar story plays out with state insurance trust funds. States hold funds in trust to pay unemployment insurance and workers' compensation claims. These funds are invested, making them highly cyclical. Indeed, as Figure 4 shows below, for the fifty states collectively, state revenue fluctuations are primarily the result of fluctuations in insurance and pension fund revenue. (A similar picture exists if local government revenue is included.)

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<sup>95</sup> See ALICIA H. MUNNELL ET AL., CTR. FOR STATE & LOCAL GOV'T EXCELLENCE, ISSUE BRIEF: WHY HAVE DEFINED BENEFIT PLANS SURVIVED IN THE PUBLIC SECTOR? 3 fig.1 (2007), available at <http://slge.org/wp-content/uploads/2011/12/Why-have-db-plans-survived.pdf> (reporting that 92% of state and local employees in 2005 had defined-benefit pension plans).

FIGURE 4: STATE REVENUE FLUCTUATIONS<sup>96</sup>

A consequence of this political economy is that states have limited political ability to accumulate rainy day funds. If a state runs a surplus, there are inevitable demands for taxes to be lowered, services to be increased, or both. While a state may be able to hold on to some of the surplus in a rainy day fund, constituent demands on politicians and the politicians' desire to please constituents will limit the state's ability to save.<sup>97</sup>

### C. The Political Economy of Budget Crisis Responses

Once a budget crisis emerges, meaning that a budget gap must be closed within a limited window, the moral hazard becomes a temptation to "gamble on resurrection" in various forms, where states count on their finances improving on their own over time. There are four manifestations of such resurrection gambling.

First, state legislatures may simply dither and delay in the hopes that the economic climate will change or that something will turn up. For example, if state revenue derives heavily from sales taxes, special

<sup>96</sup> CENSUS BUREAU HISTORICAL DATA, *supra* note 39. Figure 4 does not show the increase in federal transfer payments to states under the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115, as these would be reflected only starting with 2010 revenue for the states.

<sup>97</sup> Reforms to the fiscal federalism arrangement that encourage states to save countercyclically could be very beneficial. For example, federal matching funds could encourage state savings. See William J. Baumol, *Macroeconomics of Unbalanced Growth: The Anatomy of Urban Crisis*, 57 AM. ECON. REV. 415, 426 (1967) (suggesting the need for federal support for cities); cf. Robert P. Inman, *Dissecting the Urban Crisis: Facts and Counterfactuals*, 32 NAT'L TAX J. 127, 136-37 (1979) (proposing countercyclical revenue sharing).

excise taxes, income taxes, federal grants-in-aid, or even property taxes, delay lets the legislature gamble on the possibility that economic activity, federal funding, or property values will go up and thus that revenue will increase without an increase in the tax rate.

Dither and delay, however, is not always the result of a rational gamble, but often the result of political deadlock between those who would raise taxes and those who would reduce spending.<sup>98</sup> The inability to decide between these options—a type of Buridan’s ass problem—only exacerbates matters.<sup>99</sup>

Second, state legislatures will be tempted to “borrow” from reserves designated for unmatured future obligations, such as pensions, in order to meet current expenses (a process known as “sweeping”). In borrowing from these reserves, legislatures hope that adequate funding for those future obligations will materialize somehow. Doing so, however, creates a backdrop for a future crisis as the maturity of those now-underfunded future obligations approaches. Indeed, because pension funds are typically raided during an economic downturn when their market value is depressed,<sup>100</sup> the damage to the funds is exacerbated by the loss of future market appreciation on the raided funds. Selling depreciated assets locks in the losses so that the pension funds cannot benefit in future market upswings.

Pension obligations are not included in states’ general funds and thus are not subject to states’ balanced budget requirements, which generally apply to states’ general funds and some specific funds.<sup>101</sup> State pension plans are not subject to ERISA,<sup>102</sup> meaning that nothing forces states to fund their plans. Instead, states are able to determine when they fund their pension plans, resulting in underfunded pension liabilities in lean times—a form of implicit borrowing against future revenues.<sup>103</sup>

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<sup>98</sup> See Alt & Lowry, *supra* note 54, at 811; Poterba, *State Responses*, *supra* note 54, at 816–18; see also Nouriel Roubini & Jeffrey D. Sachs, *Government Spending and Budget Deficits in the Industrial Countries*, 4 *ECON. POL’Y* 99, 126–27 (1989) (describing the same political deadlock in regards to budgetary policy for OECD countries); Nouriel Roubini & Jeffrey D. Sachs, *Political and Economic Determinants of Budget Deficits in the Industrial Democracies*, 33 *EUR. ECON. REV.* 903, 930–31 (1989) (same).

<sup>99</sup> Buridan’s ass found itself at a point equidistant from a pail of water and a stack of hay. Because the ass could not decide which way to go, it ended up dying of hunger and thirst. See Sharon M. Kaye, *Why the Liberty of Indifference Is Worth Wanting: Buridan’s Ass, Friendship, and Peter John Olivi*, 21 *HIST. PHIL. Q.* 21, 21 (2004).

<sup>100</sup> See J. Fred Giertz, *The Impact of Pension Funding on State Government Finances*, 29 *ST. TAX NOTES* 507, 511 (2003).

<sup>101</sup> See *id.* at 507–11.

<sup>102</sup> See Barbara A. Chaney et al., *The Effect of Fiscal Stress and Balanced Budget Requirements on the Funding and Measurement of State Pension Obligations*, 21 *J. ACCT. & PUB. POL’Y* 287, 288 (2002).

<sup>103</sup> See Giertz, *supra* note 100. It is important to distinguish, however, between total pension funding obligations and those that mature in any given year. Even if a pension

Third, state legislatures will be tempted to make overoptimistic assumptions about the budgetary impacts of service cuts, tax rate increases, or future market returns. As a result, service cuts and tax increases will not be large enough to put the state on sound financial footing, and the issue will have to be reexamined, thereby extending the crisis and potentially reigniting the issue as soon as midyear budget performance data is reported.

Fourth, states have resorted to accounting tricks to delay the unpleasant choice between tax hikes and spending cuts. These tricks only defer the recognition of problems rather than eliminate them. All fifty states operate on cash rather than accrual budgets.<sup>104</sup> Cash accounting means that the budget reflects outlays and receipts, which track when funds are actually paid or received, as opposed to reflecting expenses and revenues, which track when goods or services are actually used.<sup>105</sup> In other words, accrual budgeting tracks costs incurred today but not payable until the future.

Cash budgeting allows states to play tricks with their accounting. (Unfortunately, the alternative, accrual accounting, is equally, if not more, problematic in this regard.) In its crudest form, cash accounting lets states balance budgets by stiffing creditors. As an example, New Jersey balanced its budget by simply not paying \$3 billion in obligations.<sup>106</sup> The state still owed those obligations, however, and had to address them in the 2010 budget. Similarly, Illinois did not pay \$3.8 billion in obligations from 2010.<sup>107</sup>

Cash budgeting also allows a state to improve its financial picture for a current budget year through borrowing. The borrowed funds are received in the budget year and are counted as receipts, whereas the debt service payments will be outlays, but in future years. Thus,

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plan is underfunded, it may not matter in terms of having sufficient assets and liquidity to make current payments. Thus, a cyclically sensitive pension funding system may not be a particular concern as long as it produces sufficient assets to meet obligations as they come due.

As most state pension plans are defined benefit, rather than defined contribution, the state is responsible for the difference between the investment return on the employee contribution and the promised benefit. *See id.* at 507–11. The result is that state finances are cyclically linked to stock market performance, so states are also implicitly betting on future above-average stock market returns when they underfund their plans. *See id.*

<sup>104</sup> *See* David Crane, (Not) *Accounting for State Governments*, S.F. CHRON., Jan. 19, 2011, [http://articles.sfgate.com/2011-01-19/opinion/27036398\\_1\\_general-fund-debt-affordability-report-credit-card](http://articles.sfgate.com/2011-01-19/opinion/27036398_1_general-fund-debt-affordability-report-credit-card); INST. FOR TRUTH IN ACCOUNTING, *supra* note 49, at 26. Some states, like Illinois, have repeatedly shifted between cash and accrual budgeting based on what would provide the easiest way to balance the budget. *See id.* at 28. States also use accrual accounting selectively to count future revenues or savings in their current budgets, but not future expenses. *Id.*

<sup>105</sup> *See* Crane, *supra* note 104.

<sup>106</sup> *See id.*

<sup>107</sup> Michael Cooper, *States' Money Woes Show No Favorites*, N.Y. TIMES, July 18, 2011, at A12.

states are effectively able to borrow against the future through an accounting trick, despite balanced budget requirements. There is a limit to the usefulness of this trick, however, as too much current fiscal-year borrowing will result in higher debt service in the future.<sup>108</sup>

Likewise, cash accounting encourages states to enter into sale-leasebacks of state property, whereby the state books the sale revenue from the privatization in the current year but books lease payments into the future.<sup>109</sup> Sale-leasebacks are functionally secured loans. The same is true for future-flow securitization. States have securitized future revenue such as tobacco settlement payments in order to book it immediately.<sup>110</sup>

Cash accounting also fuels the moral hazard in state politics because it shields states from recognizing the costs of current spending decisions that will not be paid until the future. Cash accounting creates spending ability today while shifting the pain of repayment into the future. For example, cash accounting has allowed states to pay their employees more in the form of deferred benefits (such as pensions), as these deferred benefits do not appear in the current budget, meaning that states do not have to raise taxes to pay for the benefits at the time they promise them.<sup>111</sup> Politicians receive immediate patronage benefits from the costs being deferred to future budgets. Cash accounting thus allows politicians to reap the benefits of spending now and leave the costs to their successors, a particularly appealing route for politicians who hope to be upwardly mobile.<sup>112</sup>

Unfunded mandates and balanced budget requirements create a structurally untenable basis for state budgets. State political economics create a moral hazard that exacerbates this structural problem.

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<sup>108</sup> See Super, *supra* note 4, at 376–77 (noting gimmickry as a “prominent feature of states’ response to fiscal crises”).

<sup>109</sup> See INST. FOR TRUTH IN ACCOUNTING, *supra* note 49, at 29 (“[Sale-leasebacks] have had the effect of dramatically improving the budget deficit while increasing future governmental expenditures . . .”).

<sup>110</sup> See Behn & Keating, *supra* note 28, at 7. Municipalities like Chicago have engaged in similar transactions by selling municipal revenue streams such as parking meters or the Chicago Skyway toll road. See TONY DUTZIK ET AL., ILL. PIRG EDUC. FUND, PRIVATIZATION AND THE PUBLIC INTEREST: THE NEED FOR TRANSPARENCY AND ACCOUNTABILITY IN CHICAGO’S PUBLIC ASSET LEASE DEALS 1 (2009), available at <http://www.illinoispirg.org/sites/pirg/files/reports/Privatization-and-the-Public-Interest.pdf>; Julie A. Roin, *Privatization and the Sale of Tax Revenues*, 95 MINN. L. REV. 1965, 1993–99 (2011).

<sup>111</sup> See INST. FOR TRUTH IN ACCOUNTING, *supra* note 49, at 26 (“[C]ash basis budgeting ignores the effects of [pension obligations] . . .”).

<sup>112</sup> Cash accounting is not the only way states circumvent balanced budget requirements. Balanced budget requirements do not always apply to the entire state budget. Sometimes they only apply to the general fund or to the general fund and to some but not all specific funds. This allows “sweeps” whereby states transfer money from noncovered funds to balance the budget in the general fund by claiming the transferred money as “revenue,” although the transfer is no more revenue than a transfer of funds from an individual’s savings account to a checking account. See *id.* at 26–28.

The result is a limitation of states' ability to engage in countercyclical budgeting and saving in rainy day funds. Instead, states are encouraged to cut taxes or increase spending in good times, which only sets up larger budget gaps and more difficult choices in bad times.

Still another budgeting trick by the states is to engage in legal fictions to work around legal restrictions on budgets and debt issuance, such as issuing "subject-to-appropriation" debt.<sup>113</sup> Subject-to-appropriation debt involves states contracting, subject to appropriation, to pay the annual debt service on a revenue bond to the government entity issuing that bond.<sup>114</sup> Because of the "subject to" language, states are not bound to pay the obligation absent an appropriation, and thus they incur no debt for debt-limit purposes prior to the appropriation.<sup>115</sup>

The prevalence of these tricks suggests that states' budget problems require a two-part political solution. First, fiscal federalism needs to be reevaluated. And second, to the extent that fiscal federalism leaves states with a procyclical budget, state political agency problems need to be reformed to create countercyclical spending and saving mechanisms.

The issue of how best to go about these reforms is beyond the scope of this Article, but it is important to note that these problems are structural political ones, not financial ones. They do not concern the particular choices necessary in balancing any given fiscal year's budget. Instead, the political wrangling over tax hikes and spending cuts is a symptom of much deeper structural problems for state budgets. While procedural mechanisms like bankruptcy might potentially facilitate the choices necessary to balance budgets, they may themselves be problematic, as discussed below, and budget crises will inevitably reoccur absent structural change.

Accordingly, proposals to address state fiscal crises need to be evaluated in political, rather than financial terms. Many of the proposals for addressing state fiscal crises involve the use of some form of a bankruptcy regime—meaning a binding collective debt restructuring proceeding.

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<sup>113</sup> See Briffault, *supra* note 43, at 920.

<sup>114</sup> See *id.* at 920–21. A revenue bond is payable solely by a dedicated stream of income from a discrete project such as a toll road or a power plant, as distinct from a general obligation bond, which is payable from any of a state's revenues. See *id.* at 918–19.

<sup>115</sup> See *id.* at 920–25; see also *Lonegan v. State*, 819 A.2d 395, 401, 409 (N.J. 2003) (holding that general obligation bonds issued "subject to appropriation[s]" do not count toward debt limit because they are not legally enforceable against the state); *Lonegan v. State*, 809 A.2d 91, 136 (N.J. 2002) (holding that school construction bonds issued "subject to appropriations" do not count toward debt limit because they are not legally enforceable against the state).

## III

## THE BANKRUPTCY TOOLBOX

## A. Traditional Rationales for Bankruptcy

Even if the states' problems were primarily fiscal, rather than political, would bankruptcy make sense as a response? Traditionally, bankruptcy has not been viewed as a political tool. Instead, debt-restructuring regimes have been justified by reference to three rationales:

1. Overcoming collective action problems for creditors, including both a race-to-the-courthouse phenomenon and a free-riding problem as creditors wait for other creditors to forgive debt;
2. Restructuring in order to preserve going-concern value and prevent illiquidity from metastasizing into insolvency (and its collateral damage on non-creditor constituencies); and
3. Providing a fresh start in order to avoid economic loss due to debt overhang.

None of these rationales fits state bankruptcy well. As discussed below, states do not experience a race to the courthouse; states lack any meaningful going-concern value because they cannot be liquidated and can almost never be truly insolvent; and debt overhang problems for states are different than for individuals, firms, or national sovereigns because most creditors are "domestic"—meaning that they are state residents, who are concerned not just about existing debt, but also about the state's ability to provide future benefits and services.

1. *Creditors' Collective Action Problems*

One prominent rationale for bankruptcy is the avoidance of collective action problems for creditors. The chief collective action concern is a race to the courthouse, as creditors compete for the limited common pool of the debtor's assets.<sup>116</sup> Per this rationale, bankruptcy is a procedural mechanism for the orderly and fair distribution of those assets.

States, however, do not represent a limited common pool because they have the ability to increase revenue and cut expenses in a manner that firms or individuals do not. To be sure, the Laffer curve imposes a theoretical limit on states' ability to increase revenue or cut services; if taxes become too high or services too meager, enough tax-

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<sup>116</sup> See, e.g., JACKSON, *supra* note 21, at 10–19 (describing bankruptcy as a response to a common pool problem).

payers may leave the jurisdiction, thus causing a net decline in revenue.<sup>117</sup>

Even if states did represent a common pool problem, however, it is not clear how much bankruptcy would help in addressing the collective action problem. Bankruptcy's major tool in dealing with the race to the courthouse is the automatic stay.<sup>118</sup> State sovereign immunity, while often waived, limits that problem, meaning that the automatic stay may not have much additional purchase in addressing collective action problems. And, if the boundaries of a particular state's waivers of sovereign immunity are suboptimal for dealing with a fiscal crisis, that is a political problem.

## 2. *Preservation of Going-Concern Value*

A second rationale for debt-restructuring regimes like bankruptcy is to enable the preservation of going-concern value in illiquid but solvent firms. Illiquidity can quickly become insolvency (just as insolvency can result in illiquidity) when individuals or firms must dispose of assets at fire sale prices to gin up liquidity. The result is the destruction of going-concern value—the value of an enterprise above liquidation value or difference between the value of the whole enterprise and the sum of its parts. Such destruction can hurt not just creditors through the loss of going-concern value, but also other non-creditor constituencies such as communities and purchasers who benefit from the existence of the debtor as an operating entity. Bankruptcy can provide a forum for creditors to make a collective decision about a firm's viability and determine if its illiquidity is because of or in spite of insolvency and whether the firm should be reorganized or liquidated. It can also enable a “soft landing” to help protect non-creditor constituencies.

The preservation of going-concern value makes little sense when applied to states for two reasons. First, states do not have going-concern value, as that exists only in relation to liquidation value, and states cannot be liquidated or sold. Indeed, it is hard to speak of the financial value of a state in any meaningful sense. For this reason, it makes little sense to speak of a “soft landing” because there is no landing to soften.<sup>119</sup>

Second, while states may face liquidity problems, they are never insolvent in any meaningful sense other than in extreme disaster sce-

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<sup>117</sup> See James M. Buchanan, *Principles of Urban Fiscal Strategy*, 11 PUB. CHOICE 1, 7 (1971); Tiebout, *supra* note 46.

<sup>118</sup> See 11 U.S.C. § 362(a) (2006).

<sup>119</sup> *But see In re Pub. Serv. Co. of N.H.*, 99 B.R. 155, 161–73 (Bankr. D.N.H. 1989) (describing bargaining between state and creditors over ways in which electric power rates would be increased in a public utility's Chapter 11 plan).

narios. While states can conceivably be insolvent on a snapshot balance sheet basis, this insolvency need not be more than temporary, as states, unlike firms, can increase revenue by raising taxes or cut expenses by reducing services.<sup>120</sup> Whereas firms' ability to increase revenue or cut expenses is limited by market conditions and competition, states are limited solely by the Laffer curve and state politics.<sup>121</sup>

One could imagine a cataclysmic disaster that would leave a state unable to raise sufficient revenue to service its existing debt obligations, regardless of the level of taxation, because of devastation to the tax base: a tsunami wiping out much of Rhode Island, an earthquake leaving much of California under the Pacific Ocean, or a nuclear disaster making much of a state uninhabitable.<sup>122</sup> It is not clear, however, why bankruptcy is needed to insure against such freak occurrences or why the federal union could not be relied upon for mutual aid in such circumstances. Indeed, federal transfer payments themselves provide states with some insurance against localized revenue shocks.<sup>123</sup>

Ultimately, the preservation of going-concern value does not present a compelling argument for creating a special state-restructuring procedure like a new chapter of the Bankruptcy Code.

### 3. *Fresh Start and Debt Overhang*

Provision of a fresh start for debtors through debt forgiveness makes bankruptcy a type of social insurance against financial failure. Overleveraged individuals have limited incentives to increase productivity because the gains from their labor go to their creditors.<sup>124</sup> Similarly, the earnings of overleveraged firms go to creditors, not owners. This possibility limits individuals' and firms' incentives to take risks lest they end up in eternal debt peonage. Bankruptcy or other types of debt restructuring are a method of fixing this incentive problem and returning overleveraged individuals and firms to productivity.

Economist Paul Krugman has applied this rationale to sovereign debt, arguing that a restructuring regime is necessary to prevent eco-

<sup>120</sup> States may choose to tie their hands in this regard through constitutional limits on tax increases, such as California's Proposition 13. See *infra* text accompanying note 152.

<sup>121</sup> See sources cited *supra* note 117.

<sup>122</sup> Arguably, this happened to Louisiana, and to the city of New Orleans in particular, in the wake of Hurricane Katrina. The jurisdictions faced huge new costs, a reduced population, and a reduced economy, but all of their prior debts. Yet the state and city both muddled through, although New Orleans reportedly did consider filing a Chapter 9 bankruptcy.

<sup>123</sup> For estimates of the insurance function of federal transfer payments, see *supra* note 63 and accompanying text.

<sup>124</sup> See generally Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393 (1985) (outlining the justifications for the "fresh start" policy).

conomic losses from debt overhang.<sup>125</sup> An overleveraged public debtor may be unable to obtain the financing to undertake net present value (NPV) positive projects. A system for deleveraging the debtor thus avoids deadweight loss. The fresh-start–debt-overhang rationale provides the strongest argument for a state bankruptcy system, but its application to states is messy and uncertain.

For some welfare-enhancing projects, states have a workaround to debt-overhang problems. Project finance in the form of revenue bonds enables a state to separate the financing of revenue-generating projects from the finances of the state as a whole, which may be subject to statutory creditor-priority schemes.<sup>126</sup> Revenue bonds are bonds backed solely by the cash flow from a specific revenue source, as opposed to general obligation bonds, which are backed by the full faith and credit of the state.<sup>127</sup> Holders of revenue bonds have first dibs on the cash flow from that revenue source, ahead of other creditors of the state.<sup>128</sup> Thus, a state can borrow funds for a NPV positive project by borrowing against the future cash flows on that project. For example, a state can finance a toll road by borrowing against the future revenue from the tolls. Similarly, a state can finance a power plant by borrowing against the plant's future revenue. States and local governments use revenue bonds extensively: between 1996 and 2010, revenues from specific sources backed two-thirds of all U.S. state and local government debt.<sup>129</sup>

Some value-enhancing projects, however, do not produce distinct cash-flow streams, such as investments in health, education, and welfare. These investments may indirectly increase property values and property tax revenues, yet revenue bonds cannot always finance these projects.<sup>130</sup> Even so, the fresh-start–debt-overhang bankruptcy rationale is less convincing for states than for other entities.

First, it makes little sense to talk of a state's productivity as one would an individual's or a firm's. An individual's or firm's productivity is measured by earnings. But a state's earnings are largely a consequence of the productivity of its population and its tax code.

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<sup>125</sup> See Paul Krugman, *Financing vs. Forgiving a Debt Overhang*, 29 J. DEV. ECON. 253, 266–67 (1988).

<sup>126</sup> See, e.g., CAL. CONST. art. 16, § 8.

<sup>127</sup> E.g., Kordana, *supra* note 16, at 1049.

<sup>128</sup> E.g., *id.*

<sup>129</sup> See STEVEN MAGUIRE, CONG. RESEARCH SERV., R41735, STATE AND LOCAL GOVERNMENT DEBT: AN ANALYSIS 5 (2011) (citing data from Thomson Reuters provided by the Securities Industry and Financial Markets Association).

<sup>130</sup> If there is a clear positive effect on property values, revenue bonds known as tax increment financings (TIF) can be issued backed by the property tax revenue in excess of a preproject baseline. See Richard F. Dye & David F. Merriman, *Tax Increment Financing: A Tool for Local Economic Development*, LAND LINES, Jan. 2006, at 2, 2.

A state's ability to undertake NPV positive projects could provide a measure of its productivity. Yet, in order to undertake such projects, the state must divert resources from residents who could possibly undertake those projects directly, without state involvement.

Whereas individuals and firms should maximize their productivity to increase their consumption power and thereby enhance their own welfare, such a rationale does not hold with the states. An increase in state taxation does not necessarily translate into a net welfare increase; it does, however, add transaction costs and redistribute wealth, which may or may not be Kaldor-Hicks efficient.

Second, many of a state's creditors are domestic, meaning that they experience an offset between losses in a restructuring and the future benefits or business they receive from the state. State bond debt—known somewhat confusingly as “municipal debt” or “municipal bonds”—and states' vendors particularly exemplify this problem. Municipal bond creditors are often state residents, because the state tax benefits of municipal debt, which are in addition to the federal tax benefits, accrue solely to state residents.<sup>131</sup> Similarly, states' vendors and social benefit recipients are mainly residents. Accordingly, it is not clear that debt forgiveness or other restructuring would actually be in the interest of the state's residents as a whole, much less for any particular resident. The future benefits a state's residents would receive from a state being able to undertake more NPV positive projects would be offset to some degree by the immediate losses from debt forgiveness. Conversely, if the state had to increase taxes or cut services to pay its obligations, these costs would offset the benefit to the residents of timely, full payment. In the abstract, it is impossible to know how either of these scenarios would net out, but at the very least, the prevalence of domestic creditors considerably complicates the idea that a fresh start through debt forgiveness is beneficial to states' residents.

Finally, and most critically, the restructuring rationale explains bankruptcy as a means of preserving the going-concern value for firms with good overall business models that also have liquidity problems.<sup>132</sup> Restructuring, however, is always conditioned on three basic principles. First, the debtor must have a viable business model (“feasibility”

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<sup>131</sup> See Brief for Nat'l Fed'n of Mun. Analysts as Amicus Curiae in Support of Neither Party at 17, *Dep't of Revenue of the Commonwealth of Ky. v. Davis*, 553 U.S. 328 (2008) (No. 06-666), 2007 WL 2115441; *Investor Bulletin: Focus on Municipal Bonds*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/investor/alerts/municipal.htm> (last updated Sept. 20, 2010).

<sup>132</sup> See, e.g., Anna Gelpern, *T.A.R.P. R.I.P.: Illiquency Watch*, CREDIT SLIPS (Nov. 14, 2008, 12:31 AM), <http://www.creditslips.org/creditslips/2008/11/tarp-rip-illiqu.html>; David Zaring, *Anna Gelpern: . . . and Another Thing: Illiquency*, THE CONGLOMERATE (Oct. 14, 2008), <http://www.theconglomerate.org/2008/10/anna-gelpern-an.html>.

in bankruptcy parlance), meaning that there will not be repeat bankruptcy filings.<sup>133</sup> Second, the restructuring has to give creditors at least as much as in a liquidation (“best interests” in bankruptcy parlance).<sup>134</sup> Third, the restructuring must be done in good faith (which includes observance of the absolute priority rule—meaning that senior claimants must be paid in full before there is any recovery for junior claimants—and includes the absence of unfair discrimination among similarly situated creditors).<sup>135</sup> These concepts have little applicability to state bankruptcy.

The feasibility of state bankruptcy plans depends on state political will as much as general economic factors. States pose a real danger of serial filing. It would be possible to restrict repeat filings by states, but it is unclear whether such a restriction would be credible in the face of a serious state budget crisis, and if it were, it would ultimately defeat the purpose of state bankruptcy. Indeed, even in the rarely used Chapter 9 municipal bankruptcy context, serial filing is a problem.<sup>136</sup>

Similarly, the best interests principle makes no sense for states. There is no “liquidation value” for a state and thus no going-concern value. How can one possibly value California? Finally, good faith is questionable given the motivation for state bankruptcy proposals, which are conceived as a method for enabling states to reject collective bargaining agreements and pension obligations (and more generally to weaken organized labor as a political force).<sup>137</sup> The definition of good faith is inherently problematic, but bankruptcy jurisprudence has tended to distinguish between actions undertaken offensively and those undertaken defensively, with the sword as bad faith and the shield as good faith.<sup>138</sup>

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<sup>133</sup> See 11 U.S.C. §§ 941, 1129(a)(11) (2006).

<sup>134</sup> See *id.* §§ 941, 1129(a)(7), 1173(a)(2), 1225(a)(4)–(5), 1325(a)(4)–(5).

<sup>135</sup> See *id.* §§ 941, 1129(a)(3), 1129(b)(2)(B), 1225(a)(3), 1325(a)(3).

<sup>136</sup> There have been 260 Chapter 9 filings between January 1980 and April 2012 according to PACER data. PACER, <https://pacer.login.uscourts.gov/cgi-bin/login.pl?appurl=https://pcl.uscourts.gov/search> (log in and select the “bankruptcy” tab, then select the chapter as “Chapter 9,” then hit “search”; this retrieves all PACER files for Chapter 9 cases). Forty-eight of the 260 are erroneous filings, such as Chapter 9 filings by individual debtors. Of the remaining 212 filings, forty-four were by municipalities or counties (as opposed to hospital or sanitary districts or other entities). Five of those forty-four were repeat filings. The serial filers are Pritchard, Alabama; the Village of Washington Park, Illinois; the City of Westminster, Texas; the City of Macks Creek, Missouri; and the Town of Moffet, Oklahoma. Another forty-four of the 212 were by various Nebraska sanitary districts. In other words, Nebraska sanitary districts have used Chapter 9 as extensively as cities and counties. Given the experience of Chapter 9, one might seriously question whether it should be repealed, rather than extended.

<sup>137</sup> See Gillette, *supra* note 18, at 1–2.

<sup>138</sup> See, e.g., *In re DBSD N. Am., Inc.*, 634 F.3d 79, 101–05 (2d Cir. 2011) (upholding designation of votes of claims purchased by a competitor for the purpose of forcing a strategic transaction rather than protecting its interests as a creditor); *In re Owens Corning*, 419 F.3d 195, 216 (3d Cir. 2005) (refusing to grant substantive consolidation when sought

#### 4. *Bankruptcy as Market Discipline Insurance*

The fresh-start–debt-overhang rationale understands bankruptcy as a type of social insurance for financial failure. While this view has been most prominent in discussions of consumer bankruptcy,<sup>139</sup> George Triantis redirected it as a justification for state bankruptcy because insurance “premia” provides a form of market discipline for the states.<sup>140</sup> Triantis has proposed permitting states to opt into a bankruptcy system for their prospective obligations,<sup>141</sup> meaning that if a state were unable to meet its obligations and fulfilled the requirements of the bankruptcy regime, those obligations would be discharged. The premia for this insurance would be found in the price of credit for the states.<sup>142</sup> Riskier states would have higher premia, and the market would function as a risk regulator.

There are several problems with an insurance view of state bankruptcy. First, it is unclear what bankruptcy would add in terms of market discipline that the municipal bond market (again, referring to the state bond market) does not already provide.

The mere risk of a state defaulting on its bonds affects states’ ability to go to the market for more capital.<sup>143</sup> Even without bankruptcy, riskier states pay higher risk premia.<sup>144</sup> Perhaps the existence of a

to be used as a sword and not a shield); *In re SGL Carbon Corp.*, 200 F.3d 154, 164–69 (3d Cir. 1999) (holding that it is bad faith to file for Chapter 11 for the purpose of avoiding paying a single creditor); *In re Gen. Growth Props.*, 409 B.R. 43, 66–67 (Bankr. S.D.N.Y. 2009) (holding that there is good faith to file for Chapter 11 when creditor could not negotiate).

<sup>139</sup> See, e.g., Jean Braucher, *Consumer Bankruptcy as Part of the Social Safety Net: Fresh Start or Treadmill?*, 44 SANTA CLARA L. REV. 1065, 1065–66 (2004); Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129, 129 (2005); Richard M. Hynes, *Non-Procrustean Bankruptcy*, 2004 U. ILL. L. REV. 301, 350–59 (explaining debt relief as a form of social insurance and comparing bankruptcy to other social insurance programs).

<sup>140</sup> George Triantis, *Bankruptcy for the States and by the States*, in WHEN STATES GO BROKE: ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS, *supra* note 8, at 237, 241.

<sup>141</sup> *Id.* at 242.

<sup>142</sup> *Id.* at 243.

<sup>143</sup> Other state creditors might not adjust as readily as bond creditors, but that has little to do with whether there is a bankruptcy option available. The problems of nonadjusting creditors and future claimants are particularly acute for states, which have a multitude of trade vendors, retirees, tax refund claimants, and tort creditors (present and future).

<sup>144</sup> See, e.g., Tamim Bayoumi et al., *Do Credit Markets Discipline Sovereign Borrowers? Evidence from U.S. States*, 27 J. MONEY, CREDIT & BANKING 1046, 1047 (1995) (finding that increases in relative state debt loads correspond with an increase in yields on state general obligation bonds); Morris Goldstein & Geoffrey Woglom, *Market-Based Fiscal Discipline in Monetary Unions: Evidence from the US Municipal Bond Market*, in ESTABLISHING A CENTRAL BANK: ISSUES IN EUROPE AND LESSONS FROM THE US, *supra* note 63, at 228, 253–54 (finding evidence of lower borrowing costs for states with more responsible fiscal policies); Poterba & Rueben, *supra* note 50, at 537 (finding correlation between unexpected state deficits and high bond yields).

formal bankruptcy regime would increase these premia by steepening the priority hierarchy, but a state default under the current regime would probably have much the same impact on bond values as would a state bankruptcy. States do not need formal bankruptcy regimes in order to impose costs on creditors, and so sophisticated creditors already adjust their risk premia. Therefore, even without bankruptcy, the market imposes considerable discipline upon the states.

Second, bankruptcy would only be effective at disciplining state budgets if the market were efficient. As noted above, bankruptcy would be unlikely to add much to the efficiency of municipal debt markets. The irony, however, is that these markets do not appear to be particularly efficient themselves, as discussed below, despite being the most robust and liquid market in state debt. Put differently, it is not apparent what in Triantis's proposal would result in a more efficient market discipline relative to what municipal bond rates already provide.

The municipal bond market has a much higher quotient of retail investors than other securities markets, in part because only individuals are able to benefit from the tax-advantaged treatment of some municipal bonds.<sup>145</sup> The presence of so many retail investors raises questions of market efficiency, as retail investors often lack the access to information and the analytical capacity of institutional investors.<sup>146</sup> Moreover, to the extent the market is betting that at least some states (e.g., California) are too big to fail, market discipline might be weak.

A glance at historical credit default swap (CDS) prices for municipal bonds raises serious questions about the market's efficiency.<sup>147</sup> The CDS market is linked with the debt markets themselves, as an investor wishing to go long on municipal debt could either sell CDS protection or buy the debt directly. The arbitrage between municipal bonds and CDS derivatives is distorted by the lack of tax advantages for the CDS market and by the more constrained pool of CDS investors given the absence of retail investors in CDS.<sup>148</sup> Nonetheless, arbi-

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<sup>145</sup> Compare Holders of U.S. Municipal Securities, SEC. INDUS. & FIN. MKTS. ASS'N, <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/Municipal-US-Municipal-Holders-SIFMA.xls> (last visited July 15, 2012), with Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1026 (2009).

<sup>146</sup> See Alicia Davis Evans, *A Requiem for the Retail Investor?*, 95 VA. L. REV. 1105, 1116–22 (2009) (arguing that retail investors may enhance market efficiency); cf. Brian D. Galle & Ethan Yale, *Can Discriminatory State Taxation of Municipal Bonds Be Justified?*, TAX NOTES, Oct. 8, 2007, at 153, 155 (arguing that there is no good justification for “a discriminatory tax exemption for municipal bonds”); Langevoort, *supra* note 145, at 1043–44 (questioning assumptions about retail investor behavior and sophistication).

<sup>147</sup> See *infra* Figure 5.

<sup>148</sup> See Mike Jakola, *Credit Default Swap Index Options: Evaluating the Viability of a New Product for the CBOE 15–16* (June 2, 2006) (unpublished manuscript), available at <http://www.kellogg.northwestern.edu/research/fimrc/papers/jakola.pdf>.

trage possibilities remain between selling CDS protection and investing directly, meaning that a rise in CDS prices—when investors demand a larger risk premium for going long on the state's debt—would translate into an increase in the yield that investors demand in the municipal bond market.

It is unclear how robust the municipal CDS market is, but CDS pricing seems to reflect significant pooling and herding behavior.<sup>149</sup> There is a high correlation in CDS pricing for most states. Table 1, below, shows correlations in CDS pricing over three years, from July 2008 to July 2011, among eight states selected based on the length of time that data exists on their municipal bond CDS: California, Illinois, Massachusetts, Michigan, Nevada, New Jersey, New York, and Texas. State municipal bond CDS data does not exist for all states, and for many it has existed for a substantially shorter period than the three-year window available for these eight states. This group of states includes some with recurrent fiscal crises and at least one (California) with a fundamentally broken fiscal constitution, as well as some states with relatively healthy budget processes (e.g., Massachusetts).

The correlations are presented in Table 1 as Pearson's  $r$ , the correlation variable expressing the linear dependence between two variables from +1 and -1. For municipal bond one-year CDS prices, the correlations for these states range from 54% (Illinois and Texas) to 98% (Nevada and New Jersey). Indeed, excluding Illinois and Texas, the correlations among the other six states are all over 90%, which indicates that investors are generally not responding to state-specific factors. Unfortunately, between July 2008 and July 2011, national factors were unusually powerful and may have disguised meaningful market responses to state-specific factors. Regardless, while CDS pricing for Michigan and Illinois in Figure 5 (the first and second major spikes, respectively) shows the existence of some state-specific pricing, it is not clear how Professor Triantis's proposal can work in a market with weak efficiency.

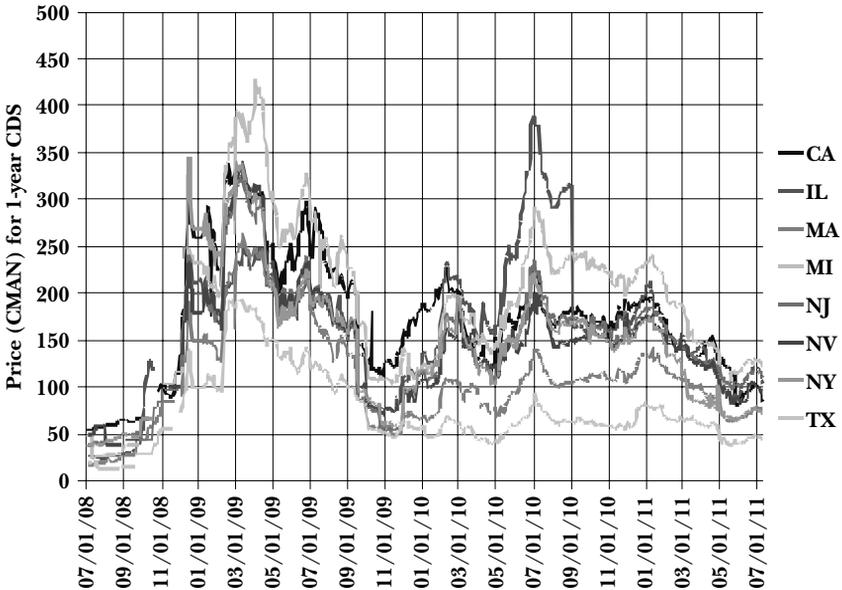
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<sup>149</sup> See David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 465 (1990) (describing herding behavior by reputationally concerned agents); see generally Michael Spence, *Job Market Signaling*, 87 Q.J. ECON. 355, 373–74 (1973) (discussing how the inability to distinguish between risks causes players to rely on market signaling that leads to pooling equilibria).

TABLE 1: STATE MUNICIPAL BOND CDS PRICING CORRELATION<sup>150</sup>

	CA	IL	MA	MI	NJ	NV	NY	TX
CA		67%	91%	90%	92%	92%	94%	91%
IL	67%		65%	77%	78%	69%	73%	54%
MA	91%	65%		95%	94%	97%	90%	96%
MI	90%	77%	95%		96%	96%	90%	89%
NJ	92%	78%	94%	96%		98%	94%	88%
NV	92%	69%	97%	96%	98%		94%	93%
NY	94%	73%	90%	90%	94%	94%		87%
TX	91%	54%	96%	89%	88%	93%	87%	

FIGURE 5: HISTORICAL STATE MUNICIPAL BOND CDS PRICES<sup>151</sup>



If bankruptcy qua insurance were effective at creating market discipline, it might lessen the political economy problems, including political moral hazard in state politics. Yet, because many of the political economy problems are due to self-interested actors only secondarily interested in the well-being of the state, the impact of market discipline might be limited.

Critically, however, market discipline via bankruptcy would not affect the underlying structural problem in state budgets. In addition,

<sup>150</sup> Author’s calculations using Bloomberg GCDS 1-year CDS data (CMAN).

<sup>151</sup> Bloomberg GCDS. Data is CMAN for 1-year CDS.

bankruptcy poses its own moral-hazard problems.<sup>152</sup> The traditional responses to moral hazard are copayments, deductibles, coverage limits, and exclusions that aim to impose some limited cost internalization on the insured. Bankruptcy's versions of these moral-hazard reducers are the best interests test, the nondischargeability of certain types of debt, the absolute priority rule, and good-faith filing and confirmation requirements. None of these solutions are meaningful, however, in the context of a state bankruptcy.

The best interests test lets creditors insist on receiving at least the liquidation value of the debtor. But for a state, this test is meaningless, as states cannot be liquidated. Nondischargeability functions as policy exclusion, but the wider the exclusion, the less effective the insurance coverage. Nondischargeability also functions as a type of hidden priority system. What, if any, obligations of a state would be nondischargeable is unclear, but this is the moral-hazard reducer that is the most adaptable to a state bankruptcy system.

The absolute priority rule, which insists on paying senior claimants in full before junior claimants receive any recovery, functions as a type of deductible—equity must pay out before creditors absorb losses.<sup>153</sup> But the absolute priority rule as applied to equity makes no sense for states, as there are no equity holders, only residents who

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<sup>152</sup> There may also be adverse selection and information problems. It is possible that states would opt into a bankruptcy system because they possess better information about their risks than their creditors, so the insurance is being inefficiently underpriced. Parties opt for insurance as a risk-management device. Third-party insurance (for that is what bankruptcy would be since the losses would be absorbed by creditors) only makes sense if it is cheaper than first-party insurance (losses absorbed by the states' citizens in the form of reduced services and higher taxes). Why would there be a pricing difference between first and third party insurance?

One possibility is that there is a difference in ability or willingness to bear risk. Third-party insurance makes sense when parties are faced with losses that they cannot easily absorb and which cannot be easily managed through more careful behavior. These factors are generally inapplicable for the states. They can typically manage the risk of insolvency through the budget process. One exception is the sudden catastrophe scenario (e.g., epic natural disaster or derivatives gamble like Orange County). See Leah Nathans Spiro & Nanette Byrnes, *Today, Orange County . . . The Muni Mess on Wall Street: How Bad?*, Bus. Wk., Dec. 19, 1994, at 28, 28–30. Another exception is where a state has so completely tied its hands politically on the budget process that it cannot correct course. See, e.g., Nanette Asimov, *Prop. 39 Passage a Blow to Prop. 13*, S.F. CHRON., Nov. 9, 2000, at A1 (describing a similar scenario in California caused by Proposition 13 in 1978, which was later amended by Proposition 39 in 2000). Perhaps a state's citizens are unusually loss averse, but if so, it also seems unlikely that they would want to pay the bankruptcy premium.

There may also be an information problem making bankruptcy insurance markets imperfect. The state debt market lacks many of the traditional controls over and information sources about state budgets that it has over private companies. State debt obligations do not include financial covenants and ratios and state budget reporting is not subject to the same legal requirements as private companies. These factors weaken market discipline and increase the likelihood of inefficiently priced insurance (i.e., too high or too low).

<sup>153</sup> See, e.g., *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 116–17 (1939) (applying the absolute priority rule).

cannot be stripped of their residency the way equity holders are stripped of their ownership of a firm.<sup>154</sup>

Conceivably, the absolute priority rule could be adapted to require a state's taxpayers to pay as much as they can, either by maximizing tax revenue or minimizing services up to the tipping point of the Laffer curve, before creditors absorb losses. But this modified rule would render bankruptcy worthless as an insurance regime. The whole point of such insurance is to *protect* the states' residents and shift losses from them to third-party creditors.

Good-faith filing and confirmation requirements play much the same function as absolute priority, even if they cast a broader net. But is it good faith for a state to impose costs on creditors when it has not first asked its citizens to make sacrifices via higher taxation and reduced services? If absolute priority and good-faith requirements are taken seriously, then state bankruptcy would provide insurance in the form of true loss shifting only in extremely limited scenarios where the federal union itself is likely to bailout states without a moral-hazard problem (e.g., for natural disasters).

Finally, even if bankruptcy can be justified as insurance for extreme, catastrophic risk, it still needs to be compared to the costs of regular catastrophic-risk insurance and against the high likelihood that the federal government would assist a state faced with a catastrophic budget crisis (for whatever cause). The federal union itself is an imperfect form of catastrophe insurance for states.

## B. What Bankruptcy Cannot Do: Cure Bad Business Models

If state fiscal problems are structural, albeit exacerbated by political agency problems, can bankruptcy help? The answer is no. Bankruptcy is a remarkably successful tool for dealing with collective action problems,<sup>155</sup> preserving going-concern value, ridding debt overhang,<sup>156</sup> and providing social insurance.<sup>157</sup> If a firm's problems are merely financial—that is, if the firm is overleveraged or illiquid but solvent—bankruptcy provides an excellent forum for reorganizing the

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<sup>154</sup> Absolute priority also conflicts with state constitutional priority schemes. *See, e.g.*, CAL. CONST. art. 16, § 8(a) (requiring state revenue to be used first to pay public school and public higher-education expenses). The status of these schemes in a federal bankruptcy proceeding would be uncertain. Arguably they should be honored like private contractual subordination agreements under 11 U.S.C. § 510(a) (2006).

<sup>155</sup> *See, e.g.*, JACKSON, *supra* note 21, at 10–19 (1986) (describing bankruptcy as a response to a common pool problem).

<sup>156</sup> *See, e.g.*, DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 40–50 (4th ed. 2006) (explaining the fresh-start rationale for individual debtors); JACKSON, *supra* note 124, at 1395–98 (1985); KRUGMAN, *supra* note 125, at 254–55 (1988) (describing debt-overhang problems in developing countries).

<sup>157</sup> *See, e.g.*, Braucher, *supra* note 139, at 1065–66 (discussing bankruptcy as social insurance); Feibelman, *supra* note 139, at 129–34 (same); Hynes, *supra* note 139 (same).

firm's capital structure to preserve going-concern value or, if there is none, to provide for an orderly liquidation. Moreover, bankruptcy provides a backdrop against which private orderings can occur, both when the initial decision to extend credit is made and when outstanding debt needs to be restructured.

But bankruptcy is not a panacea for all problems that enterprises face. Bankruptcy can cure financial problems, but not operational problems. Bankruptcy can extricate an enterprise from burdensome contracts<sup>158</sup> and slough off extra leverage, but bankruptcy cannot fix a bad business model.

If a firm's business is the sale of whale oil, corset stays, bustles, flash bulbs, slide rules, floppy disks, cassette tapes, 8-tracks, or books or CDs in a brick-and-mortar store, bankruptcy cannot help it beyond providing an orderly way to redeploy its assets and giving it a dignified funeral. At best, bankruptcy can buy an enterprise the financial breathing room to undertake an operational restructuring, but nothing in bankruptcy law—understood broadly, with a small “b” as any form of debt restructuring, not necessarily along the lines of the existing chapters of the U.S. Bankruptcy Code<sup>159</sup>—can fix a bad business model.

In Chapter 11, bankruptcy provides a forum for creditors to make a collective decision about the viability of a firm. If creditors do not think that a firm's business model will work even as restructured, they can try to block a reorganization plan and liquidate the firm.<sup>160</sup> The creditors' collective viability decision is only meaningful, however, because of the liquidation option, which gives them leverage to push for changes that they believe will enhance viability. Thus, while creditors cannot formally require price increases in a debtor firm's products in Chapter 11, they can functionally achieve this goal by refusing to vote for a plan that does not contemplate such a move, either explicitly or by providing for creditor control over new management—perhaps by transforming creditors into shareholders.<sup>161</sup> In a state bankruptcy, however, creditors would not have the leverage of refusing to vote for a plan and moving for liquidation if the state did not increase taxes.

For a state, as with a municipality, there is no liquidation option.<sup>162</sup> Therefore, even if the state's business model is fundamentally flawed—as it necessarily is given the problems with the current fiscal

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<sup>158</sup> See 11 U.S.C. § 365 (permitting rejection of unexpired leases and executory contracts).

<sup>159</sup> See Gelpert, *supra* note 11, at 893.

<sup>160</sup> 11 U.S.C. § 1126.

<sup>161</sup> *Id.* § 1129(a)(7).

<sup>162</sup> In theory a municipal corporation could be liquidated, but Chapter 9 does not contemplate such an action. See Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 465 (1993).

federalism arrangement—creditors would be stuck with a financially reorganized but nonviable entity.

Existing chapters of the U.S. Bankruptcy Code attempt to deal with this problem with a (vague) plan of feasibility requirements.<sup>163</sup> But none of the chapters contemplate the bankruptcy of an entity where there is an inherent risk of serial filing due to structural problems. Nothing prevents states from being serial bankruptcy filers in the same way that Argentina and Mexico have been serial defaulters and several municipalities have been serial Chapter 9 filers.<sup>164</sup>

Bankruptcy cannot fix the underlying cyclical structural problem in states' budgets stemming from the confluence of unfunded federal mandates and balanced budget requirements. At most, then, bankruptcy might be able to mitigate some of the political-agency problems that exacerbate state budget problems. As the following section argues, however, bankruptcy is a perilous tool to use to solve political problems.

### C. Bankruptcy as a Political Tool

The ill fit of traditional bankruptcy to the states suggests an additional rationale for bankruptcy: bankruptcy as a political tool. Bankruptcy could function as a political tool in several ways. It could serve as a political discipline mechanism, provide cover for politically unpopular decisions, serve as a convening mechanism to facilitate negotiations, and facilitate negotiations by setting baseline rules and alternatives.

Bankruptcy could serve as a political-discipline mechanism, in that a state's bankruptcy plan could impose discipline on the state's budget politics. State bankruptcy, then, could function as a form of "second-order rationality,"<sup>165</sup> as it gives state politicians the tools to tie their hands because they know they lack the political willpower otherwise. But any second-order rationality benefits might be short lasting, because courts have no ability to prevent states from going right back to their old habits once they are out of bankruptcy, or more precisely, these benefits do not fix the problem of the business cycle interacting with state balanced budget requirements, much less problems in state political economies.

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<sup>163</sup> See 11 U.S.C. §§ 943(b)(7), 1129(a)(11), 1225(a)(6), 1325(a)(6).

<sup>164</sup> See Carmen M. Reinhart et al., *Debt Intolerance*, 2003 BROOKINGS PAPERS ON ECON. ACTIVITY 1, 1, 6 (discussing countries that are in serial default). For serial Chapter 9 filings, see *supra* note 136.

<sup>165</sup> See Richard A. Epstein, *Second-Order Rationality*, in BEHAVIORAL PUBLIC FINANCE 355, 360–62 (Edward J. McCaffery & Joel Slemrod eds., 2006) (explaining that second-order rationality refers to a range of rational responses to cognitive biases).

Bankruptcy could also provide politicians with the cover to undertake deals that are opposed by their constituents. It is impossible to say, however, whether this feature enables politicians to look out for the commonwealth rather than be beholden to narrow rent-seeking interests, or whether it merely gives politicians the ability to reach deals of personal convenience without regard to their constituents' interests.

Bankruptcy also provides a convening and negotiating mechanism that can bind nonconsenting holdouts to a deal. Its usefulness, however, is limited in the case of the states. As a convening tool, bankruptcy brings all claimants together into a single proceeding and settles (nearly) all claims.

In Chapter 11, this works by bringing together creditors, employees, and equity holders. But for states, a major stakeholder is absent—voters. Court-mandated austerity measures (or tax increases) require the acquiescence of voters because the politicians involved in reaching deals on austerity measures are responsive to voters. The exclusion of other stakeholders may make creditors in turn reluctant to cut deals because of a concern as to whether the deals will stick without the assent of the absent stakeholders. Thus, bankruptcy's convening power is limited for states.

Bankruptcy can facilitate negotiations by presenting an unattractive alternative to a negotiated solution, a type of "penalty default" rule.<sup>166</sup> Contract theory has long debated the use and usefulness of penalty default rules—the judicial imposition of contract gap fillers that contracting parties do not like in order to incentivize more complete contracting<sup>167</sup>—and while the penalty default rule concept has been expanded beyond contract law,<sup>168</sup> it has extended only passingly

<sup>166</sup> RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 114 (3d ed. 1986) (discussing penalty defaults); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 91 (1989) (coining the term "penalty default rule").

<sup>167</sup> See generally Ian Ayres, *Ya-Huh: There Are and Should Be Penalty Defaults*, 33 *FLA. ST. U. L. REV.* 589 (2006) (arguing in favor of penalty default rules); Omri Ben-Shahar & John A.E. Pottow, *On The Stickiness of Default Rules*, 33 *FLA. ST. U. L. REV.* 651 (2006) (discussing the "sticky" nature of penalty default rules, even when they seem inefficient); Curtis Bridgeman, *Default Rules, Penalty Default Rules, and New Formalism*, 33 *FLA. ST. U. L. REV.* 683 (2006) (discussing the applicability of penalty default rules in the new formalist view of contract law); Daniel A. Farber, *Another View of the Quagmire: Unconstitutional Conditions and Contract Theory*, 33 *FLA. ST. U. L. REV.* 913 (2006) (applying thought about constitutional rights to penalty default rules); Eric Maskin, *On the Rationale for Penalty Default Rules*, 33 *FLA. ST. U. L. REV.* 557 (2006) (criticizing popular support for penalty default rules); Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 *FLA. ST. U. L. REV.* 563 (2006) (arguing against penalty default rules).

<sup>168</sup> See generally Scott Baker & Kimberly D. Krawiec, *Incomplete Contracts in a Complete Contract World*, 33 *FLA. ST. U. L. REV.* 725 (2006) (proposing a relationship-specific investment default to help fill incomplete contracts); Margaret F. Brinig, *Penalty Defaults in Family Law: The Case of Child Custody*, 33 *FLA. ST. U. L. REV.* 779 (2006) (extending the idea of a default rule to child custody arrangements); John Ferejohn & Barry Friedman, *Toward a*

to bankruptcy.<sup>169</sup> Bankruptcy can be understood as serving a similar function, not in creating complete contracting incentives, but in creating negotiation incentives. If the parties find the outcome of a bankruptcy (including the costs of the bankruptcy) less attractive than those in a deal outside of bankruptcy, it encourages them to reach a deal outside of bankruptcy. It is unclear, however, whether a state bankruptcy system would in fact facilitate negotiations outside of bankruptcy, as bankruptcy could be a more attractive outcome to some parties.

Bankruptcy's operation as a penalty default rule works differently in the context of state or municipal bankruptcy than in business or consumer bankruptcy, because when states attempt to close budget gaps, the negotiating parties are not the creditors negotiating with each other and the debtor as they are in a business or consumer bankruptcy. Instead, the negotiations are between political parties, and the parties' motivations are different from those of creditors or debtors. Instead of financial interests at stake, each political party has particular constituencies of creditors or state service beneficiaries that it wishes to protect, as well as a political agenda it wishes to advance. Unless the bankruptcy "penalty" is a political penalty, bankruptcy might be seen by a political party as more attractive than a negotiated resolution of the budget gap outside of bankruptcy.

Consider, for example, a state bankruptcy regime in which collective bargaining agreements could be rejected. Such a regime might encourage public employee unions and their Democratic allies to compromise outside of bankruptcy, but it would make Republican governors and legislators less likely to do so, particularly if bankruptcy offered a broader way to cut spending and avoid revenue increases. Similarly, consider a state bankruptcy regime that protected collective bargaining agreements but mandated that budget gaps be closed through progressive income-tax increases. Such a regime would encourage Republicans to compromise outside of bankruptcy, but might make Democrats less likely to do so. A bankruptcy regime that is too favorable to any partisan agenda could increase gridlock and reduce democracy, rather than encourage political compromise. From a decision-theory standpoint, the value of a bankruptcy backdrop for producing more efficient, negotiated solutions is highly dependent upon the terms of the bankruptcy system and whether the bankruptcy penalty is appropriately calibrated to the negotiating parties.

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*Political Theory of Constitutional Default Rules*, 33 FLA. ST. U. L. REV. 825 (2006) (discussing the possibility of default rules in constitutional law); Bradley C. Karkkainen, *Information-Forcing Environmental Regulation*, 33 FLA. ST. U. L. REV. 861 (2006) (examining default rules used for environmental regulation).

<sup>169</sup> Robert R. Niccolini, Note, *The Voidability of Actions Taken in Violation of the Automatic Stay: Application of the Information-Forcing Paradigm*, 45 VAND. L. REV. 1663, 1680–84 (1992).

Bankruptcy's power as a negotiating mechanism for resolving disputes among creditors is further diminished because of the lack of a viable liquidation threat and absolute priority distribution baseline. For firms and individual debtors, bankruptcy forces claimants to come to the negotiating table, lest they be locked out of a legally binding deal. The convening power's real value is that it is coupled with a negotiating mechanism that relies on two implicit threats that facilitate voluntary deal making outside of bankruptcy:

1. You'd better reach a deal or else you'll just get liquidation value.
2. If everyone else reaches a deal, you'll be forced to go along.

These threats vanish in the case of states because there is no liquidation option (with absolute priority applied) and thus no best interests test baseline to protect nonconsenting creditors. Bankruptcy is only able to bind nonconsenting creditors by giving them at least liquidation value and making the deal in their best interests.<sup>170</sup>

Bankruptcy can bring states' creditors together, but if Chapter 9 is the model, then it lacks the leverage to encourage deals in most cases. The alternative facing a creditor in a state bankruptcy would not be liquidation, but instead whatever the creditor would get outside bankruptcy. Thus, creditors that think they will fare better in the normal course of state politics will be reluctant to deal in bankruptcy. Their own liquidity concerns may encourage deal making in order to get paid,<sup>171</sup> but this threat is much weaker than liquidation value.

The only area in which a Chapter 9-based state bankruptcy regime would enhance deal-making leverage might be when the debtor is dealing with creditors with executory contracts—contracts in which both the creditor and the debtor still have material obligations.<sup>172</sup> Under current bankruptcy law, including Chapter 9, the debtor may assume or reject these contracts at its sole discretion.<sup>173</sup> An assumed executory contract is treated as an administrative expense of the bankruptcy estate and receives priority treatment,<sup>174</sup> while a rejected exec-

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<sup>170</sup> 11 U.S.C. §§ 1129(a)(7), 1225(a)(4)–(5), 1325(a)(4)–(5) (2006).

<sup>171</sup> Cf. Sarah Pei Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615, 1617–18 (2012) (observing that liquidity concerns can encourage creditors to seek liquidation, rather than seeking maximizing returns).

<sup>172</sup> Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973) (defining an “executory contract” as “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other”).

<sup>173</sup> 11 U.S.C. § 365(a).

<sup>174</sup> *Id.* § 503(b) (allowing administrative expenses); *id.* § 507(a)(2) (establishing priority for administrative expenses); *id.* § 1129(a)(9) (requiring allowed administrative ex-

utory contract is treated as a general unsecured claim.<sup>175</sup> Collective bargaining agreements and retiree benefits are exempted from this treatment for Chapter 11,<sup>176</sup> but not for Chapter 9,<sup>177</sup> so a wholesale application of Chapter 9 to states would in fact give states considerable leverage vis-à-vis public employee unions—precisely the target of proponents of state bankruptcy. Yet it is far from certain that rejecting collective bargaining agreements with public employees would fix states' budgets; if recent experience is any guide, states might well face serious labor unrest as a consequence, possibly crippling state government.<sup>178</sup>

The inherent benefits of bankruptcy as a political tool are uncertain. Unfortunately, bankruptcy could also serve as a mechanism for carrying out partisan agendas under the cover of judicial robes. As discussed above, bankruptcy courts have not traditionally had the power to order tax increases. Instead, they simply supervise spending cuts. This imbalance in the powers of bankruptcy courts raises serious concerns that a state bankruptcy regime would be used as a partisan political device to balance state budgets through cuts to employees' compensation, services, and benefits, and through service cuts, but not through tax increases.<sup>179</sup> Indeed, it is notable that only Republican politicians have endorsed the state bankruptcy idea thus far.<sup>180</sup> Bankruptcy, then, would be an end run around democratic checks and balances on distributional decisions, rather than a way of enabling tough political decisions.

As a political tool, bankruptcy could thus be either a means of forcing states to make unpleasant choices, or it could provide cover for politicians to make those choices, which may be a good or bad thing. Bankruptcy can enable good deals or force bad deals. The virtues of bankruptcy as a political tool are hardly certain; it carries with it the possibility of being abused to carrying out partisan agendas. Thus, what one makes of bankruptcy as a political tool likely depends on what outcomes one envisions it producing, and for many that means considering it as a tool to deal with the political fights of today, rather than as a long-lasting system.

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penses to be paid in cash on the effective date of a Chapter 11 plan as a requirement of plan confirmation).

<sup>175</sup> *Id.* § 365(g) (addressing the treatment of rejected executory contracts).

<sup>176</sup> *Id.* §§ 1113–1114.

<sup>177</sup> *Id.* § 901(a).

<sup>178</sup> *See Davey, supra* note 3 (describing the shutdown of the Minnesota government).

<sup>179</sup> *See supra* note 9 and accompanying text.

<sup>180</sup> *See supra* note 9. Ironically, sovereign bankruptcy in the international context is a cause associated with the left rather than the right.

## IV

## THE POLITICS OF BANKRUPTCY

It is possible to envision, however, a state bankruptcy system in which the court would have the power to direct tax increases or, at the very least, deny relief absent tax increases.<sup>181</sup> Leaving aside questions of constitutionality, such an arrangement would mitigate the danger of the use of bankruptcy as a factional device. If we were to fantasize about such a system, would it be a good one? Put differently, are courts the proper body for making decisions about tax increases and spending cuts?

Professors Robert Amdursky and Clayton Gillette have noted that it is unclear whether courts have any institutional advantage over other bodies, like legislatures, in balancing the conflicting interests of governments' debtor constituents.<sup>182</sup> Amdursky and Gillette also observe some reasons to prefer judicial second-guessing, such as the concern that legislatures will cater to the interests of voters over debt holders.<sup>183</sup>

Amdursky and Gillette's concern is well-taken, but it has broader application than they could have recognized when they wrote it. Different fora are more or less favorable to different interest groups. Bankruptcy courts, for example, are a forum that is more favorable to secured creditors and less favorable to creditors with ongoing contracts, such as vendors and labor, because of the courts' ability to reject executory contracts. In particular, in Chapter 9 bankruptcy, which proponents cast as the model for a state bankruptcy regime,

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<sup>181</sup> Already, some courts will not confirm Chapter 13 plans unless they include a minimum dividend paid to unsecured creditors. *See, e.g., In re Francis*, 273 B.R. 87, 90 (B.A.P. 6th Cir. 2002). If such a minimum dividend is higher than the debtor can pay based on current earnings, the court is effectively requiring either asset sales or more work effort. This is analogous to requiring the people of a state to contribute more toward meeting the state's obligations via higher taxes. While the court is not actually ordering the tax increase, the denial of relief would have such an effect. Moreover, a court could conceivably prohibit payments on other particular favored expenses unless a revenue target is hit. All of this is to say that a court might be able to coerce a tax increase without actually ordering one.

A possible way to integrate tax increases into bankruptcy is through a type of insolvency test. Chapter 9 currently requires insolvency, by which it means a "balance sheet" insolvency test, as opposed to an "equity" insolvency test—whether the debtor is paying its obligations as they come due. *See In re Marshall*, 300 B.R. 507, 511 (Bankr. C.D. Cal. 2003). One can imagine a third type of insolvency test for states—a "Laffer insolvency" test—which looks at whether the state can increase tax rates without loss of tax revenue or cut services without a population flight that would offset the savings with diminished tax revenue. This is a very high threshold. It would, in effect, force the costs of state profligacy onto the body politic as a whole and make citizens internalize the costs of fiscal irresponsibility. The feasibility of such a Laffer insolvency analysis is, of course, another matter.

<sup>182</sup> AMDURSKY & GILLETTE, *supra* note 52, § 1.3.1.

<sup>183</sup> *Id.*

collective bargaining agreements and retiree benefits are not subject to the extra protections that exist in Chapter 11.<sup>184</sup>

Courts' qualities as decision-making bodies cannot be divorced from the legal framework in which they operate; courts' discretion is circumscribed by legislatures, just as legislatures' discretion is circumscribed by constitutions. Thus, the relative appeal of courts making distributional decisions depends heavily on the distributional rules that courts must follow. If bankruptcy courts could raise taxes but not cut services, their appeal as a forum would be different than if they could only cut services but not raise taxes or if they could both cut services and raise taxes. Accordingly, the same factors that should concern us about legislative outcomes should also concern us about judicial outcomes.

Whether one prefers legislatures or courts making budget-balancing decisions is, of course, a normative matter. But the long-standing normative choice embodied in the structure of American government is that distributional decisions beyond a constitutionally mandated baseline—the ultimate political choice—should be made by electorally responsive bodies.<sup>185</sup> This area is where state sovereignty

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<sup>184</sup> 11 U.S.C. §§ 1113–1114 (2006); *cf.* *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 516 (1984) (permitting, before the enactment of §§ 1113–1114, a collective bargaining agreement to be rejected under § 365).

<sup>185</sup> *See, e.g., Schweiker v. Wilson*, 450 U.S. 221, 230 (1981) (“The equal protection obligation imposed by the Due Process Clause of the Fifth Amendment is not an obligation to provide the best governance possible. This is a necessary result of different institutional competences, and its reasons are obvious. Unless a statute employs a classification that is inherently invidious or that impinges on fundamental rights, areas in which the judiciary then has a duty to intervene in the democratic process, this Court properly exercises only a limited review power over Congress, the appropriate representative body through which the public makes democratic choices among alternative solutions to social and economic problems.”); *Weinberger v. Salfi*, 422 U.S. 749, 769–70 (1975) (applying the standard of *Dandridge v. Williams*, 397 U.S. 471 (1970), to uphold an exclusion from Social Security benefits); *San Antonio Indep. Sch. Dist. v. Rodriguez*, 411 U.S. 1, 54, 58 (1973) (upholding the constitutionality of Texas public school financing, which assures a “basic education for every child in the State” as “[i]t has simply never been within the constitutional prerogative of this Court to nullify statewide measures for financing public services merely because the burdens or benefits thereof fall unevenly depending upon the relative wealth of the political subdivisions in which citizens live” and because “[t]he consideration and initiation of fundamental reforms with respect to state taxation and education are matters reserved for the legislative processes of the various States”); *Dandridge*, 397 U.S. at 485–86 (“In the area of economics and social welfare, a State does not violate the Equal Protection Clause merely because the classifications made by its laws are imperfect. If the classification has some ‘reasonable basis,’ it does not offend the Constitution simply because the classification ‘is not made with mathematical nicety or because in practice it results in some inequality.’ . . . To be sure, the cases cited, and many others enunciating this fundamental standard under the Equal Protection Clause, have in the main involved state regulation of business or industry. The administration of public welfare assistance, by contrast, involves the most basic economic needs of impoverished human beings. . . . And it is a standard that is true to the principle that the Fourteenth Amendment gives the federal courts no power to impose upon the States their views of what constitutes wise economic or social policy.” (quoting *Lindsley v. Natural Carbonic Gas Co.*, 220 U.S. 61, 78 (1911))).

fundamentally collides with bankruptcy law. There is a fundamental difference between transferring governance rights to creditors from shareholders and transferring them to creditors from voters. The individual shareholder has opted into a financial relationship that is subject to this transfer of governance rights; the individual voter has not.<sup>186</sup> The former is part of the change of control that can occur during a business bankruptcy, while the latter is an abandonment not just of sovereignty, but also of democracy.<sup>187</sup>

Distributional decisions are political decisions. There are choices involved in determining whose ox will wax fat and whose will be gored. Oxen often grow fat at someone's expense or are gored to someone's benefit. The choice over whether to raise taxes or cut spending—put more starkly, whether we should cut music and art classes from school or raise marginal tax rates—is the quintessential political question about what sort of society to we want to live in. This is exactly the kind of question that should go before voters rather than creditors.<sup>188</sup>

We cannot escape the reality that bankruptcy is itself fundamentally a political exercise because of its distributional nature. Bank-

<sup>186</sup> The Tieboutian choice model would indicate consent by the voter based on the voter choosing to remain in the dysfunctional state. See *Shapiro v. Thompson*, 394 U.S. 618, 648 (1969) (securing the right of interstate travel). Yet the state's fiscal management is only one of numerous factors in a voter's locational decision—employment, family, state identity and allegiances, climate, and other factors might weigh in the voter's decision of where to locate herself and might offset the voter's feelings on the state's fiscal management. See *id.* at 632 (“[W]e do not perceive why a mother who is seeking to make a new life for herself and her children should be regarded as less deserving because she considers, among others factors, the level of a State's public assistance.”). Also, to be sure, the individual voter has elected the officials whose management of the state has led to the current fiscal problems and the inability to resolve them, and the voter has also elected whatever Congress and President enacted the changes to federal bankruptcy law that would enable state debt restructuring.

<sup>187</sup> Democracy is the constitutive characteristic of the states. U.S. CONST. art. IV, § 4 (“The United States shall guarantee to every State in this Union a Republican Form of Government . . .”). While the Supreme Court has long declined to address what the Guaranty Clause means as being a political question, this in no way takes away from the democratically constitutive nature of the states. See *Luther v. Borden*, 48 U.S. 1 (1849); *Pac. States Tel. & Tel. Co. v. Oregon*, 223 U.S. 118 (1912). John Hart Ely famously argued that judicial encroachments on democracy are justified only to protect permanent minorities or to prevent the incumbent majority from obstructing channels of democratic discourse. JOHN HART ELY, *DEMOCRACY AND DISTRUST: A THEORY OF JUDICIAL REVIEW* *passim* (1980). Neither justification would urge judicial resolution of state budgets; instead, it shows that state budget problems are ordinary political problems, not transcendent ones that justify abrogating democracy.

<sup>188</sup> See *Kramer v. Union Sch. Dist.*, 395 U.S. 621, 626–27, 627 n.7, 630 (1969) (applying the one-person, one-vote rule to school board elections in the case of a childless renter and noting that “[s]tatutes granting the franchise to residents on a selective basis always pose the danger of denying some citizens any effective voice in the governmental affairs which substantially affect their lives,” and “[t]his is precisely the situation with regard to the size of the school budget in districts where [a statute limiting the right to vote for school boards with taxing authority] applies”).

ruptcy is unavoidably distributional—who will bear losses and who will not? It is a system of picking winners and losers; bankruptcy law implements distributional norms. The distributional nature of bankruptcy makes it an inherently political exercise.

As a result, attempts to explain bankruptcy solely from a contractarian perspective, be it the dominant “creditor’s bargain” theory,<sup>189</sup> bankruptcy qua procedure,<sup>190</sup> or bankruptcy as team production<sup>191</sup> are necessarily incomplete because they do not account for the politics of and in bankruptcy.<sup>192</sup> While bankruptcy can be a response to procedural issues like collective action problems, it is a response built around a distributional norm, namely that “equity is equality,” meaning similar creditors should have similar recoveries.<sup>193</sup>

In the same vein, the major critique of contractarian approaches to bankruptcy—Professor Elizabeth Warren’s argument that it fails to address noncontractual interests—is also incomplete because, while broadening the inquiry, it does not address the larger political economics of loss allocation in society that determine when and how bankruptcy law is used.<sup>194</sup> Bankruptcy cannot be understood as a pos-

<sup>189</sup> See, e.g., JACKSON, *supra* note 21; Baird, *supra* note 21; Jackson, *supra* note 21, at 895 n.17; Jackson & Scott, *supra* note 21, at 164; Robert E. Scott, *Through Bankruptcy with the Creditors’ Bargain Heuristic*, 53 U. CHI. L. REV. 690, 692–94 (1986) (discussing the benefits and limitations of the creditors’ bargain).

<sup>190</sup> Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 951 (2004).

<sup>191</sup> Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741, 754–64 (2004).

<sup>192</sup> Curiously, the importance of political economy considerations has been recognized in scholarship on Article 9 of the Uniform Commercial Code, where public-choice theory has been explored alongside contractarian efficiency theories. See, e.g., Barry E. Adler, Commentary, *Limits on Politics in Competitive Credit Markets*, 80 VA. L. REV. 1879 *passim* (1994); Clayton P. Gillette, Commentary, *Politics and Revision: A Comment on Scott*, 80 VA. L. REV. 1853 *passim* (1994); Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 638–42 (1995); Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1803 (1994).

<sup>193</sup> See 11 U.S.C. § 726(b) (2006) (requiring pro rata distribution among similar creditors in a Chapter 7 liquidation); *id.* § 1129(a)(7) (requiring impaired, nonaccepting creditors to receive at least as much in a Chapter 11 plan as under a Chapter 7 liquidation); *id.* § 1129(b)(1) (prohibiting “unfair discrimination” among impaired, nonaccepting classes in a plan of reorganization confirmed under section 1129(b)). The phrase “equity is equality” is an equity maxim about the treatment of similar parties. It should not be interpreted to mean that equity holders will fare well in bankruptcy. See also Scott, *supra* note 189, at 700–07 (discussing a risk-sharing function of bankruptcy by analogy to the “general average” principle in admiralty law, which requires pro rata sharing of expenses necessary to save a ship at sea, such as jettisoning of cargo or cutting off a mast).

<sup>194</sup> Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 779–80 (1987); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 366–67 (1993). For other critiques of the contractarian perspective on bankruptcy, see ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 24 (2d ed. 1997); KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM 12–14 (1997); David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1355 (1987); Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031, 1043–45

itive matter without accounting for politics, and normative views of bankruptcy—even those that claim to be apolitical—are necessarily political statements.

Notably, the creditors' bargain has been developed by scholars whose primary focus is business bankruptcy, whereas the theory's critics have tended to focus on consumer bankruptcy, where social policy issues are more pronounced.<sup>195</sup> Business bankruptcy can often operate in a closed universe of consensual, contractual creditors. Accordingly, contractarian approaches to bankruptcy inherently focus on the firm and its restructuring on a microeconomic level rather than on bankruptcy as a piece in a larger macroeconomic system.

Business bankruptcy, however, is but one type of insolvency regime. Individual bankruptcy, bank, and insurance-company insolvency, and sovereign and subsovereign state bankruptcy all immediately implicate issues that go well beyond individual firms' contractual organization to the political question of loss distribution in society. Not surprisingly, the scholarship in these subfields of insolvency law is highly engaged with the politics of insolvency.

Politics is hardly missing from business bankruptcy. The Bankruptcy Code is replete with explicit special-interest provisions relating to business bankruptcy (e.g., the treatment of certain financial contracts,<sup>196</sup> shopping center leases,<sup>197</sup> airplane leases,<sup>198</sup> utilities,<sup>199</sup> collective bargaining agreements,<sup>200</sup> as well as numerous implicit special-interest provisions), but these provisions have been largely ignored by the creditors' bargain literature.

The consumer bankruptcy literature has, in contrast, had quite a bit to say about the politics of the Code, particularly after the controversial Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.<sup>201</sup> Yet, the consumer bankruptcy literature has never addressed the politics of bankruptcy in an integrated way. Instead, it has tagged individual provisions as abhorrent special-interest deviations, rather

(1994); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 767, 774 (1991).

<sup>195</sup> See Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 576–80 (1998).

<sup>196</sup> §§ 362(b)(6), (b)(7), (b)(17), (b)(27), 546(e)–(g), 548(d)(2), 555–556, 559–562.

<sup>197</sup> *Id.* § 365(b)(3).

<sup>198</sup> *Id.* § 1110.

<sup>199</sup> *Id.* § 366.

<sup>200</sup> *Id.* §§ 1113–1114.

<sup>201</sup> Pub. L. No. 109-8, 119 Stat. 23; see, e.g., Adam J. Levitin, *Resolving the Foreclosure Crisis: Modification of Mortgages in Bankruptcy*, 2009 WIS. L. REV. 565, 600; Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 376–79; Michael Simkovic, *Effect of BAPCPA on Credit Card Industry Profits and Prices*, 83 AM. BANKR. L.J. 1, 2–4 (2009); Elizabeth Warren, *The Phantom \$400*, 13 J. BANKR. L. & PRAC. 77, 77 (2004).

than consistent with bankruptcy law's nature as a set of political bargains and compromises—a messy, fuzzy, and sometimes shifting armistice line between competing interest groups.<sup>202</sup>

Indeed, the bankruptcy literature largely ignores the reality that bankruptcy is part of a larger economic system<sup>203</sup> and functions as such only because the messy political armistice line prevents either creditor or debtor interests from dominating. As discussed above, parties negotiate in the shadow of bankruptcy, which operates as a fuzzy penalty default rule because of the degree of uncertainty about bankruptcy outcomes.<sup>204</sup> Thus, a bankruptcy system cannot be too favorable to any party or else it will not function well as a penalty default rule that encourages parties to negotiate on their own. A system that is too favorable to any party relative to a negotiated outcome will not incentivize that party to negotiate.<sup>205</sup>

From the perspective of the larger economic system, then, bankruptcy works best as a penalty default rule if it is sufficiently unattractive to everyone relative to a negotiated solution. Optimally, no one should be happy with where the bankruptcy armistice line is, but even if that is the case, sometimes negotiations fail because of coordination problems, holdouts, interests in seeing a bankruptcy filing, or lack of time. Bankruptcy cannot be a suicide pact. While mutually assured destruction would encourage negotiations, the bankruptcy system has to be able to redeploy assets, including human capital, and distribute losses effectively when negotiations fail. Thus, bankruptcy should not be the creditors' bargain but rather their "unbargain"—the deal that they would not want, or more precisely, a deal that is second best to a negotiated deal.

The creditors' bargain hypothesizes the bargain creditors would strike if they could. But the bargain that creditors would strike very much depends on particular circumstances, such as creditors' own liquidity.<sup>206</sup> The idea of a generic, hypothetical bargain is too vague to provide a meaningful policy guide. When bankruptcy acts as an effec-

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<sup>202</sup> Indeed, just as ignoring the politics of bankruptcy is a political position, so too is the empirical turn in consumer bankruptcy scholarship itself part of the political fight, because the response to the political bargain is to demonstrate empirically how lousy it is for one or both sides.

<sup>203</sup> But see Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 COLUM. BUS. L. REV. 83, 89, 92, 148 (discussing the market in bankruptcy claims as "the residual capital market" and noting the upstream effects of bankruptcy law).

<sup>204</sup> See *supra* text accompanying notes 166–69.

<sup>205</sup> Because bankruptcy involves multilateral negotiations, but filing is primarily at the debtor's option, a system that is too disfavorable to debtors will cease to function as a penalty default rule for creditors because it will not be invoked. The possibility of involuntary bankruptcy alleviates this problem in theory, but only to the degree that involuntary bankruptcy is a feasible mechanism for creditors.

<sup>206</sup> See Woo, *supra* note 171.

tive penalty default rule, it forces the creditors' actual bargain. To get to the real bargain, bankruptcy must be a less desirable, or at least less certain, outcome than what creditors would negotiate. By being a messy, fuzzy, politically negotiated armistice line, bankruptcy law produces something close to that result.

The bankruptcy history literature necessarily engages with the political debates over bankruptcy,<sup>207</sup> but this literature has never taken the next step of turning a description of political debates and interest group contests into a theory of bankruptcy law. Likewise, the small literature specifically on the politics of bankruptcy reform,<sup>208</sup> by its very nature of focusing on reform efforts, overlooks that reform and status quo positions are both expressions of competing interest groups.

The fundamental problem in bankruptcy is how to divide a pool of assets that is insufficient to satisfy all claimants. The decision of who will be paid first, who second, and who last—which could mean not getting paid at all—are inherently political decisions. While reorganization bankruptcy aims to increase the pool of assets so as to pay off more claimants, it imposes an additional risk—that the reorganization will actually destroy value—so the distributional scheme remains equally important. All of bankruptcy law is distributional and caters to particular interests. Indeed, the very existence of bankruptcy law as a procedural mechanism is itself such a distributional choice. The only question is the transparency of the choice when it is made.

The normal legislative process, while itself obviously a political exercise, tempers bankruptcy's political character because the distributional priorities of bankruptcy law are shaped in generic terms, be-

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<sup>207</sup> See, e.g., EDWARD J. BALLEISEN, *NAVIGATING FAILURE: BANKRUPTCY AND COMMERCIAL SOCIETY IN ANTEBELLUM AMERICA* 103–04, 119–24 (2001); BRUCE H. MANN, *REPUBLIC OF DEBTORS: BANKRUPTCY IN THE AGE OF AMERICAN INDEPENDENCE* 168–69 (2002); DAVID A. SKEEL, JR., *DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* 23–24, 43–44, 247 n.13 (2001); CHARLES WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* 12–49 (1935); David A. Skeel, Jr., *Bankruptcy Lawyers and the Shape of American Bankruptcy Law*, 67 *FORDHAM L. REV.* 497, 499–507 (1998); David A. Skeel, Jr., *The Genius of the 1898 Bankruptcy Act*, 15 *BANKR. DEV. J.* 321, 323–28 (1999); John Fabian Witt, *Narrating Bankruptcy/Narrating Risk*, 98 *NW. U. L. REV.* 303, 305 (2003) (book review).

<sup>208</sup> See generally Jeb Barnes, *Bankrupt Bargain? Bankruptcy Reform and the Politics of Adversarial Legalism*, 13 *J.L. & POL.* 893 (1997) (discussing the politics of legal reform in the context of bankruptcy law); Susan Block-Lieb, *The Politics of Privatizing Business Bankruptcy Law*, 74 *AM. BANKR. L.J.* 77 (2000) (examining the political arguments over whether private contracts or mandatory legislation should guide firms in bankruptcy); Mark Bradshaw, Note, *The Role of Politics and Economics in Early American Bankruptcy Law*, 18 *WHITTIER L. REV.* 739 (1997) (analyzing how politics shaped early bankruptcy law); Stephen Nunez & Howard Rosenthal, *Bankruptcy "Reform" in Congress: Creditors, Committees, Ideology, and Floor Voting in the Legislative Process*, 20 *J.L. ECON. & ORG.* 527 (2004) (examining legislative voting on bankruptcy bills); Elizabeth Warren, *The Changing Politics of American Bankruptcy Reform*, 37 *OSGOODE HALL L.J.* 189 (1999) (discussing the shift of political influence over bankruptcy law); sources cited *supra* note 201 (analyzing the politics of the Bankruptcy Code).

hind a Rawlsian veil,<sup>209</sup> due to the fact that legislators cannot be sure of the identity of the parties in future cases. Sometimes financial institutions, for example, will be first-lien-secured creditors. Sometimes they will hold junior liens. Sometimes they will be unsecured creditors. While it might be possible to surmise that most of the time a particular party will be a first-lien-secured creditor, there is no certainty that it will always be. For example, a creditor cannot tell *ex ante* whether the Bankruptcy Code's provision permitting the avoidance of preferential payments (voidable preferences) made on the eve of bankruptcy<sup>210</sup> will be used against it or will increase its recovery as a creditor. Although the Bankruptcy Code is replete with special-interest provisions,<sup>211</sup> the generic terms of the Code are one of bankruptcy law's great virtues and are critical to establishing its legitimacy as a distributional regime.

With state bankruptcy proposals, however, the Rawlsian veil of legislation becomes embarrassingly threadbare. There is no doubt whose ox is to be gored by state bankruptcy: it is that of organized labor. Public employees' unions, not municipal bondholders or taxpayers, are the clear target of state bankruptcy.<sup>212</sup> State bankruptcy proposals make no pretense of even being a means of mitigating the procyclical fiscal problems facing states.<sup>213</sup>

Rather than fixing state political dysfunction, state bankruptcy proposals are likely to result in the use of bankruptcy to carry out a partisan vendetta behind the cover of judicial robes. Such maneuverings only increase state political dysfunction and denude bankruptcy law of its legitimacy.

#### CONCLUSION

State bankruptcy proposals offer a financial-restructuring solution to a political problem, yet the limits of such an approach are patent. At best, bankruptcy could potentially facilitate political deal making and reduce the inefficiencies of state politics, but it is equally possible that bankruptcy will be used to further a partisan agenda in state budget-balancing debates. In neither scenario, however, does bankruptcy as a solution even start to touch on the underlying structural problem of state budgets: the interaction of fiscal federalism with

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<sup>209</sup> JOHN RAWLS, A THEORY OF JUSTICE 36–42 (1971).

<sup>210</sup> 11 U.S.C. § 547 (2006).

<sup>211</sup> See *supra* notes 196–97 and accompanying text.

<sup>212</sup> Halonen, *supra* note 17 and accompanying text. It is not clear that states need bankruptcy, however, to reform collective bargaining agreements. Several states have managed to gain significant concessions from their public employees' unions without bankruptcy.

<sup>213</sup> See Galle & Klick, *supra* note 20, at 190 (discussing the lack of scholarly literature on this point).

state legal and political culture. State legal and political culture is unlikely to change in the foreseeable future, and fiscal federalism is not quickly or easily rethought, as the issues involved go to the very essence of the federal union. But it is to a reform of fiscal federalism that we must first look if we are to take state budget crises seriously.

Bankruptcy's limitations in solving state fiscal problems also show that contractarian theories of bankruptcy are necessarily incomplete because they fail to address the political economics that shape bankruptcy law. Similarly, critiques of special-interest provisions in bankruptcy law fail to situate these provisions within their context as part of a shifting and messy armistice line between competing interest groups. The lesson from the bankrupt politics of state budgets is that bankruptcy law cannot be separated from its politics.

