The Case for a State-Level Debt-Financing Authority

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The Case for a State-Level Debt-Financing Authority

by David Gamage and Darien Shanske

Introduction

Much has been written about state budget crises and state-level fiscal distress.1 Of growing importance is the related topic of local government fiscal distress. Unlike state governments, local governments can declare bankruptcy if specific preconditions are satisfied. Looking just at California, the recent bankruptcies in Vallejo, Stockton, and San Bernardino demonstrate the pressing importance of understanding local government finances.2

We have written previously about state-level tax increase limitations (TILs).3 Local governments are also often bound by TILs,4 and those TILs are a significant contributor to the budgetary problems facing local governments.

Yet there is an important fiscal constraint that most local governments do not operate under — namely, state-level fiscal controls regarding debt issuance. In this essay, we argue for the adoption of state-level debt-financing authorities as part of a broader package for reforming local government borrowing.

This analysis and its examples focus on California.5 Our recommendations, however, apply to most states, not just to California.6 We focus on California primarily for ease of exposition. Also, with the bankruptcies of Stockton and San Bernardino, concerns

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4For instance, in California, see Cal. Const., Art. 13A, section 4.

5At a recent conference sponsored by the Berkeley Institute for Governmental Studies, a participant asked why California doesn’t have a local government commission modeled on the successful North Carolina one. There is, in our opinion, no good reason. That question was part of the initial impetus for this essay.

6See, e.g., Robert Slavin, “Larkin: State Actions Are Key to Local Bankruptcies,” The Bond Buyer, Aug. 6, 2012; Omer Kimhi, “Reviving Cities: Legal Remedies to Municipal Financial Crises,” 88 B.U. L. Rev. 633, 636 (2008) (“I claim that . . . state financial boards, which place the burden of the crisis on the state [are] the most efficient remedy for local crises. The reason for this claim is that the state, as opposed to the residents or the creditors, has the ability to prevent potential crises and to minimize their harmful effects. Neither creditors nor local residents can avoid looming crises, because often the causes of these crises are outside their (and the local officials’) realm of control. The state, on the other hand, has both the legal authority and the political power to deal with the causes of urban crisis, and thereby to rehabilitate ailing localities.”)
about local government borrowing seem more pressing in California — especially since California’s local governments, particularly cities, are struggling with the end of redevelopment funds (and with TILs). Moreover, events in California, such as the State Legislature giving a state-level commission more input on local government bankruptcies and the comptroller taking a more active role in auditing troubled cities, suggest that the Legislature is inching toward a more comprehensive approach for regulating local government borrowing.

Ideally, we might recommend that California follow North Carolina’s model, broadly empowering a California local government commission to monitor the fiscal affairs of the state’s cities and other local government entities. But to keep our analysis tractable, and also to highlight a clear path for reform, we will focus on state monitoring of debt issuance.

Our basic proposal has two simple components:
- state-level monitoring of local debt should be increased; and
- the ability of local governments to issue debt should be liberalized.

### Why Should a State Regulate Local Government Borrowing?

Giving local governments the power to finance capital projects is inherent in the arguments for having decentralized governance in the first place. For economic and political reasons, it makes sense to assign governmental spending and taxing powers to the lowest possible level of government capable of providing a given service efficiently. For example, the taxpayers who will actually use a school have the right incentives to ensure that the school is both excellent and a good use of their tax dollars. Yet a school is a capital asset that will last through several generations. It is often neither possible nor advisable for a school building to be financed only with the tax dollars of the current residents of a school district. To do its job, the school district must be able to match up benefits and burdens not just geographically but also temporally. In other words, local entities like school districts must be able to borrow.

For a larger community to benefit fully from decentralization, each local government would have to bear the entire cost of any poor decisions made by that local government.

There is considerable literature about the importance of regulating subnational borrowing. For a larger community to benefit fully from decentralization, each local government would have to bear the entire cost of any poor decisions made by that local

would affect democratic values significantly, especially since we argue that any new restrictions on local debt issuance (for example, fewer competitive sales) should be balanced by enabling more local democratic decisions (that is, through lowering voter approval thresholds).

11Among questions we do not address here is to what extent state fiscal oversight, especially in a severe crisis (for example, one requiring a state takeover), should be allowed to trump local democratic values. For a discussion of this issue, see Michelle Wilde Anderson, “Democratic Dissolution: Radical Experimentalism in State Takeovers of Local Governments,” 39 Fordham Urb. L.J. 577 (2012). We do not think the kinds of reforms to debt issuance we propose in this column (Footnote continued in next column.)
government, including any choices regarding borrowing. That rule is called a “hard budget constraint.” Hard budget constraints require local citizens to take full ownership of their local government because they bear the consequences of any local government failures.14

However, there is a compelling argument that higher levels of government cannot impose truly hard budget constraints. There are many reasons for that, including the sensible central government fear of fiscal contagion if subnational governments are left insolvent. Relatedly, there are likely to be many other negative externalities if a locality is truly allowed to cease providing essential services, such as police and fire protection. Hence, because hard budget constraints must always be imperfect, and because lower-level government officials know that, there is always a risk that lower-level governments will borrow too much and thereby leave the higher level of government on the hook.

Market discipline is one means for controlling subnational borrowing; municipal creditors can refuse to lend to any local government that does not properly manage its affairs. However, though the municipal market in the United States has been (and remains) vigorous, it is not a perfect market.15 Because of the limitations of both hard budget constraints and market discipline, it is therefore common for central governments to impose tighter regulation on local government borrowings before poor borrowings occur.

**Where is a local government to get the money to run a bond campaign?**

There are other reasons to be concerned about local government borrowing. Many smaller local governments lack experience with municipal financing and, unsurprisingly, tend to pay higher borrowing costs.16 And then there is the related problem of pay-to-play arrangements.17 In California, as elsewhere, local borrowing generally requires an election and approval by a supermajority (usually two-thirds) of voters.18 Where is a local government to get the money to run a bond campaign? Public tax dollars cannot be used. Conveniently, investment banks (and finance professionals) hoping to earn commissions in conducting the borrowing, should it be approved, are often happy to contribute to bond campaigns. There are local and federal laws and regulations that seek to limit pay-to-play practice, and more are likely on the way.19 Yet those rules are not generally seen as effective.20

**How Big Is the Problem and How Much Would This Proposal Help?**

To briefly investigate the scale of the problem, we must first make a few distinctions. First, special purpose entities are involved in most events of default (for example, missing a payment) and those of outright bankruptcy (filing under chapter 9 of the federal bankruptcy code).21 Without a doubt, those entities, like irrigation districts, especially when

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15California Constitution, Art. 16, section 18.
17Randall Jensen, “Brokers’ Gifts That Keep Giving,” The Bond Buyer (Jan. 17, 2012) (“When broker-dealers give money to California school bond campaigns, it appears to be money well spent. A review of campaign finance records by The Bond Buyer found a nearly perfect correlation between broker-dealer contributions to California school bond efforts in 2010 and their underwriting subsequent bond sales”); see also, Kevin Opp, comment, “Ending Pay-to-Play in the Municipal Securities Business: MSRB Rule G-37 Ten Years Later,” 76 U. of Colo. Law Rev. 243 (2005). The extent to which one believes that localities were pushed into inappropriate financing might color one’s perspective on the extent to which bondholders should share the pain in restructuring those financings if they go bad. Cf. Clayton P. Gillette, “Bondholders and Financially Stressed Municipalities,” 39 Fordham Urb. L.J. 639, 674 (2012). (“If the objective in assigning priorities to limited funds in the event of default takes into account the relative capacity of the relevant actors to monitor against fiscal distress, the fact that underwriters who market bonds have both legal and financial incentives to access the appropriate information indicates that bondholders may be better positioned to identify impending fiscal distress than residents”).
they are created by general purpose local governments, such as cities, should be monitored by a new state-level authority. An example of those sublocal special districts would be an assessment district created by a city to put some utility lines underground. When special-purpose entities get into trouble, it is most often because the specific projects they are financing run into trouble. This is called enterprise risk. A state-level regulator could require those districts to establish better financing structures and even to pursue better projects (for example, by insisting on more conservative assumptions), but the new regulator could do only so much if the project a special-purpose entity is created to build is poorly conceived.

**Special purpose entities, like irrigation districts, especially when they are created by general purpose local governments, such as cities, should be monitored by a new state-level authority.**

Bankruptcies of general purpose governments, such as cities and counties, are rarer, though a few recent bankruptcies, such as those of Vallejo and Stockton, do suggest the possibility of a trend. Despite those high-profile cases, we agree with the many analysts who do not believe that a municipal bankruptcy tsunami looms, though there is some likelihood of an increase in bankruptcies. The reasons why an explosion of municipal bankruptcies is unlikely are that the economy is slowly improving, general purpose governments have a lot more flexibility than special purpose entities, the stigma from declaring bankruptcy is still significant, and bankruptcy is far from a panacea. That said, the recovery will come too late for some localities, and the recent uptick in filings has reduced the stigma somewhat.

Even if there were a significant increase in the bankruptcies of general governments, such as Vallejo, poor debt management practices are far from the primary driver of local fiscal distress. That means that even for general purpose governments, our proposed new state-level regulator could have only a limited effect. After all, better debt management practices could hardly have saved a locality from the effects of the Great Recession.

If we do not believe that there is necessarily a large problem with local government bankruptcies or defaults that could be solved with a state-level regulator of debt issuances, why are we proposing a solution? Our first answer is that the size of the problem should not be measured in terms of the quantity of bankruptcies and defaults. Even a small number of defaults or bankruptcies can cause big problems — most obviously in creating misery for the citizens of a bankrupt locality, but also possibly in generating fiscal contagion that may spread to other localities and to the state. Poor debt issuance practices that do not lead to a bankruptcy or default may still result in tax dollars being misdirected, thereby harming local government finances. If a state-level system for managing local government borrowing increases market trust in that borrowing — as seems to have been the case in North Carolina — the state-level system might thereby reduce borrowing costs for all local governments within the state, effectively increasing the resources available for funding local government projects.

Our second reason for offering this proposal is that given our national infrastructure needs, it is not only that we have to ensure that every dollar is well spent, but also that many more dollars will likely have to be spent. And for that to happen, we


See, e.g., Moody’s, supra note 21; Slavin, “Fitch Is Negative on Localities,” The Bond Buyer (Sept. 21, 2012) (Fitch analysts see a possible increase in municipal bankruptcies, but “for the most part issuers retain a strong willingness to repay their debts”); “Buffett Says Muni Bankruptcies Posed to Climb as Stigma Lifts,” The Bond Buyer (July 16, 2012) (Warren Buffett said the nation isn’t on the brink of hundreds of billions of dollars in defaults, as banking analyst Meredith Whitney predicted in 2010. “I don’t think we’re at the precipice,” Buffett said. “People will use the threat of bankruptcy to try and negotiate, particularly pension contracts, with their employees”).


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believe, the public has to have more confidence in local government financing techniques. We thus propose that in “exchange” for establishing a strong and professional state-level regulator, the voters of California should be asked to approve lower voting thresholds for bond approvals. In our view, the expense (and risk) of creating a new state-level regulator might not be worth it if not tied to a liberalizing of local government finances.

We believe that adopting this package of reforms is possible. As noted above, state-level debt management reforms are now part of the political conversation. There have also been periodic proposals to lower the vote thresholds for local government debt issuance.26 Indeed, in 2000, California voters approved Proposition 39, which established a lower approval threshold (55 percent versus two-thirds) for (some) school bonds in return for more oversight approval threshold (55 percent versus two-thirds) proved Proposition 39, which established a lower overall half the money finally approved (over $20 billion) would not have been approved if not for the lower threshold.28

Models for State Control Practices

There already exist a few examples of state regulatory regimes designed to ensure proper debt issuance practices — regimes that roughly correspond to what theory would recommend in the absence of perfect budget constraints or market discipline.29 For example, in New York many entities must sell their bonds competitively or get permission from the State Comptroller’s Office to do otherwise.30 The economic evidence in favor of requiring competitive sales in most instances is robust,31 and to us, at least, intuitive. Why not conduct an auction for a product that is in many cases a commodity? Further, requiring competitive sales is almost a complete solution to the problem of pay to play at the local level. If any voter-approved bonds will ultimately be sold competitively, why should a particular firm make a large donation to a bond campaign? There is, therefore, a strong argument for a default rule favoring competitive sales with a state-level regulator having the power to authorize negotiated sales.

There is a strong argument for a default rule favoring competitive sales with a state-level regulator having the power to authorize negotiated bond sales.

The leading model of a state with a powerful regulator is North Carolina. The North Carolina Local Government Commission (LGC) must approve local bond issues.32 It also has significant oversight authority over the financial affairs of local governments generally.33 The LGC is commonly judged a success both by academics and the market.34

31See, e.g., SEC report, supra note 15, at 17 (“Negotiated offerings appear to be more expensive for issuers than competitive offerings both in terms of bond yields and underwriter gross spreads”); Simonsen et al., supra note 16, at 716 (“We conclude that, absent some compelling reason, competitive sales should be used. In other words, the threshold for the use of negotiated sales should be much higher. State statutes or regulations that require justification for negotiated sales seem sensible at a bare minimum”).

32N.C. Gen. Stat. Ann. section 159-51 (“No bonds may be issued under this Article unless the issue is approved by the Local Government Commission”); Charles R. Coe, “Preventing Local Government Fiscal Crises: The North Carolina Approach,” 27 Public Budgeting & Finance 39, 41 (2007) (“The LGC sells all GO bonds competitively. In deciding whether a local government can sell a GO bond, the LGC evaluates the adequacy of the bond amount, the bond’s effect on the property tax rate, and whether the bond can be marketed at a reasonable interest rate”).

33See, e.g., N.C. Gen. Stat. Ann. section 159-181(c) (“The Local Government Commission shall have authority to impound the books and records of any unit of local government or public authority and assume full control of all its financial affairs (i) when the unit or authority defaults on any debt service payment or, in the opinion of the Commission, will default on a future debt service payment if the financial policies and practices of the unit or authority are not improved, or . . .”).


(Footnote continued on next page.)
Note that the composition of the California Debt and Investment Advisory Commission’s (CDIAC) Board is similar to that of the North Carolina LGC, both of which are led by an elected treasurer. Both entities are created by statute. Also, like the LGC, the CDIAC charges issuers fees. That suggests that the path to (at least) New York-style reform in California might not be that forbidding. First, the CDIAC, supported by fees, could be required to approve all debt not sold competitively. Second, CDIAC approval could be required for all local debt with some potentially problematic characteristics, such as those issuances that involve complex structures, rely on a speculative revenue stream, or are not voter approved. Note that having good default rules is particularly important because the required approval should not result in long delays. Third, there could be additional sensible default rules for negotiated sales (and complex financings), perhaps allowing them presumptively in the case of large or sophisticated issues or issuers. Note that giving the CDIAC more authority in approving debt is consistent with the CDIAC recently being given greater authority regarding municipal bankruptcies.

**Conclusion**

Though we think improving debt issuance practices is worth doing in and of itself, we would prefer that optimizing local debt issuance practices occur as part of larger reforms to local government finance. That is especially true considering the uncertain size of the current problem with local-government borrowing and the many other fiscal questions facing state and local governments. We would not suggest that creating a state-level debt-financing authority is a priority outside a larger package of reforms.

Instead, we have argued that — at least in California — the creation of a state-level debt-financing authority should be accompanied by a reduction in the voter approval thresholds for local-government debt issuances. In our view, lowering the approval thresholds for local-government borrowing is imperative if the state is going to deprive local governments of a vital source of contributions to bond campaigns through mandating competitive sales. To do otherwise would be to effectively discourage local government infrastructure financing. We think that encouraging more infrastructure finance at a time of high infrastructure needs and high unemployment is surely the better course. Thus, a Proposition 39-type proposal, with lower voter approval thresholds tied to greater professional state-level oversight, strikes us as extremely promising.

("The three national agencies that evaluate municipal bonds think so highly of the commission that they have rewarded North Carolina communities with bond ratings higher than those in most of the United States").


38California has already mandated that in the context of schools. Calif. Ed. Code section 17150.1 (county offices of education must approve non-voter-approved debt).


40Or perhaps in other cases. One intangible advantage attributed to negotiated sales is that they encourage the forming of long-term relationships between borrowers and financial professionals — that is, a banker knows that she will be an entity’s banker just so long as she provides good service, including between debt issuances. We are unsure how important those relationships are for most issuers that would be issuing vanilla debt under the watchful eye of the state regulator. Yet we acknowledge that there might be smaller specialized issuers who would benefit from having the security of a longer-term arrangement.

41Cal. Gov’t Code section 53760 et seq. Indeed, section 1 of AB 506, 2011-2012 Leg. Sess., the statement of intent regarding this reform, is an outline of a theoretical argument for better state management of local debt.

42And that would be especially problematic in light of the end of redevelopment entities in California.