DIRECT DEMOCRACY AND STATE FISCAL CRISES: THE PROBLEM OF TOO MUCH LAW

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The recent debate concerning state fiscal crises has appropriately focused on the question of money: that is, the money states have committed to their employees, bondholders, and citizens, and the implications of economic recession for those promises to pay.[1] In that sense, the debate is not strictly about state *fiscal* crises, but state *debt* crises, and proposals to resolve them focus on ways in which the states can restructure these debts in order to avoid the crisis entirely.

This focus on debt is understandable. The collective debts of the several states are staggering, and states frequently rely on unrealistic projections of tax and pension fund growth that, during an economic decline, may render the states unable to meet those obligations.[2]

But what if the problem facing the American states is not a problem of too much debt, but one of too much law? Put differently, state debt crises might be symptomatic of a deeper crisis whereby the state fiscal policy-making process is gummed up by statutory and constitutional restrictions on the use of public resources, such that combating budgetary shortfalls—whether caused by economic

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1. See, for example, David Skeel, *State Bankruptcy*, U. CHI. L. REV. (forthcoming 2012), for an overview.

2. *See generally* Olivia Mitchell, *Public Pension Pressures in the United States*, *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS (Peter Conti-Brown & David Skeel eds., 2012) [hereinafter WHEN STATES GO BROKE] (providing an overview of state pension obligations).

recession, political gridlock, or some combination of the two—becomes increasingly unlikely. This essay takes a look at that issue: state fiscal crises and the problem of too much law.

This problem broaches two sequential, but otherwise unrelated, dynamics: lawmaking by direct democracy on the one hand, and fiscal federalism and the moral hazard it can create on the other. First, in the states that allow them, constitutional amendments by direct democracy—whether by popular initiative or by legislature-approved referendum—can place unyielding restrictions on the state budgets that, in times of crisis, may render the state unable to meet its fiscal demands. Add this dynamic to the frequently dysfunctional fiscal policy processes so often associated with these same states' legislatures and the result can be fiscal deadlock and, potentially, fiscal crisis.

Second, while direct democracy can create other problems for a polity, the risk of moral hazard that inheres in fiscal federalism can make direct democracy a problem for those who do not participate in it. In a federal system such as exists in the United States, state fiscal crises create moral hazard easily, as states take risks that they hope the federal government will absorb. If the federal government agrees, federal taxpayers would thus absorb the losses of state fiscal crises in a way that, if history is a guide, can distort political conversations regarding fiscal policy and push the costs of risky behavior to those who do not enjoy the benefits. The interaction between these problems—the potential instability of fiscal policy by constitutional amendment and the risk of moral hazard in a federal system—is an important and understudied dynamic of state fiscal crises.

This essay is not the first to observe that democracy influences fiscal crises. The problem is that "voters do not fully understand the relationship between current deficits and future taxes—they simply reward spending and punish taxation."[3] As one commentator on the state of California's fiscal affairs colorfully put it, the Californian experience is that its citizens expect to be "taxed like libertarians, but subsidized like socialists."[4] Add to the paradoxical—but fully rational—preference for taxes and subsidies the penchant for using

3. JONATHAN RODDEN, HAMILTON'S PARADOX: THE PROMISE AND PERIL OF FISCAL FEDERALISM 21 (2006) (citing JAMES BUCHANAN & RICHARD WAGNER, DEMOCRACY IN DEFICIT: THE POLITICAL LEGACY OF LORD KEYNES (1977)).

4. Troy Senik, *Who Killed California?*, NAT'L AFFAIRS, Fall 2009, at 60, *available at* http://www.nationalaffairs.com/doclib/20091229_Senik_Fall09.pdf.

laws promulgated via direct democracy to bind the hands of legislators in the fiscal policy-making arena, and the result may be a dysfunctional fiscal policy process.

This symposium essay offers a preliminary, counter-intuitive solution to this unholy confluence of direct democracy, fiscal policy sclerosis, and federation moral hazard: the use of direct democracy to combat direct democracy, thereby providing protection to federal taxpayers exposed to losses by state fiscal crises. Taking a cue from the Financial Review Board[5] system seen in the municipal bankruptcy context, this essay proposes a state constitutional amendment by referendum or initiative that dislodges the fiscal policy-making process from the legislature and referendum-burdened state constitution. In place of these traditional fiscal policy-making regimes, the referendum[6] would accept the authority of a federally created commission called the Fiscal Restoration Commission (FRC). The FRC would then recreate the state's budgetary laws from the ground up. The release of federal funds to save a state's fiscal affairs would be contingent on the adoption, again by referendum, of the FRC's proposals. The result would be a clearing of restrictive *law*, rather than the clearing of restrictive *debt*, the focus of most state restructuring proposals offered until now.

This essay explains this proposal in detail and assesses several legal and policy arguments against it. Perhaps befitting a proposal grounded partially in constitutional law but advanced by a student of business law and bankruptcy, the arguments are necessarily tenuous and preliminary. But however preliminary, the problem the proposal seeks to address is not far-fetched. The interaction of state fiscal crises and direct democracy is a potentially serious one; the risk of moral hazard in a federalist system is high; and the present regime is ill-equipped to resolve the problems, particularly in times of crisis when the problems are on fullest display.

5. "Financial Review Boards" are also known as "Financial Control Boards." *See, e.g.*, Note, *Missed Opportunity: Urban Fiscal Crises and Financial Control Boards*, 110 HARV. L. REV. 733, 735–45 (1996). For reasons explained below, I prefer "Financial Review Boards." *Infra* note 27.

6. Except where noted, I use the term "referendum" to refer to any mechanism whereby the populace accepts or rejects changes to state statutory or constitutional law, irrespective of the origin of such law. As such, the use of the term encompasses both voter-directed initiatives and legislature-directed referenda. I do so only for concision and euphony. There are key differences between referenda and initiatives that are relevant to this discussion only where noted.

The benefits of the proposal are several. First, it allows the extent of the states' fiscal crises to manifest itself fully before a structural overhaul is needed. As many scholars have noted, the problem of state fiscal crises is political, not economic.[7] In order for the FRC to be triggered, the political regime already in place must be incapable of resolving the fiscal problems that its state faces. This mechanism protects the proposal from being exploited for partisan, rather than fiscal, ends. The structure proposed here would only come into play when its citizens determine that the state is actually and squarely faced with the prospect of defaulting on its debts, whether to its employees, its citizens, or its bondholders. And because there may well not be, at present, a connection between direct democracy and fiscal crises,[8] structuring a solution that waits for a problem to manifest itself does not presume the problem it awaits to resolve.

Second, the proposal allows for a nonpartisan mechanism to evaluate the many statutory and constitutional restrictions on a state's budget and provides the state with a streamlined alternative to its own budget-making process. And third, it goes deeper than a simple restructuring, allowing a constitutional amendment to do away with decades of accumulated, perhaps inconsistent, budgetary restrictions that can clog a state's ability to navigate fiscal crises.

The main aim in this essay is to create a space for discussion of the problem of too much law in the context of state fiscal crises—a problem the existence of which should be more fully established by empirical analysis, especially concerning the most recent state debt crises and their relationship to direct democracy. The FRC proposal offered here is intended to be strictly nonpartisan: it must offend or please parties on the left and right alike if it is to be successful. Any aspect that strays into one corner or another should be criticized and modified; the entire purpose is to create a mechanism that identifies a failure of partisan politics and uses nonpartisan decision-making to overcome that failure. The proposal's very plausibility, from an academic perspective, depends on the ability to supersede political considerations.

7. *See, e.g.*, Jonathan Rodden, *Market Discipline and U.S. Federalism*; Adam J. Levitin, *Fiscal Federalism and the Limits of Bankruptcy*; Damon A. Silvers, *Obligations Without the Power to Fund Them*, *in* WHEN STATES GO BROKE, *supra* note 2.

8. *See, e.g.*, John G. Matsusaka, *Direct Democracy and Fiscal Gridlock: Have Voter Initiatives Paralyzed the California Budget?*, 5 ST. POL. & POL'Y Q. 248, 249–50 (2005).

The essay proceeds as follows: Part I provides the background of the problems described above. Part I.A describes the problem of direct democracy in the context of fiscal crises, using California as an example. Part I.A also describes the problem of fiscal federalism and explains how moral hazard can result in this context. Part I.B then describes the mechanism used to override a similar problem in an analogous context, namely the establishment of Financial Review Boards that oversee municipal bankruptcies.

Part II turns to the solution and describes the Fiscal Restoration Commission, explaining its many components based in state and federal law, as well as the importance of institutional design in creating the FRC. Part III addresses the constitutional and policy counterarguments, while also distinguishing the FRC from the category of solutions generally referred to as "state bankruptcy," which address the related—but distinct—problem of excessive state debts.

I. THE POPULAR CONTEXT OF FISCAL CRISIS

A. State Fiscal Crises and Direct Democracy in Context

Fiscal crises in the American states are as American as Pop-Tarts. The presence—and more especially, the threat—of fiscal crises have been a part of the political discussion since the American states have existed as cognizable legal entities. This dynamic is unlikely to change. And yet, as economists Isabel Rodriguez-Tejedo and John Wallis have noted, "[h]ope springs eternal in America, . . . and for close to 200 years, state governments and their citizens have regularly tried to prevent the next crisis from occurring by changing the constitutional rules that constrain state government taxing, spending, and borrowing."[9]

Rodriguez-Tejedo and Wallis call these efforts "fiscal constitutions."[10] As Rodriguez-Tejedo and Wallis describe them, they come in four stripes.[11] The first, and most common, is the constitutional imposition of procedural requirements that limit the amount or variety of debts that a state can issue.[12] Second are the

9. Isabel Rodriguez-Tejedo & John Wallis, *Fiscal Constitutions & Fiscal Crises: A History*, *in* WHEN STATES GO BROKE, *supra* note 2, at 9.
10. *Id.*
11. *Id.* at 19.
12. *Id.*

nearly ubiquitous balanced-budget amendments, never successful at the federal level but wildly popular among the states.[13] Third is a constitutionally mandated "rainy day fund," which requires the states to put away money in good years and then draw on that money in harder times.[14] And fourth are tax and expenditure limits that either link the fates of tax and expenditure levels or raise procedural barriers to changing tax or expenditure levels, such as allowing tax increases only through supermajority voting.[15]

There is another class of fiscal constitutions, however, that is the inverse of the categories Rodriguez-Tejedo and Wallis identify. This class contains constitutional amendments mandating that the annual state budget devote a fixed percentage of resources to a given cause or activity. The quintessential example is California's Proposition 98, a referendum passed in 1988 that requires the state legislature to devote a fixed amount of the budget to education, subject to different constraints depending on the state's general economic outlook.[16] Proposition 22—the Local Taxpayer, Public Safety, and Transportation Act (2010)[17]—is another example, though it is structured differently. Proposition 22 banned the state from "borrowing" funds raised primarily from local taxes for any purpose other than local public safety, emergency response, or other local government services.

However guided or misguided the aims of Proposition 98, Proposition 22, and other similarly structured popular amendments, the budgetary restriction is clear. Indeed, such restrictions are the very point of the proposition: no matter what other competing budgetary goals, California must, in the example of Proposition 98,

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13. Of all the states, only Vermont and Wyoming lack such amendments, and even Wyoming is "required to balance in practice." GEN. ACCOUNTING OFFICE GAO/AFMD-93-58BR, BALANCED BUDGET REQUIREMENTS: STATE EXPERIENCES AND IMPLICATIONS FOR THE FEDERAL GOVERNMENT 3 & n.3 (1993), *available at* http://gao.gov/assets/80/78648.pdf.

14. Rodriguez-Tejedo & Wallis, *supra* note 9, at 19.

15. *Id.*

16. Cal. Proposition 98: Sch. Funding Initiative Constitutional Amend. and Statute, *reprinted in* California Ballot Pamphlet 79, 127–28 (1988), *available at* http://library.uchastings.edu/ballot_pdf/1988g.pdf (showing that upon passage of Proposition 98, during normal economic times forty percent of the state general fund will be spent on kindergarten through community-college education).

17. Cal. Proposition 22: Prohibits the State From Borrowing or Taking Funds Used for Transp., Redevelopment, or Local Gov't Projects and Services. Initiative Constitutional Amend. 30 (2010), *available at* http://library.uchastings.edu/ballot_pdf/2010g.pdf (showing that upon passage of Proposition 22, California would be prohibited, even during a period of severe fiscal hardship, from delaying the distribution of tax revenues for transportation, redevelopment, or local government projects and services).

pay as much as forty percent of its annual budget to public education. Or in the example of Proposition 22, it may not remove local tax revenues from hotel or sales taxes to fund state services in other areas of the state.[18]

These kinds of specific budgetary restrictions appear to be relatively rare among California's constitutional amendments. But that is not to say that all other instances of direct democracy are fiscally innocuous. Indeed, many such propositions are costly even without tying up a fixed percentage of the budget. The annual parade of propositions that would amend the state constitution may adversely impact the public fisc in myriad ways, whether that impact is felt directly on the public resources that must be devoted to fund the propositions or indirectly through the requirements that compliance imposes on private actors.[19]

Many states that allow for constitutional amendment via popular referendum specifically require a "fiscal impact statement" to accompany proposed amendments.[20] But fiscal impact statements are themselves necessarily speculative and substantively incomplete. A *true* fiscal impact statement would mention not only the potential cost of a given proposition, but also the ways in which that cost would require the elimination or subtraction of other services, an increase in taxes, or the increased likelihood of fiscal crisis. This is not a criticism of fiscal impact statements, but simply a recognition that voters at the ballot box—or, for that matter, legislators in the state capitol—are rarely best situated to recognize the cost of these amendments.

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18. For an entertaining illustration of the phenomenon of California's popular referendum and fiscal crisis, see *The Daily Show with Jon Stewart*: *California's Direct Democracy Troubles* (Comedy Central cable television broadcast Dec. 5, 2011), *available at* http://www.thedailyshow.com/watch/mon-december-5-2011/california-s-direct-democracy-troubles.

19. California's Proposition 65, titled "The Safe Drinking Water and Toxic Enforcement Act," provides a good example here. Initiative Measure, Proposition 65 (approved Nov. 4, 1986) (codified as amended at Cal. Health & Safety Code §§ 25, 249.5-.13 (West 1999 & Supp. 2001)), *available at* http://www.oehha.ca.gov/prop65/law/P65law72003.html. Proposition 65 requires business owners to give a "clear and reasonable warning" of any potential exposure to chemicals "known to the state to cause cancer or reproductive toxicity" to any individual who may be exposed to such chemicals. *Id.*

20. *See, e.g.*, CAL. ELEC. CODE § 9005 (West 2010); NEV. REV. STAT. ANN. § 295.015 (West 2011); *see also* NAT'L CONFERENCE OF STATE LEGISLATURES, INITIATIVE AND REFERENDUM IN THE 21ST CENTURY: FINAL REPORT AND RECOMMENDATIONS OF THE NCSL I&R TASK FORCE 27 (2002), *available at* http://www.ncsl.org/Portals/1/documents/legismgt/irtaskfc/IandR_report.pdf.

1. Moral Hazard and Fiscal Federalism

The reason—in many ways, the *only* reason—that such fiscal constitutions are the business of anyone other than the state's citizens is simple: in a federation, there is a high tendency for moral hazard based upon the expectation of subnational governmental bailout from the national government. This tendency is a corollary to the principle of fiscal federalism, long an aspect of discussion of federalism among economists and political scientists.[21] Jonathan Rodden, the leading academic analyst of this phenomenon, describes the "dangerous equilibrium" of moral hazard in federations in these terms:

> The central government—because of its role in funding most provincial-level expenditures—cannot credibly commit to ignore the fiscal woes of troubled provincial governments, but because of its political composition, it also cannot cut off their access to borrowing. In these situations, semi-sovereign provincial governments can borrow with implicit federal guarantees and over-fish the common pool of national revenue, ultimately undermining the creditworthiness of the entire public sector.[22]

Rodden describes this equilibrium using formal theory, case studies, and the reactions of credit-rating agencies to explain exactly how this implicit guarantee is formed and how individual governments—local and central—react in various circumstances.[23]

Of course, there are a number of different ways in which systems can federate. The European Union under the Maastricht Treaty, the United States under the U.S. Constitution, the United States under the Articles of Confederation, and explicitly trade-centered federations like the North American Free Trade Agreement are just a few examples of different types of federations. But in instances where the federation has expressly or impliedly backstopped the fiscal affairs of its governmental subunits—regardless of the ties that connect the federation otherwise—there is the risk that a textbook example of moral hazard can arise. If the insolvent state has the promise—through a unified currency, economy, or polity—of support in time of fiscal distress, the tendency to engage in risky behavior will increase. The benefits of such behavior redound to individual states,

21. For the original discussions of fiscal federalism, see generally WALLACE OATES, FISCAL FEDERALISM (1972) and RICHARD MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN POLITICAL ECONOMY (1959).

22. RODDEN, *supra* note 3, at vi.

23. *Id.* at 12, 47, 136.

the costs to the entire federation. There is ample reason that the bailouts of the states would either exacerbate this moral hazard or allow others to perceive such exacerbation and thus cause a groundswell of support for political change on this question.

The particulars of how and when such moral hazard arises will vary according to context. Rodden describes one apparently necessary, though insufficient, condition as where "subnational governments rely on grants and revenue-sharing rather than independent local taxation."[24] Thus, the very participation of the federal government in the state's provision of governmental services increases the likelihood of moral hazard, a topic addressed in greater detail below.

The upshot from Rodden and others' observations regarding moral hazard and fiscal federalism is simply that it exists, making the fiscal problems of subnational governments the potential fiscal problems of citizens throughout the federation. Thus, resolving these problems necessarily becomes a concern for the entire national government, and not simply the subnational government most directly affected.

B. Financial Review Boards

The fact that states have changed their constitutions in ways that reflect fiscal rigidity is not an indictment of that process. There is nothing untoward or irrational about a populace's interest in lashing state legislators to the mast in order to guarantee the provision of certain services in the future. That is the very essence of a Ulysses contract, which is an accepted view of what constitutional law is and does.[25]

Indeed, such legal precommitments are not *ipso facto* fiscally dangerous. The problem is that they can quickly *become* dangerous, especially as economic conditions deteriorate. And while the crisis

24. *Id.* at 12.

25. For more on lawmaking as a Ulysses contract, see JON ELSTER, ULYSSES UNBOUND: STUDIES IN RATIONALITY, PRECOMMITMENT, AND CONSTRAINTS (2000) (describing the nature of precommitments generally); Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439 (2011) (discussing the weaknesses of law as a precommitment device in the context of private bailouts); Peter Conti-Brown & Ronald J. Gilson, The Limits of Independence in Institutional Design (2012) (unpublished manuscript) (on file with author) (discussing precommitments in institutional design). For a discussion of such precommitment devices in the context of constitutional law, see Michael C. Dorf, *The Aspirational Constitution*, 77 GEO. WASH. L. REV. 1631, 1643 (2009).

among the states may well be overstated,[26] the risk of crisis is unquestionably exacerbated by the presence of such policies.

In the event that such restrictions prove more than a state could handle, it would seem reasonable to seek to restore the budgetary flexibility that such referenda have removed. A potential means of doing so would be through a legislative veto of some or all such referenda themselves. But this is an undesirable mechanism for handling the problem of budgetary inflexibility. The entire point of legislating—or amending the constitution, as the case may be—by referendum is that the usual process of representative democracy has come under question. Allowing legislators to veto the voters would subvert the very point of direct democracy. Perhaps allowing legislators to enervate the direct democracy process is a desirable policy outcome. But if a state's citizens have become suspicious of the mechanisms of popular referenda writ large, perhaps a more reasonable constitutional device would be to remove direct democracy from the picture entirely, rather than attempt a hybrid system that, ultimately, removes direct democracy in effect without doing so in fact. In other words, legislative veto of a popular referendum is no popular referendum at all.

This essay takes a different tack and would seek that "veto" only on the condition that a crisis does, in fact, exist. In such an event, the veto would not reside in the state legislature, but in the hands of an appointed commission. To understand how that process works, it is helpful to understand Financial Review Boards, an analogue from municipal bankruptcy.[27]

Financial Review Boards are designed to require a bankrupt municipality to subject its fiscal affairs to an outside authority, consisting primarily of delegates of the state government. They are creatures of the state, in some cases designed on an *ad hoc* basis as specific state agencies.[28] Financial Review Boards have been used in

26. Rodriguez-Tejedo and Wallis place the states' fiscal crisis in historical perspective and demonstrate that the American states have proven remarkably consistent in paying their debts as they come due. Rodriguez-Tejedo & Wallis, *supra* note 9, at 11–14.

27. I use the term Financial Review Boards, but the term more often deployed is "Financial Control Board." *See Financial Control Boards: Hearing Before the Subcomm. on D.C. of the Comm. on Gov't Reform & Oversight H.R.*, 104th Cong. 57 (1995) [hereinafter *Hearings*]. I prefer "review" in the context of federal-state relations, because of its emphasis on the nature of the federal power being used.

28. See the case of the Bridgeport Financial Review Board, described more fully in Dorothy A. Brown, *Fiscal Distress and Politics: The Bankruptcy Filing of Bridgeport as a Case Study in Reclaiming Local Sovereignty*, 11 BANKR. DEV. J. 625, 630–32 (1995) (describing how

the context of municipal bankruptcies in at least Connecticut,[29] New Jersey,[30] New York City,[31] and Philadelphia,[32] but are far from widespread. California, for example, does not appear to use them.[33]

In addition to their relative lack of use, the Boards are something of a curious beast in the municipal bankruptcy context. Federal law provides for municipal bankruptcy,[34] but the Bankruptcy Code does not require that such boards be established: where they exist, they are state entities, not federal ones. From a multilevel governmental perspective, this is perhaps as it should be. The constitutional justification for municipal bankruptcy is that *municipalities* are corporate entities that are subunits of the states in which they reside and do not of themselves possess sovereignty of the sort recognized by the U.S. Constitution. That the sovereigns presiding over these corporate entities might want to impose a mechanism of accountability over bankrupt subentities seems plausible, even desirable. At the very least, the presence of Financial Review Boards in the municipal bankruptcy context is certainly less controversial than the idea that the federal government could impose a similar institution to oversee the fiscal affairs of the sovereign states.

The use of a Financial Review Board in Bridgeport, Connecticut, is illustrative. In 1988, when local Bridgeport officials refused to deal with the city's mounting fiscal distress and maintain the required balanced budget,[35] the Connecticut legislature passed a Special Act creating the Bridgeport Financial Review Board (the Board) to

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the State Assembly of Connecticut created a Financial Review Board to oversee Bridgeport's fiscal activities after city officials failed to address the city's financial crisis).

29. *Id*. at 630.

30. Anne Marie Vassallo, *Solving Camden's Crisis: Makeover or Takeover?*, 33 RUTGERS L.J. 185, 204 (2001).

31. *See* WILLIAM K. TABB, THE LONG DEFAULT: NEW YORK CITY AND THE URBAN FISCAL CRISIS 28–31 (1982) (describing the austerity measures instituted by the Fiscal Control Board).

32. *Hearings*, *supra* note 27, at 57 (statement of Bernard E. Anderson, Former Chairman, Pennsylvania Intergovernmental Cooperative Authority).

33. The (in)famous bankruptcy of Orange County in 1993 did not include a Financial Review Board. Mark Baldassare's history of the county's bankruptcy contains no reference to either financial review or financial control boards. *See generally* MARK BALDASSARE, WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY (1998).

34. At first, the Supreme Court invalidated this controversial mechanism. Ashton v. Cameron Cnty. Improvement Dist., 298 U.S. 513, 531–32 (1936). In what can truly be called a "switch in time," however, the Supreme Court upheld a substantively identical statutory scheme just two years later. *See* United States v. Bekins, 304 U.S. 27, 49–51 (1938).

35. Brown, *supra* note 28, at 630.

oversee the city's fiscal affairs.[36] The Board consisted originally of nine members, six of whom were either state officials or appointed by state officials.[37] In exchange for state guarantees for Bridgeport's debt, which allowed the city to continue to finance its deficits, Bridgeport ceded almost all control over its budget-making process.[38] The city had to submit its annual budget to the Board, which could determine whether the budget comported with the Special Act's requirements.[39] Under certain circumstances, the Board could adopt an alternative budget for the city.[40]

The use of Financial Review Boards will vary with the states that authorize them.[41] The general idea, for the purposes of this essay, is simply that a group of policy-makers is given the authority to weigh in on the fiscal processes of a subgovernmental unit. The fact that the relationship between cities and states is very different from that between states and federal governments, from the perspective of constitutional law, will mean that a state Financial Review Board will look quite different. The next Part explains how.

II. THE FISCAL RESTORATION COMMISSION

Borrowing from the concept of the Financial Review Board, this essay proposes the creation of a Fiscal Restoration Commission (FRC). In the proposal that follows, the essay makes three conceptual assumptions. The first is that there is, in fact, a fiscal crisis that requires some sort of state budgetary restructuring beyond the conventional, legislative means of doing so. The essay expresses no opinion on the accuracy of that assumption. Declining to do so highlights that the state of the emergency is far from a closed question: agnosticism regarding a state crisis, in the face of the states' mounting debts, is to remain open to the possibility that either states' debts are not ultimately excessive, or that the states are already well equipped, outside the context of a crisis, to deal with those debts without putting

36. *Id.*
37. *Id.* at 630–31 (citing Act of June 9, 1988, 1988 Conn. Spec. Acts 88-80 (An Act Authorizing the Issuance of Bonds by the Town and City of Bridgeport), amended by Act of June 5, 1989, 1989 Conn. Spec. Acts 89-24; Act of June 27, 1989, 1989 Conn. Spec. Acts 89-47; Act of June 6, 1990, 1990 Conn. Spec. Acts 90-31; Act of June 10, 1991, 1991 Conn. Spec. Acts 91-40).
38. *Id.* at 631–32.
39. *Id.* at 632.
40. *Id.*
41. For more discussion on this point, see *Hearings*, *supra* note 27, at 68–69.

the burdens on the federal government. This agnosticism is not to say that state fiscal crises *cannot* occur, only to say that the crisis may not have *already* occurred.

Second, this essay assumes that if such a fiscal crisis does occur, it will be related to the budgetary rigidity associated with popular referenda, the difficulty of reaching budgetary compromises in the face of mandatory supermajority voting requirements, or both. This is an empirical question that appears to have been addressed only partially, and not since the most recent fiscal crisis.[42] Further exploration would be a promising vein for future empirical research.

And third, the essay assumes that a failure to resolve a fiscal crisis in a state within a federation creates a moral hazard, as the federation is likely to cover the losses of the state, thereby dispersing the costs and concentrating the benefits of such risk-taking. This assumption appears to be the least contestable of the three.[43]

If these three assumptions are correct today, or plausibly correct tomorrow, a solution is in order that will allow states to restructure their liabilities in a way that will reach the cause of the fiscal problems, rather than merely the symptoms of those problems. The FRC is such a proposal. This Part explains its features.

A. Federal Statutory Authorization

The FRC would require one federal and two state statutory triggers. First, with regard to the federal statutory authorization, the creation of a federal commission charged with recommending budgetary changes could—in theory—be done by either statute or executive order. The ill-fated National Commission on Fiscal Responsibility and Reform, better known as the Bowles-Simpson Commission after its co-chairmen, is an example of an executive agency created without congressional authorization.[44] The Commission was charged with proposing a dramatic restructuring of the federal budget; it produced a report but was not embraced.

The FRC should be a creature of Congress and not the Executive for at least three reasons. First, the FRC's creation is explicitly linked to the deployment of federal funds. And while the deployment of

42. *See generally* Matsusaka, *supra* note 8 (addressing the restraints imposed by budgetary referenda).
43. *See supra* Part I.A.
44. Exec. Order No. 13,531, 75 Fed. Reg. 7927–28 (Feb. 18, 2010).

federal funds has not always been initiated in Congress—for example, the Federal Reserve's deployment of funds in the rescue of Bear Stearns[45] and AIG,[46] or the Treasury's use of funds in the bailout of the Mexican peso[47]—a politically controversial move of the magnitude of a federal bailout of a state will require the accountability associated with congressional approval.

Second, there is no obvious candidate for already established bailout funds currently within the reach of the Executive, unless the American states are deemed systemically important financial institutions for purposes of Dodd-Frank.[48] This, however, seems a stretch, given the dubious legality of deeming the automakers "financial institutions"[49] for purposes of the Troubled Asset Relief Program,[50] and Dodd-Frank's further clarification that financial institutions are only those whose consolidated revenues are primarily—defined as "eighty-five percent"—"financial in nature."[51] Whatever a state's fiscal commitments, such a categorization is facially absurd.

And third, the FRC can and should be created preemptively, in anticipation of the first state-level statutory authorization described above. That is, Congress could legislate in times of non-crisis to create this infrastructure, which would then be triggered by the passage of the "fiscal state of emergency" referendum. The latent commission would then spring into action, with any necessarily contingent appointments left to the Executive as appropriate. There could be constitutional concerns if the President creates a commission by executive fiat that is not pursuant to any kind of legislative

45. *See* Marcel Kahan & Edward Rock, *How To Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 EMORY L.J. 713, 717–20 (2009) (describing how the Federal Reserve worked with other parties, such as J.P. Morgan, to provide funding to stave off Bear Stearns' collapse).

46. *See generally* William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009) (describing the terms of the AIG bailout).

47. Alan Friedman, *For Its Loans, Mexico Will Pay A Weighty Price in Sovereignty: The Rescue of the Peso: A Humbling Experience*, N.Y. TIMES, Feb. 2, 1995, http://www.nytimes.com/1995/02/02/news/02iht-imf.html?scp=14&sq=1995%20mexico&st=cse.

48. *See* 12 U.S.C.A. §§ 5331(a), 5323 (West 2010) (describing the different kinds of systemically important financial institutions that the Financial Stability Oversight Council will regulate).

49. *See* Cong. Oversight Panel, September Insight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automotive Industry 71–77 (2009), *available at* http://cybercemetery.unt.edu/archive/cop/20110402043042/http://cop.senate.gov/documents/cop-090909-report.pdf (including an exhaustive analysis of that strained interpretation).

50. Troubled Asset Relief Program, Pub. L. 110-343, 122 Stat. 3765 (2008).

51. § 201(a)(11)(iii), (iv); §201(b).

authorization and remains a latent solution to a problem that has, by its own terms, yet to arise.

The features of the FRC would be formal and structural, and would focus almost entirely on the ways in which the members are appointed. None of the features discussed below is sacred, but for the purposes of comprehensibility, I will describe several features in detail.

First, because the FRC deals so obviously with highly charged political issues, it is desirable to create as independent a commission as possible.[52] The important first step would be the appointment of the FRC's co-chairs, one from each party. The statute could direct the President to appoint, by executive order—without the advice or consent of the Senate, as this would not be a federal officer—the first co-chair. That appointment would, by necessity, be a member of the other political party. The presidentially appointed co-chair would then appoint the other co-chair, a member of the President's party. The idea here is that the President will appoint a moderate, independent-minded member of the other party. That independent co-chair would then choose a partner from the other party. The two would then constitute the entire commission.

The two-person commission is a departure from other models, such as those used in Financial Review Boards or in other federal agencies. Such a departure is desirable. The point here is to give the FRC accountability but also to eliminate, to the extent possible, the likelihood that it would replicate the political dysfunction of the home state's own political structure.

The two co-chairs would then appoint a nonpartisan staff, and the appointment of each staff member would require the consent of both co-chairs. That staff should be as technocratic as possible, reflecting relevant disciplinary expertise (economics, accounting, law, etc.) and substantive, area-specific expertise (such as the California budget, California constitutional law, etc.). The benefit of a fully technocratic staff is not necessarily a vaunted view of technocrats. Rather, this preference reflects the skeptical view that a more robustly apolitical process is more likely to yield results that a politicized polity will respect. The anti-model here is the recent Financial Crisis Inquiry

52. See Conti-Brown & Gilson, *supra* note 25, for more discussion of the nature of independence in institutional design.

Commission (FCIC). The FCIC has largely been deemed a failure.[53] While some of this criticism draws unnecessarily rosy comparisons to previous commissions,[54] the reality is that the partisan reports that the FCIC issued enervated its ultimate conclusions. Furthermore, the appointment of almost all politicians or former high-level political appointees among the FCIC—many of whom are young enough to seek to make a political career on the basis of their work at the FCIC—led to a more divided report than might have been possible otherwise. By creating a two-headed commission appointed in the way described, the likelihood of partisan bickering would be low and accountability high. This would thus increase the likelihood of a successful, unanimous report.

But there is yet more that can be done, starting with the ways that the co-chairs—and, importantly, their appointed staff—are compensated. The FCIC exemplifies the traditional compensation regime. Section 5(f)(1) of the Fraud Enforcement and Recovery Act of 2009, which created the FCIC, provides that "[e]ach member of the Commission may be compensated at a rate not to exceed the daily equivalent of the annual rate of basic pay in effect for a position at level IV of the Executive Schedule under section 5315 of title 5, United States Code."[55] In the FRC, the co-chairs of the commission and their staff would be compensated also by reference to the Executive Schedule, but with the following statutory variations:

> (2) In the event the Commission fails to file a comprehensive report in which both co-chairs concur, the compensation for co-chairs and staff will be half the rate for level IV of the Executive Schedule under section 5315 of title 5, United States Code. In the event the Commission does file a comprehensive report in which both co-chairs concur, the compensation for co-chairs and staff will be twice the rate for level IV of the Executive Schedule under section 5315 of title 5, United States Code.

This statutory variation would encourage a comprehensive, unanimous report. The reason to link the staff's compensation to the

53. *See, e.g.*, Tim Fernholz, *The Failure of the Financial Crisis Inquiry Commission—and of Facts*, AM. PROSPECT (Dec. 15, 2010), http://prospect.org/article/failure-financial-crisis-inquiry-commission-and-facts (arguing that partisanship obstructed the commission from achieving its primary objective of determining what happened in the crisis).

54. *See generally* Peter Conti-Brown, *The Accidental History of Federal Banking and Securities Laws: A Review of Michael Perino's* The Hellhound of Wall Street: How Ferdinand Pecora's Investigation of the Great Crash Forever Changed American Finance, 39 SEC. REG. L.J. 45 (2011) (drawing comparisons to the Pecora Commission).

55. Pub. L. 111-21, § 5(f)(1), 123 Stat. 1617 (2009).

success of the report is to mitigate the risk that wealthy co-chairs might engage in political grandstanding, since the five- or six-figure compensation for their work might not be sufficient to discourage such politicking. If, on the other hand, their entire staff will suffer, the social incentive hopefully will be sufficient to induce unanimity.

The importance of unanimity is simply to avoid the appearance that the report, or the process that created it, was a reflection of partisan politics. The more confidence the public, and especially the voting public in the relevant state, can have in the FRC, the more likely its recommendations will be adopted by that public.

One final important point about the federal authorization of the FRC: it is essential that the creation of the commission be linked to federal dollars deployed to guarantee state debts, and that the statute clearly state that no federal funds would be deployed to guarantee debt without acceptance of the FRC's report. Query whether such precommitments are actually effective or plausible;[56] the point is not to eliminate forever the possibility that such a bailout would occur outside the context of FRC, but to increase the political costs for doing so. There may be merit to the alternative course, which would allow the creation of an FRC when a crisis is not directly bearing down on the state. But I am not convinced that this is the best course. The idea behind the present proposal is that there must be a fiscal crisis that the regular political process cannot resolve. Limiting the establishment of the FRC to respond to actual crises would help ensure that a request for federal funds will bring with it some federal power to dictate the terms upon which such funds will be deployed.

In this sense, a federal bailout of an American state subject to the conditions of an FRC would look more like the private bailouts of 2008 to 2010. Although hugely unpopular, they have almost all been revenue-positive for the U.S. government.[57] The reason, in part, is that a bailout in this context mostly meant the power to dictate which assets were bought and sold, which executives could stay or must go, and other such decisions. In the context of federalism and the sovereignty of the American states, these kinds of demands are impossible without a structure that allows the sovereign to accede to such demands. The FRC—including the state statutory authorization

56. Levitin, *supra* note 25, at 483–84.

57. See Peter Conti-Brown, *Elective Shareholder Liability*, 64 STAN. L. REV. 409, 447–48 (2012), for an overview of this issue.

and adoption—is that structure and allows the federal government to place these conditions on the expenditure of its funds.

B. State Statutory and Constitutional Authorizations

There would be two state triggers to the creation of the FRC: one would precede the creation and the other would accept or reject the FRC's proposal. The first would entail a constitutional amendment by referendum that would read along the following lines:

> Section 1. The State of [California] hereby declares a budgetary emergency, and authorizes the creation of the Fiscal Restoration Commission, with members appointed as required by federal law.
>
> Section 2. A special referendum shall be scheduled for the first Tuesday after 30 days following the release of the FRC's report. That referendum will read as follows:
>
> > "The duly authorized federal Fiscal Restoration Commission has released its report, which would change [California] law—including by amending the [California] Constitution. That report is available at http://www.fiscalrestoration[ca].gov/fullreport/. The FRC's full report is accepted in its entirety, and given the force of statutory and constitutional law, as specified in that report."
>
> Section 3. Failure to adopt the FRC's full report will preclude any federal governmental assistance to satisfy the exclusive debts of the state.

Three points are worth highlighting here. First, the state trigger is done by initiative. The state's legislature must be deemed, by the people themselves, to have failed to resolve the budgetary crisis. Second, the vote to accept or reject the FRC's report must be complete. There must be no partial acceptance of the FRC's report, unless done so by the state legislature (or through another referendum, which must occur through the usual means), which would use the publicly available FRC report as persuasive authority in its own regular lawmaking. Third, the acceptance of the FRC's report must be the necessary prerequisite to the receipt of federal funds to guarantee the state's liabilities; this would be acknowledged both by the state referendum and the federal statute.

The timing of the statute would be as follows: the federal authorization would allow the federal government to backstop an individual state's debts only via the adoption of the FRC, with plenary authority to propose statutory and constitutional changes where necessary. The state would then initiate its "state of fiscal emergency," request the deployment of federal funds on its behalf, and commit to adopting the FRC's report as a condition of receiving federal funds. The FRC would produce its report, and a second referendum would accept or reject it in its entirety.

C. Benefits

The benefits of the FRC model are several. The model allows a clearing of the cluttered fiscal desk of the state's budget-making. It raises the costs of seeking federal funds, thus mitigating the moral hazard associated with fiscal federalism. And, although I remain skeptical of the law's ability to enforce ironclad precommitments, it at least raises the political cost of reneging on those precommitments.

Perhaps most meaningfully, it allows the problem of too much law, and any directly related fiscal crises, to become truly ripe. This vitiates the ability of partisans to create a crisis at the expense of political opponents. This is not a foregone conclusion. John G. Matsusaka, for example, has presented evidence consistent with the view that direct democracy restricts only a third of the state budget and directs funds to ends that the legislature would already support in the amounts required.[58] Matsusaka's analysis is important and helpful, and this proposal is not inconsistent with those findings. By using direct democracy to address this problem, it waits for a problem to exist. This is markedly different than a regime imposed on the states without their initiation.

Moreover, the FRC provides helpful political cover to those state actors who would advocate for certain fiscally prudent positions consistent with their values, but feel that they cannot do so without offending various constituencies. Bernard Anderson—the former chairman of the Pennsylvania Intergovernmental Cooperation Authority, the Financial Control Board set up in 1991 to supervise Philadelphia's finances—explained his Board's successes in this way:

> I would say that part of the reason we were successful is that an oversight board of the type we have gives elected officials the political cover they need to make unpopular choices and to control spending. In other words, the oversight board, in effect, is a heat shield. The mayor [and] members of the city council can make

58. *See generally* Matsusaka, *supra* note 8 (demonstrating that voter initiatives took up only thirty-three percent of California's spending in 2009–10).

> decisions on spending and blame it on the board because they don't have any choice in the matter, and this can be a very useful device for allowing the city to reduce payrolls, to eliminate services, to restructure government, to introduce new management techniques, to renegotiate labor contracts and do all other things that are necessary.[59]

Providing cover to politicians afraid to do their jobs is not normally considered a virtue in a policy proposal, but in this context, it is exactly that.

III. COUNTERARGUMENTS

The FRC proposal outlined above is certainly bold, but it is also sound as a matter of law and policy. Part III explains why, on both counts.

A. Constitutional Arguments: Sovereignty

Critics may argue that the proposed structure would render a sovereign state's entire fiscal structure subject to the plenary veto of two politicians and their technocratic, bureaucratic staff. It is thus hardly a badge of respect to the states' ability to determine their own futures under principles of federalism. But I think the mechanisms just described fully respect the sovereignty of the states. The adoption of the FRC model is entirely voluntary at two stages: the states must seek the help of the federal government by referendum and then must accept that help through authorized means of constitutional amendment. The first referendum must cede the authority to create wholesale changes to the state's fiscal laws; the second must then approve the FRC package without modification. If sovereignty in the states that rely on direct democracy resides with the people themselves, then the people themselves can legislate as they please so long as no other federal constitutional prohibitions are triggered.

To understand the limits of the federalism critique of this proposal, consider a thought experiment. Suppose Iceland has made a mess of things and is in dire need of getting its fiscal house in order. Politicians lack confidence in their own ability to do so, leading them to seek assistance from their creditors—mostly the English, in various public and private capacities. To do so, the English impose a set of conditions that if unmet will preclude assistance. Has Iceland's

59. *Hearings*, *supra* note 27, at 68–69.

sovereignty been abridged?

The answer is obviously no, and the analogy is not hypothetical.[60] Nor would one find that sovereignty had been abridged in the other equally applicable analogies of Greece *vis-à-vis* the European Union (EU); Argentina *vis-à-vis* the International Monetary Fund (IMF); or heavily indebted African countries *vis-à-vis* the World Bank and its bilateral creditors. Of course, the relationship between California and the United States is not the same as Iceland and the UK, Greece and the EU, or Argentina and the IMF, but the analogy between these sovereign interactions and the ones contemplated by the FRC proposal is sufficiently apt.

That said, the proposal here would no doubt trigger significant criticism on these grounds. The nature of federalism in the United States remains, of course, one of the most widely and hotly argued topics in both academic and public spheres—consider, for example, the recent debates over the constitutionality of the Affordable Care Act's Medicaid expansion.[61] Congress has long had the ability to make conditional federal grants to state governments subject to the limits of the Spending Clause[62] of the Constitution.[63] The Supreme Court identified these limits in *South Dakota v. Dole*.[64] The limits are five: (1) the condition must be in pursuit of the general welfare of the United States, a question on which "courts should defer substantially

60. *A Parable of Two Debtors: Does Iceland Hold Lessons for Ireland and the Rest of Troubled Europe?*, THE ECONOMIST, Apr. 14, 2011, http://www.economist.com/node/18557977.

61. *See* Lyle Denniston, *Argument Preview: Health Care, Part IV—The Medicaid Expansion*, SCOTUSBLOG (Mar. 23, 2012, 12:02 AM), http://www.scotusblog.com/2012/03/argument-preview-health-care-part-iv-the-medicaid-expansion/ (describing the "angry public discourse" over limited government in the healthcare debate).

62. U.S. CONST. art. I § 8, cl. 1 ("The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.").

63. *See* Oklahoma v. Civil Serv. Comm'n, 330 U.S. 127, 143 (1947) (explaining that "[w]hile the United States is not concerned with and has no power to regulate local political activities as such of state officials, it does have power to fix the terms upon which its money allotments to states shall be disbursed"). For academic discussion of these questions, see generally Lynn Baker, *Conditional Federal Spending and States' Rights*, 574 ANNALS 104 (2001) (explaining why the Supreme Court will likely reconsider *South Dakota v. Dole*'s germaneness test); Thomas R. McCoy & Barry Friedman, *Conditional Spending: Federalism's Trojan Horse*, 1988 SUP. CT. REV. 85 (1988) (arguing that the Supreme Court's decision in *South Dakota v. Dole* has subverted basic principles of federalism); Albert J. Rosenthal, *Conditional Federal Spending and the Constitution*, 39 STAN. L. REV. 1103 (1987) (arguing that the conditional spending power's invalid intrusion test requires closer scrutiny).

64. 483 U.S. 203 (1987).

to the judgment of Congress;"[65] (2) "if Congress desires to condition the States' receipt of federal funds, it must do so unambiguously;"[66] (3) the condition must relate "to the federal interest in particular national projects or programs;"[67] (4) the condition cannot independently violate another constitutional provision;[68] and (5) the condition cannot be "so coercive as to pass the point at which pressure turns into compulsion."[69]

The FRC and the associated legislative enactment satisfy the *Dole* test, in each case but one, by obvious implication in no need of further elaboration. The protection of the federal fisc is appropriately within the "general welfare" of the United States. The entire point of the FRC is to make the condition "unambiguous."[70] The federal interest in preventing state bailouts is centrally related to the condition. There is no obvious alternative provision of the Constitution that the FRC would violate.

The only potential argument is that conditioning the grant of federal funds for a state bailout on the acceptance of the FRC's report may be sufficiently coercive to render it unconstitutional. Again, at the time of this essay's publication, the "coercion" element of *South Dakota v. Dole* remains unsettled and will be clarified by the Supreme Court's historic consideration of the Obama Administration's healthcare law.

At present, though, the element of coercion is not established in the context of the FRC. To conclude otherwise would be to assert that the alternative to the federal condition—that the state must resolve its own fiscal problems, including whatever problems the fiscal constitutions created via direct democracy—is so unsatisfactory that the promise of federal money coerces the state's compliance with the FRC. This Hobson's choice argument is unpersuasive, and indeed,

65. *Id.* at 207.
66. *Id.* (internal citations omitted).
67. *Id.* (internal citations omitted).
68. *Id.*
69. *Id.* at 211.
70. The preamble of the Dodd-Frank Wall Street Reform and Consumer Protection Act, for example, tells us that it is designed to "end 'too big to fail'" and "to protect the American taxpayer by ending bailouts." Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C.A § 5301). Section 214 ("Prohibition on Taxpayer Funding") further guarantees that "taxpayers shall bear no losses from the exercise of any authority under this title." Pub. L. No. 111-203, § 214(c), 124 Stat. 1518 (2010) (codified as amended at 12 U.S.C.A § 5394). There is no reason, given the political toxicity of the idea of bailouts, that we would expect congressional statutory drafters to be coy in allowing, preemptively, for congressional bailouts.

suggests limits to state sovereignty that the Constitution does not sanction. The coercion argument just described makes the states passive actors in their own fiscal policy-making. Instead, the FRC allows for a legitimate choice between two competing restructuring regimes: either use the tools already available to the state—default, tax increases, spending decreases, etc.—or use the federal government as a guarantor subject to the requirements that the state's fiscal and legal house be put in order. This essay leaves further elucidation of these squarely constitutional arguments to constitutional scholars, but does not concede that the FRC statutory scheme described above comes close to the line of "coercion," wherever that line may reside.

Voluntary cession of this kind of authority is not uncontroversial in the context of state bankruptcy,[71] which is also doubly voluntary in the sense that the state has the authority both to seek bankruptcy protection and then to propose its new plan itself. But the voluntariness of the FRC is even more protective of state sovereignty in two respects. First, in bankruptcy, for example, the state proposes the reorganization plan, but must abide by the plan's final adjudication by federal courts including, ultimately, the U.S. Supreme Court. Here, the final adjudication is performed by the voting citizens of the state. Although parties whose interests are harmed by the legislative or constitutional reorganization that an FRC plan might entail may have recourse to the federal courts, as would any party jilted by the exercise of state governmental authority, that judicial review will be much more limited. The cession of control by the states in an FRC-style proposal is consequently, at least in the context of adjudication, less complete than is the case in state bankruptcy. And in the context of fiscal policy-making, such limited judicial review is very desirable indeed.

Second, the FRC proposal is more respectful of state sovereignty by putting the question of federal delegation—to courts in state bankruptcy, to the FRC in the proposal described above—to the source of the state sovereignty: the people, not the legislature. If it is the case that the state fiscal policy apparatus is deeply dysfunctional, allowing the state to prepare the reorganization plan may create the same political pressures that put the state in uncertain legal footing in the first place. This is not necessarily so: again, state bankruptcy seeks

71. Michael W. McConnell, *Extending Bankruptcy Law to States: Is It Constitutional?*, *in* WHEN STATES GO BROKE, *supra* note 2, at 232–35.

to address a fundamentally different problem than the one contemplated in this essay. But to the extent that there is overlap, state bankruptcy proposals that are initiated through the political process that created the crisis in the first place may face significant barriers to their success.

B. Contract Clause

The constitutional concern that has the most traction is that the Commission's recommendation would include adjustments to the state's contracts that would violate the Contract Clause of the Constitution.[72] This is a concern, especially to the extent that the FRC must change the contracts already in place, say, with employees or bondholders.

This is a strong argument: the Contract Clause would unquestionably restrict the FRC in what it could propose. The reason that such a flaw is not fatal is that the FRC includes the plenary power to do anything that is legally enforceable, since it represents a change of statute and state constitution by referendum. In other words, if it is possible for the state to change its employment contracts or default on its bonds outside the context of the FRC, it will be possible to do so within that context. This is not to say that such spurned creditors will not have judicial recourse, in the way that any change in law would similarly provide judicial recourse. This is an issue that future scholars—and, if this proposal gains any traction, policy-makers and, eventually, members of the FRC—will have to analyze more carefully. But the main point is the same: if it is possible to abridge a contract via statute (in the form of changing prospective pensions, employee benefits, interest rates, services, etc.), then so too would it be possible through the FRC.

C. Why is the FRC Better than Bankruptcy?

The leading alternative—and, it seems, almost exclusively academic—proposal is "state bankruptcy." This proposal would modify the federal Bankruptcy Code to allow states voluntarily[73] to file for bankruptcy, which would allow a bankruptcy court to adjudicate the claims of the states' various creditors.

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72. U.S. CONST. art. I, § 10, cl. 1 ("No State shall . . . pass any . . . Law impairing the Obligation of Contracts.").

73. *But see* Adam Feibelman, *Involuntary Bankruptcy for American States*, 7 DUKE J. CONST. L. & PUB. POL'Y 81 (2012) (arguing that voluntariness is not necessary).

The essay has already addressed some of the concerns for state bankruptcy. But the emphasis on the comparison should be on the fact that the FRC is a complementary proposal, not a competitive one, and attempts to solve a fundamentally different problem: state bankruptcy seeks to resolve the problem of excess debt, and the FRC seeks to resolve the problem of excess law. But even to the extent that the two policies overlap, the FRC offers benefits that state bankruptcy proposals do not. To understand why, it is necessary first to note what problems the "state bankruptcy" label creates. A chorus of scholars have challenged its viability and advisability. As Anna Gelpern has argued, the very concept of state bankruptcy "flips the logical sequence: it posits an institutional fix for a theoretically undefined and empirically contested problem. As a result, a debate that should be filling gaps in public debt theory yields yet another chapter on the uses of bankruptcy."[74] Moreover, Gelpern argues, "the bankruptcy label presumptively narrows the inquiry, making creditor collective action problems and the Contracts Clause of the U.S. Constitution play host to broader principles of fiscal policy and democratic governance," leading to a "distort[ed]" policy conversation.[75] Finally,

> the bankruptcy label injects the intellectual and political conflicts of bankruptcy into the world of public debt. "Bailout" and "cramdown" are fighting words in both worlds, but such overlaps are misleading. Talking about state debt as "state bankruptcy" sets the stage for replaying entrenched arguments from a different field, and threatens to derail a useful exchange for the wrong reasons.[76]

State bankruptcy is thus, at best, a metaphor—and not necessarily an apt one—for the fiscal crises that states face. As Steven Schwarcz has put it, "extending municipal bankruptcy law to states . . . can bring in a lot of excess baggage."[77]

Schwarcz's own solution would be what he terms a "minimalist" approach, which is essentially bankruptcy-lite: it places the authority to approve and finance the state's restructuring in a "Supervisory Authority," but with a more removed role in dictating the terms of the

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74. Anna Gelpern, *Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt*, 121 YALE L.J. 888, 891 (2012).

75. *Id.*

76. *Id.* at 891.

77. Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy"*, 59 UCLA L. REV. 322, 326 (2011).

renegotiation than would occur in state bankruptcy.[78]

David Skeel, the leading academic proponent of a state bankruptcy proposal, recognizes the "baggage" that the label brings. He also critiques "the tendency to envision bankruptcy in monolithic terms, as a single framework rather than a wide range of possible restructuring mechanisms."[79] To the extent that state bankruptcy represents that "wide range," even the FRC fits within these proposals. In that sense, the debate over state bankruptcy is better cast as between those who believe that there should be a model for debt restructuring of *any* kind, regardless of the involvement of the federal government, and those who think there should not. The finer points of the debate sometimes get lost in the problem of labeling that both Gelpern and Skeel have identified.

The fact that the FRC proposal and the proposals of Skeel, Schwarcz, and others who advocate a form of state bankruptcy are part of the same recognition—that there may be a problem with state debt that the usual process cannot resolve—partially illustrates why the FRC proposal is not incompatible with state bankruptcy. But the complement is more pronounced even than that. Because state bankruptcy aims to eliminate state debt as opposed to state law, such proposals would fare better than the FRC at the renegotiation of specific, retroactive contracts because the FRC likely would be limited in doing so by the Contract Clause of the Constitution.

The FRC addresses something different, and aims not simply at the symptoms of fiscal crises, but at their core. If the main problem with state fiscal crises is a broken system of fiscal constitutions, then renegotiation of debt will start the states back with the same broken system that likely will flare up at the next economic downturn. Perhaps the best solution, then, would be a mechanism like the FRC (by which *laws* can be cleared) legislated in tandem with a state reorganization mechanism (by which *debts* can be cleared).

In this sense, the FRC proposal follows the suggestion of George Triantis that a state bankruptcy regime should be initiated by the states and not by the federal government.[80] He argues:

78. *See id.* at 351 n.153 (allowing the Supervisory Authority to impose conditionality pursuant to a back-to-back lending structure when funding has been privatized).

79. Skeel, *supra* note 1, at 3.

80. George Triantis, *Bankruptcy for the States and by the States*, *in* WHEN STATES GO BROKE, *supra* note 2, at 237.

> The state bankruptcy process should be enacted by state legislation for the following reasons: (1) state circumstances and political preferences vary, and each state can tailor its bankruptcy process, (2) the state would internalize the cost of issuing debt under the bankruptcy regime of its choice and this would reduce the rent-seeking distortions in the legislative process, and (3) particularly if combined with federal legislation that is expressly a default, allowing states to pass their own, this may further minimize the pressures for a federal bailout in the future.[81]

Because the FRC is state-initiated, even if federally approved, it allows for state tailoring that a top-down model would not. Essentially, one FRC's recommendations for California would not be the same as a different FRC's recommendations for, say, Colorado.

D. The Federal Government Caused the Crisis

A last critique of the FRC model, or indeed any other model, would be that the states did not cause their crises: the federal government did.[82] The idea is that the federal government has shifted the fiscal burden of healthcare, welfare, education, and other services to the state governments, including through unfunded mandates. Recall Rodden's argument that such entanglement of central and semi-autonomous regional governments in the provision of services leads to a greater likelihood of bailout.[83] In light of that reality, why should the states be burdened with remaking their laws in order to accommodate a hostile federal government that created the crisis in the first place?

To that argument, I have no answer, except to say that a state-initiated recovery from budgetary restrictions strikes me as more plausible than a wholesale reversal of the defederalization of government benefits and services.

IV. CONCLUSION

This essay has made the preliminary case for a Fiscal Restoration Commission, a federal commission that would dictate, at the state's

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81. *Id.* at 6.

82. Damon Silvers, *Obligations Without the Power to Fund Them: The Origins, Consequences, and Possible Solution to the Fiscal Crisis of the States*, *in* WHEN STATES GO BROKE, *supra* note 2, at 1.

83. *See* Jonathan Rodden, *Market Discipline and U.S. Federalism*, *in* WHEN STATES GO BROKE, *supra* note 2, at 143 (claiming that market discipline would be enhanced by efforts to disentangle obligations of federal and state governments).

request and subject to the state's approval, the statutes and constitutional provisions that have otherwise limited the state's ability to put its fiscal house in order. It would be a *law*-clearing mechanism, not a *debt*-clearing one, which represents its main strengths and main weaknesses in allowing for meaningful resolution of fiscal crises. But it would also mitigate two real harms commonly discussed in the debate about the states' fiscal situations. First, it requires that there actually be a crisis. As many commentators have observed, fiscal crises are political crises, not economic ones.[84] While there is no question that the states face enormous pressure and sometimes significant budget shortfalls, the real question is whether the states have the political will to resolve these questions in ways that citizens will respect. In the event that the answer is no, the FRC can provide an alternative. Second, by making the provision of federal funds contingent on the adoption of the FRC's report, the proposal here significantly lessens—though, almost certainly, does not eliminate—the likelihood of federal bailouts of individual states, with the associated skewed incentives and moral hazard that results.

84. *E.g.*, Silvers, *supra* note 82, at 45; Levitin, *supra* note 25, at 214.