

THE FINANCE, ECONOMICS, AND LAW OF FISCAL CRISES

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COURSE: Our aim in this course is to introduce students to the finance, economics and law of government fiscal crises and the resulting implications for citizens and the private economy. The focus will be on the causes of fiscal crises, a careful detailing of who wins and who loses, and then on how such crises might be resolved and, perhaps most importantly, how they might be prevented in the future. The course will draw upon the fiscal experiences of U.S. local governments (New York, Philadelphia, Detroit, Orange County, Puerto Rico), utilities (WPPSS) and states (Illinois), and the international experience from such countries as Greece, Brazil, and Argentina. The costs of such crises for citizens, pensioners, and bond holders can be significant. We seek to understand the underlying economic, political, and legal/regulatory causes of such events so that they may be prevented in the future. The importance of private information and public regulation for disciplining the fiscal performance of democratically elected governments will be a central concern. We believe strongly that diagnosing and treating the “disease” of fiscal mismanagement is an interdisciplinary endeavor drawing on finance, economics, political science, and the law. Students with backgrounds in any of these disciplines are welcome. As a seminar class enrollment will be limited to a total of 40 students, divided (about equally) between Wharton and Law students.

ASSIGNMENTS AND GRADING: Students will be responsible for the readings for each class and will be expected to participate actively in class presentations and discussions. Students will be responsible for a midterm examination (week of March 29) and a paper at the end of the semester. The paper will be a maximum of 14 pages, double spaced (excluding appendices). , double-spaced. Grades will be based upon class participation (30 percent), the mid-term examination (30 percent), and the paper (40%). The course is scheduled for 3 hours (with a break) once a week and will be taught in seminar style. Classes often will entail one “session” for faculty presentation and a second “session” for group discussion. Students will be expected to actively participate in class discussions.

READINGS: Required and optional readings for each class will be noted before class. Readings marked with an * are more technical and will be summarized in class, but introductions and conclusions should at least be skimmed for an understanding of their core ideas. We will be available to discuss those readings in detail – with an obvious division of labor.

COURSE SCHEDULE

I. Introduction: When Do Governments Default and Should We Care? : January 18

NYTimes, “Worsening Debt in Poor Nations Threatens Crisis” December 4, 2022.

II. Economics and Politics of Public Debt: January 25 and February 1

A. Economic Theory of Public Debt:

H. Rosen, *Public Finance* “Taxation” (Chapter 13) and “Debt” (Chapter 18).

B. Political Theory of Public Debt:

Kriss Sjoblum, “Voting for Social Security,” *Public Choice*, 1985.

* Andrés Velasco, “Debt and Deficits with Fragmented Fiscal Policy-Making,” *Journal of Public Economics*, 105-125, 2000.

Pierre Yared, “Rising Government Debt: Causes and Solutions for a Decade-Old Trend,” *Journal of Economic Perspectives*, 2019.

Jagadeh Gokhale and Kent Smetters, “Fiscal and Generational Imbalances: An Update,” *Tax Policy and the Economy*, 2006.

C. Legal Theory of Public Debt: When Is Debt *Odious*?

Patrick Bolton and David Skeel, “Odious Debt or Odious Regimes?” *Law and Contemporary Problems*, 2007.

* Viral Acharya, Raghuram Rajan, Jack Shin, “When is Debt Odious? A Theory of Government Repression, Growth Traps, and Growth Boosts,” Becker Friedman Institute, WP 2022-106.

III. Fiscal Crises in Historical Perspective Feb. 8

A. The Founders’ Debt Debate

Alexander Hamilton, *Report on Public Credit*, Jan. 9, 1790

B. Trade-offs in the 19th Century

David Schleicher, *States of Insolvency*, Chapter 1-2.

IV. How to Have a Fiscal Crisis February 15 and 22, March 1.

A. The Path to a Fiscal Crisis

* Henning Bohn, "The Behavior of US Public Debt and Deficits?" *Quarterly Journal of Economics*, 1998.

Ricardo Reis, "Debt Revenue and Sustainability of Public Debt," *Journal of Economic Perspectives*, 2022.

B. Economics Fundamentals and Fiscal Crises

Nathan Bomey, *Detroit Resurrected: To Bankruptcy and Back* (2016), Chapters 1 and 2.

C. Political Causes of Fiscal Crises

Robert Inman, "Anatomy of a Fiscal Crisis," *Business Review: Federal Reserve Bank of Philadelphia*, 1983.

Robert Inman, "How to Have a Fiscal Crisis," *American Economic Review*, 1995.

D. Financial Causes of Fiscal Crises

Philippe Jorion, *Derivatives and Bankruptcy in Orange County: Big Bets Gone Bad*, Chapters 1-10.

Joshua Rauh, "Hidden Debt, Hidden Deficits: 2017 Edition," Hoover Institution. 2019.

* M. Azzimonti, E.D. Francisco, V. Quadrini, "Financial Globalization, Inequality, and Rising Public Debt," *American Economic Review*, 2014.

E. Legal Causes of Fiscal Crises

Burgos v. State of New Jersey, 118 A. 3d 270 (NJ Supreme CT. 2015)

Selected Puerto Rico and Illinois Ruling and Constitutional Provisions

V. Consequences of a Fiscal Crisis: March 15 and 22

A. Economic Consequences (Static)

* Andrew Haughwout and Robert Inman, “Fiscal Policies With Firms and Households in Open Cities with Firms and Households,” *Regional Science and Urban Economics*, April, 2001.

B. Economic Consequences (Dynamic)

* Viral Acharya, Raghuram Rajan, Jack Shin, “When is Debt Odious? A Theory of Government Repression, Growth Traps, and Growth Boosts,” Becker Friedman Institute, WP 2022-106.

C. Fiscal Consequences

New York City: Martin Shefter, *Political Crisis, Fiscal Crisis: The Collapse and Revival of New York City*, Chapter 6: The Fiscal Crisis and Its Budgetary Consequences.

* *Greece*: Pierre-Olivier Courinchas, Thomas Phillipon, and Dimitri Vayanos, “The Analytics of the Greek Crises,” *NBER Macroeconomic Annuals*, 2016.

Puerto Rico: The New Fiscal Plan for Puerto Rico: Restoring Growth and Prosperity, May, 2019, pp. 8-13, 49-54.

D. Financial Consequences

Edward Gramlich, “New York City Fiscal Crisis: What Happened and What Is to Be Done?” *American Economic Review*, 1976.

Josefin Meyer, Carmen Reinhart, Christoph Trebesch, “Sovereign Bonds Since Waterloo,” NBER Working Paper, 25543

*Viral Acharya and Raghuram Rajan, “Sovereign Debt, Government Myopia, and the Financial Sector,” *Review of Financial Studies*, 2013.

*Franklin Allen and Douglas Gale, “Financial Contagion,” *Journal of Political Economy*, 2000.

MIDTERM EXAMINATION COVERING SECTION I-V: Week of March 29

VI. Managing a Fiscal Crisis: March 29 and April 5

A. Austerity

Alberto Alesina, Carlo Favero, Francesco Giavazzi, “Effects of Austerity: Expenditure-Based and Tax-Based Approaches,” *Journal of Economic Perspectives*, 2019.

Alberto Alesina and Dorian Carloni, and Giampaolo Lecce, “The Electoral Consequences of Large Fiscal Adjustments,” in *Fiscal Policy After the Financial Crisis*, NBER WP 17655.

Pablo Gluzmann, Martin Guzman, and Joseph Stiglitz, “An Analysis of Puerto Rico Debt Relief Needs to Restore Debt Sustainability,” NBER WP 25256.

B. Bailouts:

Robert Inman, “Transfers and Bailouts,” in Rodden (ed.) *Fiscal Decentralization and the Challenge of Hard Budget Constraints*, 2003.

C. Fiscal Oversight:

Clayton Gillette, “Dictatorships for Democracy: Takeovers of Financially Failing Cities,” *Columbia Law Review*, 2014.

PEW Foundation, “The Future of Fiscal Oversight in Philadelphia – PICA.”

B. Capraru, G. Georgescue, N. Sprincean, “Fiscal Rules, Independent Fiscal Institutions, and Sovereign Risk,” Independent Social Fund, 2022.

D. Bankruptcy:

Clayton Gillette and David Skeel, “Governance Reform and the Judicial Role of Municipal Bankruptcy,” *Yale Law Journal*, 2016.

Expert Report of Martha Kopacz Regarding the Feasibility of the City of Detroit Plan of Adjustment, 2014, 103, 120-121, 199-207.

* David Schoenherr and Jan Starmans, “When Should Bankruptcy Law be Creditor or Debtor Friendly? Theory and Evidence,” *Journal of Finance*, 2022.

VII. Preventing a Fiscal Crisis I: Information: April 12

A. Hidden Debt

Robert Inman, “Do You Know How Much Money is in Public Purse?” *Business Review, Federal Reserve Bank of Philadelphia*, 19XX.

Sebastian Horn, Carmn Reinhart, Christoph Trebesch, “Hidden Defaults,” *American Economic Review, Papers and Proceedings*, 2022.

B. Accounting Standards

Andrew Haughwout and Robert Inman, “The How’s, Why’s, and Consequences of State and Local Deficits,” *State Finances and Fiscal Crises*, Cambridge University Press.

C. Rating Agencies

Standard and Poors, *Guide to Credit Ratings Essentials*.

Lawrence White, “Credit Rating Agencies: An Overview,” *Annual Review of Financial Economics*, 2013.

J. Leigland and R. Lamb, “A Case Study in WPPSS Credit Analysis,” in *Who Is to Blame for the WPPSS Disaster*.

* Konrad Stahl and Roland Strausz, “Certification and Market Transparency,” *Review of Economic Studies*, 2017.

D. Market Information and Fiscal Efficiency:

Itay Goldstein and Haresh Sapra, “Should Banks’ Stress Test Results be Disclosed? An Analysis of the Costs and Benefits,” *Foundation and Trends in Finance*, 2013. (As you read this article, substitute the word “government” for “bank” and it will be a perfect fit for our agenda.)

* Itay Goldstein and Liyan Yang, “Information Disclosure in Financial Markets,” *Annual Review of Financial Economics*, 2017.

Robert MacKay, “Implicit Debt Capitalization in Local Housing Prices: An Example of Unfunded Pension Liabilities,” *National Tax Journal*, 2014.

E. Transparency and Political Accountability

James Naughton and Holger Spamann, “Fixing Public Sector Finances: the Accounting and Reporting Lever,” *UCLA Law Review*, 2015.

“Mendoza Model: The Wine-Growing Province Offers Lessons on How to Reform,” *Economist*, March 30, 2019

VIII. Preventing a Fiscal Crisis II: Regulation and Balanced Budget Rules: April 19

Robert Inman, “Do Balanced Budget Rules Work? US Experience and Possible Lessons for the EMU,” in Horst Siebert (ed.), *Quo Vadis Europe*.

Philip Joyce, “What’s so Magical About Five Percent? A Nationwide Look at Factors That Influence the Optimal Size of State Rainy Day Funds,” *Public Budgeting and Finance*, 1997. .

IX. Investing in Distressed Credits:

(Supplemental Class, Readings will be distributed to the class and we are happy to meet to discuss as convenient for those interested.)

A. Predicting a Crisis

Xavier Debrun, et. al., “Public Debt Sustainability,” in Rogoff (ed.), *Sovereign Debt: a Guide for Economists and Practitioners*.

B. Predicting a Bailout

Robert Inman, "Transfers and Bailouts," in Rodden (ed.) *Fiscal Decentralization and the Challenge of Hard Budget Constraints*, 2003.

C. Predicting a Settlement

Robert Inman, The Allocation of Settlement for Defaulted WPPSS 4/5 Bonds.

D. Case Study:

Donald Keim, "The Risk and Return Characteristics of WPPSS 4/5 Bonds."