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### Mandatory Disclosure for Municipal Securities: A Reevaluation

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# Mandatory Disclosure for Municipal Securities: A Reevaluation

ANN JUDITH GELLIS\*

## TABLE OF CONTENTS

I.	INTRODUCTION .....	16
II.	ROLE OF INFORMATION.....	21
	A. <i>Efficient Allocation of Savings</i> .....	22
	1. Revenue Bonds .....	22
	2. General Obligation Bonds .....	23
	B. <i>Adjustment Mechanism</i> .....	24
III.	THE INADEQUACIES OF THE TRADITIONAL RATIONALES AGAINST MANDATORY DISCLOSURE FOR MUNICIPAL SECURITIES.....	25
	A. <i>Low Credit Risk</i> .....	26
	1. Default Rate .....	26
	2. Indirect Measures of Risk: Yield Structure and Insurance.....	30
	3. Other Factors .....	33
	B. <i>Nature of Investors</i> .....	34
IV.	APPLICATION OF THE MARKET INCENTIVES THEORIES OF VOLUNTARY DISCLOSURE TO THE MUNICIPAL SECURITIES MARKET .....	40
	A. <i>Arguments Against Mandatory Corporate Disclosure</i> ....	40
	B. <i>Are the Arguments Against Mandatory Corporate         Disclosure Applicable to Municipal Issuers?</i> .....	44
	1. Goals and Incentives.....	45
	a. Politicians.....	45
	b. Bureaucracy .....	50
	i. Importance of Bureaucracies in the Flow of Information .....	50

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ii. Bureaucratic Motivations . . . . .	51
iii. Information Control by Bureaucrats in the Budgetary Process . . . . .	53
2. Controls . . . . .	56
a. Legislators . . . . .	57
b. Citizens . . . . .	59
c. Interest Groups . . . . .	61
d. Investors . . . . .	62
e. Underwriters . . . . .	63
V. EMPIRICAL EVIDENCE CONCERNING MUNICIPAL DISCLOSURE . . . . .	65
VI. CONCLUSION . . . . .	70

## I. INTRODUCTION

IN 1984 there were 8,183 new publicly offered issues of municipal securities.<sup>1</sup> Their aggregate dollar volume substantially exceeded that of all publicly issued corporate securities.<sup>2</sup> Unlike the corporate securities market, however, public offerings of municipal securities are not subject to the registration requirements of the Securities Act of 1933 ("1933 Act"),<sup>3</sup> nor are municipal issuers subject to reporting requirements under the Securities Exchange Act of 1934 ("1934 Act").<sup>4</sup> This Article argues

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1. THE BOND BUYER'S MUNICIPAL STATBOOK 1984, at 7 [hereinafter MUNICIPAL STATBOOK]. The term "municipal securities" refers to the debt obligations of both states and local governments. As of June 1, 1983, there were over 80,000 local governmental units, a term which is defined by the United States Department of Commerce, Bureau of the Census, to include municipalities, counties, townships, school districts and special districts. In 1983, the outstanding municipal debt totaled \$454,501 billion, representing an estimated 52,000 issuers and one and one-half million separate issues. A majority of the municipal borrowers were special districts and statutory public authorities (classified as special districts by the Bureau of Census). U.S. GENERAL ACCOUNTING OFFICE, TRENDS AND CHANGES IN THE MUNICIPAL BOND MARKET AS THEY RELATE TO FINANCING STATE AND LOCAL PUBLIC INFRASTRUCTURE, S. DOC. NO. GA 1.13 PAD 83-46, at 2, 14 (1983) [hereinafter GAO REPORT].

2. New issue dollar volume of municipal securities for 1984 was \$132,950 billion, as compared with \$95,986 billion in publicly offered corporate securities (equity and debt). THE BOND BUYER, May 8, 1986, at 24; MOODY'S INVESTOR SERVICE, MOODY'S INDUSTRIAL MANUAL FOR 1985, at 26.

3. Securities Act of 1933, 15 U.S.C. § 77a (1982) [hereinafter 1933 Act]. Section 3(a)(2) of the 1933 Act exempts from the registration and prospectus requirements of Section 5 securities issued by "any State of the United States, or by any political subdivision of a State or territory or by any public instrumentality of one or more States or territories . . . ."

4. Securities Exchange Act of 1934, 15 U.S.C. § 78a (1982) [hereinafter 1934 Act]. As "exempted securities" under Section 3(a)(12) of the 1934 Act, municipal securities are not subject to the reporting requirements of Sections 12 and 13 of the 1934 Act. The antifraud provisions of Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act are, however, applicable to transactions in

that it is time to re-evaluate the decision of fifty years ago not to impose these registration and reporting requirements on municipal issuers.

The historical reasons for exempting state and local government issuers from the federal disclosure regulations stem, in part, from the perceived nature of municipal securities as relatively risk free investments that, because of the tax-exempt feature of the securities, appealed primarily to investors capable of fending for themselves in the marketplace. To the extent Congress considered the question of whether to make the 1933 Act applicable to offerings of municipal securities, there was a reluctance to encroach upon an area as politically sensitive as state financing when other factors indicated that there was not a pressing need for federal intervention.<sup>5</sup>

Despite a tremendous increase in the amount of state and local borrowing after World War II, accompanied by an increasing reliance on revenue bond financing rather than general obligation bond financing,<sup>6</sup>

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municipal securities. Dealers and brokers in municipal securities are subject to regulation under Section 15B of the 1934 Act, which was added in 1975 and created the Municipal Securities Rulemaking Board to govern the activities of municipal securities dealers.

5. For a discussion of the legislative history of the exemptions for municipal securities from the federal securities laws, see Note, *Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation*, 28 VAND. L. REV. 561, 582-86 (1975); see also Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. W. L. REV. 29, 46 (1959).

6. State debt in 1972 was 23.1 times that of 1946, while local debt increased almost nine-fold in that period. W. SMITH, *THE APPRAISAL OF MUNICIPAL CREDIT RISK* 172 (1979). The average annual growth of municipal bond issues in the period 1946-65 was 12.4% as compared with an average growth of less than 4% in gross national product and 5.3% average annual growth for corporate bonds for the same period. STUDY PREPARED FOR THE SUBCOMMITTEE ON ECONOMIC PROGRESS OF THE JOINT ECONOMIC COMMITTEE 89TH CONG., 2D SESS., *STATE AND LOCAL PUBLIC FACILITY NEEDS AND FINANCING*, vol. 2, 243 (Comm. Print 1966) [hereinafter JEC REPORT]. For a discussion of the increase in state and local government expenditures in the period 1946-65, see *id.* at 53-60. The compound annual rate of increase in outstanding debt of state and local governments for the period 1946-80 was 9.4%. L. MOAK, *MUNICIPAL BONDS PLANNING, SALE AND ADMINISTRATION* 4 (1982).

Revenue bond financing constituted 17.1% of the municipal issues in 1946, issued primarily to finance municipal utility systems and (to a lesser extent) toll roads and bridges. JEC REPORT, *supra*, at 157. Since 1977, revenue bonds have constituted over 50% of the long-term bond market. GAO REPORT, *supra* note 1, at 15. In 1984, over 70% of the market was revenue bond financing. MUNICIPAL STATBOOK, *supra* note 1, at 7. The increase in the use of revenue bonds is related, in part, to the greater reliance on special districts and authorities for the provision of government services. In many cases, these units, particularly public authorities, do not have general taxing power and therefore cannot issue general obligation bonds.

Increasing use of revenue bonds is also related to a shift in the use of bond proceeds from the more traditional uses (for example, roads and utilities) to nontraditional uses: housing, hospitals, industrial development, pollution control, and student loans (or what is sometimes referred to as "on behalf of debt"). The ten year period from 1970-80 saw a 49% increase in "on behalf of" financing. (This figure includes financing for municipally-owned electric and gas utilities but not other utilities.) L. MOAK, *supra*, at 14. Most of this debt was revenue bond financing. In 1980 "on behalf of" debt

the decision not to require disclosure of information by municipal issuers went unquestioned until April, 1975, when New York City, with \$600 million in short term notes due and no money in its coffers, could not find a market for any more of its securities to raise the needed funds.<sup>7</sup> At the time of New York City's financial collapse, it had over \$14 billion of debt outstanding, of which approximately one-half was short-term debt, theoretically secured by either tax receipts or other city revenues.<sup>8</sup> Examination after the fact revealed that New York City had come to the brink of bankruptcy as a result, among other things, of extensive and long-standing abuses in the city's financial practices that inflated reported revenues to cover ever expanding budget deficits.<sup>9</sup>

As the story of New York City's fiscal plight unfolded, reforms were called for. The market had clearly been unaware of the City's serious financial position until it was too late. By all accounts of the fiscal crisis, it appears that the major participants in the underwriting of the City's securities—the City's underwriters and bond counsel—neither understood the information given them nor sought explanations or further information. Two bills were introduced in Congress to require mandatory disclosure by municipal issuers,<sup>10</sup> but neither of these bills became law.<sup>11</sup>

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(not including any municipally-owned utilities) formed 52% of the long-term bonds issued. W. JACKSON, CAPITAL, CREDIT, AND CROWDING OUT: CYCLES AND TRENDS IN FLOWS OF FUNDS OVER THREE DECADES, CRS-44 n.35 (Congressional Report Service Report No. 82-142E, August 1, 1982).

7. SUBCOMMITTEE ON ECONOMIC STABILIZATION OF THE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 95TH CONG., 1ST SESS., STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK 245 (Comm. Print 1977) [hereinafter SEC REPORT] (transmitting Securities and Exchange Commission Report). With the City's last offering in March, 1975, New York had issued \$4 billion in short-term debt in the previous six month period. The city needed an estimated \$2 billion in borrowings for the remainder of fiscal 1975 (ending June 30, 1975) to cover its projected deficit, of which approximately \$1.5 billion would be short-term. SEC REPORT, *supra*, ch.1, at 235; C. MORRIS, THE COST OF GOOD INTENTIONS-NEW YORK CITY AND THE URBAN EXPERIMENT, 1960-1975, at 228 (1980). For a detailed account of the events leading up to the closing of the financial markets to the city's securities, see generally SEC REPORT, *supra*, at ch.1.

8. SEC REPORT, *supra* note 7, Introduction and Summary, at 2. Over \$1 billion in short-term debt was issued against anticipated property tax revenues and over \$3 billion was issued against other city revenues, including other taxes and federal monies. *Id.* The City's short-term obligations made up over 40% of the municipal note market. C. MORRIS, *supra* note 7, at 223.

9. It has been estimated that the property tax receivables were overstated by approximately \$408 million. Similar gaps in other anticipated revenues existed. The New York State Comptroller found, for example, that intergovernmental aid had been overstated by \$324.6 million. SEC REPORT, *supra* note 7, Introduction and Summary, at 4. An internal memorandum from the City Comptroller's office in October, 1974, suggested that \$2.7 billion of New York City receivables would be required to be written off under generally accepted accounting principles. C. MORRIS, *supra* note 7, at 223.

10. A Senate bill introduced by Senator Eagleton would have removed the exemption in Section

Congress' decision not to place any disclosure requirements on municipal issuers must be viewed in light of the *National League of Cities v. Usery*<sup>12</sup> decision in 1976, which resuscitated the tenth amendment as an independent check on the exercise of the commerce power by Congress. While the *National League of Cities* case raised more questions than it answered, it was clear that any federal legislation in the area of disclosure would be challenged as a violation of the tenth amendment. Against the uncertainty as to how far Congress could legislate, there was evidence that underwriters, after the New York City crisis, were, in fact, forcing more "voluntary" disclosure by municipal issuers.<sup>13</sup>

Eight years after New York City's crisis, in July, 1983, the Washington Public Power Supply System ("WPPSS"), composed of a group of publicly owned utility districts and cities in Washington State,<sup>14</sup> defaulted on \$2.25 billion in revenue bonds issued to finance the construction of two nuclear power plants ("Plants 4 and 5"). Construction of Plants 4 and 5 had been cancelled the previous January when it became clear that the necessary additional funding could not be raised to finance their completion. This constituted the largest default of publicly issued securities in capital markets history, and again an unregulated municipal entity was the issuer.<sup>15</sup> Although what happened at WPPSS is still under

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3(a)(2) of the 1933 Act for municipal securities, thus subjecting municipal issues to the registration requirements of Section 5, unless otherwise exempted under another provision of the Act. S. 2574, 94th Cong., 1st Sess. (1976). A more limited approach was taken in a bill sponsored by Senators Williams and Tower, which provided for disclosure statements for new issues over \$5 million and annual reports by issuers with over \$50 million in outstanding debt. S. 2969, 94th Cong., 2d Sess. (1976).

11. Certain reforms of the municipal securities market, however, were enacted in the 1975 Amendments to the 1934 Act. These reforms made explicit the application of the antifraud provisions of Rule 10b(5) to municipal issuers and created, for the first time, a mechanism for the regulation of the activities of municipal securities dealers similar to the regulation of brokers and dealers of corporate securities. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) (codified as amended at 15 U.S.C. § 78o-4(a)-(c) (1982)).

12. 426 U.S. 833 (1976).

13. See, e.g., *Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 3 [hereinafter 1976 Hearings] (testimony of Professor Ronald Forbes at Senate Hearings on S. 2574 and S. 2969); see also Petersen, Doty, Forbes & Bourque, *Searching for Standards: Disclosure in the Municipal Securities Market?*, 1976 DUKE L. J. 1177, 1187-97; *infra*, Section V.

14. WPPSS is a municipal corporation and joint operating agency of the State of Washington created in 1957 to facilitate the provision of electric power and energy. See WASH. REV. CODE ANN. § 43.52 (1983) (detailing the formation and administration of such operating agencies). In addition to Plants 4 and 5, WPPSS owns three companion nuclear power plants, of which only Plant 2 is in operation; it also owns and operates two other electric generating plants. WASHINGTON PUB. POWER SUPPLY SYS., OFFICIAL STATEMENT 26-27 (Mar. 17, 1981).

15. Penn Central defaulted on \$618.18 million in debt, constituting the largest corporate debt

investigation, and the numerous securities fraud suits by WPPSS bondholders are still in the discovery stages, the occurrence of such a large default not many years after New York City's near default suggests that the decision, made at the time the securities laws were passed, not to require disclosure of information by municipal issuers demands yet another look. Such a re-evaluation is particularly timely, because the decision of the Supreme Court, in 1985, to overrule *National League of Cities*, means that the tenth amendment no longer casts as much of a pall over any efforts at reform.<sup>16</sup>

Section II of the Article reviews the role of information in security pricing and the social importance of accurate pricing of municipal securities. This review makes clear that a re-evaluation should not, however, be discussed solely in terms of the traditional rationale for the federal securities laws—investor protection—but should have a broader focus: the role the municipal securities market plays in how society decides the amount and mix of public sector expenditures.<sup>17</sup> Section III considers the reasons historically given for exempting municipal securities and finds them unpersuasive in light of the nature of today's market for municipal securities and the social role that it plays. Section IV explores an alternative argument for exempting municipal securities based on the skepticism of many modern finance theorists as to the need and cost effectiveness of traditional corporate disclosure regulations. This skepticism suggests, at least at first blush, that an extension of the corporate disclosure requirements to cover municipal issuers as well is a move in the wrong direction. It is based on a growing body of literature that posits that market incentives alone are sufficient to force issuers to produce and disseminate all the information investors actually want.<sup>18</sup> This argument is then considered in the context of the municipal securities market, applying public

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default. MORGAN STANLEY, THE DEFAULT RATE EXPERIENCE ON HIGH YIELD CORPORATE DEBT 27 app. (Mar. 1985).

16. *Garcia v. San Antonio Metro. Transit Auth.* 469 U.S. 528 (1985).

17. A re-evaluation of the decision to include municipal securities within the registration exemption of Section 3(a)(2) of the 1933 Act involves many considerations. For example, an initial matter to be addressed is whether mandated disclosure for offerings of municipal securities should only be required at the time of original issuance or, given the Securities and Exchange Commission's ("SEC") commitment to integrated disclosure, which seeks to combine the disclosure obligations of the 1933 and 1934 Acts, whether municipal issuers should be required to disclose material information on a continuing basis. Any such re-evaluation must confront the issues of the relationship between the benefits of any proposed federally mandated disclosure regulations and the cost to municipalities, elected officials and other persons who would be involved in the preparation and dissemination of the disclosure material. It must also include a judgment of the relative effectiveness of current state and federal regulation of municipal securities, issuers and dealers.

18. See *infra* Section IV(A).

choice theory and organization theory to the behavior of politicians and government bureaucrats, in order to determine whether we can expect similar responses from municipal issuers to market incentives for disclosure. Political and bureaucratic factors create at least as great incentives for governmental officials to withhold information as exist in the private sector. But, neither the market incentives nor the monitoring devices that are said to promote voluntary disclosure in connection with the corporate securities market operate for municipal securities. Section V of the Article examines some of the empirical evidence as to current disclosure practices of municipal issuers. This evidence generally indicates a less than optimal amount of disclosure in the municipal securities market. Problems of non-disclosure of relevant information and the lack of uniformity as to what is disclosed continue to plague the market. These problems cannot be resolved without mandatory rules of disclosure.

## II. ROLE OF INFORMATION

In the case of private firms, the allocation of investors' savings is accomplished through market pricing of their securities. The accuracy of the prices is a function of how much information is possessed by the market participants. The accuracy of the pricing mechanism of the capital market is important because it assures the flow of savings, a scarce resource, to its most productive uses.<sup>19</sup> In a fully informed market, those firms whose projects are the most promising will attract investors' funds at acceptable costs, while firms with less promising projects will choose not to proceed due to the increased cost of attracting capital. If securities prices are inaccurate because of a lack of information or because of erroneous information, there will be a misallocation of capital. Some of the most promising projects could go unfunded, while others with less promising prospects of success would be funded.<sup>20</sup>

Is the accuracy of the pricing mechanism for municipal securities as important? It will be seen that accurate pricing of municipal securities serves two important societal functions. First, comparable to prices of corporate securities, they serve as a guide to the efficient allocation of savings to, and within, the public sector. Second, accurate pricing serves to signal when adjustments need to be made in the level of public expend-

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19. Mendelson, *Economics and the Assessment of Disclosure Requirements*, J. COMP. CORP. L. & SEC. REG., 49, 50-51 (1978).

20. Barry, *The Economics of Outside Information and Rule 10(b)(5)*, 129 U. PA. L. REV. 1307, 1316-18 (1981).



itures when such level is not supportable in the long-run at politically acceptable rates of taxation, given the existing tax base.

### A. *Efficient Allocation of Savings*

To understand the allocation function of pricing in the municipal securities market, we must first distinguish between the two types of municipal securities: revenue bonds, or non-guaranteed debt, which is secured solely by the revenues generated by the particular project to which such bonds relate, and general obligation bonds, or guaranteed debt, which is backed by the general tax revenues of the issuing entity.

1. *Revenue Bonds.* Revenue bonds, which constitute almost three-quarters of the municipal market,<sup>21</sup> are used by state and local governments for the construction of facilities that, theoretically, through the imposition of fees or charges, will generate sufficient revenues to amortize the debt over the useful life of the facility. Thus, revenue bond financing has been traditionally associated with the construction of toll roads, bridges, and community water, sewer, and power systems. More recently, revenue bond financing has become associated with industrial development projects that are, in fact, projects of private industry utilizing the tax advantages of municipal issuers.<sup>22</sup>

The revenue bond portion of the municipal securities market is analogous to the corporate securities market in that the investor's investment decisions are similarly concerned with the determination of the relative productive uses of capital. Accurate pricing of revenue bonds enables investors to evaluate competing investment opportunities and channel savings to projects that show the most promise of success.<sup>23</sup> Clearly, this is the case with industrial development and pollution control bonds, which in 1984 constituted approximately 15% of the publicly offered municipal securities market.<sup>24</sup> With respect to the more tradi-

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21. GAO REPORT, *supra* note 1, at 13-14.

22. *Id.* at 15, 50.

23. In 1984, there were 3,652 publicly offered revenue bond issues among which investors could choose to invest their savings. Municipal bond information provided by the Public Securities Association's Colorado-based Lockheed data base (1984) (on file at the BUFFALO LAW REVIEW).

24. MUNICIPAL STATBOOK, *supra* note 1, at 7. Accurate pricing of industrial development and pollution control bonds will not, however, correct the inequities created by the federal tax subsidies in favor of industries that obtain revenue bond financing.

The Bond Buyer's 1984 figures for pollution control bonds and industrial revenue bonds are \$14.6 billion and \$4.5 billion, respectively. These figures do not include the sizeable market of "small issue" industrial revenue bonds that, because of the \$10 million limit in the size of certain types of industrial revenue bond issues, I.R.C. § 103(b)(6)(D) (1986), are more often privately placed with

tional revenue bond financed projects, absent government subsidies, accurate pricing would again result in the allocation of capital to the most promising projects. Very few government owned-and-operated projects are, however, without some form of government subsidy, whether in the form of direct appropriations or tax benefits. The existence of these subsidies may weaken the precision with which the market channels funds to such projects because they reduce the risks of default associated with less promising projects. The market is, nevertheless, a powerful force in that a project judged to be unpromising, absent subsidies, requires the commitment of more subsidies if the securities are to be sold at an acceptable cost.

2. *General Obligation Bonds.* Long-term general obligation bond financing, once the mainstay of municipal financing, is used for funding those public facilities that either do not produce revenues (for example, town halls, police stations etc.), or for which it is considered, as a matter of public policy, inappropriate to levy fees for public use (for example, public schools or parks). Short-term general obligation note financing is used to bridge cash flow gaps between expenditures and the receipt of revenues or proceeds from long-term bond issues.<sup>25</sup>

Financing to support the provision of public services cannot be analyzed in terms of the allocation of investment resources to the most productive uses. Municipal borrowing of this kind is the community equivalent of an individual borrowing to finance the purchase of a consumer durable, such as a car. One community's choice of government

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financial institutions. The industrial revenue bond market (including small industrial revenue bond issues) was estimated to be \$12.7 billion for 1982. GAO REPORT, *supra* note 1, at 48 app. VI.

Because there have been no reporting requirements for municipal issuers, there has not developed a single repository for statistical information concerning state and local debt. Data compiled by The Bond Buyer, the Public Securities Association, and the Bureau of the Census are generally relied on by observers of the market. All three focus on publicly offered debt. The Bond Buyer and the Public Securities Association use the calendar year and their figures, while rarely in total agreement, are substantially the same. (For example, the total amount of long-term bonds issued in 1984 was \$101.9 billion according to The Bond Buyer and \$104.9 billion according to the Public Securities Association. Pub. Sec. A., Municipal Market Developments: Use of Proceeds Report from 1/1/84 through 12/31/84 (Feb. 26, 1985)). The Bureau of the Census uses the fiscal year as its basis for compiling data, and its figures therefore do not tally with the others. L. MOAK, *supra* note 6, at 12-13. As a result of revisions to Section 103 of the Internal Revenue Code in 1982, issuers are now required to supply details of "private purpose" bond issues to the Treasury Department, defined to include: industrial development bonds, student loan bonds and private exempt entity bonds (loans to Section 501(c) organizations). I.R.C. § 103(l) (1986), P.L. 97-248, § 215(b)(1).

25. For discussion of the uses and advantages of the different forms of municipal securities, see R. LAMB & S. RAPPAPORT, MUNICIPAL BONDS 9-17 (1980); L. MOAK, *supra* note 6, at 112-18; JEC REPORT, *supra* note 6, at 148-61.

services cannot readily be compared with another's. Although it may not be possible to determine if community A's use for capital is more or less productive than community B's, it is possible, through accurate pricing, to insure that the community that places more value on borrowing, that is, on proceeding now with a program of public services to be paid for later, has access to capital. If prices are inaccurate, so that community A, with a higher chance of default (including the possibility of failure to repay on schedule) than community B, is able to borrow at terms equal to or better than community B, the expected return to an investor in community A's securities, and hence the expected cost of borrowing to community A, will be lower than the expected cost of borrowing to community B. In such a case, community A might choose to borrow and community B might choose not to, even if community B places more value in borrowing. Where prices are accurate, so that the expected costs are the same for each, the prices, in a sense, test the strength of a community's commitment to its goals. With equal expected costs, the more unified public officials perceive the citizens of a community to be with regard to a particular allocation of resources for public services, the more likely they will be willing to pay the cost of borrowing.<sup>26</sup>

#### B. *Adjustment Mechanism*

Accurate pricing also facilitates needed adjustments in the level of public expenditures in that current services are not sustainable in the long run at politically acceptable rates, given the community tax base. The need for adjustments can arise either because of an adverse change in the tax base or other revenue source, or because of overly ambitious public sector programs. As developed in Section IV of this Article, there is a strong potential for public officials to engage in fiscal mismanagement. A well functioning market for municipal securities is likely to produce signals of such mismanagement long before it would otherwise be apparent to the public, since much of the budget information is under the control of the government bureaucracy and not easily available to elected officials and legislators. In addition, that which is available will often not be passed on to the citizens.<sup>27</sup>

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26. The degree of commitment within the community will be reflected in its willingness, as a political matter, to be taxed. For example, one study of the municipal securities market in the late 1950s found that communities with a strong public demand for particular projects went ahead with financing, despite a market that might have been "temporarily weak." R. ROBINSON, *POSTWAR MARKET FOR STATE AND LOCAL GOVERNMENT SECURITIES* 46 (1960).

27. For a discussion of the capacity and willingness of these groups to monitor the activities of the bureaucracy, see *infra* Section IV(B)(2).

To illustrate this point, consider the New York City fiscal crisis. The growth of government services during the period 1965 to 1975, particularly in the areas of health, higher education and welfare services, and the higher than average labor union settlements were frequently cited as major contributing factors in trying to determine the how and why of New York City's financial collapse.<sup>28</sup> The market cannot determine whether New York City should operate municipal hospitals, provide free tuition, operate open admission colleges, or pay its employees higher wages in the form of pension benefits. Those are political determinations. But, if the market had had access to the relevant information as to the City's declining employment and eroding tax base, its uncollected tax revenues and unfunded pension obligations, the market, through its prices, could have signaled earlier than it did that revenues at politically acceptable rates of taxation were not likely to be sufficient to continue to support the level of services New York was providing.

More accurate pricing of New York City's securities at an earlier date would not have been a panacea for the City's problems, many of which were either beyond its control or so intractable as to be beyond its control. But, by facilitating the recognition of new economic realities, it would have made these realities less wrenching for citizens and investors alike.

### III. THE INADEQUACIES OF THE TRADITIONAL RATIONALES AGAINST MANDATORY DISCLOSURE FOR MUNICIPAL SECURITIES

Accurate pricing serves societal functions in the municipal securities market at least as important as it does in the corporate securities market. Since accurate pricing depends on accurate information, what are the mechanisms for the production and dissemination of information in the municipal market and how do they relate to the legal alternatives available to us? The discussion which follows reviews the traditional justifica-

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28. For discussions of the City's spending patterns in the decade preceding the fiscal crisis, see P. McCLELLAND & A. MAGDOVITZ, *CRISIS IN THE MAKING* 310-20 (1981); C. MORRIS, *supra* note 7, at 172-94; CONG. BUDGET OFF., 94TH CONG., 1ST SESS., *NEW YORK CITY'S FISCAL PROBLEM: ITS ORIGINS, POTENTIAL REPERCUSSIONS, AND SOME ALTERNATIVE POLICY RESPONSES* (1975), reprinted in 90 POL. SCI. Q. 659, 669-72 (1976) [hereinafter CONG. BUDGET OFF.]; Gramlich, *The New York City Fiscal Crisis: What Happened and What is to be Done?*, 66 AM. ECON. REV. 415, 417-21 (1976). Gramlich's study found that much of the City's deficit was composed of expenditures for welfare, higher education, public hospitals, public housing, transit, and pension contributions, and that these individual component deficits were much greater than those incurred by other cities. *Id.* at 421.

tions made for not establishing a system of mandatory disclosure by municipal issuers and finds them to be of questionable validity under modern conditions.

Two factors are generally cited as justifying the continued exemption of municipal securities from the registration and reporting requirements of the securities laws: the low credit risk associated with municipal securities, and the financial sophistication of the investors. Credit risk is a measure of the chances of default in the timely payment of principal and interest. It is asserted that, since the default rate of municipal securities historically has been low compared with corporate securities, these securities pose little financial risk to the investor. Moreover, because investors in municipal securities are overwhelmingly financial institutions and wealthy individuals, they are in a position to understand, evaluate and bear those credit and market risks which are involved in purchases of municipal securities.<sup>29</sup>

#### A. *Low Credit Risk*

1. *Default Rate.* Since the Depression, municipal bonds, in particular general obligation bonds, have had a very favorable credit record, both in terms of a low default rate and in terms of the ultimate payment of those obligations on which there are defaults.<sup>30</sup> The low default rate for general obligation bonds stems from the existence of a stream of tax revenues independent, at least in the short-term, of the value of the goods and services produced by the issuer. Tax revenues for most local governments are derived primarily from property taxes, a revenue source less

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29. For an articulation of these arguments in opposition to the proposed federal regulation of the municipal securities market, see, e.g., 1976 Hearings, *supra* note 13, at 155-66 (testimony of Hon. Richard Carver, Mayor of Peoria, Illinois, on behalf of the National League of Cities and the U.S. Conference of Mayors). A number of law review articles and notes appeared following the New York City crisis that examined the traditional rationales for the exemption from the federal securities laws. See, e.g., Doty & Petersen, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 NW. U.L. REV. 283, 325-29, 341-42 (1976); Note, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, 1976 DUKE L. REV. 1261, 1267-70; Note, *Federal Regulation of Municipal Securities*, 60 MINN. L. REV. 567, 579-86 (1976); Note, *Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation*, 28 VAND. L. REV. 561, 564-65 (1975).

30. There were 431 recorded defaults for state and local governments in the period 1945-69, most of which were "technical and temporary," with a total dollar volume of \$450 million. J. PETERSEN, *THE RATING GAME* 110 (1974). Permanent losses on principal and interest in the twenty year period 1945-65 were less than .01% of the debt outstanding at the end of 1965. *Id.* at 111 (citing G. HEMPEL, *POSTWAR QUALITY* 19-21 (1971)). For statistics comparing the default rate of municipal bonds with that of corporate bonds, both during the Depression and in the post-Depression era, see Seligman, *Municipal Disclosure*, 9 DEL. J. CORP. L. 647, 651-52 n.17 (1984).

buffeted by cyclical downturns in the general economy<sup>31</sup> and hence more stable than the sales of most corporate enterprises. Having revenue sources separate from the value of their outputs also means that if bankruptcy threatens, governments can fall back on their tax revenues, giving them a longer lead time than corporate borrowers to put their financial houses in order. Even in the absence of threatened bankruptcy, their financial health is enhanced by having a greater ability to avoid borrowing during periods of high interest.<sup>32</sup> These factors also help explain why there is a substantial likelihood that payment will be ultimately made on those obligations that do default.<sup>33</sup>

Notwithstanding these factors and the overall low default rate for general obligation bonds, recent history suggests that defaults on such bonds are still sufficiently important to raise questions about the need for mandatory disclosure. The amounts involved in the defaults of New York City and WPPSS each exceeded the largest corporate default in history, that of Penn Central in 1970, and each affected large numbers of bondholders.<sup>34</sup> New York City involved general obligation short-term

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31. CONG. BUDGET OFF., *supra* note 28, at 666; Ladd, *The Role of the Property Tax: A Reassessment*, in BROAD BASED TAXES: NEW OPTIONS AND SOURCES 39, 77-78 (R. Musgrave ed. 1973).

32. There are, of course, costs involved in withdrawing from the market, namely, forbearance of needed capital improvements. High interest rates have played a "significant role" in the decline in expenditures on public infrastructure. GAO REPORT, *supra* note 1, at 30.

Various studies have found that interest cost fluctuations affect the timing of bond issues by state and local governments. Smaller governmental units faced with tight credit either persevered with their financing or cancelled the projects. Larger units used short-term debt or "ran down financial assets" during periods of high interest rates. JOINT ECONOMIC COMM., 94TH CONG., 2D SESS., CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT, 30 (Comm. Print 1976). Another study analyzed reported delays or postponements of bond issues in the period 1974-82, as compared with total actual funding, and found that the rise and fall in delays and cancellations roughly paralleled the rise and fall of interest rates. GAO REPORT, *supra* note 1, at 27. It further found that fluctuations appeared to be more important than actual interest rate level, which finding supports the earlier study done for the Joint Economic Committee in 1966. *Compare id.* at 28 with JEC REPORT, *supra* note 6, at 318. The author of the earlier study suggested that concern as to fluctuation may be related to concern about the arbitrage rules. JEC REPORT, *supra* note 6, at 315. Arbitrage is the gain that the issuer obtains from the reinvestment of the proceeds of a municipal bond issue in higher yielding taxable obligations. The Internal Revenue Code limits the circumstances in which municipal issuers can arbitrage bond proceeds. I.R.C. § 103(c)(2) (1986).

33. Of the \$1.35 billion in municipal bonds in default in 1932, permanent losses were about \$200 million. W. SMITH, THE APPRAISAL OF MUNICIPAL CREDIT RISK, 244 (1979). The repayment record of municipal issuers on defaulted obligations suggests that investors who were not forced to sell at distressed prices lost little in the way of principal repayment. *Id.*

34. See *supra* note 15. It has been estimated that at the time of New York City's "near" default, there were 160,000 individual holders of the City's long-term bonds. SEC REPORT, *supra* note 7, ch. 7, at 1. As to its short-term obligations, no specific figures can be found. It is known, however, that the City's short-term notes, aggregating \$4.5 billion, constituted over 40% of the nation's short-term market. C. MORRIS, *supra* note 7, at 223. During the months of October and November, 1974, the

notes.<sup>35</sup> WPPSS involved a hybrid form of revenue bond designed to be marketed as providing the security of a general obligation bond.<sup>36</sup> Although New York City avoided bankruptcy, and through a financial restructuring ultimately met its obligations, the holders of the City's securities suffered significant market losses.<sup>37</sup> For holders of WPPSS Plants

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City issued \$2.5 billion in notes. Due to market saturation, in November, 1974, the City reduced the face amount of a portion of its notes from \$25,000 to \$10,000 in order to attract individual investors. SEC REPORT, *supra* note 7, ch. 1, at 3, 27.

The WPPSS bonds for Plants 4 and 5 are held by an estimated 75,000 investors. Gleckman, *WPPSS: From Dream to Default*, CREDIT MARKETS, Jan. 3, 1984, at 1, 39. At hearings before the Subcommittee on Mining, Forest Management and the Bonneville Power Administration of the Committee on Interior and Insular Affairs, a representative of Lazard, Freres and Co., the investment banking firm that was, at the time, WPPSS's financial advisor, testified that it was his "impression" that "the market for the 4 or 5 bonds from the beginning of sales of those bonds always was much more to retail or individual market than the net billed bonds [those relating to Plants 1, 2 and 3]." *Bonneville Power Administration: Financial Fallout From Termination of WPPSS Nuclear Projects 4 and 5. Hearings Before the Subcomm. on Mining, Forest Mgmt., and Bonneville Power Administration of the House Comm. on Interior and Insular Affairs*, 98th Cong., 1st Sess. 117 (1983) [hereinafter *Bonneville Hearings*] (statement of John S. Tamagni). The representative, who was the partner in charge of Lazard's municipal bond department, estimated the percentage of Plants 4 and 5 bonds held by institutions to be "very low." *Id.* One estimate puts individual holdings at 70% of the Plants 4 and 5 bonds. Bernstein, *A Nuclear Fiasco Shakes The Bond Market*, FORTUNE, Feb. 22, 1982, at 112.

35. The City's short-term debt included approximately \$1 million in tax anticipation notes ("TANS"), \$3.2 million in revenue anticipation notes ("RANS"), \$1.8 million in bond anticipation notes ("BANS"), and \$108,000 in other short-term debt. SEC REPORT, *supra* note 7, Introduction and Summary, at 2. The TANS, RANS and BANS were marketed as having a "first lien" on the City's revenues. This first lien for TANS and RANS, however, was, in fact, the right to have payments set aside if such notes were not paid within five years of the date of issuance; there was no first lien of any kind for BANS. N.Y. CONST. art. VIII, § 2. Despite apparent agreement among City officials and its bond counsel that there was no such first lien, the City's notices of sale for its short-term notes continued to refer to the existence of a first lien on City revenues. SEC REPORT, *supra* note 7, ch. 3, at 66-71.

36. Debt service on the WPPSS Plants 4 and 5 bonds was ostensibly to come from the revenues generated from the sale of electricity produced by the nuclear power plants to the 88 utilities participating in the projects. Bondholders were protected against the risk of insufficient revenues by "take-or-pay" contracts executed by the participating utilities, whereby the utilities agreed to pay their respective portions of total costs whether or not the projects were completed or operating. The economic thrust of the take-or-pay financing was to put the utilities in the position of guaranteeing the payments of principal and interest on the bonds. As municipally-owned utilities, they could raise their rates as needed without prior state regulatory approval. *See*, WASHINGTON PUBLIC POWER SUPPLY SYSTEM, OFFICIAL STATEMENT, Mar. 17, 1981, at cover page (providing factual details of bond terms). Plants 1, 2, and 3 were also financed with revenue bonds, but those bonds were backed by a financing device known as a net billing arrangement with the Bonneville Power Administration ("BPA"), a federal agency, whereby BPA assumes the participants' obligations to pay their share of the costs of construction.

37. The \$1.6 billion of New York City short-term notes that were subject to the N.Y. State Emergency Moratorium Act for the City of New York, 1975 N.Y. Laws 874-75 [hereinafter *Moratorium Act*], enacted by the New York State legislature to extend the notes' maturity and reduce interest payments to 6%, lost approximately 40% of their par value. Notes exchanged for the 10-

4 and 5 bonds, the loss in value was total. The participating members of WPPSS who had backed the bonds for the defunct projects with guarantees of payment under take-or-pay contracts have been relieved by the courts of their obligations.<sup>38</sup> The underlying projects remain uncompleted and, as such, will never produce revenue. In each case, the effects of the defaults were felt by other issuers in the market in the form of higher borrowing costs.<sup>39</sup>

Most of the other municipal defaults that have occurred in the post-World War II period have been with respect to revenue bonds.<sup>40</sup> The greater risk of default, should project revenues be insufficient, is reflected in the interest rate differential between revenue bonds and general obligation bonds.<sup>41</sup> On average, revenue bonds carry an interest rate approximately one-half of one percent higher than general obligation bonds.<sup>42</sup>

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year bonds of the Municipal Assistance Corporation at 8% interest, sold at 70% of par value. Doty & Petersen, *supra* note 29, at 332-33 nn.194-95. Discounts in the 35-45% range were also found after default. SEC REPORT, *supra* note 7, Introduction and Summary, at 1. The Moratorium Act was held unconstitutional by the New York Court of Appeals in *Flushing Nat'l Bank v. Municipal Assistance Corp. of New York*, 40 N.Y.2d 731, 358 N.E.2d 848 (1976).

38. In June, 1983, the Washington State Supreme Court held that the participation agreements entered into by the State's municipalities and public utility districts, covering 70% of the construction costs, were ultra vires and unenforceable. *Chemical Bank v. Washington Pub. Power Supply Sys.*, 99 Wash.2d 772, 666 P.2d 329 (1983).

39. Studies conducted after the New York City fiscal crisis showed that the City's default increased borrowing costs for other northern industrial cities in the immediate period following default. Cook, *Determinants of Individual Tax-Exempt Yields: A Survey of the Evidence*, 68 ECON. REV. 14, 26-27 (May/June 1982). Since the WPPSS default, Washington State has paid a premium on its bond issues of 30-50 basis points. THE BOND BUYER, Aug. 16, 1983; THE BOND BUYER, Apr. 4, 1984, at 1-2; THE BOND BUYER, May 23, 1986, at 1. In November, 1983, the bonds of a major participating utility in WPPSS were priced to yield over one percentage point higher than bonds of comparable issuers. N.Y. Times, Nov. 16, 1983, at D9, col. 1.

The effect of the WPPSS default has been felt by issuers outside Washington State as well. Once alerted to the problems in the public power industry, the market priced the bonds of the first power authority to issue bonds after the WPPSS default, Michigan Public Power Agency, to yield three-quarters of a percentage point more than comparable issuers. N.Y. Times, Sept. 9, 1983, at D7, col. 1. A recent report prepared by the Bond Investors Association and Professor Robert Lamb of New York University Graduate School of Business Administration, estimates that the WPPSS default resulted in \$700 million in additional interest costs in 1985 for municipal borrowers. THE BOND BUYER, May 30, 1986, at 4.

40. Of the \$450 million of defaulted bonds in the period 1945-1969, \$334 million represented the defaults of two major revenue bond issues. J. PETERSEN, *supra* note 30, at 110-11. Similarly, most of the remaining defaulted issues related to revenue bond financings. *Id.* at 112; JEC REPORT, *supra* note 6, at 245-46.

41. It has also been suggested that the rate differential is attributable to the poorer marketability of revenue bonds and the inability of commercial banks to underwrite them. Cook, *supra* note 39, at 35.

42. GAO REPORT, *supra* note 1, at 17; Kidwell & Koch, *The Behavior of the Interest Rate Differential Between Tax-exempt Revenue and General Obligation Bonds: A Test of Risk Preferences*



This difference in default risk is important to the question at hand because, since the passage of the federal securities laws, revenue bond financing has eclipsed general obligation bonds as the major portion of the market. And while the federal tax exemption for industrial development, pollution control, and mortgage revenue bonds has been curtailed under the recent revisions of the tax laws,<sup>43</sup> other forms of revenue bond financing should increase as local governments, legally or politically restrained in their ability to raise property taxes, turn more to user fees as a means of financing public services.<sup>44</sup>

2. *Indirect Measures of Risk: Yield Structure and Insurance.* Even without the two sizeable exceptions of New York City and WPPSS, and the basic distinction between general obligation and revenue bonds, the bond yield structure for municipal securities tells us that not all municipals are created equal and that information concerning issues is important to the market despite the low overall risk of default. Issues of comparable size, maturity, and interest often sell at different prices. This

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*and Market Segmentation*, 37 J. FIN. 73 (1982). The study conducted by Kidwell and Koch of the yield differential between the two types of securities found that the differential varied countercyclically with the level of economic activity; increases in commercial bank demand for tax-exempt securities and increases in the supply of revenue bonds relative to general obligation bonds increased the yield differentials. *Id.* at 77-80, 84. For a discussion of commercial bank investment in municipal securities, see *infra* notes 63-66 and accompanying text. See also Heins, *The Interest Rate Differential Between Revenue Bonds and General Obligation Bonds: A Regression Model*, 15 NAT'L TAX J. 399, 399-405 (1962).

43. Under the Tax Reform Act of 1986, P.L. 99-514, the amount and types of some forms of "private purpose" bonds are restricted and others are eliminated. For example, pollution control bonds are now taxable. Small issue industrial development bonds will lose their exemption over the next three years. *Id.* at § 1301.

44. The use of user fees increased 135% in the period 1972-80 as compared to a 104% increase in taxes. GAO REPORT, *supra* note 1, at 16. In absolute dollars, the years 1978-79 and 1979-80 show 14% and 15% increases, respectively, in user fee revenues as compared with 1% and 4.8% for property tax revenues. Petersen, *Federal Fiscal Policy and Aid to State and Local Governments: An Age of Austerity*, 34 NAT'L TAX J. 383, 384 (1981). The increase is attributed in part to the property tax revolts during this period, which led to the adoption of more stringent property tax limitations such as Proposition 13 in California and Proposition 2½ in Massachusetts. The need for voter approval for general obligation bond issues also will continue to influence the decisions of issuers to use revenue bonds, which generally do not require voter approval. While we may have passed the peak of voter resistance, in the period 1971-78, only 53% of proposed bond sales were approved by voters as compared with 80% in the 1950s. Forbes, Fischer & Petersen, *Recent Trends in Municipal Bond Financing*, in EFFICIENCY IN THE MUNICIPAL BOND MARKET: THE USE OF TAX EXEMPT FINANCING FOR "PRIVATE" PURPOSES 149, 159-60 (G. Kaufman ed. 1981). A recent example of states turning to revenue bond financing where voter approval of general obligation bonds has not been forthcoming is the use of leasing schemes for prison construction. In 1983, only 40% of prison bond proposals before the voters passed as opposed to an overall rate of 72% for bond proposals. THE BOND BUYER, Aug. 26, 1986, at 4, 21.

suggests that the market determines each bond's yield to maturity based on an individual assessment of the credit and market risks of such bond.

The municipal securities market is characterized by an extremely large number of issuers and issues<sup>45</sup> and by a variety of forms of debt obligations, designed to comply with, or avoid, particular state laws with respect to the issuance of debt.<sup>46</sup> Given the array of issuers and issues and the lack of any uniform reporting requirements, market participants rely on the two national rating agencies, Moody's Investors Service and Standard & Poor's Corporation, to evaluate the credit risk of new issues of securities. Between the two agencies, 60% of new issues are rated and 90% of the total dollar volume of new issues is rated.<sup>47</sup> The importance of the rating process in the pricing of municipal securities is reflected in the cost of borrowing. The higher the rating, the lower the yield demanded by investors.<sup>48</sup> The differential between an Aaa/AAA rated bond (highest investment grade) and a Baa/BBB bond (the lowest investment grade) averages 75 basis points.<sup>49</sup> Studies also show that higher

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45. GAO REPORT, *supra* note 1, at 2. At the time of the GAO Report, there were an estimated 1½ million outstanding municipal issues as compared with 6,000 outstanding corporate stock and bond issues. *Id.*

46. For a description of the various, and often confusing, classification schemes that have been developed to deal with the number of different types of issuers and debt instruments in the municipal securities market, see L. MOAK, *supra* note 6, at 37-43. Revenue bonds, in particular, come in many forms depending on the source of the pledged revenues. For example, the Public Securities Association classifies revenue bonds into six subclasses, while Moody's Investors Service uses three categories for revenue bonds, which are then further broken down into 14 different subclasses. See *infra* text accompanying note 47.

The existence of state constitutional limitations on the amount of debt states and local governments can issue, and the judicial interpretation of such limitations as only applying to full faith and credit obligations (that is, general obligation bonds), have been a significant impetus in the creation of different forms of "non-guaranteed" debt, including moral obligation bonds, special fund bonds and lease obligation bonds, all of which have been held, with few exceptions, not to count against the issuer's debt limitations because they are not backed by the full faith and credit of the issuer. A. WALSH, *THE PUBLIC'S BUSINESS* 21-22 (1978). See generally Bowmar, *The Anachronism Called Debt Limitation*, 52 IOWA L. REV. 863 (1967) (discussing devices that have been created to avoid debt limit restrictions); Gillette, *Risk of Project Failure and Definition of "Debt,"* 6 MUN. FIN. J. 311 (1985) (succinct analysis of how courts should approach issue of what constitutes debt).

47. J. PETERSEN, *supra* note 30, at 4.

48. *Id.* at 43-45, 119-23; R. LAMB & S. RAPPAPORT, *supra* note 25, at 70. In a review of the studies that have been conducted to measure default risk, it was found that "the most important determinant of variations in yields across tax-exempt bonds" was the rating category. Cook, *supra* note 39, at 25.

49. Cook, *supra* note 39, at 25. Studies indicate that the differential widens as the maturity lengthens. *Id.* Issues rated below investment grade are often termed "speculative," and as a general rule are not purchased by institutional investors, either because of government regulations restricting investment to investment grade bonds or because their fiduciary obligation to act in a prudent man-

rated competitively bid issues receive more bids than lower rated issues,<sup>50</sup> and that the more bids received, the lower the yields to maturity, and hence the lower the borrowing costs for the issuer.<sup>51</sup>

High credit ratings are not, however, a guarantee of lower interest costs if the issue is small and unknown in the marketplace. Both in the original issue market and the secondary market, bonds of small issuers are priced at higher yields than those of larger issuers with comparable ratings. The ratings are not sufficient by themselves to overcome the problem of marketability for lesser known issuers.<sup>52</sup>

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ner in making investment decisions results in such restrictions. R. LAMB & S. RAPPAPORT, *supra* note 25, at 69; *see also* J. PETERSON, *supra* note 30, at 64-67.

50. Cook, *supra* note 39, at 27.

51. Kessel, *A Study of the Effects of Competition on the Tax-Exempt Bond Market*, 79 J. POL. ECON. 706, 723-32 (1971). Kessel found that the reoffering prices increase (yields decrease) as competition among underwriters, evidenced by the number of bids, increases. *Id.* at 707. The reasons for the positive correlation between the number of bids and yield are the subject of much debate. Kessel theorizes that because underwriters know what customers will pay for bonds, the larger the number of bids, the greater the probability of discovering the underwriter in possession of the knowledge of who will pay the most for a prospective issue: "[T]his is apt to be the underwriter who submits the winning bid." *Id.* at 729. The increase in bids means that a more extensive search has been conducted. Others have argued that the number of bids is a reflection of the lower underwriting costs associated with high quality bonds, because of both inherent credit qualities and marketability. Since, with competitive bidding, underwriters are not assured of having the winning bid, there are less costs at stake in bidding on issues of high quality and marketability in that pre-bidding search costs are minimal. Schaeffer & Smith, *Debating Bank Underwriting of Municipal Revenue Bonds*, 5 SEC. INDUSTRY TRENDS 1, 4 (Jan. 30, 1979) (summarizing study conducted by Professor Michael Mussa). *See generally* Cook, *supra* note 39, at 29-31 (discussing literature regarding correlation between number of bids and reoffering prices).

52. The higher yields are primarily a reflection of lack of marketability for small issues. Small issues are unlikely to have a secondary market. This inability to market at a later point, except, perhaps, at significant costs, is taken into account when the bonds are initially priced. Investors seek a higher yield to compensate them for their potential losses should they be forced to sell before maturity. It is estimated that the cost of selling in the secondary market for a lesser known issuer may be as high as \$5 per \$100. Cook, *supra* note 39, at 30, 33. The cost of trading in the secondary market is higher for small issues even when limited to trades in their own regional markets dominated by regional dealers, where presumably such bonds should be more marketable. Staats, *The Secondary Market for State and Local Government Bonds*, in REAPPRAISAL OF THE FEDERAL RESERVE DISCOUNT MECHANISM 9 (Bd. of Governors of the Fed. Reserve Sys. ed. 1972).

A study analyzing bond yields in 1960, 1963, and 1967, showed that the size of the issue was a significant factor in bond yields, particularly when commercial banks were the dominant trader, due to their preference for large block investment. Hastie, *Determinants of Municipal Bond Yields*, 8 J. FIN. & QUANTITATIVE ANALYSIS 1729, 1748 (1972). In addition, more effort is needed to search out initial investors for smaller issues, thereby raising underwriting costs. JEC REPORT, *supra* note 6, at 249. Because of the difficulty in marketing, small issues tend to receive fewer bids in competitive bidding and are the subject of negotiated sale more often. R. ROBINSON, *supra* note 26, at 131. Increased yields thus may reflect either the behavior of investors or underwriters or both. *See supra* note 51.

For small issuers that are unrated (approximately 40% of the number of issues, but only 10-15%

The rapid growth of private insurance for municipal securities in the last ten years suggests that, whatever the historical record of default for municipals may indicate, investors are increasingly concerned about the credit risks involved in investment in municipal securities. In 1983, 14% of the new issues were insured as compared with 3% in 1980; in 1984, the amount was 21%, and in 1985, the percentage grew to 27%.<sup>53</sup> Ten years ago the amount of insured bonds was negligible.<sup>54</sup> It can be argued that the availability of insurance assures low credit risk. This is probably not so. To see why, examine the market's reaction to insurance. Thus far, Moody's has rated two municipal insurers triple A. Issues backed by other insurance companies continue to be rated by Moody's on the basis of the underlying issuer's credit. Standard & Poor's rates insured issues on the basis of the credit rating of the insurer and has rated a number of municipal insurers triple A.<sup>55</sup> Yet, even where the insured bonds carry a triple A rating, they are priced in the market more like single A or double A rated bonds in recognition of the limitations inherent in insurance on long-term obligations. Should one or more of the large issuers default, the insurance companies may not be able to meet their obligations.<sup>56</sup>

3. *Other Factors.* There is one final consideration in connection with the use of the low default rate since the Depression as a justification for exempting municipal issuers from mandatory disclosure: this default rate was achieved in a period of prosperity. During the Depression, 4,770

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of the dollar volume), issuers pay, on average, 30 basis points more than single A rated bonds that are otherwise similar. J. PETERSEN, *supra* note 30, at 131, 133.

53. N.Y. Times, Aug. 30, 1984, at D1, col. 2; THE BOND BUYER, Mar. 20, 1985, at 1; THE BOND BUYER, Apr. 16, 1986, at 4.

54. In 1974, the two municipal bond insurance companies, American Municipal Bond Assurance Corporation and the Municipal Bond Insurance Corporation, insured a total of 24 issues. The total insurance for that year was \$63 million. N.Y. Times, Jan. 8, 1984, at F10, col. 2. See also Joehnk & Kidwell, *Determining the Advantages and Disadvantages of Private Municipal Bond Guarantees*, 7 GOVERNMENTAL FIN. 30 (1978).

55. N.Y. Times, Aug. 30, 1984, at D1, col. 2; Telephone interview with Michael Beauchamps of Moody's Investors Service (May 16, 1986).

56. Feldstein, *Municipal Bond Insurance and Pricing*, in 1 THE MUNICIPAL BOND HANDBOOK 404 (1983). As an example of the uncertainty with respect to insurance, one insurance company, rated triple A by Standard & Poor's in 1985, was down-rated in April, 1986, to double A, because of poor underwriting results. The rating change affected \$1.1 billion in principal amount of bonds.

Nevertheless, insurance can provide significant savings in interest costs over the life of a long-term bond and, therefore, is attractive not only for low rated issuers, but also for all small issuers, regardless of credit standing, whose bonds are less liquid than those of larger, more well-known issuers. The first two states to utilize bond insurance were (not surprisingly) New York and Washington.

municipal issuers defaulted on approximately 9% of the outstanding municipal bonds.<sup>57</sup> Although much of that debt was ultimately repaid, another depression may find larger numbers of municipal issuers in default due to fundamental changes in the market and the financing of public services. Revenue bond financing constituted a small portion of the outstanding debt issues prior to the mid-forties.<sup>58</sup> In bad economic times, a state or local government may permit its unsuccessful revenue bond financings to go unpaid. While this will damage its reputation as a general obligation issuer, reputational damage will not be as great if other municipal issuers do likewise, as is likely. For large issuers, such as states and major cities, the property tax is a less dominant form of tax revenue than in previous years.<sup>59</sup> To the extent that these governments rely more on income and sales taxes, their revenue sources have become more vulnerable to a sharp downturn in the economy.<sup>60</sup>

### B. *Nature of Investors*

The second justification traditionally given for the exemption of municipal securities from mandated disclosure under federal law is that those who invest in municipal securities are financial institutions and wealthy individual purchasers who have sufficient financial sophistication so as not to need such protection. The discussion that follows suggests that individual investors have always played an important role in the market, and today more so than ever. Moreover, these individual investors do not differ from corporate investors. Because a portion of the return on

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57. R. LAMB & S. RAPPAPORT, *supra* note 25, at 9.

58. *See supra* note 6.

59. Recent figures from the Bureau of the Census show that the property tax, as a percentage of total state and local government tax revenues, has decreased from 24.4% in 1966-67, to 15% in 1981-82. At the local level, the property tax remains the dominant tax, constituting three-fourths of local tax revenues; but as a percentage of total revenue, the property tax dropped 11 percentage points in the decade between 1971-72 and 1981-82, from 36.3% to 25%. BUREAU OF THE CENSUS, U.S. BUREAU OF COMMERCE, 1982 CENSUS OF GOVERNMENT, 4 GOVERNMENTAL FINANCES, NO. 5, COMPENDIUM OF GOVERNMENT FINANCES xvii, xix (1984). The Bureau of the Census reports that, for city governments, property taxes constituted 21.5% of their own source revenues in 1982-83, down from 25.6% in 1975-76. Current charges (e.g., license fees and user fees) increased from 17.7% in 1975-76 to 25.7% in 1982-83, while non-property taxes increased from 16.6% to 19.7% in the same periods. The statistics for the Census figures are based on data from cities with populations of 25,000 or more. BUREAU OF THE CENSUS, U.S. DEPARTMENT OF COMMERCE, CITY GOVERNMENT FINANCES IN 1982-3, at V (1984).

60. For example, the impact of the recession has been cited as one factor contributing to New York City's fiscal problems, noting that the City relied more heavily on cyclically sensitive taxes—sales and income taxes—than did other local governments serving metropolitan areas. Property taxes as a percentage of total revenues for these governments was 62% in 1972-73, while for New York the percentage was 42%. CONG. BUDGET OFF., *supra* note 28, at 666.

municipal securities comes in the form of the federal tax exemption for the interest income,<sup>61</sup> there is no question that they are attractive only to those investors in sufficiently high marginal tax brackets to be able to gain in after-tax income from the exemption.

Historically, there have been three major holders of municipal securities: commercial banks, individual investors, and fire and casualty insurance companies.<sup>62</sup> Over the years, the commercial banks and the individual investors have seesawed back and forth as the dominant source of investor funds. Whenever commercial banks have retreated from the market, the slack has been picked up by individual investors.<sup>63</sup>

As a general matter, commercial bank investment in municipals reflects cyclical monetary conditions in the economy. When time deposits outstrip loan demand, commercial banks participate more actively in the municipal market; in periods of credit restraint, they withdraw from the market and concentrate on meeting loan demand.<sup>64</sup> Withdrawal from the market by the banks, accompanied often by liquidation of their existing municipal portfolios in the secondary market, drives up the cost of capital for government borrowers, since they are forced to increase the yield on their securities to make them more attractive to lower tax bracket individual investors.<sup>65</sup> Commercial bank investors have been primarily interested in only a portion of the municipal securities market. Their preference for shorter maturities (one to ten years) for liquidity reasons is

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61. Although the question—whether the exemption from federal taxation is constitutionally required under the doctrine of reciprocal immunity between the states and the federal government—has not been definitively answered by the Supreme Court since the enactment of the sixteenth amendment to the Constitution, the exemption has been provided by statute since 1913. I.R.C. § 103(a) (West Supp. 1987).

62. Doty & Petersen, *supra* note 29, at 326.

63. See generally JOINT ECON. COMM., 94TH CONG., 2D SESS., CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT 35-40 (Comm. Print 1976) [hereinafter CHANGING CONDITIONS] (discussing behavior of commercial banks and other institutional investors with regard to municipal bonds between 1960 and 1975); R. ROBINSON, *supra* note 26, at 67-100 (examining practices and policies of principal groups of investors in municipal securities); L. MOAK, *supra* note 6, at 68-75 (analyzing behavior of major investors in municipal securities markets).

64. See CHANGING CONDITIONS, *supra* note 63, at 35-40.

65. *Id.* at 39; JEC REPORT, *supra* note 6, at 328; Staats, *supra* note 52, at 16-17. The municipal securities market is characterized by a higher degree of price volatility than that of either the corporate bond or U.S. Treasury bond market. R. ROBINSON, *supra* note 26, at 69. This volatility is attributed in large part to the "shifting composition of the market," particularly between commercial banks and individuals. *Id.* at 70. "State and local obligations are the second choice of many investors, the first choice of a very few." *Id.* at 99. For a discussion of the effects of commercial bank activity in the secondary municipal securities market on prices, supporting the finding that the buying or selling of municipal securities by commercial banks results in greater fluctuations in municipal bond yields, see also Staats, *supra* note 52, at 17.

reflected in the yield curve for municipals, with the longer maturities consistently carrying higher yields to attract the individual investor.<sup>66</sup>

While commercial banks continue to be a major force in the municipal market, figures from the last fifteen years indicate that individual investors are now consistently the main purchasers of municipal securities.<sup>67</sup> This shift reflects a changing tax picture for both commercial banks and individuals alike. For the banks, the 1970s saw the growth of other tax shelter devices that, for the now more aggressive commercial banking industry, were seen as more attractive than tax exempt securities.<sup>68</sup> Deregulation of interest rates paid on bank deposits in 1980 added to the pressure on banks to seek out higher yield investments.<sup>69</sup> The availability of these other opportunities for investment not only caused a decline in bank activity in the municipal market as a whole, it skewed bank participation toward the smaller banks for whom these other investment opportunities were not viable alternatives.<sup>70</sup>

Municipal issuers faced with lower bank demand responded with higher yield securities in smaller denominations and often with shorter maturities to lure more individual investors into the market.<sup>71</sup> Sustained individual investor interest in municipals stems from another factor as

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66. "Individuals represent the marginal investor at longer maturities, and because they pay taxes at lower rates, longer term municipal yields are a much higher proportion of longer-term taxable yields." Koch, *Recent Developments Affecting the Slope of the Municipal Yield Curve*, 5 MUN. FIN. J. 137, 138 (1984). Koch's study of municipal yield spreads between shorter and longer term maturities finds that the dominance of individuals in the market today, combined with a wider perception that investment in municipals is more risky, has increased the slope of the yield curve significantly. *Id.* To the extent the higher yields reflect a default risk premium, another recent study suggests that the term to maturity effect on default risk premiums varies countercyclically, that is, the yields increase during recessions despite otherwise lower interest rates. Leonard, *The Behavior of Municipal Bond Default Risk Premiums*, 4 MUN. FIN. J. 14, 18 (1983).

67. Commercial banks' share of the municipal securities market has been steadily declining since 1972. GAO REPORT, *supra* note 1, at 20. In 1972, household purchases (including mutual funds) were approximately 16% of the new issues of municipals; in 1982 they purchased 87% of the new issues. *Id.* at 22. Purchases by mutual funds increased from 13% in 1981 to 23% in 1982. Koch, *supra* note 66, at 146.

68. Kimball, *Commercial Banks, Tax Avoidance, and the Market for State and Local Debt Since 1970*, NEW ENG. ECON. REV., Jan.-Feb. 1977, at 3, 9-16; CHANGING CONDITIONS, *supra* note 63, at 38.

69. GAO REPORT, *supra* note 1, at 21; Koch, *supra* note 66, at 143.

70. Kimball, *supra* note 68, at 17, 20.

71. For example, the use of zero coupon bonds and variable rate bonds. Zero coupon bonds do not pay interest and are heavily discounted when sold. The advantage to the investor is low purchase price with automatic reinvestment of interest at a compound rate. Amdursky, *Creative State and Local Financing Techniques*, in 3 ANN. INST. ON MUN. FIN. L. 343, 382 (1984). One commentator suggests that "[z]eros . . . are suited only for those investors who can do without investment income and want a very certain return." Investors who fit this definition are likely to be individuals rather

well: inflation resulted in more individuals in higher tax brackets who sought relatively low-risk tax shelters. In 1983, individual purchases accounted for approximately three-fourths of new bond sales.<sup>72</sup> Banks and insurance companies are generally restricted to investment grade securities, and the evidence is that most investment by financial institutions is in the higher grade securities.<sup>73</sup> For low rated issues or less well-known issuers, the market is dominated by individual investors.<sup>74</sup>

Large and frequent issuers in the market appear especially to rely on individual purchases. Inquiries into who owned New York City and WPPSS bonds have shown that the securities of these issuers were widely held by individuals. It is estimated that at the time of New York City's crisis, there were 160,000 individual holders of the City's long-term bonds, holding approximately two-thirds of its long-term debt.<sup>75</sup> Over 60% of those responding to questionnaires sent by the Securities and Exchange Commission ("SEC") to individual investors in the City's notes indicated they had never previously invested in the municipal market.<sup>76</sup> Preliminary evidence in the WPPSS default shows increasing individual participation in the 1979-81 period when the institutional market was both saturated with WPPSS bonds and growing leery of the prospects for Plants 4 and 5. In a 1980 offering of \$130 million, \$95 million worth of bonds were sold to retail customers.<sup>77</sup>

A variety of evidence suggests that, today, the wealth of investors in the unregulated municipal securities market is similar to that of investors in the regulated corporate securities market. The medium income for corporate shareholders is \$36,800.<sup>78</sup> A Moody's comparison of yields on municipals, taxable corporate bonds and long-term treasury bills as of October, 1983, showed that municipals began to be attractive to individ-

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than institutions. Langley, *Variable Rate Bonds and Zero-Coupon Bonds*, in 1 THE MUNICIPAL BOND HANDBOOK 375 (1983).

Variable rate demand instruments have a floating interest rate and "put" features that require the issuer to repurchase if so requested by the holder when the interest rates are reset. It has been reported that as of November, 1984, \$6.3 billion variable rate demand instruments had been sold, primarily to tax-exempt money market funds. PUB. SEC. ASSOC., MUNICIPAL MARKET DEVELOPMENTS 4 (Nov. 30, 1984); see also Langley, *supra*, at 378-79 (discussing features of this type of municipal security).

72. Koch, *supra* note 66, at 146.

73. R. LAMB & S. RAPPAPORT, *supra* note 25, at 69; J. PETERSEN, *supra* note 30, at 64-67.

74. J. PETERSEN, *supra* note 30, at 67.

75. See *supra* note 34.

76. SEC REPORT, *supra* note 7, ch. 7, at 1.

77. Gleckman, *supra* note 34, at 32.

78. New York Stock Exchange, Inc., Facts (Dec. 4, 1985).



uals in the 30% tax bracket.<sup>79</sup> Similarly, two current "how to" books on investment in tax-exempt bonds use the family income figures of \$25,000<sup>80</sup> and \$30,000<sup>81</sup> as the level at which individuals would begin to find municipal bonds to be an "advantageous form of investment."<sup>82</sup>

A significant portion of less wealthy investors in both the municipal and corporate markets are indirect participants in the sense that they utilize mutual funds. But even if the "typical" municipal bond investor is wealthy, the same is true for the "typical" corporate shareholder who is given the protection of the securities laws.<sup>83</sup> Moreover, it is clear from the high degree of reliance on ratings by all investors in municipal securities that sources of information for investors are extremely limited.<sup>84</sup>

There is a modern supplement to the traditional rationale that municipal disclosure need not be regulated because of the nature of the investors. The argument is that no investor, rich or poor, corporate or municipal, needs protection against poor quality disclosure by issuers because he can protect himself against the associated risks by diversification.<sup>85</sup> One problem with this argument, applicable to corporate and municipal securities alike, has already been considered: accurate securities prices are needed for the efficient allocation of resources, and accurate prices depend on accurate information.<sup>86</sup>

A second problem with the argument relates directly to what is being discussed here: the nature of investors in the municipal market. Both individual and bank investors in the municipal market are less protected

79. THE BOND BUYER, Oct. 31, 1983, at 47.

80. H. RICHELSON & S. RICHELSON, INCOME WITHOUT TAXES, AN INSIDER'S GUIDE TO TAX-EXEMPT BONDS, 5 (1985).

81. R. LAMB, HOW TO INVEST IN MUNICIPAL BONDS, at ix (1984).

82. *Id.*

83. Fifty percent of stock holdings are held by the 2% of families with incomes over \$100,000. *Survey of Consumer Finances, 1983*, 70 FED. RESERVE BULL. 679, 689 (1984). Corporate bond holdings are overwhelmingly institutional. HOUSE COMM. ON ENERGY AND COMMERCE, 99TH CONG., 1ST SESS., CORPORATE BOND RISK PREMIUMS AND PUBLIC POLICIES 13 (Comm. Print 1985)(report for use of Subcommittee on Telecommunications, Consumer Protection and Finance).

84. Petersen's 1974 study of the role of ratings of the municipal securities market, which is to date the only comprehensive study of the rating process, found that both commercial banks and individuals relied extensively on ratings for their investment decisions. J. PETERSEN, *supra* note 30, at 62-72. Lamb and Rappaport's study of the municipal bond market, published in 1980, supports Petersen's earlier findings. R. LAMB & S. RAPPAPORT, *supra* note 25, at 48-49.

The ratings were recently described as "the benchmark in our business for determining investment grade and investment portfolio decisions . . ." *Bonneville Hearings*, *supra* note 34, at 115 (statement of Eileen V. Titmuss, Vice-President of Drexel, Burnham, Lambert, Inc.).

85. Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 182-84 (1984).

86. *See supra* Section II.

against the risk of default than investors in the corporate market in that their portfolios are likely to be less diversified. The municipal market, particularly the secondary market, has a strong regional bias; investors tend to concentrate their holdings in the securities of issuers within their state of residence or those of neighboring states.<sup>87</sup> One reason for this is the taxing policy of most states, which is to exempt from state taxation interest earned on their own securities or those of their political subdivisions.<sup>88</sup> For example, unit trusts and bond funds are often composed of securities of a single state.<sup>89</sup>

A second reason for this regional bias is related to the general lack of information about the myriad municipal issuers in the market. Investors purchase securities of local issuers because they have more personal information about those issuers and about the economic and demographic factors at play within the region in which they reside or do business. Commercial banks, as both major investors and major underwriters of municipal securities,<sup>90</sup> are particularly subject to local pressures, arising out of their positions in the community and out of concern for ongoing banking relationships, to support their own state and local government units by bidding on, purchasing, and retaining until maturity, the offered securities. Their portfolios tend, therefore, to be less geographically diversified.<sup>91</sup> But, as the credit problems of New York State and its cities and agencies in the mid-seventies clearly demonstrated, the economic fortunes of states and their subdivisions are intertwined. Both

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87. R. ROBINSON, *supra* note 26, at 149-50; Staats, *supra* note 52, at 9; R. LAMB & S. RAPAPORT, *supra* note 25, at 48-49.

88. Staats, *supra* note 52, at 11; Feldstein & Fabozzi, *Tax Exempt Securities*, in THE HANDBOOK OF FIXED INCOME SECURITIES 400 (1983). The state tax exemption also effects yields. Feldstein and Fabozzi report that in high income tax states that also exempt interest income on their own bonds (e.g., New York), the bonds of such states yield less than otherwise identical investments from other states because the availability of the exemption creates a "strong investor demand" for in-state issues and thus reduces yield. *Id.*

89. R. LAMB, *supra* note 81, at 66.

90. The Glass-Steagall Banking Reform Act of 1933, which prohibits commercial banks from acting as underwriters of securities, exempts general obligation bonds from its prohibition. 12 U.S.C. §§ 64a, 221a, 378-78a (1933). In the past, commercial banks, as underwriters, dominated the marketing of general obligation bonds. The growth of revenue bonds at the expense of general obligation bonds has cut back the commercial banks' level of activity. A comparison of the 10 leading underwriters in 1969 with those in 1979 reveals that the first two underwriters in 1969 were commercial banks; in 1979, no bank was on the list. Forbes, Fischer & Petersen, *supra* note 44, at 180-81. The Senate Banking Committee is currently considering the question of whether to permit banks to underwrite revenue bonds. The SEC supports this expansion. THE BOND BUYER, May 23, 1986, at 1.

91. Hendershott & Kidwell, *The Impact of Relative Security Supplies*, 10 J. MONEY, CREDIT & BANKING 337, 338-40 (1978). See also R. ROBINSON, *supra* note 26, at 104-06 (discussing special character of bank underwriting activities with respect to municipal securities).

the problems of New York City and WPPSS led to higher interest rates for issuers within the region in general.<sup>92</sup>

#### IV. APPLICATION OF THE MARKET INCENTIVES THEORIES OF VOLUNTARY DISCLOSURE TO THE MUNICIPAL SECURITIES MARKET

This Section explores the recent arguments being advanced for modification or elimination of mandatory disclosure for corporate issuers and considers whether application of these arguments to municipal issuers forms a more satisfactory alternative justification for their continued exemption from mandatory disclosure. The conclusion is that they are not. This determination is based on what is known in public choice theory and organization theory about differences in behavior between corporate managers and political and bureaucratic officials.

##### A. *Arguments Against Mandatory Corporate Disclosure*

The disclosure requirements of the 1933 Act that mandate, in connection with the public offering of corporate securities, the filing of a registration statement and the distribution of a prospectus, each containing detailed information as to the nature of the issuer, its business, and financial position, are predicated on the beliefs that the production and distribution of such information is necessary to prevent misrepresentation and fraud in the sale of securities, and that investors should participate in the market with equal access to information.<sup>93</sup> The need for, and effectiveness of, the mandatory disclosure requirements have recently been the subject of much debate growing out of both theoretical and empirical work in economics.<sup>94</sup> This literature suggests that the forced production of information is not required to protect investors in the corporate securities market and that it is inefficient because some of the

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92. See *supra* note 38.

93. See generally 1 L. LOSS, *SECURITIES REGULATION* 118-28 (2d ed. 1961) (describing how reaction to events of 1929-33 influenced Congress' regulation of securities market).

94. Jensen and Meckling developed what is often referred to as the "agency theory" of the firm. Jensen & Meckling, *Theory of the Firm*, 3 J. FIN. ECON. 305 (1976). In firms where management is separate from share ownership, voluntary disclosure, nevertheless, will come about through contractual arrangements between managers and outside shareowners, which contracts align management's interests with those of the outside equity holders. A related theory—signaling theory—also suggests that the market provides sufficient incentives for voluntary disclosure. Since good news is willingly disclosed to increase share price, other firms are put under pressure to release information lest their failure to do so be perceived to be bad news. Ross, *The Economics of Information and Disclosure Regulation Debate*, in *ISSUES IN FINANCIAL REGULATION* (F. Edwards ed. 1979). See also Easterbrook & Fischel, *Mandatory Disclosure and The Protection of Investors*, 70 VA. L. REV. 669, 682-83

required information costs more to generate and disclose than it is worth to investors.<sup>95</sup> Thus, even if the traditional justifications for exempting municipal issuers from a system of mandatory disclosure do not persuasively establish that municipal issuers should be treated differently from corporate issuers, perhaps neither, rather than both, should be subjected to such a system. The literature opposed to mandatory corporate disclosure is controversial, but it is being taken seriously by legal scholars.<sup>96</sup> This suggests that the debate concerning the regulation of municipal disclosure would be significantly advanced by a review of this literature and, under the assumption that it has at least some merit, an examination of its applicability to municipal issuers.

The theoretical literature opposed to mandatory corporate disclosure identifies a number of forces that should lead a firm's management voluntarily to pursue a disclosure policy that maximizes share price, and suggests that such a policy is socially optimal. According to the theory, management will become concerned with share price as soon as it contemplates offering shares to outsiders. The higher the price, the greater the managerial gain from the sale. If management assures prospective purchasers that the firm will pursue a disclosure policy that maximizes

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(1984) (suggesting that both agency theory and signaling theory operate to produce disclosure "worthwhile to investors" without resort to mandatory rules).

The works of Professors George Stigler and George Benston have attempted to prove empirically that the costs of the current mandatory corporate disclosure system outweigh any benefits. See, e.g., Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964); Benston, *The Costs and Benefits of Government Required Disclosure: SEC and FTC Requirements: An Appraisal*, in *CORPORATIONS AT THE CROSSROADS: GOVERNANCE AND REFORM* 37 (D. DeMott ed. 1980). Their findings have been challenged by others. See, e.g., Friend & Herman, *The SEC Through a Glass Darkly*, 37 J. BUS. 382 (1964) (responding to the Stigler study); Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 12-51 (1985) (refuting Benston's contention that securities fraud was not widespread prior to enactment of federal securities laws). See also Mendelson, *Economics and The Assessment of Disclosure Requirements*, 1 J. COMP. CORP. L. & SEC. REG. 49 (1978) (discussing debate on benefits of mandatory corporate disclosure).

95. Professor Stigler concluded that "grave doubts exist whether, if account is taken of the costs of regulation, the S.E.C. has saved the purchasers of new issues one dollar." Stigler, *supra* note 94, at 142. Similarly, Professor Benston asserts that "[I]ittle, if any, evidence supports the belief that these [claimed benefits by proponents of mandatory disclosure] have been achieved . . . [R]eason does not support belief that the benefits claimed can be achieved or are indeed benefits . . ." Benston, *supra* note 94, at 49-50.

96. See H. KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* (1979); N. WOLFSON, *THE MODERN CORPORATION* (1984); Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1985); Easterbrook & Fischel, *supra* note 94; cf. Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) (taking issue with notion underlying agency theory that investors knowingly enter into contracts with management regarding management's obligations and degree of discretion).

the value of the shares, these investors will offer the highest price for the shares.<sup>97</sup> Once the shares are issued, management will, for a number of reasons, continue to be concerned with the price at which the shares trade. First, the firm may wish, from time to time, to raise funds by issuing additional shares. Second, share price is a significant factor in determining the vulnerability of the firm's management to replacement by a hostile takeover.<sup>98</sup> Third, management compensation schemes are often directly tied to share price.<sup>99</sup> Fourth, high share price can also enhance the price at which individual members of the management team can sell their services to others should they choose to leave the firm; and the existence of such lucrative outside opportunities increases their compensation if they choose instead to stay with the firm.<sup>100</sup>

One kind of information of value to outside shareholders concerns the performance of management. The need for this information arises because of the separation of ownership and control in the typical modern corporation.<sup>101</sup> The less equity managers have in the firm, the more likely they will fail to act in the interests of shareholders to maximize profits.<sup>102</sup> Rather, they will have an interest in extracting additional compensation at the expense of shareholders in the form of salary, perquisites, shirking of responsibilities or insider trading.<sup>103</sup> Such behavior lowers the overall value of the firm in terms of what, in the aggregate, it offers the management and the shareholders.<sup>104</sup> Agency theory suggests that, to the extent management can create expectations at the time of the initial offering of shares to outsiders that it will not engage in such behavior, the resultant increase in share price will be such that management will gain more than it loses. Thus, management will agree to subject itself to various monitoring devices, such as periodic audits, to measure management's perform-

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97. Jensen & Meckling, *supra* note 94, at 325-26.

98. Empirical studies support a finding that "relatively unprofitable and/or undervalued corporations do run a somewhat greater risk of being taken over." F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 37 (2d ed. 1980).

99. *Id.* at 36. See also Easterbrook, *supra* note 96, at 560-62 (reviewing recent literature concerning relationship between management's compensation and performance of the firm).

100. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

101. This phenomenon, identified by Berle and Means, is the rule, rather than the exception, with respect to the large corporations that control significant shares of our economy's industrial assets. A. BERLE & G. MEANS, *THE MODERN CORPORATIONS AND PRIVATE PROPERTY* (1932); see also Fox, *Shelf Registration, Integrated Disclosure, and Underwriters Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1019 n.43 (1984) (containing statistics as to number and magnitude of management controlled corporations).

102. Jensen & Meckling, *supra* note 94, at 313.

103. *Id.*

104. *Id.* at 328.

ance.<sup>105</sup> Similarly, management's interests can be better aligned with shareholder interests by providing for share-price based compensation, again with the aim that management's share of the profits earned through the more efficient operation of the firm will exceed the value of its loss in personal consumption of the firm's resources.<sup>106</sup>

Continuing managerial interest in share price is likely to create other forces for disclosure that go beyond the mechanisms put in place at the time of the initial offering. As a general matter, a firm that has a "following" of security analysts will do better in the market. A firm cannot obtain such a following without providing the kinds of information that the analysts demand.<sup>107</sup> Also, signaling theory suggests that once firms disclose such information as a "signal" to the market, other firms are forced to provide on-going information to avoid the inference of bad news.<sup>108</sup> This contributes to the development of a consensus among analysts as to what information firms ought to supply, and those unwilling to meet the standard will be penalized in the form of lower share price.<sup>109</sup>

Information is useful to investors only if it is accurate. Investors will want, therefore, verified, or at least verifiable, information in order to distinguish among all the statements being made in the marketplace. To meet this demand, management allows independent review by outsiders as part of the monitoring of its performance. The most common form of verification is the use of independently certified financial statements.<sup>110</sup> Investment bankers, with their own reputations at stake as financial intermediaries, also act as verifiers of the information transmitted by them from firms to investors and, hence, are motivated to ensure the accuracy of the information.<sup>111</sup> It has been suggested that the role of the investment banker as verifier explains the use of syndications: a larger number of firms participating in underwriting "increase[s] the amount of reputational capital put behind the offering."<sup>112</sup> In addition to allowing inves-

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105. *Id.* at 324.

106. *Id.* at 328; Masson, *Executive Motivations, Earnings and Consequent Equity Performance*, 79 J. POL. ECON. 1278 (1971).

107. H. KRIPKE, *supra* note 96, at 123-24.

108. Ross, *supra* note 94, at 185.

109. H. KRIPKE, *supra* note 96, at 124.

110. Jensen & Meckling, *supra* note 94, at 338-39. Professors Watts and Zimmerman find support for the agency theory in the history of audits, which, their research shows, have long been employed as a voluntary monitoring device of firms. Watts & Zimmerman, *Agency Problems, Auditing, and the Theory of the Firm: Some Evidence*, 26 J. L. & ECON. 613 (1983).

111. Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 618 (1984).

112. Easterbrook & Fischel, *supra* note 94, at 675.

tors (existing and prospective) to monitor management's activities, management, wishing to distinguish itself from other firms, may also incur certain "bonding costs" in conjunction with providing accurate information. It will take actions such as personal guarantees, salary cuts, high debt/equity ratio, etc., in an attempt to vouch for the accuracy of, and its commitment to, its statements.<sup>113</sup> Even without such outside review and bonding costs, managers, unless they have only a very short time horizon, can be expected to strive for accuracy in the information they provide the market. Overly optimistic statements today improve share price temporarily but, over the long run, they depress share price because they damage management's credibility.

B. *Are the Arguments Against Mandatory Corporate Disclosure Applicable to Municipal Issuers?*

Assuming, arguendo, that firms and investors in the corporate securities market act in the manner described by the market incentives theories, therefore making mandatory corporate disclosure unnecessary, how valid are these incentive theories as applied to municipal issuers? Will government officials respond to the same incentives? The studies of bureaucratic behavior of not-for-profit organizations in general, and studies of government institutions in particular, suggest that the goals and motivations of government officials are sufficiently different from the agents of profit-making institutions to make doubtful the application of these theories to the municipal securities market.<sup>114</sup>

According to the incentives theories, corporate management will, as we have seen, disclose all the information that investors want because it is motivated to promote as high a share price as possible, both at the time initial outside financing is sought and on an ongoing basis thereafter. Higher share price leads to higher management compensation and greater job security. The information that investors want is straightforward: what is management doing to maximize the long run profitability of the firm. It might be argued that investors in government debt instruments would put the same kinds of pressures for disclosure on govern-

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113. Ross, *supra* note 94, at 185-86; see also Grossman & Hart, *Corporate Financial Structure and Managerial Incentives*, in *THE ECONOMICS OF INFORMATION AND UNCERTAINTY* 107 (J. McCall ed. 1982) (discussing use of issuing debt as a bonding device). Since the issuance of debt creates the risk of bankruptcy, which if it becomes a reality will cause management to lose the benefits it derives from the firm, management would prefer an all equity financial structure. By issuing debt, management signals that it will profit-maximize in order to avoid bankruptcy, and that signal, in turn, increases the market value of the firm.

114. See *infra* notes 121, 137, 139-45 and accompanying text.

ment agents as shareholders do on corporate managers. Such an argument would be based on the assumption that government managers will act to provide those public services desired by its citizens at the lowest cost possible. If that is true and disclosure of needed information results in lower interest costs on borrowings, government managers, acting rationally, will disclose such information, just as corporate managers would do.<sup>115</sup>

The problem with this argument is two-fold. First, the personal welfare of a government manager is not directly tied to the financial health of his institution. Both politicians and bureaucrats are likely to see personal advantage in sponsoring increased public services, regardless of cost. Second, citizens, who through their votes constitute the ultimate check on the decisions of government managers concerning borrowing and the size and direction of government programs, themselves lack the information necessary to perform this role effectively. Thus, neither the carrot nor the stick form of incentive is at work in the municipal securities market.

An accurate picture of the disclosure behavior of municipal issuers requires a comprehensive survey of the goals and incentives of the managers of government—political leaders and government bureaucrats—and of the information monitoring undertaken by legislators, citizens, interest groups, investors, and underwriters. Such a survey is set forth in the following Sections.

### 1. *Goals and Incentives.*

a. *Politicians.* The goals of politicians and the inherent limitations on their control over government bureaucracy make it unlikely that the process of deciding on government expenditures will be one in which, if unregulated, information is gathered, processed and transmitted to the relevant participants, including municipal securities investors, in a fashion that will promote the efficient allocation of resources and, when needed, adjustments in the level of government spending. Politicians are more than high-level managers; they have symbolic functions as leaders of the community. Citizens make political decisions based upon limited information, and the consequences of government actions often are not clearly discernible. In such a world, citizens respond favorably to politicians who can provide them with assurance of command, of knowing

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115. Professor Kripke indirectly makes this argument by suggesting that municipal issuers will voluntarily supply the information required by underwriters and investors once all parties are aware of their antifraud liabilities under the 1934 Act. H. KRIPKE, *supra* note 96, at 129-30.



how to deal with society's problems, even if the actual effectiveness of their acts is limited. Promises may, in fact, be more important than deeds.<sup>116</sup>

For most politicians, the primary goal is either reelection or appointment to a higher public position. Their terms in office are short. In order to secure this goal, they need to develop, in a short period of time, the appearance of being decisive, strong leaders. This need leads to a myopic vision of the world with an emphasis on short-term gains.<sup>117</sup> Any long-term losses will be discounted since they will not be felt during the incumbent's term in office.<sup>118</sup> In contrast, information concerning the long-run future performance of a corporate firm, once that information is known by a few outside observers, is taken into account (through the mechanisms of the efficient market hypothesis) in the price of the firm's shares—something of immediate concern to management.

Politicians are consequently attracted to those acts or programs that will produce tangible results relatively quickly. Capital improvements, in particular, are tangible testimony to a politician's *ability to get things done*.<sup>119</sup> The continuing survival of state constitutional debt limits, despite their ineffectiveness in curtailing long-term debt financing, can be seen as the public's demand for at least a symbolic antidote to the bias of politicians to disregard future costs.

Against this background, bad economic news is very bad indeed for

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116. See M. EDELMAN, *THE SYMBOLIC USES OF POLITICS* 75-94 (1964) (describing symbolic role of politicians as leaders in American society). Professor Edelman argues that the ability to project competence, an aura of command, and an assumption of responsibility, is more important psychologically to members of society than a politician's ultimate successes; these qualities reduce society's anxiety about the environment in which they live. Similarly, Katz and Kahn, commenting on the desire that political leaders be charismatic, state that "charisma is not the objective assessment by followers of the leader's ability to meet their specific needs. It is a means by which people abdicate responsibility for any consistent, tough-minded evaluation of the outcome of specific policies. They put their trust in their leader, who will somehow manage to take care of things." D. KATZ & R. KAHN, *THE SOCIAL PSYCHOLOGY OF ORGANIZATIONS* 545-46 (2d ed. 1978).

117. See R. AUSTER & M. SILVER, *THE STATE AS A FIRM: ECONOMIC FORCES IN POLITICAL DEVELOPMENT* 75 (1979); D. KATZ & R. KAHN, *supra* note 116, at 507.

118. For a discussion of the divergence of interests between the issuer and the local decision maker (for example, politician) in the weighing of the economic costs associated with the issuance of bonds, see Gillette, *Fiscal Federalism and the Use of Municipal Bond Proceeds*, 58 N.Y.U. L. REV. 1030, 1059-66 (1983). Professor Gillette notes that the individuals making the decision will discount the costs to be borne by the issuer due to their "short-term need to survive the next election." *Id.* at 1062.

119. *Id.*; see also A. WALSH, *supra* note 46, at 234-35 (discussing this phenomenon in context of productivity in public sector); P. MCCLELLAND & A. MAGDOVITZ, *supra* note 28, at 6-14 (describing relationship between politicians' motivations and creation of debt with regard to New York City fiscal crisis).

a politician. It requires curtailing capital and operating expenditures. Various interest groups that would have been otherwise benefited (including the voters constituting the bureaucracy of the government itself) are disappointed and the politician risks losing their political support for reelection. Moreover, bad economic news undermines the politician's symbolic role as leader, as someone in control of events.<sup>120</sup>

The serious consequences of bad news creates blocks to timely processing of information at all levels. Lower level appointees and bureaucrats will tend to suppress bad news not wishing to displease their superiors.<sup>121</sup> Politicians will tend to ignore what bad news is given them, and information they do absorb is unlikely to be passed on to the public.<sup>122</sup>

The New York City fiscal crisis provides a useful example of this phenomenon. The mayor at the time, Abraham Beame, had been Comptroller for New York City, first in Robert Wagner's administration from 1961 to 1965, and then during the second term of John V. Lindsay's administration, 1969-73. He not only knew of certain of the City's financial gimmicks, he helped create many of them in order to allow the City to continue to market its securities.<sup>123</sup> Yet, he steadfastly maintained, as a public stance, that nothing was wrong, even after April, 1975, when the markets had closed and New York City faced bankruptcy. He wanted to retain the support of the citizens whom he would face for reelection in two years. He also wanted to stave off state and federal involvement in city finances, which would ultimately reduce his power as mayor. To accomplish these ends, he appealed to local chauvinism by invoking the symbolism of the "Big Apple." Nothing could be wrong with the nation's largest city. Bondholders could not be hurt. The problem was with those

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120. Professor Edelman notes that economic forces are "much more difficult to personify or even to identify, so that a leader finds it hard to demonstrate his capacity for attacking them. There is a strong chance the incumbent will look impotent." M. EDELMAN, *supra* note 116, at 82.

121. See H. SIMON, *ADMINISTRATIVE BEHAVIOR* 162-63 (3d ed. 1976); A. DOWNS, *INSIDE BUREAUCRACY* 77 (1967). Subordinates who desire to advance will engage in "pleasing the sovereign" behavior, as Gordon Tullock refers to this recognized behavioral response of bureaucrats to suppress bad news. Tullock's thesis is that pleasing the sovereign behavior causes "the ambitious and intelligent bureaucrat [to] . . . cut himself off from external reality . . . . The official who is not hypocritical about his task soon learns that an active curiosity leads either to quarrels with superiors or bad conscience; hence he suppresses his curiosity." G. TULLOCK, *THE POLITICS OF BUREAUCRACY* 70-71 (1965).

122. M. EDELMAN, *supra* note 116, at 82, 116; A. DOWNS, *supra* note 121, at 121-23. In addition to the desire to suppress unfavorable information, politicians may adopt a "wait and see" attitude in order to determine the accuracy of the alarm signals being given before taking action. *Id.* at 189-90.

123. C. MORRIS, *supra* note 7, at 216.

who sought to discredit the City.<sup>124</sup>

This appeal was not only aimed at the average citizen. At least one study of the New York City fiscal crisis suggests that investment bankers and other observers of City affairs failed to pick up more quickly on the City's financial situation; they discounted the negative information being conveyed to them as being inconsistent with their concept of the City in which they lived and worked as the "Big Apple."<sup>125</sup>

The impact of political appeals for citizen loyalty and support in the face of economic reality can also be illustrated by an earlier event in New York City's fiscal wars. In 1972, three years before the culmination of the City's fiscal problems, Beame, then Comptroller, with some support from the state comptroller, took on the rating agencies for the City's Baa rating, claiming the downgrading from an A rating cost the City \$150 million in "unnecessary" interest costs.<sup>126</sup> The downgrading of the City's rating in the late sixties was attributed by Moody's, in large part, to the City's practice of deficit financing.<sup>127</sup> Beame's crusade led to congressional hearings. By the end of 1972, Moody's raised the City's rating to "A," where it remained until October, 1975, despite even greater deficits. Moody's was later greatly criticized for continuing to rate the City's securities "A" into 1975.<sup>128</sup> Yet, in light of the consequences of the previous downgrading, when the City's fiscal crisis finally came to a head, it is not surprising that Moody's waited until its decision to downgrade was irrefutable.

The capacity of politicians encountering fiscal problems to engage in symbolic appeals creates an additional problem: self-delusion. For example, Mayor Beame's refusal to recognize the City's financial plight appears not to have been entirely a desperate attempt to salvage his political career. He and other critical participants may, to some extent, have believed their own rhetoric.<sup>129</sup> The reluctance of political leaders to engage in information disclosure goes beyond the instrumental goal of being re-

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124. Beame consistently placed the blame for New York's fiscal problems on the City's bankers. He faulted the bankers for not "talking up" New York's securities. P. MCCLELLAND & A. MAGDOVITZ, *supra* note 28, at 308. He repeatedly cited the bondholders' first lien position as proof that the bondholders could not be harmed. C. MORRIS, *supra* note 7, at 224.

125. P. MCCLELLAND & A. MAGDOVITZ, *supra* note 28, at 308.

126. J. PETERSEN, *supra* note 30, at 127. Petersen notes that the rating change in 1972 came one day before hearings by the New York State Senate Select Committee to Investigate the Rating of Tax-Exempt Bonds. *Id.* at 129.

127. SEC REPORT, *supra* note 7, ch. 5, at 13.

128. Wall Street Journal, Nov. 2, 1981, at 1, col. 6.

129. In 1976, Mayor Beame admitted: "I knew there were going to be problems, obviously, but . . . nothing like this." P. MCCLELLAND & A. MAGDOVITZ, *supra* note 28, at 310. It is, moreover,

elected or appointed to higher office. A political leader perceives his social role differently than does a corporate manager. The political leader is likely to have a particular conception of the "public interest," and he seeks political power in order to shape society in accordance with that conception.<sup>130</sup> While disclosure may improve the functioning of governmental processes generally, it is likely to weaken the politician's power, and hence ability, to further the public interest as he has defined it.<sup>131</sup>

The tendency of politicians to suppress information in order to enhance their ability to further the public interest as they see it is not limited to bad news. For example, the Port Authority of New York and New Jersey for years paid higher costs for borrowings and willingly agreed to more severe restrictive covenants rather than make its financial statements public.<sup>132</sup> The reason in this case for non-disclosure was not to hide bad news but to hide good news. Its executive director at the time was convinced that the public interest was best served by the continued standing of the Port Authority's bonds as safe long-term investments, which he believed would be threatened by involvement in mass transit projects. If the Authority's current flush financial position were publicly known, it might be forced to bow to the growing pressure from the surrounding political entities for Port Authority participation in mass transit. The higher costs incurred to raise capital were secondary to preserving the organization's goals for long-run financial stability.<sup>133</sup>

Often a politician's conception of the public interest leads him to identify with a particular program (for example, nuclear power). Literature on organizational theory suggests that such an identification may create biases in the decision-making processes of the organization. For example, Herbert Simon maintains that the tendency of an administrator

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difficult for the politician to "distinguish between what is 'good for me' and 'what is good' ". G. TULLOCK, *supra* note 121, at 24.

130. J. WILSON, *THE POLITICS OF REGULATION* 362-63 (1980) (distinguishing economics and politics; suggesting that essence of politics is the effort of government to change people's preferences).

131. Mayor Robert Wagner is quoted as having said: "I do not propose to permit our fiscal problems to set the limits of our commitments to meet the essential needs of the people of this City," as an example of the fiscal irresponsibility of the City's leaders. P. MCCLELLAND & A. MAGDOVITZ, *supra* note 28, at 322 (footnotes omitted). It can also be seen, in its best light, as a recognition of the other factors concerning the public's interest that public officials must consider in addition to fiscal impact.

132. For a discussion of the Port Authority's "willingness to sacrifice revenues and even some bond marketability in order to defend the confidentiality of detailed financial data," see A. WALSH, *supra* note 46, at 89-103.

133. Walsh finds that the Port Authority's behavior was just one example of the typical practice of authorities to utilize financial restrictions to protect against "political interference." *Id.* at 156-57.

who identifies himself with a particular goal is to measure his organization "in terms of *adequacy* (the degree to which its goals have been reached) [rather than] of *efficiency* (the degree to which the goals have been reached relative to available resources)."<sup>134</sup> To the extent disclosure of bad news (such as increases in construction costs and extension of completion dates) is viewed as decreasing the possibility of achieving the goal, there will be a tendency to be less than forthcoming, even if the subsequent damage to the issuer's credibility means that future issues of debt will be more costly than would have been the case with full disclosure. These higher future costs are justified in the mind of the political leader because of the importance of attaining the goal.

b. *Bureaucracy.*

i. *Importance of Bureaucracies in the Flow of Information.* Government bureaucracies gather or create most of the existing information that is potentially useful to political leaders, voters, and investors in the performance of their respective functions. First, bureaucracies possess information concerning their own operations. This information is important because bureaucracies are the means through which government services are provided to the public. In addition, bureaucracies act as major gatherers of information regarding citizens' wants and needs and thus are key factors in defining what the public interest is. In order to determine what information, possessed by bureaucracies, will be made available voluntarily to investors (either directly or through political leaders), it is necessary to examine the personal motivations of individual bureaucrats and the relationship they have with their political superiors.

While bureaucracies and the problems they present in terms of efficient management of organizations are not unique to governments,<sup>135</sup>

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134. H. SIMON, *supra* note 121, at 212. Simon further finds that identification with the organizational goals is "more frequent in public administration than in the administration of commercial enterprises." *Id.* at 212 n.17.

135. Bureaucracy is a term generally used to describe all large, typically hierarchal, organizations. Tullock, *What is to be Done?*, in BUDGETS AND BUREAUCRATS: THE SOURCES OF GOVERNMENT GROWTH 275 (T. Borcharding ed. 1977) [hereinafter BUDGETS AND BUREAUCRATS]. Anthony Downs's study of bureaucracy defines four primary characteristics of a bureaucracy: (a) large size; (b) most members are seriously committed to the bureau because they depend upon it for most of their income; (c) advancement is based on performance; and (d) "the major portion of the output is not directly or indirectly evaluated in any markets external to the organization by means of voluntary *quid pro quo* transactions." A. DOWNS, *supra* note 121, at 25. What distinguishes government bureaucracies from other bureaucracies is "the type of constraints and the strength of the constraints to which the bureaucracy is subject." Tullock, *supra*, at 281; *see also* Rosenbloom, *Accountability in the Administrative State*, in ACCOUNTABILITY IN URBAN SOCIETY 87, 89-96 (1978)

governmental bureaucracies play a greater role in the flow of information within and outside the organization than their counterparts in private firms. As a general matter, political leaders and their appointees, the persons who are the top level managers in government, obtain their positions for reasons independent of any substantive knowledge of the services for which they are responsible and often independent of any demonstrated managerial skill. Their terms in office, moreover, are relatively short compared with career and civil service bureaucrats. For these reasons, the politicians and their top level appointees depend heavily on the expertise of the bureaucracy in the operation of the various government functions. This problem is aggravated by the fact that the information possessed by the participants in a governmental organization tends to be highly diverse and not easily translated into numbers that can be aggregated to form a picture of the performance of the organization as a whole. Thus, each individual governmental unit is likely to be the sole repository of information as to its particular functions.

ii. *Bureaucratic Motivations.* In order to understand what bureaucrats do with the information they possess, we need to review what the literature says about basic bureaucratic behavior. It is almost axiomatic to say that an essential goal of a bureaucracy is to increase its size.<sup>136</sup> In governmental organizations, where salaries generally are below those in the private sector economy, many of the rewards of employment come in the form of power, prestige, certainty of employment, and the "psychic income" of working for the public interest.<sup>137</sup> The strength of those rewards is dependent on growth. Increasing the size of a unit within a bureaucracy enhances the position of the leader of that unit and buttresses the chances of survival of the unit, which in turn assures lower level bureaucrats of the certainty of employment with minimal conflict.<sup>138</sup>

The desire to expand, however, has implications beyond just the number of personnel employed. Economists who have compared govern-

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[hereinafter ACCOUNTABILITY IN URBAN SOCIETY] (analyzing accountability problems presented by special characteristics of bureaucracies).

136. See A. DOWNS, *supra* note 121, at 16-18. Downs comments that "what sets bureaus apart [from all other organizations which similarly have inherent tendencies to expand] is that they do not have as many restraints upon expansion, nor do their restraints function automatically." *Id.* at 17. See also D. KATZ & R. KAHN, *supra* note 116, at 98-119 (examining forces involved in life cycle of organization that push it toward expansion).

137. See generally R. AUSTER & M. SILVER, *supra* note 117, at 77-83 (discussing characteristics of public employment in democracies that provide non-pecuniary compensations as substitutes for monetary profits).

138. A. DOWNS, *supra* note 121, at 17, 18.

ment output of goods and services with that of the private sector suggest that government bureaucracies are not "cost minimizers."<sup>139</sup> One model of bureaucratic behavior holds that government bureaucrats are "budget maximizers" rather than profit-maximizers.<sup>140</sup> Under this theory, governmental units are motivated either to overproduce in terms of the optimal level of output, but at minimum costs (that is, production efficient), or to produce at optimal levels at higher costs (that is, production inefficient). A unit chooses the first route when its managers are unable to utilize the difference between costs and the appropriated budget (the "fiscal residuum") in the form of salary or perquisites such as leisure time or amenities. In such a situation, the budget can be expanded to provide such increased rewards only by increasing output. On the other hand, a unit chooses the second route if its managers are able to appropriate part of the fiscal residuum as salary, perquisites or staff increases. In that case, the fiscal residuum will be maximized by limiting output.<sup>141</sup>

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139. There are large bodies of literature examining the processes by which the preferences of individuals within a community for public services are taken into account by their elected officials, and the processes within the government bureaucracy for deciding on any given level of output of public services. See, for example, the seminal work of J. BUCHANAN & G. TULLOCK, *THE CALCULUS OF CONSENT* (1962); A. DOWNS, *AN ECONOMIC THEORY OF DEMOCRACY* (1957); R. MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* (1959); R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* (2d ed. 1976); see also R. BENNETT, *THE GEOGRAPHY OF PUBLIC FINANCE* (1980) (reviewing literature of public finance in reference to how public choice affects, and is affected by, where individual is located among different horizontal and vertical levels of governments).

With respect to the economic study of government output, see generally W. NISKANEN, *BUREAUCRACY AND REPRESENTATIVE GOVERNMENT* (1971) (develops a theory of supply of public services based on economic behavior of bureaucrats); Baumol, *The Macroeconomics of Unbalanced Growth: The Anatomy of the Urban Crisis*, 57 *AM. ECON. REV.* 415 (1967) (develops theory that because production of most government services is labor intensive and non-progressive technologically, costs continue to rise); Niskanen, *Bureaucrats and Politicians*, 18 *J.L. & ECON.* 617 (1975) (reflections on the findings of certain empirical studies of government spending on Niskanen's earlier hypotheses).

140. This theory, advanced by William Niskanen in 1971, and refined in his subsequent article, *supra* note 139, at 617, applies a utility maximization model to study the objectives of, and constraints on, the public bureau. W. NISKANEN, *supra* note 139. Because the various elements of a bureaucrat's utility function, such as salary, perquisites, power, etc., are a positive monotonic function of the total budget, rational behavior and survival of the organization support the assumption that bureaucrats are budget maximizers. *Id.* at 37-38; cf. J. WILSON, *supra* note 130, at 374-78 (suggesting that "careerists"—employees who identify their careers and rewards with a regulatory agency—are not concerned as much with affirmatively seeking growth, as they are with avoiding a crisis or scandal which would threaten their autonomy).

141. Niskanen applies a utility maximization model to the study of government bureaucratic behavior. See Niskanen, *supra* note 139, at 617. For a review of three economic models of bureaucracy: Niskanen's model, Oliver Williamson's model, and Jean-Luc Migue's and Gerard Belanger's model, see also Orzechowski, *Economic Models of Bureaucracy: Survey, Extensions, and Evidence*, in *BUDGETS AND BUREAUCRATS*, *supra* note 135, at 229-59. Williamson's model analyzes the neo-classical firm, in which management, separated from the owners of the firm, appropriate, in the form

A corollary of the budget maximizing and fiscal residuum theories is the theory that government bureaucrats prefer production methods that require heavy capital spending because they yield higher costs over a shorter time span.<sup>142</sup> Others who have attempted to explain higher costs in government production compared with the private sector suggest that government bureaucracies make heavier use of labor because of bureaucratic managers' preferences for larger than needed staffs.<sup>143</sup> Larger staffs generate more voters who will vote in favor of larger budgets, as well as creating the potential for more prestige and power for unit managers.<sup>144</sup> These preferences are not necessarily mutually exclusive; pursuing both simply implies bureaucratic behavior that is particularly costly for a given level of output.<sup>145</sup>

iii. *Information Control by Bureaucrats in the Budgetary Process.* The motivation of individual bureaucrats to maximize the budgets of the units or subunits for which they are responsible influences both the way information flows up through the bureaucracy to politicians in the executive branch and the kind of information that is provided to the legislature in its budgetary function. Information in hierarchical organizations originates at the lower levels and is transmitted up to the higher levels. As we have seen, information that will have unpleasant consequences for

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of larger staffs, a part of the fiscal residuum of the firm and thus produce at above minimum costs. Migue's and Belanger's model "predicts that bureaus are both exchange and production inefficient." *Id.* at 236. The Migue and Belanger paper led Niskanen to revise his theory to take into account the appropriation of the fiscal residuum under certain circumstances. Niskanen, *supra* note 139, at 617-18.

142. De Alessi, *Implications of Property Rights for Government Investment Choices*, 59 AM. ECON. REV. 13, 18-23 (1969).

143. Orzechowski, *supra* note 141, at 240.

144. *Id.* at 240-41. The bureaucrat, as voter, will desire more public goods than the non-bureaucrat because greater output increases the bureaucrat's income and in effect subsidizes the bureaucrat's purchase of public goods. Borcharding, Bush & Spann, *The Effects on Public Spending of the Divisibility of Public Outputs in Consumption, Bureaucratic Power, and the Size of the Tax Sharing Group*, in BUDGETS AND BUREAUCRATS, *supra* note 135, at 211, 216-20. Since, as at least one empirical study has shown, government employees vote more than other groups, under majority rule, the preferences of the medium voter will cause a shift toward more public output. Bush & Denzau, *The Voting Behavior of Bureaucrats and Public Sector Growth*, in BUDGETS AND BUREAUCRATS, *supra* note 135, at 90, 96-98.

145. Not everyone accepts the notion of a single economic motivation, such as budget maximizing, as the explanation of bureaucratic behavior. See, e.g., J. WILSON, *supra* note 130. Professor Wilson emphasizes the bureau's desire for autonomy in order to assure security of position and to pursue its own self-defined goals of the public interest. Under either theory of bureaucratic behavior (and it is possible that at different points in time one or the other motivating force prevails), individual members of the bureau have reasons not to disclose information.



the transmitter will be suppressed if possible.<sup>146</sup> Conventional theory of bureaucratic behavior holds that transmitted information will be distorted in terms of the personal and institutional biases of bureaucrats, in this case to increase their budgets. In government bureaucracies, the problems of information distortion are greater in that the control systems used to detect distortion and to measure performance are less effective.<sup>147</sup>

The fact that the units that initiate and carry out programs are not responsible for raising the funds to support their programs means that there is no counter-balance to the pressures to expand within the unit, other than the knowledge they will not get all that they ask for. The line units are expected to be advocates of their individual causes before the supervisory unit specializing in budgetary matters.<sup>148</sup> While the budgetary agency must choose among programs, its choices are ultimately political ones subject to pressures from within and outside the organization. Once the decisions are made, the current government's program is set and there is a united front to finance it.

The tendency to manipulate information in order to budget maximize is not met with effective opposition, as might be expected, by the political executives. For the politician whose motivation is election or reelection, the bureaucracy presents a powerful special interest group. As

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146. See *supra* notes 121-22 and accompanying text. As a general matter, a hierarchical organization restricts the flow of information in that it inhibits communication between levels, from staff to superior. Staff is "disinclined to discuss their problems with a superior for fear of revealing their ignorance." P. BLAU & W. SCOTT, *FORMAL ORGANIZATIONS* 131-32 (1962). Yet, because of the restricted flow, a hierarchical structure facilitates coordination among large numbers of persons in the performance of the tasks of the organization. See *id.* at 124-30.

147. For a discussion of the control mechanisms, see *infra* Section IV(B)(2). The difficulty in detecting biases and distortions in government bureaucracies stems from both an inability to settle upon objective measures of performance and often an inability to even agree upon the goals. A. DOWNS, *supra* note 121, at 78.

[T]he major objectives of many agencies and programs is to develop and maintain a political consensus for their continued existence. In order to do so, program goals and priorities may be obscured. Likewise, they may also be purely symbolic . . . [W]ithout knowing what an agency is supposed to do, much less how well it is doing it, it becomes impossible to hold it accountable for its program activities in any meaningful fashion.

Rosenbloom, *supra* note 135, at 96.

At lower levels in the government bureaucracy, the work of the bureaucrat is characterized by frequent interaction with citizens and by wide discretion in defining that interaction. It is rarely accompanied by on-the-job supervision. Citizen participation is generally involuntary. As a result, goals tend to be less focused, information is controlled by the bureaucrat, and the purchasers of the services have limited, if any, opportunity to go elsewhere. Lipsky, *The Assault on Human Services: Street-level Bureaucrats, Accountability and the Fiscal Crisis*, in *ACCOUNTABILITY IN URBAN SOCIETY*, *supra* note 135, at 17-23.

148. A. DOWNS, *supra* note 121, at 104; A. WILDAVSKY, *THE POLITICS OF THE BUDGETARY PROCESS* 18-21 (2d ed. 1974).

a group, government bureaucrats vote more than any other group.<sup>149</sup> And, since their interests are served by expanded services, they rationally vote for increased spending. So long as the gain from increased salary or perquisites is greater than the increase in taxes paid by the bureaucrat, he will vote for larger output and staff.<sup>150</sup> The larger the bureaucracy the more likely its political clout will be one to be reckoned with, particularly at state and local levels where often there are residency requirements for government employees, thus, making the link more pronounced.<sup>151</sup> Government bureaus, more often than not, enjoy a monopoly position in bargaining for spending appropriations. It is the unit that has contacts with the outside constituents and that, based on its information from these constituents and its own perceptions of the unit's goals and policies, prepares a budget agenda for the legislators who "purchase" the goods to be produced. If the unit in question faces some competition from either the private sector or other bureaucratic units within the government that provide similar services, there will be other sources of information as to needs and costs, which should result in more effective monitoring of bureau expenditures.<sup>152</sup>

Even so, the magnitude of the information that would be needed to carry out a complete evaluation of a budget proposal makes the legislature vulnerable to the monopoly of the bureaucracy over information. Rather than make a complete evaluation, the legislature's budgetary process is a once a year review in which the reviewers/purchasers are presented with, and vote on, a total budget output at a particular level of expenditure.<sup>153</sup> As Aaron Wildavsky states, the budgetary process is "incremental" in that it builds on the last budget and reflects previous negotiations and agreements, which, absent changed circumstances known to the reviewer, are not reevaluated.<sup>154</sup> The focus is on detectable shifts in

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149. Bush & Denzau *supra* note 144, at 90-98.

150. *Id.* See *supra* note 144 and accompanying text.

151. Downs argues that when "a newly elected (or reelected) government sets up its planned expenditure, it asks whether each expenditure 'Is . . . worth its cost in votes in terms of votes gained?'" If that is true, then the more certain loss of votes from bureaucrats (and their families) when spending is to be reduced is a significant factor. A. DOWNS, *supra* note 139, at 69.

Bush and Denzau suggest that earlier legislation that prohibited bureaucrats from voting in the political units where they worked was designed to counteract their predilection to vote for expanded budgets. Bush & Denzau, *supra* note 144, at 90-98.

152. W. NISKANEN, *supra* note 139, at 40; Inman, *The Fiscal Performance of Local Governments: An Interpretive Review*, in CURRENT ISSUES IN URBAN ECONOMICS 270, 300 (1979); Niskanen, *supra* note 139, at 636-39.

153. W. NISKANEN, *supra* note 139, at 151.

154. A. WILDAVSKY, *supra* note 148, at 13, 15-16; A. DOWNS, *supra* note 121, at 247-51.

the budget from the last one and on any new programs sought to be included in the new budget.<sup>155</sup> This is in contrast to the way in which a firm makes budgetary decisions. The budget for much of its operations is determined by the level of market demand for the firm's products and, thus, the costs and benefits are continuously reevaluated.

From the investor's perspective, the behavior of bureaucrats, which results in non-disclosure of information, is of consequence if the result of such behavior skews the true picture of future expenditures. If the assumptions as to program costs and time are inaccurate, future expenditures may be understated and revenues overstated, either of which will effect the investor's credit analysis of the issuer.

2. *Controls.* The preceding Section described the incentives to which politicians and bureaucrats respond in order to determine whether one can expect them to gather, process, and disseminate information in a way that promotes both expenditure decisions that represent an efficient allocation of resources and timely adjustments in the level of spending to respond to changes in the economic climate.

Theories of organizational behavior recognize that the individual members of an organization have needs and desires independent of those of the organization.<sup>156</sup> Rational behavior, in terms of the organization's goals, may be perceived by individual members as involving costs that are too great or rewards that are too little, and this fact influences the way these individuals process information. Much of the work in both the area of public administration and business management is aimed at devising systems of controls that monitor the behavior of agents in order to correct these inherent biases. As we have seen, the application of agency theory to shareholder management relations suggests that management can be expected to impose on itself sufficient monitoring devices and that mandated corporate disclosure is therefore unnecessary. Do similar monitoring devices exist to counter the information problems that would otherwise exist given the motivations of political leaders and bureaucrats reviewed in the preceding Section? To answer this question, we need to look at each of the potential monitors—legislators, citizens, interests groups, investors, and underwriters—and the devices available to them.

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155. A. DOWNS, *supra* note 121, at 247-51.

156. See, e.g., R. CYERT & J. MARCH, *A BEHAVIORAL THEORY OF THE FIRM* (1963); H. LEIBENSTEIN, *ECONOMIC THEORY AND ORGANIZATIONAL ANALYSIS* (1960); H. SIMON, *MODELS OF MAN* (1957); O. WILLIAMSON, *THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVE IN A THEORY OF THE FIRM* (1964).

a. *Legislators.* One potential monitor of the behavior of government agents is the legislature in that it is, in a sense, the direct purchaser of government services. To perform this oversight function effectively, legislators must overcome the bureaucracy's monopoly on information. Alternative sources of information that legislators could tap would include hearings, audits, evaluative reports, and independently commissioned research. It must be asked, however, to what extent legislators will incur the costs of obtaining information from these other sources.

An inevitable problem in relying on the legislature as a monitor stems from the wide range of programs provided by government. Because of this diversity, legislatures need to specialize in performing their monitoring role. Specialization not only makes effective overall budgetary control mechanisms more difficult, it is also likely to make the legislative monitors of the individual bureaucratic units less reliable. Committee assignments are generally based on the requests of legislators. These requests will reflect what are perceived to be the interests of the legislators' constituencies.<sup>157</sup> The individual review committees thus have a higher demand for services than would committees with randomly selected members, which would be more likely to represent the median voter.<sup>158</sup> Identification of the legislative committees with the goals of the bureaucratic units they are supposedly monitoring suggests that they are not likely to ask hard questions about unit proposals or seek alternative information, assuming their constituents are satisfied. Specialized committees are more likely, therefore, to support output budget maximizers, although not fiscal residuum maximizing.<sup>159</sup> William Niskanen suggests that the monitoring activities of legislators are not viewed as providing significant rewards for individual legislators in that all taxpayers, not just the legislator's constituents, are benefitted. As a result, monitoring activities will be undersupplied.<sup>160</sup>

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157. See Weingast & Moran, *Bureaucratic Discretion or Congressional Control? Regulatory Policymaking by the Federal Trade Commission*, 91 J. POL. ECON. 765 (1983). Professors Weingast and Moran note that the committee system in Congress works to the advantage of each member in that "he gains greater leverage over precisely those issues relevant for his own political support and hence reelection." *Id.* at 771.

158. W. NISKANEN, *supra* note 139, at 148-51.

159. Niskanen, *supra* note 139, at 625-29.

160. *Id.* Professors Weingast and Moran have suggested, contrary to the more traditional view of legislative control of the bureaucracy, that the absence of active monitoring by Congress does not mean that Congress has no control over bureaucratic agencies. Under the "legislative choice" model, agencies tailor policies to the preferences of their oversight committees in order to avoid imposition of congressional sanctions, and, therefore, more active and costly monitoring by the committees is not required. Weingast & Moran, *supra* note 157, at 777.

Employment of typical legislative monitoring devices requires additional staff, as well as a commitment of additional time by the individual legislators. At the federal level, oversight activities have led to the creation of a parallel bureaucracy of staff aides in Congress to monitor the activities of the bureaucracy of the executive branch.<sup>161</sup> At the state and local levels, where legislators are often part-time and without access to funds to employ hired staff, it is not likely that they will affirmatively procure costly information.<sup>162</sup> Similarly, with high turn over rates at the state and local levels, legislators are less likely to engage in monitoring activities.<sup>163</sup> As one commentator notes, at the local level, the legislatures are "weak vetoing agents" due to the information imbalance and do not play any major role in the budgetary process.<sup>164</sup>

The foregoing discussion concerned the functioning of states and their general local governments. When we turn to the monitoring of public authorities by the legislatures that created such entities, we find that monitoring is all but non-existent. As Ann Marie H. Walsh stated in her study of the institution of public authorities, they are the ultimate in "bureau power," satellites spun out to operate without much in the way of restraints.<sup>165</sup> The defaults of the New York State Urban Development Corporation ("UDC") in 1974 on \$100 million in notes and the WPPSS default suggest that these authorities operated without legislative monitoring until they ran into financial difficulties. The Moreland Commission investigating the UDC default found that "the principal institutional weaknesses in the authority device are the lack of accountability to or adequate monitoring by the Legislature, Comptroller, Executive and Public, and lack of overall state planning and debt management."<sup>166</sup> The Commission's recommendation was to create an independent agency to monitor the financing decisions of the state's authorities.<sup>167</sup> The Washington State legislature did not look critically at WPPSS's activities until

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161. Rosenbloom, *supra* note 135, at 105. This phenomenon represents what Downs called the law of duplication: "Any attempt to control one large organization tends to generate another." A. DOWNS, *supra* note 121, at 262.

162. Professor Walsh makes this point in connection with the lack of legislative oversight of public authorities. A. WALSH, *supra* note 46, at 298-99.

163. Gray, *Accountability in Policy Process: An Alternative Perspective*, in ACCOUNTABILITY IN URBAN SOCIETY, *supra* note 135, at 176.

164. Inman, *supra* note 152, at 300.

165. A. WALSH, *supra* note 46, at 253.

166. N.Y. STATE MORELAND ACT COMM'N ON THE URB. DEV. CORP. & OTHER STATE FINANCING AGENCIES, RESTORING CREDIT & CONFIDENCE 20 (1976).

167. *Id.*

1980, amidst wide-ranging allegations of cost overruns.<sup>168</sup> An independent review of the feasibility of Plants 4 and 5, conducted in 1981 at the request of the state legislature, recommended, among other things, more legislative oversight.<sup>169</sup>

b. *Citizens.* Citizens are the ultimate determinant of what public services are produced and consumed. They make their preferences known through voting. Between elections, citizens can communicate their wants either individually or through group activity to their representatives. The average voter, however, has little motivation to become informed due to the high costs of gathering information as compared with perceived gain.<sup>170</sup> Each voter perceives that the expected return is low on the investment of time and energy necessary to become well informed because it is unlikely that his vote, whether intelligent or uninformed, will affect the outcome of the election. Thus, each is unlikely to invest the time necessary to gather the information. However, if a sufficient portion of the electorate undertook the investment, the gains to each of them might well exceed the costs in terms of more favorable policy-making decisions by officials thus elected. But, in fact, a sufficient portion will not undertake such a task because each individual voter has an incentive to avoid the investment and "free ride" on the efforts of others.

While the same kind of problem to some extent besets reliance on shareholder votes as a control device for corporate managers, it is not as serious.<sup>171</sup> The individual shareholder with a few shares of stock has the same incentives to be a "free rider" as the individual citizen voter. But

168. Gleckman, *supra* note 34, at 27.

169. UNIVERSITY OF WASH. ENERGY RESEARCH CENTER, INDEPENDENT REVIEW OF WNP-4 AND WNP-5: FINAL REPORT TO THE WASHINGTON STATE LEGISLATURE 30 (Mar. 15, 1982).

170. This theory of the role of information in the voting decision-making process is based on the work of Anthony Downs. See A. DOWNS, *supra* note 139. Downs argues that even if one were to assume each vote would determine the elections, no one has much incentive to acquire information because:

(1) information is relatively useless to those citizens who care which party wins [it is unlikely that any information would change their minds] and (2) those for whom information is most useful do not care who wins. . . . [I]t seems probable that for a great many citizens in a democracy, rational behavior excludes any investment whatever in political information *per se*.

*Id.* at 244-45. See also J. BUCHANAN & G. TULLOCK, *supra* note 139 (economic analysis of decision-making process of voting).

171. See, e.g., Easterbrook & Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395 (1983). Easterbrook and Fischel present a recent analysis of corporate democracy, in which voting is seen as filling in the details of the contracts between shareholders and management that form the basis of the corporation. *Id.* at 402.

there are differences between corporate democracy and political democracy that make it more likely that a sufficient number of corporate shareholders will seek out information and act as an effective control mechanism. Since shares are bought and sold in the market, there will be some shareholders who will seek information for trading purposes. The fact that each share of stock is entitled to one vote, moreover, allows any given shareholder to aggregate votes. Thus, a shareholder seeking to take control of a firm through tender offer has incentives to ferret out information whether or not voluntarily disclosed.<sup>172</sup> Similarly, in recent years, some institutional investors that held major shares of an issuer and had incentives to be well informed, have used their votes on occasion to affect corporate policy. The citizen has only one vote which cannot be traded except by moving from one community to another.<sup>173</sup>

In addition to the analogy between citizens and shareholders as checks on managerial discretion, there is an analogy between citizens and consumers. Consumers of the products of a firm are likely to more effectively influence management decision making than the consumers of government services. A process of natural selection is at work in the private sector. In a competitive economy, a firm whose management persists in a pattern of behavior whereby, at the margin, the cost of the firm's product exceeds its value in the eyes of the public, is likely to be driven out of business. The price the firm receives for its product will be below its costs, reflecting the availability of the product from lower cost competitors or the availability of other products preferred by the public. By contrast, citizens as consumers of government services cannot register their complaints as quickly when that which the government produces costs more than it should, or when more services are being produced than citizens want, given what they have to pay for their costs. Their remedies are limited to political opposition to the incumbents or moving from the community. "Exiting" from the community may require the forfeiture of

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172. *Id.* at 402, 406. See also Spann, *Public Versus Private Provision of Governmental Services*, in BUDGETS AND BUREAUCRATS, *supra* note 135, at 71-72 (discussing differences between shareholders in private firms and "shareholders" in governments).

173. Buchanan and Tullock advance the theory that log-rolling is in fact a form of vote-trading, used to take into account unequal intensity in preferences among voters and thus is a means of protecting minority interests. J. BUCHANAN & G. TULLOCK, *supra* note 139, at 134-35, 270-81. Nevertheless, these are trades within the organization that neither increase the amount of information available nor provide an exit mechanism for those dissatisfied with the current level of services. Voting, moreover, as a means of voicing opposition, occurs only at set times. Between elections, citizens must accept the level of output provided. Spann, *supra* note 172, at 71, 73. See generally A. HIRSCHMAN, *EXIT, VOICE AND LOYALTY* (1970) (comparative analysis of roles of exit and voice in economic and political arenas).

significant property rights and is not likely to be exercised except in extreme situations.<sup>174</sup>

The insensitivity of the political system to the value the public puts on government services sets the stage for fiscal crises unless the municipal securities market is well informed and can facilitate needed adjustments. The level of the politically acceptable tax rate, in the long run, reflects, in part, the value the public puts on the services it receives. But when borrowing is easy, and public appreciation for services is hard to measure, a government that is producing services that cost more than their value can operate for an extended period of time without having to face this reality.<sup>175</sup>

c. *Interest Groups.* Interest groups operate as a control mechanism in at least two ways. First, they are instrumental in providing politicians, during the inter-election period, with information as to voters' preferences for specific policies and the intensity of those preferences. Thus, they help shape government policies.<sup>176</sup> Second, they clearly perform a monitoring function since, unlike the average voter, they have incentives to become informed and to inform other voters in an effort to influence government policies. They "push public agencies toward accountability

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174. De Alessi, *supra* note 142, at 13, 17.

175. Spann theorizes that competition should curtail discretionary behavior of bureaucrats and lead to higher quality goods. Spann, *supra* note 172, at 71. While Spann cites studies showing that private firms can produce some public goods more efficiently than can public entities, he provides no data as to the benefits of competition between private and public firms in terms of government output. *Id.* In another article, Spann notes that the public sector had lower rates of productivity than the private sector even in areas where it faced competition from private goods. Spann, *Rates of Productivity Change and the Growth of State and Local Governmental Expenditures*, in BUDGETS AND BUREAUCRATS, *supra* note 135, at 100, 127.

Professor Hirschman suggests that private competition may, in fact, result in less, not more, efficient production by government. A. HIRSCHMAN, *supra* note 173. According to Hirschman's theory, the existence of an exit mechanism that permits the citizen, as consumer, to switch to higher quality private services, lessens the effect of the voice mechanism by removing those persons most likely to use political processes for redress. *Id.* at 45-53. At the same time, the fact that most government services are funded, at least in part, by general tax revenues deadens the effect of the exit mechanism. *Id.* at 59. For the "lazy monopolist," as Hirschman refers to bureaucrats in such situations, competition in effect rids the system of those who might bring to the attention of legislators and top officials instances of management slack. *Id.* at 59-60.

176. Majority vote elections indicate a consensus as to the majority's first choice among candidates, which may tell us what issues are important, but not necessarily what policies are preferred. For the politicians, the task is to discern in the inter-election period what the voters want as to specific policies. See J. BUCHANAN & G. TULLOCK, *supra* note 139 at 283-95; R. DAHL, A PREFACE TO DEMOCRATIC THEORY 127-30 (1956); A. DOWNS, *supra* note 139, at 90-93; K. SCHLOZMAN & J. TIERNEY, ORGANIZED INTERESTS AND AMERICAN DEMOCRACY 165, 276 (1986).



by forcing communication."<sup>177</sup> Yet, this monitoring device has limitations in that the scope of each group's activity is dependent upon the particular expectations and goals of the group, which may or may not be consistent with what the majority of voters want.<sup>178</sup> In fact, economic interest groups (as opposed to public interest groups)<sup>179</sup> are likely to support expanded benefits, and therefore higher spending, than the general public would support if informed.<sup>180</sup>

d. *Investors.* Although the average citizen may have little or no economic incentive for gathering information concerning governmental managers, this is not necessarily true of investors in municipal securities. Active participants in the municipal securities market will seek information about alternative investments in order to assess the risks of default attached to each investment. In gathering that information, they may be advised by professional investment advisors.<sup>181</sup> However, financial so-

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177. Baer, *Interest Groups and Accountability: An Incompatible Pair*, in ACCOUNTABILITY IN URBAN SOCIETY, *supra* note 135, at 218.

178. The role of interest groups in American politics can be viewed as providing a "minoritarian tendency to counter balance the more majoritarian proclivities of other parts of the political process," in that they articulate "demands by the narrowly interested and well-organized." K. SCHLOZMAN & J. TIERNEY, *supra* note 176, at 400.

179. Despite the growth of public interest groups in the last 25 years, a recent examination of the make-up of organized interests, at the federal level, reveals that business groups continue to dominate and, in fact, increased their presence from 57% in 1960, to 72% in 1980. *Id.* at 77-78.

180. Some observers of interest group behavior criticize the effect of these groups on economic performance because they obtain benefits for a narrow group while the costs are spread throughout the community. *See, e.g.*, M. OLSEN, THE RISE AND DECLINE OF NATIONS 41-47 (1982). Olsen argues that narrow interest groups operate to gain "larger shares or slices of the social pie" for their members, reducing social output rather than striving to make the social pie larger by eliminating social losses. The latter goal results in benefits spread out for everyone in society. The goals of interest groups will emphasize the short-run benefits and ignore or discount the long-term consequences to the public as a whole. *Id.* at 42. *See also* K. SCHLOZMAN & J. TIERNEY, *supra* note 176, at 406-10 (discussing criticisms of current level of interest group activity in political process today).

181. In the last five years there has been a significant increase in the number of municipal security analysts. Prior to that time, municipal research analysts were few in number. A 1975 survey showed that of the 87 major institutional investors and underwriters of municipal securities, 54 employed no analysts and the remaining 33 employed a total of 64 full time analysts. 1976 Hearings, *supra* note 13, at 253 (testimony of Professor Forbes). The SEC investigation into New York City's securities yielded similar findings. Chase Manhattan Bank, Citibank, Chemical Bank, and Merrill Lynch, four of the six managing underwriters for the City's notes, had a combined total of nine employees who did municipal research. SEC REPORT, *supra* note 7, ch. 7, at 7-8 (analyzing questionnaires sent to managing underwriters). Today, the National Federation of Municipal Analysts (organized in 1983 and composed of six regional constituent societies) has approximately 500 members. Telephone conversation with Jeffrey Noss, chairman of the National Federation of Municipal Analysts and an analyst with Roosevelt and Cross (Sept. 5, 1986). Conversations with analysts and observers of the market suggest that this growth responds to the increase in the size of the municipal market during this period, the increased use of more complicated forms of financing, including vari-

phistication is of little value if issuers do not release information only they possess. If adequate information with which to make their assessments is not available, investors will require higher interest rates to compensate for the unknown risk. Evidence of this behavior is found in studies of bond yield premiums in the secondary municipal securities market that find an inverse relationship between yields and the intensiveness of accounting practices.<sup>182</sup> Similarly, studies show a direct relationship between municipal ratings and intensiveness of accounting practices.<sup>183</sup> However, the fact that investors have some incentive to gather information and act on it will affect the behavior of governmental managers and their resource allocation decisions only if these managers are sensitive to the sanctions that investors wield for issuers that do not provide adequate information. We have seen that, unlike corporate managers, who have a variety of reasons to want to avoid lower share prices and higher financing costs, government managers, in fact, are less inclined to respond to the consequences of poor disclosure.<sup>184</sup>

e. *Underwriters.* Underwriters play a key role in the process of information disclosure in the original issuance of corporate securities. This function would be likely to continue in the same form even if the federal system of mandatory disclosure was abandoned. Like accountants, underwriters act as verifiers of the information disclosed by the issuer.<sup>185</sup> They combine knowledge of the general conditions of the capital markets with a direct, and often ongoing, relationship with the issuer, giving them specific information as to the issuer's affairs. As financial intermediaries, whose own success is dependent upon investors continuing to accept their advice as to investment decisions, underwriters can damage them-

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ous credit enforcement devices, such as insurance and letters of credit arrangements, and the increased level of trading and money-management. Telephone interview with Perry Young, Vice President, Standard & Poor's (May 15, 1986); telephone interview with Jeffrey Noss, *supra*. For example, long-term bond issues in 1985 increased 60% from 1984. *THE BOND BUYER*, May 8, 1986, at 24. At least one commentator, Professor Ronald Forbes, Director of the Municipal Finance Study Group, State University of New York at Albany, does not believe that the increase in the number of analysts has resulted in any significant increase in available information. It is his opinion that the ratings continue to be the most important source of information in the market. Telephone interview with Professor Ronald Forbes (Aug. 4, 1986).

182. Ingram & Copeland, *Municipal Market Measures and Reporting Practices: An Extension*, 20 J. ACCT. RES. 766 (1982).

183. Copeland & Ingram, *The Association Between Municipal Market Measures and Selected Financial Reporting Practices*, 20 J. ACCT. RES. 275 (1982).

184. See *supra* Section IV(A) & (B)(1).

185. Gilson & Kraakman, *supra* note 111, at 618-21; Easterbrook & Fischel, *supra* note 94, at 688.

selves seriously if they convey inaccurate information. Thus, underwriters will take pains to verify the information they pass on to investors.<sup>186</sup>

Underwriters are much less likely to play this role with municipal securities because, unlike corporate securities, a substantial part of the market is conducted on a competitively bid, rather than negotiated, basis. The details of the competitive bidding process are intricate and have been well described elsewhere. However, certain aspects of the process are important for our discussion of the production of information.<sup>187</sup> First, unlike negotiated issues, where financial advice regarding what to market and when is performed by the same entity that puts together the underwriting syndicate, in most competitively bid transactions, these functions are performed by separate entities in order to preserve the integrity of the bidding process. For a major issue that is to be competitively bid, the process of bringing that issue to market will typically involve the utilization of an investment bank or consulting firm as financial advisor before the issue is put out to bid. This process is followed by the selection—through bidding—of a syndicate group to underwrite the issue to the public. The official statements do not typically refer to the financial advisor or underwriter by name.<sup>188</sup> Thus, neither firm's reputation is immediately at stake.

A second significant factor is the time span involved in an issue to be competitively bid. Bids are solicited by published notices of sale and are generally required within a week of the publication date. The underwriters do not have an opportunity to examine in detail the financial structure of the issuer and the feasibility of the proposed project, or to participate in the preparation of the official statement. There is no "due diligence" investigation as to the accuracy of projected revenues and expenditures, time schedules for proposed projects, and similar concerns. A miscalculation as to the marketability of the issue, or a failure to correctly predict the direction of interest rates, can leave the syndicate members with bonds they cannot sell, except at a loss, or unexpected profits. While investment bankers make similar decisions every day in terms of pricing corporate securities, that portion of their analysis that is a calcu-

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186. Gilson & Kraakman, *supra* note 111, at 618-21; Easterbrook & Fischel, *supra* note 94, at 688.

187. See, e.g., A. RABINOWITZ, *MUNICIPAL BOND FINANCE AND ADMINISTRATION* (1969); Kidwell & Sorensen, *Investment Banking and Underwriting of New Municipal Issues*, in 1 *THE MUNICIPAL BOND HANDBOOK*, *supra* note 56, at 169.

188. The notice of sale often will contain the name of the financial advisor as the source for further information in connection with the proposed offering.

lation of the particular credit risk involved in a competitively bid issue is made in a relatively short time period with limited information.

By definition, not every bid is the winning bid in a competitive bidding system. Costs incurred in gathering information about an issuer in order to make a bid may not be recouped. This means that information gathering is kept to a minimum, not only to limit losses, but also to give firms the time to bid on more issues and increase the opportunities to win.

In negotiated underwritings, underwriters and their counsel can perform the same verifying functions they perform with respect to corporate securities. Although underwriters can be sued under the antifraud provisions of the securities laws in connection with the issuance of municipal securities, they have no "due diligence" obligation under the 1933 Act with respect to municipal securities underwritten by them. In the absence of an affirmative obligation to seek disclosure (except to avoid material misrepresentations) and of a tradition on the part of underwriters to procure information due to the dominance of competitive bidding in the past, it would seem unlikely, as a general matter, that their efforts at verification differ significantly. Empirical evidence in this area is scant; but the findings of two very recent studies of disclosure practices of municipal issuers in connection with general obligation bond issues and revenue bond issues suggest that negotiated underwritings do not result in any greater degree of disclosure.<sup>189</sup> Both studies surveyed official statements of municipal issuers to determine compliance with the voluntary disclosure guidelines of the Government Finance Officers Association. The revenue bond issues surveyed, like the revenue bond market as a whole, were negotiated issues, while the general obligation issues were competitively bid. Overall, the revenue bond survey did not find any greater compliance with the guidelines than that found in the general obligation bond survey. And, as will be explored in more detail in the next Section, both revealed significant shortcomings.

## V. EMPIRICAL EVIDENCE CONCERNING MUNICIPAL DISCLOSURE

The empirical record tends to confirm the theoretical conclusion reached here that municipal issuers will not voluntarily provide investors with the optimal amount of information. While there is no absolute

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189. Forbes & McGrath, *Disclosure Practices on Tax-Exempt General Obligation Bonds: An Update*, 7 MUN. FIN. J. 207 (1986); Forbes, *Disclosure Practices on Revenue Bonds Issued by State and Local Governments: A Survey* (May 23, 1986) (prepared at State University of New York at Albany).

benchmark as to what this optimal amount is, the evidence does reveal a striking contrast between the disclosure practices of municipal issuers and those of corporate issuers. These differences cannot be easily explained in terms of differences in the needs of investors in the two markets or in the nature of the credit risks involved because the two markets have become increasingly similar.

One marked difference between the municipal securities market and the corporate securities market is the absence of consistent, uniform use of audited financial statements by municipal issuers. A survey of municipal issuers in 1975 found only 10% of the surveyed issuers supplied audited financial reports.<sup>190</sup> A 1985 survey of general obligation bond issues shows the percentage today is around 54%.<sup>191</sup> A similar survey of revenue bond issues found that, overall, 61.3% of those surveyed included audited statements. Surprisingly, issuers of over \$10 million (approximately 40% of the sample and 50% of the revenue bond market) included audited financial statements less frequently than issuers in the median range of \$5-10 million (approximately 18% of the sample and 20% of the revenue bond market), which had the highest percentage of audited statements (72% as compared with 67%).<sup>192</sup> A third study of disclosure practices with respect to bond issues that have credit enhancements, that is, issues backed by insurance or letters of credit of financial institutions, has also been recently concluded. It found little uniformity in disclosure practices. Specifically, the authors noted that there was "generally an absence of substantive financial information (e.g. audited financial statements) from the supplier of the credit enhancement," and "little information disclosed on the legal standing of the 'enhancement' in the event of an insolvency of the supplier."<sup>193</sup>

A 1983 study of municipal financial reporting practices found widespread non-compliance with generally accepted accounting principles at the local government level.<sup>194</sup> It also found that reporting of lease obliga-

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190. 1976 Hearings, *supra* note 13, at 252.

191. Forbes & McGrath, *supra* note 189, at 211.

192. Forbes, *supra* note 189, at 13-14.

193. Disclosure Practices on Tax-Exempt Bond Issues: The Case of Credit Enhancements 2 (Nov. 15, 1985) (a report by the Financial Markets Research Center, School of Business, SUNY, Albany).

194. Seligman cites an Arthur Young and Company study of 557 cities and counties in which over one-fourth of all audited statements contained inadequate accounting practices or use of an "inappropriate basis of valuation of fixed assets." Fifty-four percent of the opinions by the auditors were qualified. J. SELIGMAN, *THE SEC AND THE FUTURE OF FINANCE* 285 (1984).

There has been, since 1934, an accounting organization to establish state and local government accounting principles. This organization was the National Council on Government Accounting until

tions, pension fund liabilities, and property tax revenues, which were major problem areas with New York City's financial statements, continue to be areas where there is little meaningful disclosure.<sup>195</sup> A 1985 study of general obligation bond issues yielded findings of inadequacies in the reporting of pension fund liabilities, property tax collection, and outstanding indebtedness in prior years.<sup>196</sup> Another area of non-disclosure revealed by the general obligation bond study was the inadequate reporting of short-term debt. Previous experience with municipal defaults, both large and small, suggests that misuse of short-term debt is often a significant contributing factor.<sup>197</sup> The revenue bond study found inadequacies in providing detailed operating statements for at least one prior year and in providing current balance sheets, as well as reporting of short-term debt, schedules of current debt, and statements of prior years' debt. Information as to principal customers, capacity, and utilization of the enterprise was found to be "less likely to be discussed." Similarly, "only slightly more than 26% of the sample provided detailed summaries of the reports by engineers or financial consultants."<sup>198</sup> These areas of non-disclosure are of critical importance in evaluating the probabilities of success of the projects to be financed.

Another indication of the disclosure problems in the municipal market is the much larger role played by the bond rating agencies compared to their role in the corporate market and the questions concerning the quality of their evaluations. Most observers agree that ratings are the single most important method by which participants in the municipal securities market become informed about the credit risks associated with the issues being offered.<sup>199</sup> Empirical evidence supporting this proposition demonstrates that a change in a rating results in an immediate change in the affected issuer's borrowing costs, bringing them "in harmony with the costs of other communities in their new rating classes."<sup>200</sup>

The New York City and WPPSS defaults are not reassuring as to

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1984, when it was replaced by the Government Accounting Standards Board, modeled after the Financial Accounting Standards Board in the private sector. The hope is that this latest attempt to create standards for government accounting will meet with greater compliance.

195. *Id.* at 285-86.

196. Forbes & McGrath, *supra* note 189, at 213-16.

197. *Id.* at 214-16.

198. Forbes, *supra* note 189, at 7, 9, 10, 12.

199. J. PETERSEN, *supra* note 30, at 2; see also R. LAMB & S. RAPPAPORT, *supra* note 25, at 51-52 (ratings have "grown from next to negligible importance into a central and, in many cases, controlling factor in whether an investor or institution will buy a municipal bond.").

200. G. JANTSCHER, THE EFFECTS OF CHANGES IN CREDIT RATINGS ON MUNICIPAL BORROWING COSTS 19 (1970).

the quality of these ratings. New York City carried an "A" rating even after the markets had closed.<sup>201</sup> WPPSS Plants 4 and 5 Bonds carried an "A/A plus" rating until June, 1981, when the Managing Director of WPPSS called for a moratorium on construction. In response, WPPSS's ratings were downgraded to "Baa/A," which are still investment grade ratings, but which (as to the "Baa" rating) have speculative characteristics.<sup>202</sup> While this may be regarded as anecdotal evidence of the accuracy of ratings, the magnitude of the anecdotes in the whole municipal credit scene suggests that they should be taken seriously.

There is also statistical evidence of problems with ratings. A study of both upgraded and downgraded cities found that such cities could be "classified with a high degree of accuracy on the basis of fiscal variables alone, even up to three years prior to the actual rating change."<sup>203</sup> While there is also evidence that the market anticipates, to a significant extent, ratings changes, suggesting that other sources of information are important, the fact that the actual rating change brings a further reaction suggests that there is a segment of the market that relies on the ratings as "independent signals."<sup>204</sup>

Commentators suggest several reasons for the problems associated with the quality of the ratings. Some suggest that rating agencies respond to political pressure not to downgrade ratings.<sup>205</sup> Others blame the lag on understaffing of the agencies.<sup>206</sup> Rating agencies do not conduct anything comparable to the due diligence undertaken by underwriters in a corporate securities issue. With approximately 5,000 new issues to be rated each year by staffs of around 80,<sup>207</sup> less attention is necessarily given to seeking further information than that which is supplied by the issuers.

In the aftermath of New York City's near default, arguments for regulation were met with counter arguments that the market was forcing issuers to disclose. Much of the empirical evidence cited above suggests that there has been an improvement since 1975, but it also suggests that large differences between municipal and corporate market disclosure re-

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201. SEC REPORT, *supra* note 7, ch. 5, at 28.

202. Gleckman, *supra* note 34, at 34.

203. Raman, *Financial Reporting and Municipal Bond Rating Changes*, 56 ACCT. REV. 910, 918 (1981).

204. *Id.* at 911.

205. *Id.* at 922; The Wall Street Journal, Nov. 2, 1981, at 1, col. 6.

206. J. PETERSEN, *supra* note 30, at 91.

207. Both Standard & Poor's and Moody's have increased their staffs significantly in the last 10 years from approximately 15 to 80. This increase was attributed primarily to the growth in the number of issues and the complexity of issues. Telephone interviews with Perry Young, *supra* note 181, and with Michael Beauchamp, Moody's Investors Service (May 16, 1986).

main. Comparisons of the information voluntarily supplied by WPPSS with the facts as revealed by preliminary investigations indicate how significant the municipal disclosure problems continue to be. For example, there appears to have been less than full disclosure as to the budgets used in the offering statements. The body of the official statement gives no indication of the percentage increase in construction cost estimates over time. The estimates as to electricity consumption also appear to have been unsound. An extensive article on the WPPSS default reported that internal budget estimates existed that were far higher than those used in the offering statements.<sup>208</sup> A 1979 paper examining the WPPSS offering statements found similar discrepancies in the figures used.<sup>209</sup> For example, the March 1, 1979, offering statement for Plant 2 stated that power costs from that unit were estimated at 28.5 mills/kwh, while a March 2, 1979, letter from the managing director estimated costs at 32.7 mills/kwh.<sup>210</sup> The offering statements continued to use projected power requirements that were based on assumptions of higher growth for the region than other available studies and on the assumption of critical water shortages that, in the Northwest, with abundant water resources, were unlikely to occur frequently.<sup>211</sup> The figures as to projected energy demand also failed to account for conservation as utility rates increased.<sup>212</sup> Also, there was a failure to disclose legal questions as to the enforceability of the participation agreements that formed the basis of guarantees of payment under the take-or-pay contracts. Finally, no mention is made of the public district utilities about whom bond counsel did not opine because of doubts regarding the enforceability of their participation agreements.<sup>213</sup>

These were all critical matters. It was the cost overruns, coupled with growing recognition that the two units would not be needed for at least ten to fifteen years, that eventually led to the termination of Plants 4 and 5. The unenforceability of the participation agreements ultimately led to the default.

The overall impression given by the WPPSS official statement is that

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208. Gleckman, *supra* note 34, at 16, 27.

209. J. Lazar, *The Official Bond Statements of The Washington Public Power Supply System: A Critique*, reprinted in *Hearings Before the Subcommittee on Mining, Forest Management, and Bonneville Power Administration of the Committee on Interior and Insular Affairs*, 98th Cong., 2d Sess., at 234 (1984).

210. *Id.*

211. *Id.* at 240-41.

212. Gleckman, *supra* note 34, at 10.

213. *Id.* at 18.



the issuer did not feel pressure to take the disclosure process seriously. One indication of this casual attitude is the repetition of information from one offering statement to the next even when the information became dated. Interestingly, all but one of the fifteen offerings for the defaulted Plants 4 and 5 were competitively bid. Had there been a registration process with affirmative due diligence on the part of issuers, underwriters, and their respective lawyers, some of the areas of non-disclosure and misinformation in both the New York City and WPPSS situations would probably have been brought to light in the process of drafting a disclosure document that would have been subject to review by others familiar with the disclosure requirements.<sup>214</sup>

## VI. CONCLUSION

The municipal securities market relies on voluntary disclosure of information. It has been traditionally assumed that since the only investors attracted to municipal bonds are those who are either financially sophisticated themselves (for example, banks and casualty insurance companies) or wealthy individuals capable of buying financial advice and withstanding losses, these investors would be able to procure adequate amounts of information for themselves. Underlying this basic assumption is a second assumption that, given the low default record for municipal bonds, less information is needed. Neither assumption is true in today's municipal securities market. The profile of the investor in municipal securities is not much different than the investor in the corporate securities market, making the need for information just as great. The market does, in fact, differentiate among issuers in its pricing of securities based on its assessment of credit risk. Therefore, information is needed to make these distinctions accurately.

Accurate market determinations of municipal credit risk serve vital social functions. The communities represented by state and local governments need good fiscal management: sensible tradeoffs reflecting community preferences between amounts of services and facilities provided in the present and in the future, and paying for them in the present or the future. Citizen and legislative monitoring of governmental fiscal management has inherent limitations. Unless the market makes accurate credit determinations, serious misallocations of resources are likely to occur,

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214. For a description of the disclosure benefits derived from the process of due diligence exercised in connection with drafting a corporate registration statement for a public offering, see Fox, *supra* note 101, at 1025-26 & n.61.

and timely adjustments in the level of public expenditures may not be made.

There are good reasons to believe that municipal issuers will not voluntarily disclose all the information that the market needs to perform this pricing and credit risk analysis function. The analysis of the motivations of government managers suggests that they may withhold information, good and bad, even though this behavior results in higher borrowing costs. Less costly financing does not translate into rewards that government managers can take personal advantage of. The costs of not disclosing, moreover, may not be felt during the current management's term in office. For these reasons, other management objectives, such as larger budgets and more capital improvements, may prevail even where paying for them will at some point in the future require high tax rates, which are politically unacceptable, or severe reductions in services and capital spending.

Agency theory identifies a number of forces that are at work to elicit information concerning the behavior of corporate managers and to control that behavior. In contrast, none of the potential monitors of governmental management are likely to be effective in terms of either directly enforcing good fiscal management or in obtaining information that the market can use to do the job. The legislators on the specialized committees responsible for individual bureaucratic units have interests at variance with the general public interest. Both individual legislators reviewing the overall budget process and individual citizens as voters have insufficient incentives to become informed. Citizens cannot easily control governmental behavior by switching to another supplier of public services. Interest groups have incentives to both become informed and to inform others regarding policies they wish to promote. But they might not be concerned with good fiscal management in general, or as it relates to particular programs, if that goal results in less economic benefit for their members. Investors lack the leverage to obtain more information because of the insensitivity of government managers to the effects of insufficient disclosure on their borrowing costs. Underwriters in competitively bid issues do not have the time to undertake the kind of due diligence investigation traditionally performed by them in negotiated corporate issues.

This analysis demonstrates that there is too little information available in the municipal securities market. It is both a problem of non-disclosure of information relevant to investment decisions and a problem of lack of uniformity with respect to what is disclosed, making comparison

of investment risks difficult. Some form of mandatory disclosure rules are therefore needed.<sup>215</sup>

Two types of federal regulation were suggested in the aftermath of the New York City fiscal crisis: Senate Bill No. 2574 (the Eagleton bill) and Senate Bill No. 2969 (the Williams-Tower bill). The Eagleton bill's reform was simple: remove the exemption in Section 3(a)(2) of the 1933 Act for municipal securities, thereby placing municipal issuers under the same disclosure scheme as applicable to corporate issuers. This suggestion received little or no support. A number of arguments were marshalled against it. It was criticized for failing to recognize differences in structure between the two markets; it would over-load the SEC, which had no experience with municipal securities; it was an allegedly unconstitutional intrusion into matters of state sovereignty; and it was too costly.<sup>216</sup>

The Williams-Tower bill took a more limited approach. It provided for a disclosure statement to be prepared in connection with issues of over five million dollars in securities, and annual reports by issuers with outstanding securities in excess of fifty million dollars. The bill specified in each case the information to be required and gave the SEC the authority to require other "similar and specific information," and to prescribe forms and accounting methods. Unlike the regime for corporate issuers, however, the bill did not give the SEC any pre-filing review authority.<sup>217</sup>

The hearings and the commentary on the Williams-Tower bill revealed a number of concerns. Three were recurrent: the exemption for small issuers, the exemption for issuers in states that provided for state disclosure regulation, and questions regarding the liability of issuers, their officials, and underwriters. The bill did not pass, perhaps because of the climate created by the *National League of Cities* case,<sup>218</sup> and the preliminary evidence that municipal issuers were disclosing more

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215. Municipal issuers and underwriters are subject to the existing antifraud provisions of both the 1933 Act and the 1934 Act. *See supra* note 4. While the threat of potential liability under these provisions may act to deter egregious misrepresentations by municipal issuers, the kinds of reforms needed to serve the broad purposes of disclosure discussed in this Article require disclosure regulation that creates standards for affirmative disclosure of accurate information and provides a mechanism for monitoring its adequacy.

216. *See, e.g.*, 1976 Hearings, *supra* note 13, at 23 (testimony of SEC Chairman Roderick M. Hills); *id.* at 155-56 (testimony of Hon. Richard Carver, Mayor of Peoria, Illinois, on behalf of the National League of Cities and the U.S. Conference of Mayors); *see also* Note, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, 1976 DUKE L. REV. 1261, 1278-79.

217. S. 2969, 94th Cong., 2d Sess. 1976, § 13A(f)(2)-(3).

218. 426 U.S. 833 (1976).

information.<sup>219</sup>

The issues raised by these two proposals, as well as issues as to whether continuous disclosure is necessary in the municipal securities market, and whether other alternatives exist, such as reliance on state regulation or the availability of insurance, should be addressed in the context set forth in this Article. Any of these approaches to the problem of non-disclosure would obviously involve costs. But this Article demonstrates that the costs of ignoring the problem—higher borrowing costs borne by the taxpayers and the costs borne by society as a whole in the form of misallocation of resources and fiscal mismanagement in the public sector—may well be greater.

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219. See *supra* note 13 and accompanying text.

