PENN IUR **POLICY BRIEF**

Policy Brief: Responding to State and Local Budget Crises

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IN A BAD STATE

RESPONDING TO STATE AND LOCAL BUDGET CRISES

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Thank you so much for having me, Peter and Susan. And thanks to all of you for coming to this terrific conference.

Normally when I discuss my new book, In a Bad State: Responding to State and Local Budget Crises, I start by making sure the audience knows how important state and local budgets are. This crowd doesn't need to be told this, but it's worth mentioning anyway. The old joke is that the federal government is an insurance company with an army – it provides Social Security and Medicare and operates the military and the post office. Almost any service you receive from government is provided by state and local governments. A very large percentage of government employees are state and local employees. If you can touch something – a bridge, a new school – it was likely built by a state and local government. And state and local governments pay for much of this through local taxes, although their efforts are aided by the federal government. So fiscal crises in states and cities strike at the very heart of government and the social order in America.

Right at this moment, we are at a turning point. State and local budgets have been extremely flush. State budgets recovered very slowly from the Great Recession – the slowness of the recovery is one of the things that made the Great Recession great – but they did recover substantially during the end of the last decade. It looked during the beginning of the COVID crisis that there was going to be huge budget problems, but revenues did not decline the way people expected. The federal government, over the course of 2020 and 2021, provided a huge amount of aid to states, cities, and other local governments. And recently, inflation has helped many state and local budgets, as well.

But, as we meet, the situation is changing. Even as employment numbers have stayed high, state revenue is starting to decline. Some governments, like transit agencies with declining take from fare boxes, are starting to look quite wobbly. Covid-era federal aid is due to run out, and indeed the debt limit deal pulls back a little money that was due to be sent to states and cities for a few specific purposes.

Many governments used the flush period well, saving resources for a coming downturn. But others did not, using one-time money like federal aid and volatile tax revenues to cut taxes or create new programs that will be tough to cut in the future. Some of these jurisdictions will face real fiscal pain, even crises.

Which is where my book comes in. In a Bad State makes two central points: one analytical and historical, and the other normative and policy-oriented.

The analytical and historical point is that when faced with state or local fiscal crises, federal officials face a "trilemma." Up until now, the literature on this has focused on two choices the federal government has – bailout or austerity. As scholars like Jonathan Rodden and Robert Inman have argued, the federal government could offer bailouts to state and local governments in crisis, but this would create "moral hazard" or a "soft budget constraint," an incentive for states and cities to be irresponsible going forward. Doing so creates pressure on the federal government to constrain the powers of states and cities and leads to centralization. In contrast, if it does not offer bailouts, we get austerity. State and local budgets are pro-cyclical – they have more money and can spend more when times are good, but, unless they save in advance, have to cut when times are bad. This is bad macroeconomic policy, though, and thus avoiding bailouts can turn recessions into depressions.

But if you look across the very many fiscal crises in American history, what you see is that bailout often wasn't an option, as the federal government didn't have the fiscal capacity to provide bailouts. Instead, the question was whether to encourage states or cities to dig deep and pay their debts, sometimes overcoming their sovereign immunity, or whether instead to encourage states and cities to default on their debt. That is, the question wasn't bailout, but austerity v. default.

Over the course of American history, there have been many defaults – states defaulted in the 1840s, Southern states defaulted on much of their Reconstruction Era debt, and Arkansas defaulted in the 1930s (Arkansas defaulted all 3 times, actually, which is why the book jokingly calls it the American Argentina.). But why not more? After all, defaulting means that investors, not the federal government and not state taxpayers take the hit, avoiding moral hazard and (as much) austerity.

The answer, the book argues, is that the federal government very much wants states and cities to be able to borrow, and defaults by any jurisdiction harm that ability for all jurisdictions. Congress, as a districted legislature, has never been able to actually produce infrastructure without it falling into a mess of pork-barrel spending, as Barry Weingast and John Ferejohn have shown. But Congress also wants infrastructure built. And states need to borrow to build. So Congress subsidizes borrowing. This happens through the tax code—the interest on municipal debt is exempt from federal taxes, reducing borrowing costs for states and cities. But it also happens by enforcing the terms of municipal bonds and discouraging defaults, making investors more willing to lend. When it does so, it creates near-term economic harms, as states and cities are forced to bear huge costs to make their debt payments. But it also sets up future investment. For instance, when the Supreme Court developed a series of very aggressive pro-bondholder positions in the 1860s-90s, it meant that local governments had make severe cuts when they faced crises due to their investments in railroads, creating both worse economic downturns and real social hardship. But the same forces made it possible for cities to borrow to build the infrastructural marvels of the period, like the Brooklyn Bridge or the reversing of the Chicago River.

So when faced with a state or local fiscal crisis, the federal government has three choices, but all of them are bad. It can offer a bailout, which avoids austerity and harm to future investment, but creates moral hazard. It can allow defaults, which avoid moral hazard and austerity, but harm the bond market. Or it can force austerity, which avoids moral hazard and harm to the bond market, but creates macroeconomic problems and reduces services just when people need them most.

It's a trilemma. And there's no avoiding it, no clever trick to get out of it. Over the course of American history, we've made different choices. Hamilton's plan to assume state debts was a classic bailout, leading to investors thinking that the federal government stood behind state debt. The state defaults of the 1840s led to states getting out of the business of providing infrastructure, leaving most investment to local governments. I could keep going, from the New York City fiscal crisis and the Detroit Bankruptcy to the different interventions during COVID, but the idea should now be clear.

So what should we do if we see a state or local fiscal crisis in the future? I don't think there's one stable answer to what's the best response, as the underlying conditions about what caused the particular crisis and what the economy looks like when there is a crisis will differ. Further, the answer is going to depend on your ideological worldview. What answer you give will depend, for instance, on how much you care about the future relative to the present or how well you think elections constrain moral hazard.

My book doesn't offer a one-sized fits all answer to explaining what the federal government should do in the case of state and local fiscal crises. Hopefully, it provides both federal officials and voters with the right set of questions to ask, though.

But it does more than that, too. The second half of the book asks how we can make any response – bailout, default, or austerity – a little better. It suggests that there are some values and ideas we can embed in any type of response that will make crises a less common and less painful.

For instance, in whatever type of response it chooses, the federal government can encourage prudence going forward. Call it the "War Games" principle – state and local budget crises are a strange game, the only way to win is not to play. The best protection against crises is states and cities budgeting responsibly in the first

place. And the federal government can encourage them to do so. Bailouts or other aid can include conditions that states and cities adopt a more reasonable set of budgeting rules – modified accrual accounting instead of cash-based account – or even to adopt "volatility caps" forcing them to save when revenues unexpectedly spike. Congress could encourage bondholders to monitor state budgets more closely by repealing the "Tower Amendment" that exempts states and cities from certain financial disclosures.

The federal government can also encourage balance. While there's no avoiding the trilemma, the choice doesn't have to be all or nothing – we can have a little austerity, default and moral hazard, rather than a lot of one or another. For instance, Chapter 9 municipal bankruptcy law already has rules that make a judge determine whether a jurisdiction is "service delivery insolvent," whether services are so bad that bankruptcy is permissible. This effectively gives the bankruptcy judge the power to balance between austerity and default. Chapter 9 could be extended to state governments, who currently are not allowed to file. Governments offering aid, like the federal government to New York City in the 1970s through the Seasonal Financing Act or the State of Michigan to Detroit as part of the "Grand Bargain," can offer aid after a default or impairment has occurred, reducing the harms of default or austerity without creating too much moral hazard. Pension reforms could be enacted that respect the fact that pension underfunding is, like municipal bonds, a form of debt, but that open up greater space to reform pensions on a going forward basis if courts or state constitutional reforms abandoned the so-called "California Rule."

And the federal government could spread the harm of crises. Most Americans pay taxes to many governments – state, county, school district, city, and special districts. Forcing any one of them, or any one of their creditors (both pensioners and bondholders) to bear all of the harm of a crisis can lead to savage cuts. But if we can spread the harm across many governments, we can lessen the worst harms. This might mean opening Chapter 9 to cases filed by many overlapping governments at once. And it might mean giving federal aid directly to local governments as well as states, as the American Rescue Plan did.

There's a lot more in the book, but those are the basic themes. In a country with 50 states and thousands of local governments there will always be crises. They will always be hard to deal with – that's the lesson of the trilemma. But the question is how to reduce the number of crises and how to reduce the harms they create when they do happen.