MERCATUS CENTER
George Mason University

POLICY BRIEF
COVID-19 RESPONSE

No More State and Local Government Bailouts

Veronique de Rugy and Tad DeHaven

May 26, 2020

State and local tax revenues are declining, in line with the dramatic curtailment of economic activity owing to the COVID-19 pandemic. Subsequently, Congress has provided a substantial amount of debt-financed state and local aid: $150 billion for a Coronavirus Relief Fund, $30 billion for an Education Stabilization Fund, $45 billion for the Disaster Relief Fund, $25 billion for public transit systems, an increase in the federal government's share of Medicaid spending, and billions more for a slew of programs including the Community Development Block Grant program and Economic Development Administration.[1] The Federal Reserve (Fed) has also set up a $500 billion program to facilitate short-term state and local borrowing needs.[2] We note that the trillions in federal funds being provided to individuals and businesses could be considered an indirect state support, given that it has been the states, not the federal government, dictating what and how economic activity can continue during the pandemic.[3]

State governors are now seeking an additional $500 billion federal bailout and House Speaker Nancy Pelosi recently suggested a $1 trillion package. Bailing out the states would be the wrong choice. The states should use their sovereign fiscal powers to address revenue shortfalls while undertaking much needed reforms.

DON'T BAIL OUT POOR POLICYMAKING

The pandemic-induced revenue shortfalls are highlighting poor policy decisions. Through a combination of direct handouts and loans, targeted tax breaks, and debt issuance, state and local governments collectively direct an estimated $50 billion annually of public resources to favored businesses and industries in the name of economic development.[4]

For example, the *New York Times* recently reported on localities across the country confronting a lack of revenue to finance bonds issued to construct publicly funded convention hotels.[5] Without the dedicated tax revenues to finance the bonds, localities may have to consider redirecting general fund revenue normally used for standard public services to creditors. And as our colleague Michael Farren notes, local governments subsidizing luxury hotels was itself an attempt to increase the demand for convention centers, which have been oversupplied largely owing to previous economic development subsidies.[6] While a subsidy may benefit the direct recipient, “Among those studies that evaluate subsidies in light of their effects on these broader communities, the vast majority find little to no support for subsidies.”[7] Indeed, when the ancillary costs associated with targeted economic development incentives are considered, “a subsidy is more likely to undermine economic development than enhance it.”[8] So although not a driver of state fiscal woes per se, such misguided policies nonetheless demonstrate the need for greater fiscal accountability at the state and local levels, which federal aid and bailouts undermine.

A considerably larger problem in terms of fiscal magnitude—and another example of a situation created by poor policymaking—is underfunded pension benefits for government employees. Before the pandemic, the states were facing an estimated collective pension funding gap (the difference between a retirement system’s assets and liabilities) of more than $1 trillion (although the real amount may actually be more than $3 trillion).[9] Some states have made no improvement in their pension picture despite having been aware of the shortfall problem for over a decade and despite years of economic growth and solid market returns following the Great Recession. Although some states made modest adjustments, political and legal roadblocks prevented the larger-magnitude reforms needed to sufficiently address the projected shortfalls. In fact, states have attempted to make up the difference by pursuing increasingly risky investment portfolios and assuming unrealistically high return rates on investments.[10] As it stands, pension underfunding is much worse in some states than others, and as the Pew Research Center succinctly puts it, “Ultimately, differences in state pension funding levels are driven by policy choices.”[11]

One example of these different policy choices is visible when it comes to having “rainy day funds,” which involves states setting aside revenue during good times to help mitigate revenue shortfalls during bad times.[12] During the Great Recession, the median rainy day fund balance for the states dropped to 1.6 percent of general fund spending. In 2019, it reached an all-time high of 7.6 percent and was projected to further increase until the pandemic struck.[13] But many states did not take advantage of nine years of revenue growth to prepare for an inevitable economic downturn. For example, Illinois, Kansas, New Jersey, and Pennsylvania have little or nothing socked away while Alaska, New Mexico, North Dakota, and Wyoming have reserves in excess of 20 percent of general fund spending.[14] It is fair to ask, then, why taxpayers in states like New Mexico should be responsible for covering for the insufficient planning of states like Pennsylvania. In fact, Pennsylvania Governor Tom Wolf reportedly intends to stand by his prepandemic budget proposal to increase state spending by 4 percent.[15]

FEDERAL AID TO THE STATES

States are already heavily reliant on federal funds, and America is far removed from the founding vision of a limited federal government with enumerated powers. In 1940, federal aid to state and local government was an inflation-adjusted $13 billion. By 1980, the figure was $250 billion. Today, it's closer to $800 billion, and that doesn't include the aforementioned funds from COVID-19 legislation.[16] As a result, federal taxpayers are now responsible for around a third of total annual state spending.[17]

The problems associated with federal aid to state and local government are numerous and include wasteful spending, bureaucracy, mismanagement, granting privileges to special interest groups, and a general lack of accountability.[18] Despite the complaints about federal overreach, state policymakers have become addicted to handouts from Washington, DC, because it allows them to spend "free" money instead of asking their constituents to come up with the funds via higher taxes. Federal money is not "free," and the consequence of the federal government funding what are properly state and local responsibilities has been excessive growth of government at all levels.[19] Moreover, the federal government's previous bailouts created a disincentive for the states to adequately prepare for economic downturns.

But what about the argument that residents and businesses of some states collectively pay more in federal taxes than comes back from Washington? New York Governor Andrew Cuomo has been particularly vociferous in defending his request for additional federal money on the grounds that his state is a net donor. However, that is not a justification for bailouts even though it is certainly true that inequitable distributions are one of the federal aid system's fundamental problems. A report previously commissioned by the Cuomo administration intended to make his point actually shows that "federal grants per capita are nearly 50 percent higher than the national average in New York, driven by Medicaid and other social programs."[20] But overall, New Yorkers collectively send more revenue to Washington than they get back for two reasons. First, New York is a high-income state and the federal tax code is progressive, so New Yorkers pay considerably more than most other states on a per capita basis. Second, New York receives relatively less money in the form of federal contracts and federal employee wages. Given those realities, Cuomo's case for more federal bailout money is undermined.

STATES NEED TO UNDERTAKE REFORMS

Our colleague Matthew Mitchell and his coauthors recently examined state constitutional provisions intended to inhibit the ability of policymakers to bestow subsidies on particular commercial interests. In reviewing the history of targeted economic development incentives, the authors note that when the states found themselves in fiscal dire straits in the 1830s as a result of "ill-conceived and mismanaged" economic development projects, the federal government refused a requested bailout. That led to the states gradually adopting "constitutional fiscal reforms, including restrictions on public spending for private projects," which delivered positive results.[21] Localities, which were left largely unconstrained by state constitutional "anti-aid" reforms, would decades later face a financial reckoning for embracing the same policies. The result was further state constitutional reforms to inhibit the ability of localities to aid private interests. Although these reforms were also successful, courts weakened constitutional anti-aid provisions in the 20th century. Nonetheless, reform is possible, especially if state and local policymakers are forced to confront a problem of their own making.

The same lesson applies to pensions: state and local policymakers should be forced to take responsibility for the consequences of their policymaking by undertaking substantive reforms. That the states have thus far largely failed to undertake substantive reforms can be attributed, at least in part, to the belief (or hope) on the part of state officials that the federal government will ride to the rescue with a bailout. Indeed, it would be hard to believe that state lawmakers aren't viewing the pandemic as an opportunity to use federal money to delay the day of pension reckoning and—once again—avoid having to make the difficult decisions they were elected to make. In "The Path to Public Pension Reform," our colleague Eileen Norcross states that "true reform must address the inherent problems of public-sector accounting and management of pension funds and consider the benefits of defined contribution plans for public-sector workers."[22] In addition, the question of how to address the legacy obligations of the states' systems without running afoul of state constitutional provisions that shelter current employee benefits needs to be answered.

Federal aid to the states creates a disincentive for state and local governments to prudently manage their finances or undertake difficult but necessary reforms. Bailouts, layered on already high levels of regular federal aid, exacerbate the problem. Federal bailouts for corporations have fostered the same incentives problem.[23] Interestingly, however, many policymakers who are opposed to corporate bailouts or expect them to come with strings attached are fine with state bailouts that come with few or no strings attached.

OPTIONS AND SOLUTIONS

The question of conditional bailouts brings us to the final consideration of how to respond to the calls for another massive state and local government bailout. The need for substantive reforms at the state and local levels is undeniable. The options are complicated and come with constitutional and political concerns, and opinions vary even among those who are generally in ideological agreement.

One option that is resurfacing, as the pension problem grows more acute in the wake of the pandemic, is for the federal government to create procedures for the states to declare bankruptcy. Such procedures are already available to local governments.[24] There are constitutional, political, and efficacy concerns with the state bankruptcy option that would need to be ironed out for it to be a legitimate, let alone desirable, option.[25] A related idea is for the states themselves to take the initiative to create their own bankruptcy process.[26] Others argue that if there is going to be another bailout, provisions should be included that compel the states to implement reforms such as curbing the use of targeted economic development subsidies or designing mechanisms that would provide incentives for the states to strengthen their rainy day funds.[27]

These possibilities require further discussion and debate, but the states have varying balanced-budget requirements and are limited in their ability to borrow for general needs. That necessitates more immediate action that would not be politically easy or appealing but preferable to another federal bailout. As noted at the outset, the federal government has already approved around $300 billion in COVID-19-related assistance to the states. And the Fed's $500 billion Municipal Liquidity Facility is available to assist state and local governments with short-term liquidity needs.[28] In addition to federal assistance and rainy day funds, the states also possess the sovereign power to cut spending and increase taxes. Others have suggested the states consider accounting maneuvers and explore the ability to redirect funds set aside for dedicated purposes to more immediate concerns.[29]

These solutions may not be ideal, but difficult times require difficult decisions. State and local officials are elected to make such decisions. Unfortunately, the longer current and future federal taxpayers are forced to assume responsibility for the financial consequences of state and local policymaking, the greater the incentive of state and local policymakers to put off the hard choices.

ABOUT THE AUTHORS

Veronique de Rugy is a senior research fellow at the Mercatus Center at George Mason University and a nationally syndicated columnist. Her primary research interests include the US economy, the federal budget, homeland security, taxation, tax competition, and financial privacy. She received her MA in economics from the Paris Dauphine University and her PhD in economics from the Pantheon-Sorbonne University.

Tad DeHaven is a research analyst at the Mercatus Center at George Mason University. Before joining Mercatus, DeHaven was a budget analyst on federal and state budget issues for the Cato Institute. Previously he was a deputy director of the Indiana Office of Management and Budget. DeHaven also worked as a budget policy adviser to Senators Jeff Sessions (R-AL) and Tom Coburn (R-OK). His articles have been published in the *Washington Post*, *Washington Times*, *New York Post*, *Wall Street Journal*, *National Review*, and *Politico*. He has appeared on the CBS Evening News, CNN, CNBC, Fox News Channel, Fox Business Channel, and NPR.

NOTES

1. "COVID-19 Stimulus Bill: What It Means for States," National Conference of State Legislatures, April 2, 2020, https://www.ncsl.org/ncsl-in-dc/publications-and-resources/coronavirus-stimulus-bill-states.aspx.
2. Board of Governors of the Federal Reserve System, "Federal Reserve Takes Additional Actions to Provide up to $2.3 Trillion in Loans to Support the Economy," press release, last updated May 12, 2020, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm.
3. We are not taking a position on the propriety of each state's response to the pandemic. In the absence of state-imposed lockdowns, economic activity would have still decreased as individuals adjusted their behavior in response to the pandemic. We are merely pointing out that the unit of government responsible for deciding to curtail economic activity is not the unit of government bearing the responsibility for the costs.
4. Matthew D. Mitchell et al., *The Economics of a Targeted Economic Development Subsidy* (Arlington, VA: Mercatus Center at George Mason University, 2019), 5.
5. Joe Gose, "Plunge in Convention Hotel Travel Puts Municipal Bonds at Risk," *New York Times*, April 14, 2020.
6. Christian Britschgi, "Governments Splurged on Stadiums and Luxury Hotels Before Coronavirus Shut Them All Down," *Reason*, April 17, 2020.
7. Matthew D. Mitchell et al., "Outlawing Favoritism: The Economics, History, and Law of Anti-Aid Provisions in State Constitutions" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, 2020), 13.
8. Mitchell et al., "Outlawing Favoritism," 6.
9. Eileen Norcross and Olivia Gonzalez, "The Path to Public Pension Reform" (Economic Perspectives, Mercatus Center at George Mason University, February 2017).
10. Andrew Biggs and Eileen Norcross, "Public Sector Pensions and the COVID-19 Shock" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, April 2020).
11. The Pew Charitable Trusts, *The State Pension Funding Gap: 2017*, 2017.
12. Matthew D. Mitchell and Nick Tuszynski, "Institutions and State Spending: An Overview," *Independent Review* 17, no. 1 (2012): 38.
13. National Association of State Budget Offices, *The Fiscal Survey of States*, 2019.
14. Chris Edwards, "State Rainy Day Funds," *Cato at Liberty*, April 13, 2020.
15. Spotlight PA, "Gov. Tom Wolf Says He Won't Abandon Ambitious Spending Plan as Massive Budget Deficit Looms," *PennLive*, April 29, 2020.
16. Figures are authors' calculations based on the FY 2020 budget of the United States. See "Historical Tables," Office of Management and Budget, accessed May 20, 2020, https://www.whitehouse.gov/omb/historical-tables/.
17. National Association of State Budget Officers, *State Expenditure Report*, 2019, 3.
18. For a detailed examination of the effects of federal aid to the states see Chris Edwards, "Restoring Responsible Government by Cutting Federal Aid to the States" (Policy Analysis No. 868, Cato Institute, Washington, DC, May 20, 2019).
19. Russell S. Sobel and George R. Crowly, "Do Intergovernmental Grants Create Ratchets in State and Local Taxes ? Testing the Friedman-Sanford Hypothesis" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, August 2010).
20. Laura Schultz and Michelle Cummings, *Giving or Getting? New York's Balance of Payments with the Federal Government* (Albany, NY: Rockefeller Institute of Government, 2019), 11.
21. Mitchell et al., "Outlawing Favoritism," 15.
22. Norcross and Gonzalez, "The Path to Public Pension Reform."

23. Matthew D. Mitchell, “Government Privilege: Bailouts,” *The Bridge*, September 7, 2018.

24. Michael S. Greve, “Bailouts or Bankruptcy: Are States Too Big to Fail?” (Legal Outlook No. 1, American Enterprise Institute, Washington, DC, March 2011).

25. Michael McConnell, “A State Bankruptcy Policy and the Constitution: Michael McConnell Responds,” *Law & Liberty*, July 28, 2016.

26. George G. Triantis, “Bankruptcy for the States and by the States” (working paper, 2011).

27. Michael D. Farren and John Mozena, “Federal Bailouts Could Stimulate State Corporate Handouts, but There’s a Way to End the Economic Development Arms Race” (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, forthcoming); Brian D. Galle and Kirk J. Stark, “Beyond Bailouts: Federal Tools for Preventing State Budget Crises,” *Indiana Law Journal* 87, no. 2 (2012): 599–644.

28. “Municipal Liquidity Facility,” National Conference of State Legislatures, May 15, 2020, https://www.ncsl.org/ncsl-in-dc/publications-and-resources/municipal-liquidity-facility637226319.aspx.

29. Jared Walczak, “State Strategies for Closing FY 2020 with a Balanced Budget” (Fiscal Fact No. 702, Tax Foundation, Washington, DC, April 2020).