

## **Weathering the perfect storm -- without bailouts**

Governors and observers have come to call it the “perfect fiscal storm.” The U.S. states are faced with a convergence of terrible planning, rising health care costs, and plummeting tax revenues. Then throw in federal tax cuts that reduce state taxable income along with some unfunded mandates in homeland security and health care, and the storm clouds look dark indeed. Just as snowstorms and hurricanes evoke historical comparisons, this storm calls to mind the state fiscal crises of the 1980s and even the 1930s.

But why stop there? In fact a more perfect storm hit the states in the 1840s, when a severe recession hit a group of states that had aggressively borrowed to invest in infrastructure, establish banks, and enrich their supporters. Then as now, the press, governors, and bondholders demanded federal bailouts. British bondholders lobbied their government to attack the United States if the federal government failed to assume the states’ debts. In spite of the pressure, the federal government ultimately did nothing and a number of states defaulted. Though it was painful, the states ultimately returned to solvency by introducing new taxes, selling lands and railroads, and reassuring creditors by introducing some of the constitutional debt limitations that still bind many states today.

Over the following 150 years, the states have weathered many fiscal storms without federal bailouts. In contrast, other federal systems have faced similar crises and chosen a very different path: cycles of staggering state-level debt accumulation followed by federal bailouts. The consequences can be economically disastrous – witness Brazil and Argentina in particular. In fact, the U.S. system of fiscal federalism has achieved something quite rare among the world’s federations. Unlike their counterparts in Sao Paulo and Buenos Aires, decision-makers in the states do not expect that they can shift the burdens of present expenditures onto taxpayers in other jurisdictions through bailouts. The federal government said no to state fiscal bailouts in 1840 and then again in 1930. Voters and creditors have learned through experience that the U.S. states are fiscal “sovereigns;” they are responsible for balancing their own budgets without ad hoc federal gap-filling.

Yet current governors might object that today, states are *not* truly responsible for their own fiscal affairs. From tax cuts to partially or unfunded mandates, opportunistic federal government decisions have deep implications for states’ abilities to make ends meet. The states see their fiscal crises as Washington’s fault. Very similar complaints about federal policy lent political credibility to the bailout demands of state governors in Brazil and Argentina.

But as Brazil and Argentina make clear, two wrongs simply create a bigger wrong. The correct policy response to the current crisis is not to write a big general-purpose check to the states -- \$15 billion in Senator Daschle’s recent proposal. Not only will this section of the Senator’s proposal run the risk of creating bad incentives and unraveling one of the strengths of American federalism, it is a very poor instrument with which to stimulate the

current economy. The last major general purpose transfer – Nixon’s general revenue sharing – did little to stimulate state economies during recessions. First, the money was not targeted to high unemployment states. Washington politics made sure everyone got aid, every year. Second, because of the cycle of state budgeting, transfers went first to state bank accounts to then be spent in the following fiscal year. Finally, the money was budgeted typically to capital projects, not low income transfers or tax relief for middle income families, adding still another year or two of delay before a spending impact.

Nor is general relief aid an answer for the structural problems now impacting state budgets. The only reason for federal assistance to states is if there is a clear national interest at stake, and then we should target our assistance as directly as possible to achieve the national goal. To this end, general relief wastes national tax dollars. The only appropriate federal response to the states’ fiscal problems is a program-specific matching grant sufficient by itself to induce the states to reach the federal target of service provision. Low income assistance – and here the most pressing concern is funding health care for the poor – and homeland security are two legitimate national concerns worthy of national financial support using targeted matching aid. If those of us outside the state want the state to provide more services because we value within state provision, then we should pay for it. Congress’s politically convenient strategy is to impose upon the states partially funded (Medicaid) or unfunded (Security) mandates. Mandates are fiscally unfair, an administrative headache, and, if they open the way to general relief aid, a strong disincentive for responsible state budgeting.

It is tempting to conclude that the states should clean up their own mess. At the same time, it is hard to deny that the federal government’s opportunistic policies have made things worse. Yet if the federal government provides general relief bailouts as a response to unfunded mandates, we will have created a dangerous precedent. The United States will not turn into Argentina, but our ground rules for fiscal management, in place since the 1840s, will have been changed. Rather than lobbying for bailouts, the states should demand that the federal government change its ways and demonstrate some of the “reciprocal forbearance” emphasized by Alexander Hamilton in *The Federalist*. The federal government should respect and reaffirm state sovereignty by fully funding valid national objectives through targeted matching assistance. Help the states, but do it in the right way.

Robert P. Inman  
Miller-Sherrerd Professor of Finance and Economics  
Wharton School, University of Pennsylvania

Jonathan Rodden  
Associate Professor of Political Science  
MIT

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