BACKGROUNDER
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State Bailouts Create Poor Incentives, Do Not Fix Underlying Problems

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KEY TAKEAWAYS

Congress should not provide additional funds to cover states' budget shortfalls.

Federal bailouts make funding shortfalls worse, and would set a dangerous precedent for trillion-dollar bailouts of pension systems and other state liabilities.

Congress should provide states with additional budget flexibility by removing existing unfunded mandates.

The National Governors Association (NGA) recently asked Congress for a federal bailout of $500 billion in unrestricted money. The unrestricted money would be available to replace falling revenues and other non-health-related unforeseen budget shortfalls.[1] Similar calls have been echoed in Congress.

The federal response to the COVID-19 pandemic has already been extraordinary. In less than a month, Congress passed three bills, increasing spending and decreasing revenues by well over $2.5 trillion. President Donald Trump declared a national emergency, making about $50 billion in federal financial assistance available for states, localities, and territories, and the Federal Reserve has taken significant new actions, including buying short-term municipal debt for the first time (setting a dangerous precedent).[2]

Federal aid has primarily targeted the current crisis through direct assistance to individuals and businesses struggling as a direct result of widespread mitigation measures taken to slow down the spread of COVID-19 (the disease caused by a novel coronavirus that originated in Wuhan, China). Congress has also authorized federally funded Medicaid coverage for tests and vaccines, $260 billion in unemployment insurance aid to states, and more than $200 billion in direct support for states and localities for unforeseen coronavirus expenses.

Congress is making the same mistakes with some of the promised federal aid as lawmakers made with past federal bailouts. Doubling down on this flawed strategy by sending more money, especially unrestricted money, to state governments would grow states' budgets, increase future funding shortfalls, further undermine local decision making, and set a dangerous precedent that could lead to further federal bailouts of the most irresponsible states. Instead, Congress should provide more flexibility to states by lifting unfunded mandates.

State Bailouts Expand Programs, Create New Liabilities

The federal government included significant fiscal support for state budgets in the early 2000s and again following the Great Recession. These two episodes show that after the bailouts, states were left in a worse fiscal position and less prepared to manage the next crisis.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 included $20 billion in federal grants, including funds to "provide essential government services." Following the federal bailout, states continued to defer pension payments and increased their debts. In the subsequent five years, total state spending rose by 33 percent as detailed by the Mercatus Center's senior research fellow Eileen Norcross. State debts also increased by 20 percent in the following four years.[3]

The American Recovery and Reinvestment Act (ARRA) of 2009 included about $300 billion for state governments. About $50 billion of the ARRA funds were intended to stabilize education systems.[4] However, Lindsey Burke, now The Heritage Foundation's director of education policy, explains that many states used the funds "to create entirely new staff positions, a large number of which are non-teaching positions."[5] The ARRA also included about $90 billion for Medicaid programs through 2010. Norcross counted 28 states that "built their FY 2011 budget around the expectation that Congress would provide more funding for Medicaid, leading governors in these states to begin lobbying Congress for increased Medicaid funding for the coming year."[6]

The prospect of federal tax dollars creates an incentive for state legislatures to both expand existing programs beyond sustainable levels, and to simultaneously underfund those programs in hopes of further federal support. A Government Accountability Office (GAO) review of the 2003 grants notes that states have stopped budgeting for the full cost of natural disasters and similar emergencies that affect state budgets. This is because they are accustomed to the federal government providing most of the recovery funds.[7] The GAO notes that this "moral-hazard" problem is pervasive in federal–state relations and leads to unintended consequences. One example is how states often delay needed infrastructure projects (for which funds are locally available) in hopes of one day receiving federal funds to cover the project costs.[8]

Keeping Decisions and Funding Local

Moral-hazard problems are most pernicious when decision makers at different levels of government are separately responsible for spending and funding.

Purposeful suspension of non-essential economic activity is driving the current economic crisis. To slow down community spread of the coronavirus, governors and local leaders are responsible for adopting, and ultimately lifting, stay-at-home orders based on local conditions. Unrestricted federal grants to prop up state revenues could have the unintended consequence of shielding states from the costs of maintaining regulatory impediments that slow down the eventual recovery.

The current crisis has shown the strength of the U.S. federal system. States and their governors have rightly been central to the pandemic response. Governors and state legislators will also be best positioned to navigate each state and municipality's unique fiscal challenges in the coming years.

Dangerous Precedent for Trillion-Dollar Bailouts

The demand for another $500 billion of unrestricted federal money would set a dangerous precedent for future bailouts.

States and local governments systematically underfund their pensions and health care benefits to provide additional resources for current spending. Because government resources are fungible, putting less money away for future promised benefits allows lawmakers to elevate current spending beyond what revenues will allow over time. This has contributed to pension shortfalls between $4 trillion and $6 trillion, plus another $1 trillion in other post-employment benefits, such as health insurance.[9]

Federal subsides like those in the ARRA and the just-passed Coronavirus Aid, Relief, and Economic Security (CARES) Act can function like a kind of back-door bailout for states which would otherwise have to confront the increasingly impossible task of paying down their debts. Similarly, Washington's increasing share of state budgets can also protect states in the short run. During the past decade of economic expansion, federal taxpayers covered about 32 percent of the average state budget, freeing up more money for expanding pension costs and other priorities. Since the 1990s, economic downturns have made the problem worse by ratcheting up spending levels that then never return to their pre-crisis level. The federal share of state budgets increased by 23 percent from 2000 to 2017, from 26 percent to 32 percent from 2017 to 2020.[10] (See Chart 1.)

Providing states with hundreds of billions of dollars in additional unrestricted money would take federal taxpayers one step closer to an explicit bailout of pension and other state and local obligations.

Not All States Need a Bailout

An unrestricted bailout of the states could be highly unequal, forcing taxpayers in well-run states to subsidize those who have systematically underfunded their pensions and rainy day funds, or those states who have particularly volatile revenue systems. If states can tap federal revenues in times of crisis, it allows them to redistribute their costs from state taxpayers to federal taxpayers and circumvent their balanced budget requirements (which exist in 49 states).[11]

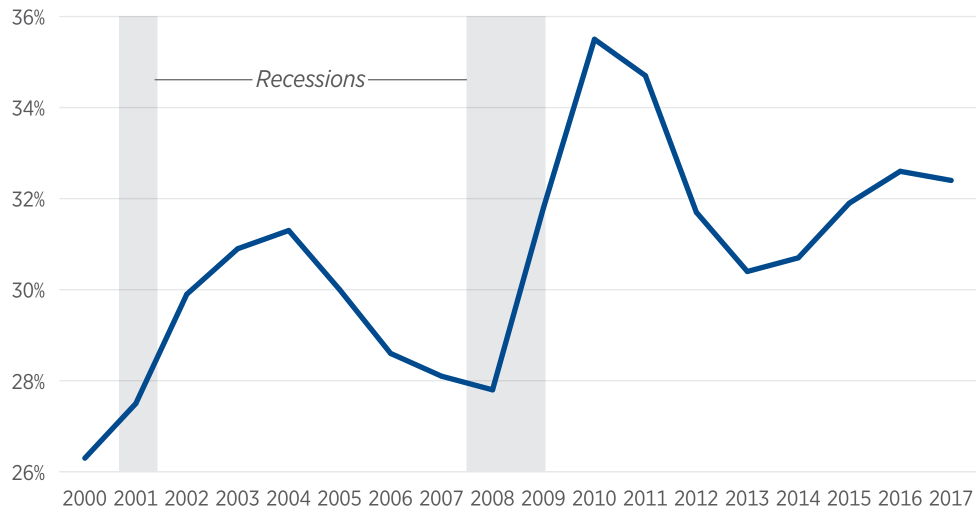
Some states have been prudent, and others reckless, in their budgeting. Although all states face pension shortfalls, some have accumulated significantly more pension debt per capita than others. According to the American Legislative Exchange Council's most recent pension underfunding report, Tennessee, Indiana, Nebraska, and Florida averaged about $9,000 in pension underfunding per capita, while Illinois, Connecticut, California, and Alaska averaged over $30,000 per capita.[12] Moreover, despite the economic recovery and strong stock market performance since 2009, states have increased their debt and unfunded retirement liabilities.[13]

Some states also look well situated for impending revenue shortfalls and higher-than-expected outlays, compared to the financial crisis. State rainy day funds at the beginning of the Great Recession could cover about 4.8 percent of state expenditures. In 2020, rainy day funds are ready to cover 8.4

CHART 1

Federal Share of State Budgets Grows in Recessions

FEDERAL SHARE OF STATE REVENUE FOR ALL 50 STATES



SOURCES: The Pew Charitable Trusts, "Fiscal 50: State Trends and Analysis, Federal Share of State Revenue," March 18, 2020, https://www.pewtrusts.org/en/research-and-analysis/data-visualizations/2014/fiscal-50#ind1 (accessed April 15, 2020), and National Bureau of Economic Research, "US Business Cycle Expansions and Contractions," https://www.nber.org/cycles.html (accessed April 16, 2020).

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percent of expenditures. However, not every state is equally well prepared. Wyoming has put away the most, covering 109 percent of its annual general fund expenditures, Alaska (52.6 percent), North Dakota (30 percent), New Mexico (26.8 percent), and West Virginia (16.9 percent) round out the top five. Illinois and Kansas have next to nothing in their emergency reserves, followed by Pennsylvania (1 percent), New Jersey (1 percent), and Kentucky (2.6 percent).[14]

In addition to large differences in preparedness, states and municipalities will face different revenue shortfalls depending on their tax structure. During the Great Recession, municipalities with greater reliance on property taxes—a very stable revenue source—were more likely to weather the economic downturn.[15] On the other end of the spectrum, revenue streams from taxes on natural resources, corporate income, and capital gains tend to be the most volatile.[16] The good news is that states with the largest rainy day funds tend to be those with the most volatile revenues.

Allowing Flexibility

Instead of providing bailouts, federal lawmakers should remove existing federal requirements that raise costs for states unnecessarily. One example is the new mandate in the Families First Coronavirus Response Act that requires small businesses, as well as state and local governments, to provide paid leave to their employees. Governments are not eligible for the tax credits provided to the private sector that offset the costs. Congress should remove this mandate, rather than sending money to cover the costs or expanding access to the tax credits.[17]

Similar unfunded mandates are pervasive in federal education funding and should be removed. The CARES Act temporarily relaxed some of the existing requirements, such as allowing schools to carry forward unused Title I and other funds from year to year. These temporary flexibility measures should be made permanent, and more work is needed.[18] For example, the U.S. Department of Education should refocus its activities to Title I ("Improving the Academic Achievement of the Disadvantaged") and allow states and local governments to determine the best ways to fund educational services without interference from Washington.

Another example is the Davis–Bacon Act, which forces increased costs on state and local governments by requiring contractors to pay an artificially high "prevailing wage" for construction projects that receive federal funding. The methods used to calculate prevailing wages result in artificially high wage rates that, in some cases, are more than double the market wages and forces additional regulatory paperwork and reporting costs on contractors.[19] State and local governments that share the cost of a joint federally funded project are also forced to pick up these unnecessary costs. Congress should repeal the Davis–Bacon Act.

Conclusion

The federal government has already provided more aid to state governments than during the Great Recession. Congress should not double down on this flawed strategy. Sending temporary, targeted aid to individuals and businesses struggling to make ends meet can help to put a floor under people while the economy is temporarily shuttered. In the post-coronavirus economy, some businesses will still fail and others will retool, as markets reveal new needs. This post-crisis evolution will ultimately make businesses and their employees better equipped for the next downturn. State and local governments are not subject to the same market discipline, thus sending unfettered aid to state governments faces more challenging incentives.

Federal aid tends to expand state budgets and make them less resilient during future crises. Simply moving state funding to the federal government does little more than redistribute local costs to federal taxpayers across all 50 states. Stay-at-home orders, program funding levels, renegotiation of future obligations, and designs of tax systems should all remain chiefly state and municipal endeavors. Congress can help states by providing flexibility in existing funding sources.

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