Commentary

Paul Rothstein

In this paper, Bob Inman gives a strong critique of crisis-driven federal support for the states. He bases this critique on an equally strong defense of American state-level public finance and the importance of preserving its capabilities. He argues that funneling crisis-driven federal money through state governments creates moral hazard and risks undermining a fundamentally sound system. If macroeconomic stimulus is needed, changes in federal taxes and transfers can deliver it. Bob then analyzes the assistance to states through the American Recovery and Reinvestment Act (ARRA) and argues that its relief is not well targeted to states with high unemployment or large budget gaps. He concludes that instead of offering more (or future) support, the federal government should reconfirm its commitment not to bail out state governments.

I essentially agree with Bob's conclusion about crisis-driven federal support for the states, which I call "ARRA-type spending." I am not, however, as inclined as Bob to read either the theory or the data about state-level public finance in such a positive way. The conditions that guarantee economic efficiency in models with multiple regions are strong and generally do not hold. Free migration of people and factors is a (mostly) good and powerful force but it doesn't do everything. More important, there are many actual pathologies at the state level, including large transfer programs, the underfunding of state pension plans, and inadequate rainy day funds. Since I find more flaws in the status quo, I weigh the costs and benefits of federal crisis assistance somewhat differently. I also suggest that measured federal assistance in a crisis need not create moral hazard if it is conditioned on specific and positive state actions taken before the crisis, such as transparent accounting and strong stabilization funds. Crisis assistance that is contingent on more than just the crisis could provide substantial net benefits.

Bob begins with a brief and balanced review of the key principles of efficient state-level public finance. He explains the virtues of residence-based taxes, but notes that source-based taxes are more common. He argues that the mobility of taxpayers and factors of production discipline state governments, but notes that benefit spillovers make intergovernmental transfers necessary. He draws on Bohn and Inman (1996) to give conditions under which states will use long-term debt appropriately, but notes that the conditions are strong and public officials have many ways to hide deficits and use borrowed money to fund current services. He then summarizes:

> In FY 2006, states were spending money on appropriate state functions, raising most of their money with efficient resident-based taxes, and running small current-account fiscal surpluses…The federal government provides assistance for state services with arguably significant interstate spillovers and does so with appropriate price-based subsidies. By most measures, states were fulfilling their assigned role in our federal system of public finance in FY 2006 (Inman, pp. 70-71).

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I would add that state-level public finance is also impressive over normal business cycles. Recent empirical work by Rodden and Wibbels (2010) on seven federations establishes that during downturns U.S. states draw down stabilization funds, reduce expenditures modestly, and allow revenues to fall (but work to attenuate the decrease with tax rate increases). These are good results insofar as sharp reductions in state spending and large tax increases can do outsized harm to businesses and consumers, a fact that Bob notes.[1] These results are largely achieved without additional central government assistance: In all but one federation, central government grants are procyclical or neutral.[2] Countercyclical ARRA-type transfers are rare.

The story so far is very positive and points toward efficient state-level public finance. There are a few caveats, however.

First, free migration ensures that all people reside in the location that best suits them, but what ensures that their utility is as high as possible? This is a complicated question. Migration imposes fiscal discipline but it need not make the outcome fully efficient. Sometimes decentralized efficiency fails (Boadway and Flatters, 1982). The known conditions under which efficiency holds are very specific (Myers, 1990). For example, giving migrants ownership stakes in the regions that they leave and enter fully internalizes the costs and benefits of moving. When capital is both mobile and taxed, inefficiency is all but guaranteed if the tax simply reduces the net return to capital and provides no benefits to capital owners (Wildasin, 1989). Efficiency has a knife-edge quality when the tax funds local public infrastructure that enhances capital productivity (Dhillon, Wooders, and Zissimos, 2007).

These models tend to predict inefficiently low levels of local public goods and infrastructure in normal times. A race to the bottom is more likely than a race to the top. Cutbacks in recessions should therefore tend to produce large welfare losses, since the cost exceeds the benefit on even the "first" reduction. Federal assistance in a recession can reduce this injury, and the net benefits may be large.

An important objection to the previous point is that federal grants can ease fiscal competition and the constraint it places on spending. This is true, but mass migration and capital flows are not the classic kinds of local public-good spillovers discussed at least as far back as Olson (1969). Federal grants may plausibly correct Olsonian spillovers, but the complexity and subtlety of non-Olsonian spillovers make it much harder to believe that efficient grants can even be computed, much less implemented. Indeed, just to illustrate the subtleties, traditional Olsonian spillovers coupled with mobility can make federal grants unnecessary (Wellisch, 1993).[3] Fiscal competition and the underprovision of local public goods seem closer to reality than efficient federal grants.

My second caveat concerns Bob's claim that "states were spending money on appropriate state functions." This claim is problematic, and the problem is Medicaid. Medicaid used 16.3 percent of state general fund revenue in 2008, down from 17.4 percent in 2006, but still substantially above the 14.4 percent in 1995.[4] It averaged 20.7 percent of total state expenditures in 2008, ranging from 8.4 percent in Alaska and 10.2 percent in Wyoming to 30.3 percent in Pennsylvania and 34.5 percent in Missouri.[5] In contrast, total public assistance expenditures were just 1.7 percent of expenditures across all states.[6] Medicaid is an enormous program and its commitments are widely regarded as unsustainable (Ward and Dadayan, 2009; U.S. Government Accountability Office [GAO], 2009).

[1] This is not to deny the positive role that some exposure to negative shocks can play in government resource allocation. Policy analysis and improvement are not substitutes for the debates about priorities and the program reviews that occur when there simply is no money.

[2] "These results should put to rest any perception that intergovernmental grants are broadly countercyclical" (Rodden and Wibbels, 2010, p. 50).

[3] In Wellisch (1993) and Myers (1990), efficiency requires resources to flow between regions, but these flows are decentralized in the sense that they are generated in Nash equilibrium by (i) regional taxes on property that is owned in part by nonresidents or (ii) explicit transfer payments chosen by the regions themselves. Even the Olsonian analysis is more complicated than it appears at first, since local revenue is still needed and some of the burden may fall on mobile bases.

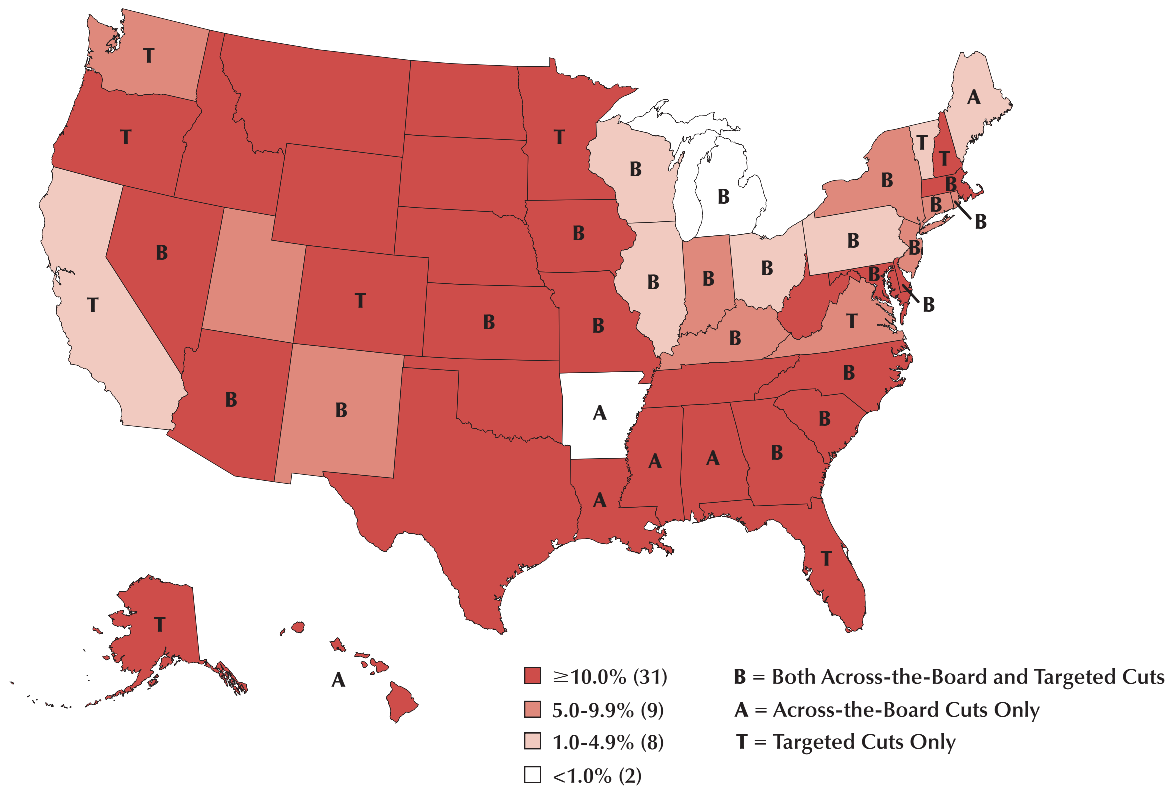
[4] National Association of State Budget Officers (NASBO, 2009, Table 3).

[5] NASBO (2009, Table 29).

[6] NASBO (2009, Table 19).

Figure 1

2007 Total Balance Percentages and 2009 Budget Cuts by State



NOTE: The 2007 total balance as percent of expenditure. The total balance equals ending balance plus stabilization fund balance.
SOURCE: NGA and NASBO (2007, 2009) and author's calculations.

Medicaid is, fundamentally, a very large transfer program. The general theory of federalism tells us that there are substantial potential benefits from complete centralization (Brown and Oates, 1987). Empirical work on differences in costs and services across the states provides additional support for centralization (Holahan, Weil, and Wiener, 2003). Furthermore, it is reasonable to suppose that Medicaid draws resources away from other state programs. An extra dollar of state-level Medicaid revenue surely comes from some combination of lower spending on other state programs and higher taxes and not just from higher taxes alone. If so, the marginal benefits from these other programs are higher than they would be if not for Medicaid. The harm from recession-induced cutbacks in other programs is therefore also higher than it would be if the states were not assigned this function.

A third caveat regarding efficient state-level public finance concerns retiree obligations. The proper matching of costs and benefits requires current taxpayers to pay for the retirement benefits of current state employees as part of their current compensation. Opinions vary about how much underfunding of retirement plans creates a risk of default, but there is no question that *any* underfunding shifts a fiscal burden to future taxpayers.[7] Underfunding is, of course, widespread. Recent work by Robert Novy-Marx at the University of Chicago and Joshua Rauh of Northwestern com-

[7] GAO (2008) provides a recent discussion of these issues.

Table 1

2007 Total Balances and 2009 Budget Cuts by State

	Fiscal year		
State	2007 Total balance* as percent of expenditure	2009 Across-the-board cuts	2009 Targeted cuts
Alaska	49.9		X
North Dakota	48.5		
Nebraska	35.1		
Montana	32.4		
Oregon	25.8		X
West Virginia	25.6		
Louisiana	20.8	X	
Texas	20.5		
Delaware	17.4	X	X
Kansas	16.6	X	X
South Carolina	16.5	X	X
Alabama	16.1	X	
Idaho	14.6		
Oklahoma	13.8		
Minnesota	13.2		X
Georgia	13.1	X	X
Missouri	13.0	X	X
Wyoming	13.0		
Nevada	12.8	X	X
Tennessee	12.2		
Maryland	12.1	X	X
South Dakota	12.1		
Florida	11.8		X
Iowa	11.4	X	X
Colorado	11.2		X
Mississippi	11.1	X	
New Hampshire	11.0		X
North Carolina	10.8	X	X
Arizona	10.5	X	X
Hawaii	10.3	X	
Massachusetts	10.0	X	X
Kentucky	9.2	X	X
New Mexico	9.1	X	X
Connecticut	8.9	X	X
Virginia	8.5		X
New Jersey	7.3	X	X
Indiana	7.2	X	X
Washington	7.2		X
Utah	6.4		
New York	5.9	X	X
Ohio	4.9	X	X
Vermont	4.7		X
Pennsylvania	4.7	X	X
Maine	4.5	X	
California	4.3		X
Illinois	3.6	X	X
Rhode Island	3.3	X	X
Wisconsin	0.9	X	X
Michigan	0.1	X	X
Arkansas	0.0	X	

NOTE: *The total balance equals ending balance plus stabilization fund balance.
SOURCE: NGA and NASBO (2007, Table A-13; 2009, Table A-5a).

Table 2

Number of States Making Budget Cuts in 2009 by Adequacy of Total Balances in 2007

	Type of cuts in FY 2009			
Total balance as percent of expenditure	Across-the-board and targeted	Across-the-board only	Targeted only	None
FY 2007: ≥10% (no. of states = 31)	11	4	6	10
FY 2007: <10% (no. of states = 19)	12	1	4	2

SOURCE: NGA and NASBO (2007, Table A-13; 2009, Table A-5a) and author's calculations. FY, fiscal year.

puted the existing liabilities to current state employees from 116 state pension plans. Assets in these plans were $1.9 trillion at the end of 2008, but liabilities exceeded assets by at least $1.3 trillion and perhaps by as much $3.3 trillion.[8]

I raise this particular issue to discuss a general point about moral hazard. If a pension fund becomes insolvent, the political leaders who did not set aside sufficient resources would surely be punished even if the federal government stepped in to soften the consequences. Thus, it is not clear how the expectation of federal assistance influences their decisions. The same conclusion holds if those leaders do not expect to be in office when a crisis occurs. Bob notes that state decisionmakers have various ways of hiding debt. Perhaps this lack of transparency is the real problem; if so, it is not clear that moral hazard is relevant. Common sense about moral hazard is sufficient to identify the worst public policies, but models of the economic and political incentives facing decisionmakers are necessary for evaluating more careful proposals about federal assistance.

Bob's discussion of the $233 billion in state assistance through the ARRA neatly summarizes a complicated policy. The nominal goal of this state assistance is to protect core state services and support states in particular distress. The aggregate funding is sufficient to close three years of projected state budget gaps. However, by regressing state-level assistance against various measures of state need, Bob shows quite elegantly that assistance is only weakly correlated with need. He then argues that the structure of the plan reveals a more basic goal: to pass a spending bill quickly. This is why the ARRA made extensive use of existing programs and aid distribution formulas. These formulas do not track current economic conditions in the states, but using them minimized disruptive haggling among legislators.

The ARRA might have provided greater short-term gains in welfare if it had been targeted to places with the greatest need. Better targeting might also have created larger multiplier effects and macroeconomic stimulus. Unfortunately, once a crisis develops, targeting assistance to the places with the greatest need may cause the *electorate* to prefer mismanagement, in which case it is surely the worst policy in terms of moral hazard. Thus, it is also hard to recommend that the ARRA should have been better targeted. Is there a policy with better short-term and long-term properties than ARRA-type spending?

In principle, the answer is yes. The key to crisis assistance that is beneficial on net is to make it contingent on more than just the crisis. It is worth recalling that conditions on federal grants in the past have improved the functioning and professionalism of state agencies.[9] It may be feasible to use indicators of responsible state budgeting, such as commitments to transparent budgeting and stabilization funds, to define qualifying standards for federal assistance during crises.

At the end of fiscal year 2007, 31 states had reserves equal to at least 10 percent of state expen-

[8] Novy-Marx and Rauh (2009, p. 4).

[9] This was certainly true for road building and public assistance; see Derthick (2001, pp. 15-17).

ditures. Nevertheless, in fiscal year 2009, 11 of these states had to enact *both* across-the-board and targeted spending cuts (see Figure 1 and Tables 1 and 2). An assistance plan that helped these 31 states—but did not support the 12 that entered the recession in a weaker position and *also* enacted both types of cuts—might enhance welfare with little risk of moral hazard. This seems like an approach worth studying.

The ARRA provides crisis-driven support for state programs. Bob sharply criticizes this approach to fiscal federalism, emphasizing moral hazard problems and the poor targeting of the support. I agree with his critique, but I still think there is a role for well-designed federal support during crises. Certain flaws in state finance suggest the possibility of large welfare losses from cutbacks during recessions. A policy that delivers federal support during crises for qualifying states can reduce such losses, encourage transparent budgeting and larger stabilization funds, and need not present moral hazard problems. This requires further research, of course. In sum, Bob provides strong arguments for uncoupling macroeconomic stimulus spending from federal support for state programs during crises but does not argue against crisis support altogether. Indeed, crisis support for qualifying states might even help to forestall future ARRA-type spending, since qualifying states are not likely to condone support for those that were less fiscally responsible in better times.

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