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Legal Outlook

Bailouts or Bankruptcy: Are States Too Big to Fail?

By Michael S. Greve

"Debts that cannot be paid will not be paid." —Alex J. Pollock

"What cannot go on will eventually stop." —Herb Stein

In any sensible discussion of the fiscal crisis of the states, Pollock's and Stein's laws should serve as a rock-bottom foundation. But they also suggest further questions: who *will not get paid, and* on what terms *will things come to stop? The answers will depend on political decisions in the states and in Washington, DC. We had better get those answers right, and we may not have a lot of time.*

Newsflash: states are in deep financial trouble. Deficits for the current budget cycle are estimated at $175 billion. In some states (Texas, California, Nevada, and Illinois), the shortfall exceeds 30 percent of projected budgets. One way or the other, states will close those gaps to comply with the balanced-budget amendments contained in all state constitutions except Vermont's. Many, however, will be able to do so only by loading up additional debt, on top of already-alarming long-term obligations. Unfunded pension obligations are estimated at upwards of $1 *trillion* and are probably three or four times that amount. Unfunded health care commitments clock in at upwards of a half trillion. Bond debt issued by state and local governments comes in around $2.8 trillion.

It is no consolation that a few heartland states are in decent shape. The Dakotas, Nebraska, and Indiana cannot compensate for the disaster that is Illinois, let alone the bicoastal basket cases. Moreover, while a robust economic recovery would create breathing room for some states, the most afflicted states' problem is structural, not cyclical. Under any plausible economic scenario, revenues will barely cover their ongoing obligations, let alone repay their debts.

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Key points in this *Outlook*:

- Federal transfer programs have contributed significantly to the states' fiscal crisis and the stranglehold of public-sector unions over state politics.
- The states' fiscal crisis is structural, not cyclical. Real recovery and reform will require drastic changes to our federal architecture.
- A critical, urgent task is to restore a federal precommitment against bailing out states. A bankruptcy option for states may be a useful step in that direction.

In some debt-plagued states (most spectacularly, Wisconsin), governments have shown commendable courage in attacking long-term fiscal problems. Concurrently, though, the states' collective predicament has prompted a debate over what, if anything, the federal government could do to assist in an orderly management of the crisis. Among the few concrete, plausible suggestions is a bankruptcy option for states, analogous to the process that Chapter 9 of the federal Bankruptcy Code has long provided for municipalities. Some scholars have championed the idea, and GOP legislators are planning to introduce bills to that effect. The proposal merits serious consideration.

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While bankruptcy cannot be a cure-all for the states' ailments, two things are right about the proposal. First, the search for a federal response draws much-needed attention to the fact that the states' travails are not entirely homegrown but a federal coproduction. Second, a bankruptcy option, and even a vigorous public debate about it, may be a step toward restoring fiscal sanity—provided that its central objectives are kept in mind. State bankruptcy must serve to break the stranglehold of public-sector unions over state politics and budgets; help restore the federal government's precommitment against bailing out states; and advance, rather than distract from, the far more fundamental federalism reforms that will be required over the coming years.

Who Put the Funk in Dysfunction?

In thinking about state insolvency, we should focus on the chief culprit: intergovernmental grants and transfer payments. These "fiscal federalism" programs—the warp and woof of the American entitlement state—were introduced on a broad scale under the New Deal and increased, massively and disastrously, under the Great Society. Federal outlays to state and local governments grew from under $50 billion in 1960 to well over $400 billion in 2008 (in 2005 dollars).[1] They have come to constitute the single largest revenue source for the states. The principal driver has been Medicaid—the most generous federal transfer program, which pays for over 57 percent of the states' health care spending on eligible populations and services.

In decades past, politicians and scholars across the ideological spectrum celebrated fiscal federalism as a means of squaring national policy imperatives with local control—provided the national government pumps enough dollars into the system and leaves the states sufficient freedom to spend the money as they see fit. This, in a nutshell, was the agenda of President Richard Nixon's "new federalism" and Newt Gingrich's push for "devolution," and it resonates today in vocal demands to liberate states from ObamaCare's onerous mandates.

Federalism scholars, in sharp contrast, have come to conclude that devolution—the combination of federal tax authority and discretionary state spending authority—appears to have devolved from the devil.[2] Fiscal transfer programs inflate the demand for government at all levels (national, state, and local); support local politicians and political elites, especially public-sector unions; and produce moral hazard—that is, state and local overspending and bets on a federal bailout. The first two effects are intended; the third is inevitable. All three are upon us.

More Government! Fiscal federalism lowers the perceived cost of government and thus drives up its actual cost. Taxpayers who would refuse to pay $100 in state taxes for some redistributive program may yet support the same program if the federal government offers to chip in $50 for every $50 spent by the state. This fiscal illusion is the engine that has driven the growth of government in the United States.

For the four decades preceding the 2008–2009 financial crisis, federal revenue hovered within a narrow range of 18–20 percent of gross domestic product (GDP). State and local revenue, in contrast, rose from roughly 6 to almost 15 percent of GDP. The difference is not 9 percent; it is 250 percent.

E Pluribus Unions. If we want to redistribute income or provide access to valuable goods and services to people who cannot afford them, the sensible thing is to take the money directly (by means of taxation) and give it directly to those in need. Social Security, food stamps, and the Earned Income Tax Credit fit this description. Those elegant schemes, however, fail to grease state politicians and their hangers-on. This is the reason we provide education, medical services, and much else through intergovernmental programs: the

local politicians and providers get to rake much of the money off the table. Economists estimate this "capture" or "flypaper effect"—the money sticks where it hits—at somewhere between 40 and 100 percent.[3]

The capture rate has emerged as fiscal federalism's central question. For example, only forty cents of every federal education dollar (we are often told) ends up in a classroom. Parent groups and earnest education reformers lament the "inefficiency." The unionized bureaucracy, in contrast, views those same forty cents as money that leaked from the system, and it will work ceaselessly to stop the bleeding. This is what the permanent wrangling over federal "mandates" is about. ("Unfunded mandate" is another term for transfer payments that escape the intergovernmental machinery.) It is also what the current brawls in state capitals are about: a few gutsy governors are tossing rocks in front of the gravy train.

Any plausible state bankruptcy code would have to foreclose the option of a federal bailout.

Moral Hazard. In addition to jacking up taxing and spending for the benefit of state bureaucracies and their clientele, federal transfer programs distort local decisions in other ways. Over time, they crowd out programs that state and local governments have to fund entirely from own-source revenues. (This is how Medicaid has come to consume nearly a quarter of the states' budgets.)

Moreover, especially in times of fiscal distress, when state revenues hit a wall, nonfunded programs have been cut to the bone, and federally funded programs cannot be cut without "leaving money on the table," states naturally hide shortfalls off-budget—predominantly, by underfunding their pension and retirement benefit systems. Of course, politicians at every level will *always* tend to pay, or rather not pay, current favors with future debts. For the reasons mentioned, however, fiscal transfers greatly increase this tendency. And they induce an added risk: chronic state and local overspending in the hope or expectation of a federal bailout.

Bailouts under Any Name

The moral-hazard problem has been endemic to every fiscal federalism system, from Argentina to Brazil to Germany. The common, temporizing response is to stage bailouts under a different name. Our own fine federalism illustrates the pattern:

- *The Children's Health Insurance Program* (initially enacted in 1997 as S-CHIP) subsidizes health insurance coverage for children whose parents might not qualify for Medicaid in all states but who cannot afford private insurance. The federal reimbursement rate under the CHIP program is even higher than under Medicaid. The point and effect of the program is to relieve pressure on states to expand Medicaid to previously ineligible populations.

- *The 2003 prescription drug benefit*, known formally as Medicare Part D, shifted the cost of prescription drugs for "dual-eligible" senior citizens from Medicaid to Medicare. Since states cover an average of 43 percent of Medicaid costs while Medicare is fully funded by the feds, the transfer—even with a partial federal "clawback"—represented a significant break for the states.

- *The American Recovery and Reinvestment Act (ARRA)*, better known as the 2009 "stimulus" bill, enacted a temporary increase in Medicaid's reimbursement formula (since extended to July 2011). It also pumped enough money into state budgets to close the predicted budget gaps at the time of passage, thus serving as a bailout for overextended states.

- *Build America Bonds*, also contained in the ARRA, provided a 35 percent interest subsidy for state and local bonds. The program, which expired in December 2010, supported the issuance of well over $115 billion in state and municipal bonds.

- *ObamaCare* is shaping up as a de facto bailout for states. To make its envisioned, monumental expansion of Medicaid palatable for the states, the act offers them a *100 percent* reimbursement rate for newly covered Medicaid populations (scheduled to decline to 90 percent in later years). More consequentially, the statute—once it is fully operational—will allow a transfer of hundreds of thousands of state and local employees and their health care expenses from state-funded programs into federally subsidized health care exchanges.

Far from providing lasting relief, the interventions have merely steepened the states' financial cliff. Note, though, their accelerating pace and escalating scale. Note, too, that the interventions are often aimed at "curing" the effects of the most generous and therefore most destructive program, Medicaid—as if the drug-addicted could be helped by a dose of pure cocaine.

That brilliant strategy has now reached its limits. States can no longer afford to undertake new federally funded commitments unless the feds pay one hundred cents on the dollar. At that level, our federalism can no longer produce the fiscal illusion that is its raison d'etre. Moreover, the federal government cannot credibly commit to full funding because everyone knows that it, too, is flat broke. A natural question, then, is what else Washington might be able to offer its stricken state clients. Bankruptcy may be one option.

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Bankruptcy?

Since the 1930s, we have had a bankruptcy process for municipalities (but not states), codified in Chapter 9 of the Bankruptcy Code. It is tempting to think of state bankruptcy as the equivalent of corporate bankruptcy under Chapter 11. However, there are several important differences between municipal and corporate bankruptcies.

In terms of the mechanics, Chapter 9 (unlike Chapter 11) requires the filing entity to be actually insolvent. There must also be a showing that the entity has tried but failed to negotiate debt readjustments, and only the insolvent entity, not its creditors, can file for bankruptcy. Inside the bankruptcy process, municipalities have greater protections than corporations, and the court's authority is far more limited. No trustee can be appointed. The local political leadership stays in place, and the bankruptcy judge may not interfere with the municipality's political institutions in any way. Conversely, creditors enjoy much less protection under Chapter 9 than under Chapter 11. For example, they cannot submit a restructuring plan of their own.

These arrangements reflect not only a respect for democratic institutions but also crucial differences in the purpose of private and public bankruptcies. Roughly, Chapter 11 contemplates two basic scenarios. A corporation may have temporary liquidity problems, but its underlying business is sound. In that case, the debt is restructured, and everyone walks off a winner. (This is sometimes called the "fresh start" theory of bankruptcy.) Or, the corporation is a basket case. In that event, we liquidate the capital structure, satisfy the creditors in order of priority and to the extent we can, and move on.

Can one replicate this model for government entities? As to liquidity problems, yes. Most successful Chapter 9 proceedings are initiated by small jurisdictions that suffered an exogenous shock—usually, a tort suit. There is nothing wrong with the local government, only with the state's tort law. So the municipality files under Chapter 9, the creditor takes a haircut, and everyone lives happily ever after.

The bankruptcy of larger jurisdictions, and especially states, is wholly different. Their problem is not a lack of liquidity; their entire business model is a nightmare. Obviously, though, one cannot liquidate or even restructure a large municipality—let alone a state—in bankruptcy. A state would leave the process as it entered it—saddled with federal transfer programs that incentivize unsustainable commitments, politicians whose time horizon extends no further than the next election, and public-sector unions that will immediately try to recover lost ground. So what good could the process do?

The good it could do is make it easier for states to get out from under their pension obligations and collective bargaining agreements. This is actually easier under Chapter 9 than under Chapter 11, and federal law could make it easier still—for example, by doing away with the obligation to renegotiate a collective bargaining agreement prior to bankruptcy filing, or by making it clear that compliance with state labor law is not a condition for a unilateral modification of a bargaining agreement in bankruptcy. (The few judicial opinions on this issue have gone both ways.) Perhaps a federal bankruptcy code could even permit the modification of pension and other obligations incurred under earlier agreements and now owed to retirees, thus reducing the states' legacy costs.

Those suggestions, in turn, point to the purposes and desirable contours of any state bankruptcy option, and to the importance of remaining clear about the objectives and getting the details right:

- Under Chapter 11, we try to make creditors whole. (The process simply serves to overcome holdout problems.) The point of state bankruptcy would be just the opposite—to make a large class

of creditors, public-sector unions, *worse* off relative to their bargained-for advantages and their positions under ordinary law. That abrogation is not an awkward detail of state bankruptcy; it is the entire point. A state bankruptcy code that fails to serve this purpose would do more harm than good.

- Few if any states will avail themselves of bankruptcy so long as the possibility of a federal bailout remains on the horizon; and the least responsible states—the ones most in hock to public-sector unions, and most in need of an orderly bankruptcy process—will be most inclined to gamble on that prospect. The temptation is to lure them and their creditors with federal funds: go bankrupt, and we will forgive or defer your federal payment obligations for *x* years. Any plausible state bankruptcy code would have to foreclose that scenario. Recall that the General Motors and Chrysler bankruptcies in 2008–2009 were preceded by a thinly disguised $25 billion federal check to the United Auto Workers. A public-sector replay is the last thing we need.

If Not Bankruptcy, What?

The history of municipal bankruptcies suggests that state bankruptcy, even within the parameters and for the purposes just sketched, may be ineffectual and perhaps counterproductive. In seven-plus decades, only one major jurisdiction (Orange County) actually filed for bankruptcy. And, after emerging from bankruptcy in 1995, it took Orange County all of seven years to lock itself into yet another pension hike for public-sector unions (sheriffs)—retroactive, mind you—with an unfunded liability in excess of $100 million and in the teeth of unequivocal state constitutional provisions prohibiting such maneuvers.[4] This experience suggests, among other things, that Wisconsin governor Scott Walker has it right: without an end to collective bargaining, any union concessions (in- or outside bankruptcy) will prove short-lived. In the meantime, though, what are the alternatives to bankruptcy?

One alternative is the Kirchner option: pay back the looming debts in Argentinean pesos, or the equivalent thereof. Inflation of 5 or 6 percent over a period of some years would take care of the states' debts, as well as a good chunk of the federal debt. In the long run, our paralyzed political system may well resign itself to this course of action. But the option is highly unattractive and, for the time being, officially anathema. (Our policy is to export inflation, not to consume it at home.)

Another alternative is to let states default on their debts. Historically, this is what we have done. States suspended debt payments temporarily, and a few actually defaulted, in the late 1830s, after the Civil War, and in one instance during the Great Depression. Calls for a federal bailout went unheeded on each occasion. However, this may no longer be an option. Throughout our history, we have had what few federal systems in the world have had—a credible federal precommitment against bailing out states. That commitment, however, was sustainable only so long as, and because, federal transfer programs remained limited. Under a bloated transfer economy and in the wake of a series of stealth bailouts, it has collapsed.

Once the credit markets seize up or a state defaults, we will no longer have a choice between bailing out the states and not bailing them out. We will rather confront the European Union's choice vis-à-vis the "PIIGS" (Portugal, Italy, Ireland, Greece, and Spain)—bail out the creditors indirectly, via the states, or bail them out directly. Perhaps one can imagine a Congress and an administration (though probably not the current administration) that would tell the public-sector unions to face the music. It is well-nigh inconceivable that we will tell bondholders the same thing. The states know it, and the boys at Pimco are betting on it.

The central problem, then, is to restore a credible federal precommitment against bailouts. That cannot be done in a single enactment or overnight; it will require a fundamental reform of the entire federalism architecture. However, big tasks are often best begun in smallish steps. In late 2010, Congress took a first step and—facing down the concrete lobby, the intergovernmental lobbies, and the municipal-bond peddlers—let Build America Bonds expire. The decision increased borrowing costs and temporarily rattled the muni-bond market; but then, the complacent denizens of that peculiar market are overdue for electroshock treatment. A well-designed bankruptcy-for-states statute could be an additional step in the right direction: it could send a much-needed signal that we might in fact *not* bail the states out. If we can make unions, officials, and bond markets guess instead of gamble, that would be progress.

Think!

The fiscal crisis of the states, and its embeddedness in the federal structure, is a challenge to the country. Democrats have a stake in a federalism that funds their base of public-sector unions, and they legislate accordingly. Conservatives have been slow to recognize the challenge. Over the coming years, they will have to reconceptualize federalism and develop a commensurate political agenda. To that end, they must confront and rethink three problems: the margin problem, the devolution problem, and the moment problem.

The margin problem is that in fiscal federalism, as everywhere, everything that matters happens, well, on the margin. The conservative impulse is to look at the "good" margin, meaning the courageous little state (Indiana, Wisconsin, Utah) that wants to experiment with efficient, small-government, citizen-friendly reforms and accordingly seeks freedom from stifling federal mandates. However, empowering states is a dangerous strategy. To illustrate the difficulty: a shift from ObamaCare's unquestionably grim and ruinous mandates to a capped Medicaid block grant would spell fiscal relief and better services for the citizens of, say, South Carolina. In the meantime, though, some much larger state will make the rational, budget-maximizing choice: defund the most vulnerable and expensive Medicaid populations, divert the "savings" to the nurses' unions and provider lobbies, and plead poverty. Five horror stories and two E. J. Dionne columns later, the federal cap will be under assault and the demand for federal funding will be higher than ever.

In that light, a funded nonmandate (that is, a block grant) is not a plausible alternative to an unfunded mandate, and may in fact make things worse. (Historically, Medicaid has grown like Topsy not on account of federal grant conditions but as a result of federal "waivers" that allowed states to expand the program.) Sensible fiscal federalism reform should facilitate experimentation by "good" states without, at the same time, liberating exploitative states to maximize their take from the federal till. No fiscal federalism program, past or present, conforms to this model; and perhaps none ever will. However, a clear-eyed recognition of the basic problem will at least yield a tried-and-true rule of thumb: first, do no harm.

The devolution problem is the conservative-libertarian *ceterum censeo* that federalism and "devolution" equal smaller government. That belief is demonstrably false in the regulatory arena, where "devolution" means hellhole jurisdictions and unleashed state attorneys general, and it is false in the fiscal arena. It was one thing to champion devolution when Wisconsin governor Tommy Thompson experimented with welfare reform. It is an entirely different thing to let California and Illinois experiment with unsustainable programs, in the expectation of a federal bailout. "Devolution" in this context is another word for moral hazard and fiscal disaster. The central task, and the necessary precondition of fiscal discipline, is not to devolve our federalism but to disentangle it.[5]

The moment problem is a potential failure to recognize the true import and the *constitutional* dimension of the current events in Madison, Trenton, Columbus, and other state capitals. "Among the most formidable of the obstacles" to the constitutional project, Alexander Hamilton wrote in *Federalist* No. 1, was the opposition of state politicians, who would resist any "diminution of the power, emolument, and consequence of the offices they hold under the state establishments." As *state* officials, they would lack any encompassing interest for the union. As *elected* officials, they would seek to maximize their returns over their own expected tenure, and that time horizon is too short to support the calculus of a constitution designed to last for ages to come. Provincialism and shortsightedness, Hamilton knew, would carry forward into politics under the Constitution. Alas, instead of acting on his insight, we have constructed a fiscal federalism that feeds on and amplifies those pathologies.

By dint of luck or perhaps a newfound realism among voters, however, we have lately been blessed with a bumper crop of politicians, especially state governors, who do *not* conform to type and expectation—who are prepared to sacrifice their own popularity and electoral interests to the demands of long-term, structural reform, and who recognize that the road to fiscal hell is paved with federal grants. This good fortune will not last, and it will not occur again in most of our lifetimes. The political response should be shaped by the attitudes so admirably displayed by the Constitution's framers—an unsentimental understanding of federalism's political economy; a long-term institutional perspective, coupled with pragmatism about the available options; and above all a recognition that moments of great opportunity are also moments of great danger. Call it the fierce urgency of now.

Miriel Thomas assisted in the preparation of this Outlook.

Notes

1. GPO Access, "Budget of the United States Government: Historical Tables Fiscal Year 2011," www.gpoaccess.gov/usbudget/fy11/hist.html (accessed March 10, 2011).

2. For a first-rate discussion and survey of the literature, see Jonathan Rodden, *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism* (Cambridge: Cambridge University Press, 2006).

3. See Robert Inman, "The Flypaper Effect" (Working Paper No. 14579, National Bureau of Economic Research, Cambridge, MA, 2008), www.nber.org/papers/w14579 (accessed March 8, 2011).

4. Incredibly, a California appeals court has sanctioned the measure: County of Orange v. Association of Orange County Deputy Sheriffs, 192 Cal.App.4th 21 (2011) (petition for review by the California Supreme Court pending).

5. For my earlier suggestions in this direction, see Michael S. Greve, "Washington and the States: Segregation Now," AEI *Federalist Outlook* (May 2003), www.aei.org/outlook/17053.