The Shaky Case for State Bailouts

Governments should prepare for emergencies by cutting spending during flush times.

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In Washington, D.C., it is common to hear that anyone who opposes the federal rescue of states experiencing budget issues due to COVID-19 must be out of his or her mind. Newspapers are running story after story about how, in the absence of such bailouts, state and local legislators are forced to slash funding for services. But if you decide to shed tears for these poor states and cities, let them be crocodile tears—as those are all this tale of woe deserves.

Consider a recent *New York Times* article, "With Washington Deadlocked on Aid, States Face Dire Fiscal Crisis." The report tells us: "Alaska chopped resources for public broadcasting. New York City gutted a nascent composting program that could have kept tons of food waste out of landfills….In Maryland, the Baltimore Symphony Orchestra will lose a $1.6 million state subsidy."

These examples not only are not dire; they represent activities that the government has no business wasting taxpayer money on. Orchestras, for instance, overwhelmingly benefit the rich. If affluent Americans want to enjoy the pleasure of live classical music, they should pay for it themselves, fully and honestly.

In addition to the funds they receive from the federal government during regular times (up to 30 percent of states' budgets), state and local governments have already received huge sums of money from Uncle Sam during this recession. Under measures such as the Coronavirus Aid, Relief, and Economic Security (CARES) Act, they've hauled in $280 billion for various pandemic-related expenses and another $150 billion for more flexible "needs." The Federal Reserve also set up a $500 billion program to facilitate short-term borrowing by state and local governments.

Washington is nonetheless being urged to fork over more cash because revenue streams for state and local governments have dried up. There is no doubt that tax revenue has taken a hit during this recession; most everyone's revenue has. But as the Cato Institute's Chris Edwards noted in a September blog post, conflating state and local government tax revenue paints a misleading picture of the situation.

"While state income and sales tax revenues have dipped, local governments raise 72 percent of their tax dollars from property taxes, which are rising," Edwards writes. "Property tax revenues were up one percent in the second quarter of 2020 from the first quarter….Local tax revenues nationwide may not fall at all, as they did not fall in the last recession."

Moreover, most analysts vastly overestimate the size of budget gaps faced by the states. Based on the Congressional Budget Office's federal revenue projections for 2020, Edwards estimates a "a modest $70 billion reduction from calendar 2019 state tax revenues of $1.09 trillion."

Even if they can't get more cash, state and local officials say, their fiscal predicament could be improved if the already-distributed federal funds were not earmarked for COVID-19 expenses. To make their case, they cite an August report from the Treasury Department's Office of Inspector General (OIG) that shows some states have spent virtually none of the federal money they received. The *Times* reports that New York state "has been sent about $2.9 billion that it can't put toward other uses." As of June 30, the OIG report says, New York state had spent just 53 percent of its federal bailout funds.

The argument for federal funding flexibility doesn't hold water. It's one thing for state and local governments to ask the federal government for help covering unforeseen expenditures related to the pandemic. But they should not demand that federal taxpayers pay for other state and local expenditures, especially when these governments have failed to plan appropriately for revenue shortfalls that arise in emergencies.

Governments should prepare for emergencies by cutting spending during flush times. If their rainy day funds prove to be inadequate, state and local governments should seek the needed additional funds from their own residents. If those residents truly support the spending, they should be willing to pay for it themselves.

That spending includes the lavish pensions paid to state employees. Why should I, as a resident of Virginia, pay for public employees' retirements in badly managed states such as Kentucky? As the *Times* explains, Kentucky has one of the most poorly funded public-sector pension systems in the country, and now it is further delaying its payments into the system. Meanwhile, "some, like California and New Jersey, had recently committed to raising their contributions to cover past underpayments—but now can't afford to do so."

Supporters of federal bailouts say we should demand that states reform their pension systems *after* we help them. They draw an analogy to an overweight patient who shows up at the emergency room after suffering a heart attack: Doctors will treat him first and lecture him second.

Unlike doctors, who are ethically obliged to help even patients who cause their own medical distress, the federal government is not obligated to help irresponsible states in financial distress. Places like New York state or Illinois need to be bailed out during every emergency, and then they inevitably fail to address the issue during good times. Instead of pruning their budgets, they hike spending between recessions.

The shaky case for bailouts depends in part on the idea, as the *Times* put it, that "state spending reductions could prolong the downturn by shaking the confidence of residents, whose day-to-day lives depend heavily on state and local services." But this claim springs from fiscal myopia. Someone, somewhere, someday must pay off all the debt that the federal government accumulates in order to postpone short-term pain for states.

In a recent paper published by the Mercatus Center, my colleague Jack Salmon and I reviewed all the published research since the last recession that looked at the impact of public debt accumulation. An overwhelming majority of these academic studies find that debt slows economic growth, only adding to the costs that will be paid by future generations. Putting aside concerns about the future, a large majority of the studies that Salmon and I summarized in a

different literature review found that one dollar of government spending during the last recession returned much less than a dollar in growth, even under the best circumstances.

Worse, systematically bailing out state and local governments creates a serious moral hazard, reducing decision makers' incentives to plan better for the next downturn. So next time you hear a sad story about states and cities that have to cut composting programs, cheer up. The lesson will serve them well.

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