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PERVERSE INCENTIVES OF ECONOMIC "STIMULUS"

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THE FEDERAL GOVERNMENT widely promoted the American Recovery and Reinvestment Act (ARRA), more commonly called the "stimulus package," as a means to help states balance their budgets for the 2010 fiscal year amid decreasing tax revenues. The ARRA allocated $140 billion to help states' budgets from mid-2009 through 2011.[1] Despite this infusion of funding from the federal government, states still face economic hardship. At least 41 states and the District of Columbia have reduced public services, and 30 states have raised taxes.[2] As of this writing, at least 42 states still face unresolved budget shortfalls.[3]

The disappointing results of the ARRA have led state and federal policy makers to call for more federal aid to states. This obscures the larger problem behind the states' deficits and will lead to negative long-run consequences. Federal aid provides short-term relief to states that are struggling to remain solvent, but does nothing to address the systemic causes of states' shortfalls: wasteful spending within bloated state bureaucracies. States are well advised to look very skeptically at targeted funds offered by Washington and instead focus on balancing their own budgets.

AMERICAN FEDERALISM

Fiscal federalism, which holds that there is a separation between the states' budgets and the federal budget,[4] is a key defining characteristic of American federalism. It is fiscal, not legal, federalism that delineates true federalism, where sub-federal governments have legitimate sovereignty, from regionalism as is practiced in countries like England and Wales, where regions have little to no taxation or budgetary authority. The American system of federalism works only so long as states are free to tax and spend independently of one another and of the federal government, forcing them to maintain fiscal discipline and allowing citizens to move to states that offer a policy environment that suits them.[5]

THE PROBLEM: SYSTEMIC BUDGET DEFICITS

THE CURRENT, HEAVY-HANDED federal involvement in state economic issues undermines American federalism and stifles responsible fiscal policy. Federal bailouts do not address the root issue of unsustainable spending by the states. Because the constitutions in 49 states require balanced budgets (that is, spending can not exceed revenues), these states can either reduce spending or increase taxes in years where revenues fall below projection. Bailouts temporarily patch the revenue side of the equation by moving state-level debt to the federal government's books, but they do not address the long-term problems caused by unsustainable spending. For the sake of their long-term fiscal health, states should consider instead addressing their deficits on the spending side rather than on the revenue side.

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These shortfalls are enormous. For fiscal year 2010, state budget shortfalls totaled $178 billion, and 2011 is expected to bring even more challenges for state policy makers.[6] When faced with shortfalls, states have several options: raise taxes, cut expenditures, dip into reserves, or borrow by issuing bonds. All of these are politically unpalatable solutions because they require taxpayers to pay more or receive fewer government services in the present or the future.

There is a limit to the extent that states can address shortfalls by raising taxes. High tax burdens are associated with business migration to lower tax climates and reduced job creation.[7] As a result, states are left with growing obligations and a shrinking tax base from which to draw revenues. States should consider not just the immediate but also the long-term ramifications of their tax and spending decisions. Failure to reduce spending to a level that locally raised tax revenues can support in both good and bad economic climates will force states to resort to higher taxes, debt, and fiscal gimmickry to close the resulting perpetual shortfalls.

THE PROBLEM WITH FEDERAL BAILOUTS

There are three key problems for the states associated with accepting federal bailouts:

1. Bailouts discourage long-term fiscal prudence by creating moral hazard.
2. Bailouts mask underlying structural budget problems rather than fix them.
3. Bailouts damage federalism by increasing federal control over state budgets.

Moral Hazard

Federal bailouts create what economists call moral hazard. Typically discussed within the context of insurance, moral hazard occurs when people or groups make decisions they would not otherwise have made because a third party will be paying the bill. Federal bailouts of state governments create moral hazard by encouraging states to spend beyond their means, assuming that the federal government will pick up the tab if revenues decline. The rationale is simple: If states are bailed out this time, when the economy picks back up, states won't have to think about their long-term fiscal health since the federal government will likely bail them out of deficits again.

Every single state used some percentage of its stimulus money to close budget gaps for fiscal year 2010.[8] Stimulus dollars can help states maintain a higher level of services in the present, but looking to the future, they have merely delayed the day of reckoning when many states are going to have to address their unsustainable programs such as education aid and Medicaid. The downturn in state revenues beginning in 2007 brought state budget shortfalls to crises levels, but many states had faced systematic budget gaps for years.

The ARRA was politically popular when it passed, but public support for increased government spending is waning. Unfortunately for state budget makers, the worst is likely yet to come because declining state revenues generally lag behind the economy as a whole during downturns.[9] In the coming fiscal year when Congress will be more hesitant to allocate more aid, history suggests that state budget shortfalls will be even higher than in the last fiscal year. The economic downturn could have shined light on states' existing budget problems, but instead it has become an opportunity for state lawmakers to turn to their federal counterparts for help. Because this cash infusion was billed as a one-time occurrence, states theoretically cannot rely on it to close future budget gaps. However, now that state officials have seen that they can successfully petition for aid, Washington has effectively softened the so-called "hard budget constraint."

Masking Structural Problems

Federal bailouts cover up rather than ameliorate structural problems. The result is that state budgets no longer act as a hard budget constraint, and deficits become not a once-in-a-lifetime anomaly but a usual state of affairs. Citizens are left unable to count on the type, quality, and quantity of public services available to them as policy makers budget on a boom-and-bust cycle.

States should not undertake spending that they cannot sustain through their own revenues over the long term. Attempts to mask unsustainable spending reduces states' control over their own finances, passes costs to residents of other states who don't enjoy the benefits of the spending, or pushes debt off on future residents of the state. Just as painting over cracks in drywall temporarily remedies the appearance of foundational problems in a house, only investment in fixing the foundation solves the underlying problem.

Increasing Federal Control

Over the past couple decades, federal aid to states and localities has increased consistently, totaling over $400 billion in 2006.[10] Since 1995, federal aid to states has nearly doubled, matched by similar increases in total state expenditures (see Figure 1). Many federal aid programs, including Medicaid, require states to match all or part of the aid amount, creating incentives for states to spend more on top of the aid money that they receive. The strings attached to federal aid cause states to cede control of their budgeting process to Congress. For states to have meaningful sovereignty and control of their own budgets, and for the federalist system of states as "laboratories of democracy" to effectively function, states need to be able to raise sufficient revenues to support the level of government that citizens want.

Intergovernmental aid on the current scale jeopardizes the American system of the separation of governments. As legal scholar Ilya Somin writes:

> *Federal subsidization of state governments undermines three of the most important advantages of a federal system of government relative to a unitary one—responsiveness to diverse local preferences, horizontal competition between states, and vertical competition between states and the federal government.*[11]

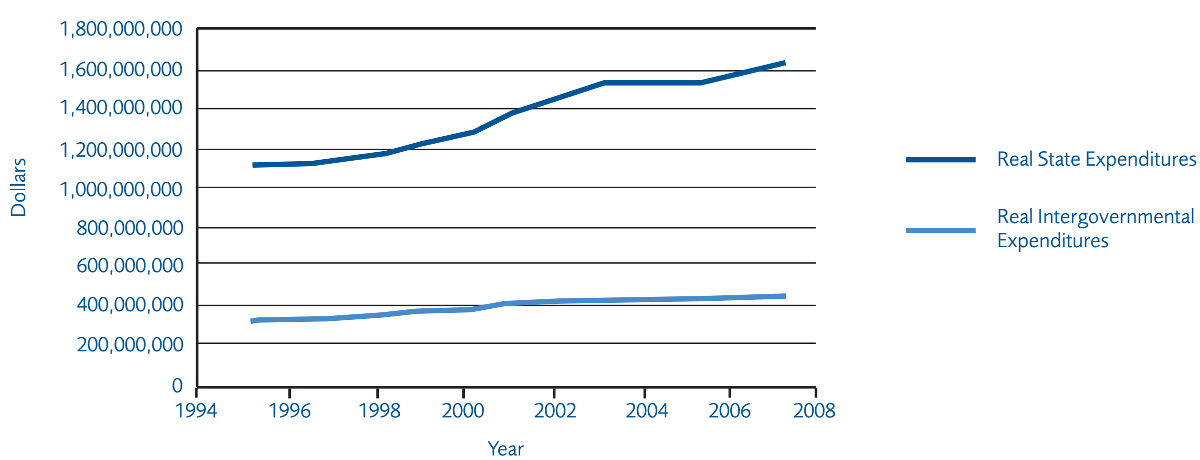
The state aid component of the ARRA is billed as temporary, but incentives at both the state and national levels will likely make these temporary increases in federal subsidies permanent.[12] Federal grants are likely to induce further public spending, and supporting these additional programs after federal funding is scheduled to expire will require higher taxes, state debt, or ongoing federal aid. This will in turn increase states' reliance on federal coffers to pay for new programs—money that will inevitably come with strings attached that further bind states' hands. In 2009, some states identified this likely outcome but were prohibited by Congress from using stimulus money to pay down debt or invest in non-approved projects.[13]

POLICY RECOMMENDATIONS

More stimulus in the form of state aid will benefit states in the short term at the expense of their long-run economic health. Spending levels in many states have reached the point of being unsustainable, and debt levels in many states preclude further bonding. Raising taxes might raise current revenues but will have deleterious longer-term consequences for states' economies.

States are certainly in a difficult budget situation, facing sharply declining revenues after a decade of increasing spend-

FIGURE 1: EXPENDITURES OVER TIME



Source: Census Bureau, "Annual Survey of State Government Finances," http://www.census.gov/govs/state/.

ing. The federal government's attempts to plug state budget shortfalls will likely decrease the ability of states to make their own fiscal decisions and increase long-run dependence on the federal government. By prolonging the inevitable cuts in spending or tax increases, ARRA has subsidized dangerous habits.

Rather than looking to the federal government to bail them out of budget shortfalls, state policy makers should embrace their financial independence that corresponds to their independence in other policy areas. Temporary aid packages such as the ARRA can stave off immediate disasters, but they also create incentives for poor fiscal practices in the future. For long-run economic health, states should address the escalating costs of their programs rather than scrambling to close budget shortfalls one year at a time.

ENDNOTES

1. Nicholas Johnson, Phil Oliff, and Erica Williamson, "An Update on State Budget Cuts," Center on Budget and Policy Priorities, December 18, 2009, http://www.cbpp.org/cms/index.cfm?fa=view&id=1214.

2. Ibid.

3. Sunshine Review, "State budget issues, 2009–2010," http://sunshinereview.org/index.php/State_budget_issues_2009-2010.

4. See Barry R. Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development," *Journal of Law, Economics, and Organization* 11, no. 1 (1995); 1-31.

5. See Gabriella Montinola, Yingyi Qian, and Barry R. Weingast, "Federalism, Chinese Style: The Political Basis for Economic Success in China," *World Politics* 48, no. 1 (October 1995). The authors outline the five conditions for market-preserving federalism: decentralization of authority, the fiscal contracting system, the common market condition, the hard budget constraint condition, and the case for townwhip and village governments.

6. Center on Budget and Policy Priorities, "State Budget and Tax," http://www.cbpp.org/research/index.cfm?fa=topic&id=40.

7. For more on domestic migration between states, see Arthur B. Laffer, Stephen Moore, and Jonathan Williams, *Rich States Poor States* (Washington, DC: American Legislative Exchange Council, 2009).

8. Sunshine Review, "State budget issues, 2009–2010."

9. National Governors Association, "Economic Stimulus, State Budget Shortfalls, and State Countercyclical Funding, January 2008," http://www.nga.org/Files/pdf/0801Stimulusinformation.pdf.

10. U.S. Census Bureau, *Federal Aid to States for Fiscal Year 2006* (Washington, DC: GPO, April 2008), http://www.census.gov/prod/2008pubs/fas-06.pdf. A large portion of this increase can be attributed to medical aid entitlement programs, which account for nearly 45 percent of federal intergovernmental subsidies.

11. Ilya Somin, "Closing the Pandora's Box of Federalism: The Case for Judicial Restriction of Federal Subsidies to State Governments," *Georgetown Law Review* 90 (2001–2002): 461.

12. See Richard Wagner, *Public Finance: Revenues and Expenditures in a Democratic Society* (Boston: Little, Brown and Company, 1983), 466.

13. Mark Sanford, "Why South Carolina Doesn't Want 'Stimulus,'" *The Wall Street Journal*, March 21, 2009, http://online.wsj.com/article/SB123759827524401409.html.

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