Market Discipline and U.S. Federalism

Jonathan Rodden
Professor, Department of Political Science
W. Glenn Campbell and Rita Ricardo-Campbell National Fellow, Hoover Institution
Stanford University

July 2011

Forthcoming in Peter Conti-Brown and David Skeel, eds., *When States Go Broke: Origins, Context, and Solutions for the American States in Fiscal Crisis*. Cambridge University Press.

1. Introduction

Like each of the last fiscal contractions, the Great Recession has brought some underlying structural deficiencies of American federalism to the surface. And as the U.S. states struggle with unprecedented debt burdens and unfunded liabilities, the policy community seems to have entered another of its periodic reflections aimed at "rethinking" or "reinventing" American fiscal federalism.

Today's juncture for American federalism seems especially crucial for several reasons. First, the depth of the unfunded pension problem is becoming clearer to elites and the general public. Second, the unsustainable fiscal paths of large and important states like California and Illinois have generated a perception that a wave of public sector defaults is on the horizon. And third, recent events in the European Union, combined with rescues of large American financial and automobile firms, has raised the specter of another round of costly public sector bailouts that would permanently change the basic structure of American federalism.

Deep concern about the future of U.S. federalism is warranted. But as scholars begin thinking about reform options, it is important to get a clear diagnosis of the problem. It is also important to understand what works relatively well in the United States in broad comparative perspective.

After all, the challenge of managing fiscal policy in a multi-layered federation is not unique to the United States in the early 21st century. In fact, it was the subject of debate among the framers of the U.S. constitution, and it has presented serious challenges in contexts as diverse as the 19th century United States, late 20th century Latin America, and of course, the European Monetary Union in the 21st century.

This chapter focuses on the problem of fiscal discipline, and provides a broad overview of the options for the future of U.S. fiscal federalism. It draws a contrast between market-based and hierarchical solutions, and argues for a reform agenda that bolsters the former.

Underlying all federal fiscal systems is a basic moral hazard problem. When the central and lower-level governments both have authority to tax and spend, individual lower-level governments can harbor the belief that unsustainable fiscal burdens will ultimately be borne by other members of the federation through bailouts. Like a child with a credit card, lower-level governments can borrow unsustainably based on the implicit guarantee of the higher-level parent.

In both families and federations, there are two very different ways to solve this problem. The most obvious is to take away the credit card or put a strict credit limit into place. Limit the access of lower-level governments to all forms of borrowing, federalize some of the unsustainable obligations, and use the deeper pockets of the central government to help arrange credit for infrastructure and to help manage the business cycle. Demonstrating a prescient understanding of the moral hazard problem, Alexander Hamilton favored this centralized, hierarchical solution.

In fact, Hamilton's assumption of Revolutionary War Debt was the first of many attempts to use a debt controversy as an opportunity to centralize fiscal authority. Debt assumptions and conditional bailouts in the wake of debt crises have been crucial centralizing moments in the history of the Argentine, Brazilian, Mexican, and German federations among others. The most ardent European centralizers view the current crisis as a unique opportunity to create an integrated European fiscal system. In the United States as well, the current fiscal crisis might be viewed as an opportunity to finally complete a project of centralization that started in the 1930s.

However, there is another way to solve the moral hazard problem. In families, a child can transition to adulthood and borrow based on his own income as the parents send a clear message that they will not assume debts in the future. In federations, if the central government can commit not to intervene in the fiscal affairs of lower-level governments, the latter can approach credit markets as miniature sovereigns. Ideally, creditors would assess their creditworthiness without assuming an implicit central guarantee, and local fiscal decisions would be governed by market discipline rather than hierarchical administrative controls.

But this solution to the moral hazard problem is only as good as the central government's commitment not to bail out the lower-level governments. Looking across the Atlantic at the European crisis, or closer to home at General Motors and Bear Stearns, the "no bailout" commitment of the federal government would appear to be completely lacking in credibility. The idea of market discipline in federations has fallen on hard times.

Nevertheless, this chapter will go against the grain of current policy discourse and argue that in contrast to many other federations, market discipline has worked well in the United States for more than a century, and although it is currently being challenged as never before, it can be maintained. As we consider short-term and long-term policy reforms, including something like the introduction of state-level bankruptcy procedure, we should do so with the goal of shoring up rather than dismantling the 19th century edifice of market discipline.

I will argue that a hierarchical system of top-down regulation is unlikely to work well in the United States, and in spite of first-glance appearances, the state governments and their creditors and voters are not currently behaving as if they expect large-scale federal interventions in the future. On the contrary, leaders in many states have made more progress than the federal government in making hard choices to achieve long-term fiscal sustainability. In short, there is ample evidence that market discipline is still working.

The second section will expand on the basic problem of fiscal discipline in federations. The third section will discuss hierarchical and market-based solutions, and the fourth will explain the disastrous intermediate category that fosters indiscipline. Section 5 will briefly review the origins and functioning of market discipline in the United States. Section 6 will examine threats to market discipline that have arisen in recent decades. The penultimate section will consider and reject the proposition that market discipline can no longer function. The final section opens the door to an agenda for reform aimed at bolstering market discipline.

2. The problem of fiscal discipline in federations

All federations must face up to a basic problem that can be conceptualized in the language of game theory as a dynamic game of incomplete information (see Rodden 2006). When lower-level governments face a serious long-term negative revenue shock requiring fiscal adjustment, they are tempted to avoid the political pain of expenditure cuts or tax increases. This temptation is driven by the belief that the higher-level government can eventually be compelled to assume their debts. Thus even if lower-level governments know that their fiscal decisions are not sustainable in the long run, they can avoid adjustment because of an implicit higher-level guarantee.

The lower-level government generally does not have full information about this implicit guarantee. The higher-level government often makes some sort of formal no-bailout pledge, and its leaders publically state that bailouts are impossible. However, lower-level governments can often see that these promises are not credible. They look to the final stage of the game, the eve of default for the lower-level government, and attempt to project whether the higher-level government will prefer bailouts to default.

Lower-level officials are not the only ones attempting to make these assessments. Market actors like fund managers, banks, and credit rating agencies also attempt to look down the game tree and evaluate the higher-level government's likely reaction at the moment of default.

They look for a variety of clues to the central government's likely behavior. They evaluate the process through which a bailout would be decided, and the political incentives of the actors. If the legislature must vote for a bailout, what is the probability that the requisite majority would favor a bailout? This is driven in part by the number of insolvent provinces and the nature of their legislative representation. If the executive has wide-ranging authority to provide a bailout unilaterally, how might the chief executive contrast the political pain associated with bailouts with that associated with default? This trade-off is shaped by the nature of the chief executive's regional support base.

Some of the most crucial questions are about the creditors. Who are they, and how powerful are they in the political process? If they are a diffuse group of foreign individual investors, perhaps the domestic political costs of default will be sufficiently low to make it a relatively attractive option. On the other hand, if the debt of the lower-level governments is an important part of the portfolio of the largest domestic banks, default might be extremely unattractive.

Lower-level officials and market actors will also derive clues from the basic architecture of the system of fiscal federalism. When the lower-level governments provide some of the most politically sensitive public services, like health care and unemployment insurance, and these services are funded almost entirely by taxes that are levied and collected by higher-level governments, voters are likely to blame the higher-level governments for service disruptions. When the political blame for local service disruptions is quickly directed at the central government, the credibility of its "no bailout" pledge is undermined, and market actors are more likely to perceive an implicit guarantee.

Perceptions about the credibility of the central government's no bailout commitment are crucial for local fiscal decision-making. If everyone believes with perfect certainty that the central government cannot commit, lower-level governments will have no incentives to adjust to negative shocks, and market actors have weak incentives to punish them, or to distinguish between the creditworthiness of the various lower-level governments.

If lower-level governments and market actors perceive the central government's commitment as perfectly credible, lower-level governments will have strong incentives to adjust, and market actors will face strong incentives to monitor their creditworthiness since default is a very real possibility. Of course democratically elected governments will often avoid adjustment as long as possible, but eventually the costs of doing so become prohibitive.

While these perfect information benchmark scenarios are instructive, a crucial point is that local officials and market actors often operate under substantial uncertainty. Decisions must be made based on bets about the credibility of the higher level government's "no bailout" commitment, using all observable information to inform their evolving beliefs.

As such, central government policies vis-à-vis lower-level governments are important not only because of the direct incentives and restrictions they place on lower-level governments, but also because they send valuable signals to players who are always updating their beliefs in a repeated game. Government policies can bolster or undermine the "no bailout" commitment, thus altering incentives of lower-level governments, creditors, and even voters.

3. Two Paths to Fiscal Discipline: Hierarchy and Markets

If the higher-level government is unable to commit not to provide bailouts, it faces an obvious and severe moral hazard problem. Consider a typical unitary country in Europe, or a highly centralized developing country that has recently made a transition from dictatorship to democracy. Taxation is highly centralized and the central government has taken on primary responsibility for most public services. Lower-level governments are mere conduits for delivering services that are funded through intergovernmental transfers. In Europe, the central government often makes a formal commitment to achieve roughly equal levels of service provision throughout the country.

In such settings, it is common knowledge that any attempt by the higher-level government to foreswear bailouts would lack credibility. It would be politically and in some cases constitutionally impossible to allow a local government to default.

In such situations, it would be disastrous to allow lower-level governments to approach credit markets and borrow without limits. Thus central governments in fiscally centralized countries typically attempt to regulate the access of lower-level governments to all forms of borrowing (Von Hagen and Eichengreen 1996). Bond issues and bank loans are strictly monitored and limited by the central government. In some cases, the central government undertakes all borrowing on behalf of local governments and then allocates infrastructure finance according to its own assessments of needs. To the extent that public employee compensation and pension programs provide windows for borrowing, these are regulated as well. Any attempts to smooth local government expenditures over the business cycle are clearly in the domain of the central government.

This type of hierarchical system has been in place in the relatively homogeneous unitary countries of Europe for much of the 20th century, where there is no pretense of viewing local governments as sovereign borrowers.

However, the story is quite different in some federations, where even after the centralization associated with two world wars and the great depression, states and provinces held on to significant authority well into the post-War era. When the powers of the central government are limited and the constituent units of the federation possess significant autonomous taxing authority, the central government might be able to credibly commit to allow them to default.

In this scenario, lower-level governments can approach credit markets as sovereign borrowers, and creditors face incentives to collect information about the sustainability of their finances. The desire to borrow at attractive rates would provide incentives for governments to make sustainable choices. Moreover, competition with other states or provinces over mobile citizens and firms would provide additional incentives for prudence and a sustainable debt burden.

This vision of decentralized, competitive federalism has been attractive to fiscal conservatives from Friedrich von Hayek to James Buchanan, and has been portrayed by Barry Weingast as an engine of growth and prosperity. In fact, an enthusiasm for this style of federalism lurks behind much of the optimism about fiscal decentralization in the development community in the early 1990s.

4. When Federations Fail

The problem with this rosy scenario, however, is that it rarely comes to fruition. Through a series of painful crises, we have learned that it can be very difficult for the central government to fully commit.

In some decentralized federations, a combination of constitutional and informal political constraints retarded the process of fiscal and administrative centralization that characterized the first half of the 20th century in much of the world. These restraints are a double-edged sword. On the one hand, by limiting the capacity and incentives of the center to intervene in the fiscal affairs of lower-level governments, robust federalism can bolster the central government's "no bailout" commitment and sow the seeds of market discipline. On the other hand, it can also prevent the central government from monitoring and regulating the borrowing of lower-level governments.

In such federations, due to the wide-ranging powers of the lower-level governments to tax, spend, and borrow, the stakes are very high if the center's commitment is in any way compromised. In the late 1980s and early 1990s, the Brazilian states and Argentine provinces were on unsustainable fiscal paths, yet they faced weak incentives to undertake politically painful adjustment because they believed the central government would ultimately step in with a bailout. The central government could not prevent them from continuing to undertake new borrowing and debt rollovers in the face of very precarious fiscal positions while explicitly waiting for federal bailouts. In both countries the bailouts eventually materialized, and a very costly moral hazard problem played a major role in facilitating a series of fiscal crises . In Argentina, of course, the end result was the dramatic default of the federal government.

The European Monetary Union has fallen prey to exactly the same problem, and seems to be failing in even more spectacular fashion. Member states and their creditors came to see the debts of the weaker member states as implicitly guaranteed by the stronger member states. Ireland and the Southern European countries were able to borrow at favorable rates, and ratings agencies were clearly bolstering their evaluations of the creditworthiness of the weaker member states by assuming an implicit guarantee. These bailout prophesies eventually became self-fulfilling. The dynamic game of incomplete information reached the final stage, and the European Union confirmed suspicions that it cannot tolerate outright default by a member state.

What are the lessons from these incidents? It is not surprising that these crises are interpreted as failures of market discipline. Unsustainable borrowing took place in part because market actors (correctly) interpreted the higher-level government's "no bailout" commitment as non-credible.

It is just as appropriate, however, to interpret them as failures of hierarchy. As part of the Stability and Growth Pact, the European Union had a formalized "Excessive Deficit Procedure" which, on paper, would have punished member states in the early stages of building unsustainable deficits or debt burdens. The Brazilian and Argentine federal systems also had elaborate procedures for monitoring and regulating the debts of the states and provinces.

Unfortunately, however, these regulations and procedures were undone by the politics of federalism. The European Excessive Deficit procedure proved to be unenforceable. The largest countries had the political power to flout the rules, and smaller countries like Greece engaged in creative accounting without punishment. In Brazil, the Senate was responsible for approving and regulating the borrowing of the states, and representatives of insolvent states found that approval for unsustainable borrowing was relatively easy to obtain as part of the game of legislative horse-trading.

These half-hearted efforts at hierarchical regulation inadvertently undermined market discipline by sending important signals about the central government's lack of credibility. If officials found it politically impossible to sanction Greece for its accounting abuses or Sao Paulo for its dubious loans from state-owned banks, how could it possibly summon the political fortitude to allow them to default? Moreover, the very act of attempting to regulate the borrowing of member states signals a certain level of responsibility. Weak or half-hearted regulations may have been worse than no regulations at all.

These failures of market discipline had another crucial common element: externalities associated with the banking system. One of the most important clues to the central government's credibility lies in the identity of the creditors of the lower-level governments, which is in turn shaped by the policies of the higher-level government. The Brazilian states were allowed to borrow directly from large commercial banks that they owned and controlled. Several of these were among the largest and most important banks in Brazil, and by the end, some of their largest "assets" were bad debts to their own state governments. It eventually became clear to everyone that a bailout of states would be necessary to save the banking system from collapse. The crisis of fiscal federalism in Brazil was thus in large part a failure in the organization of the banking system.

Something similar can be said about the European debt crisis. Data about the exposure of large European banks to insolvent member states are sparse, but it is quite clear that concern about bank failures was an important part of the logic of the bailouts of Greece, Ireland, and Portugal, which can be seen as bailouts of troubled German and French banks.

Large European banks invested not only in ill-fated real estate developments, but also in bonds of member state governments. This was encouraged by European banking regulations that provide very strong financial incentives for banks to buy government debt. Banks are not required to set aside additional reserves when they buy government debt, which is officially viewed by the European Commission as risk-free. This effectively lowers the price of government debt and distorts banks' decisions.

In other words, while the European Treaty contained a "no bailout clause," the European banking regulations explicitly provided a bailout assurance by signaling to market actors that the default risk of member states was zero. The signal was received not only by bankers, but also by other creditors and by member state governments, who came to understand that Germany implicitly guaranteed their debts.

The European and Latin American episodes demonstrate that in a decentralized federation characterized by strong representation for member states, both market and hierarchical forms of fiscal discipline can easily fail if institutions and incentives are not properly structured. A half-hearted hybrid of markets and hierarchy is unlikely to succeed.

5. Default and the Foundations of Market Discipline

While difficult, by no means is it impossible for a central government in a federation to make a credible "no bailout" commitment. A very costly and credible signal is sent when a crisis arises, the bailout game reaches the final stage, and the central government simply turns its back and allows default. Such an event would send a strong signal to creditors and other governments, providing a firm foundation for market discipline going forward. This is the road not taken in Europe.

However, this is exactly what happened in the United States in the 1840s. After states had engaged in large-scale borrowing in order to build canals, railroads, and other internal improvements, a fiscal panic led to sudden reductions in revenues, and without reliable tax revenues, several states were unable to service their debts. Many of the creditors were British citizens, and Britain threatened military attack if the U.S. federal government did not assume the debts of the states (Ratchford 1941) A coalition of insolvent states assembled a bailout proposal, attempting to buy the support of less indebted states by offering to create a per capita transfer.

However, in a pivotal moment in the history of U.S. federalism, the bailout proposal failed in the legislature. Representatives of solvent states constituted a slim majority in the legislature (Wibbels 2003), and bailout opponents turned public opinion against the proposal in those states. Perhaps another important reason for the decision can be traced, once again, to the identity of creditors, most of whom were foreign individuals rather than important domestic constituencies.

Considerable uncertainty about the federal government's payoffs in the dynamic bailout game was resolved. Several states repudiated their debts, and the entire federation was cut off from international capital markets. State governments, citizens, and creditors learned a painful lesson: the U.S. states are sovereign debtors. In order to approach credit markets again, states made substantial reforms, including the introduction of direct taxation and the institution of various balanced budget requirements. Creditors learned to carefully assess the states' revenues and obligations.

This episode marked the beginning of a long period of successful market discipline among the U.S. states that was marred only by repudiations of debts of some Southern states in the aftermath of the Civil War. Unlike the political unions described above, the U.S. federal government has not endeavored to limit the deficits or debts of the U.S. states. Yet without any hierarchical oversight or regulation, in comparison with federated entities in most other federations, the deficits and debt burdens of the U.S. states have been quite low throughout the 20th century, especially considering the very large role they play in providing basic public services and building infrastructure (see Rodden 2006).

The states typically adjust to revenue downturns rather quickly, and most likely because of their balanced budget rules, they do not smooth expenditures over the business cycle through borrowing. In fact, the revenues and expenditures of the U.S. states are both extremely pro-cyclical. Negative revenue shocks are met with rapid expenditure cuts (Rodden and Wibbels 2010). In the most recent downturns, these cuts have been so severe as to almost completely offset the impact of any federal government attempts at fiscal stimulus (see Aizenman and Pasricha 2011).

Empirical studies suggest that the balanced budget rules that emerged in the 1840s are an important part of the explanation for cross-state variation in the speed of adjustment (e.g. Poterba 1995). While states have devised a variety of tricks and gimmicks to circumvent their balanced budget requirements, including delaying payments into the next fiscal year and underfunding pensions, these rules are probably part of the explanation for the fact that as a share of gross state product, general obligation bond debts of the states have been modest throughout the 20th century.

State governments have been quite sensitive to credit ratings, and the need to keep debt burdens under control in order to keep borrowing costs down is an important part of the political discourse in the states. Credit downgrades are politically costly for governors. The empirical literature suggests that bond yields and credit ratings are quite sensitive to changes in states' debt burdens (see Bayoumi, Goldstein, and Woglom 1995, Rodden 2006), more so than in most if not all other federations
In short, the United States is one of a very small number of federations, perhaps also including Canada and Switzerland, in which the central government has been able to convince market actors that the constituent units should be treated as sovereigns, and where fiscal decisions of the constituent units have been consistently constrained by credit markets for much of the 20th century.

6. Implicit Bailouts and the Challenge to Market Discipline

This optimistic story about market discipline with roots in the 19th century seems increasingly quaint and anachronistic in 2011. First, the U.S. federal system has centralized dramatically over the course of the 20th century in ways that subtly undermine the central government's "no bailout" commitment. Second, the fiscal crisis and the recent wave of bailouts in the private sector may have provided the coup de grace for the notion of market discipline.

Perhaps the central government was able to ignore the bailout demands in the 1840s in part because its powers and obligations relative to the states were so limited, as were the economic externalities linking the states. The federal government may have more at stake in allowing California to default today than it had in allowing Pennsylvania to default in 1840. Beginning with the New Deal, the states have increasingly become conduits for the delivery of government programs, like Medicaid, that are conceived and largely funded by the federal government.

[FIGURE 1 HERE]

Figure 1 depicts the growth of federal grants as a share of current state and local expenditures. Arguably, as grants become more important components of subnational budgets and the books of the federal and lower-level governments become increasingly intertwined, the central government's "no bailout" commitment loses credibility because it has become politically implicated in service provision in the states.

When faced with a fiscal crisis requiring rapid and politically painful adjustment, elected officials in the states are tempted to avoid adjustment and call upon the central government for additional assistance. The political attractiveness of this strategy is shaped by their ability to make the case to voters that their troubles are not self-induced. This case is bolstered substantially by a plethora of grant-funded federal programs as well as unfunded mandates. Moreover, states can argue that matching provisions in some grant programs distort their incentives and discourage expenditure cuts that would enhance efficiency. The states can also shift blame for their fiscal problems by pointing out that intergovernmental grants, just like state tax revenues, are positively correlated with the business cycle, leaving them in difficult circumstances when revenues begin to dry up.

Thus with each fiscal downturn in recent decades, the story is the same. Tax revenues and federal grants fall precipitously, and states are faced with an array of costly new expenditure programs and employee benefits that had been enthusiastically promulgated during the last boom. The states buy some time by borrowing to the extent allowed by their balanced budget rules, engaging in fiscal gimmicks, and crucially, neglecting to fund their pension programs.

However, these measures are usually not enough to avoid steep expenditure cuts. Declining expenditures in the states easily offsets any federal efforts at fiscal stimulus, and a coalition for special assistance to the states begins to form in Washington. Of course these are not referred to in polite company as bailouts, but they are undeniably ad hoc, quickly negotiated transfers aimed at filling gaps in state budgets. In the most recent recession, these took the form of special short-term Medicaid supplements and pork-laden stimulus grants for shovel-ready infrastructure projects in the states.

In addition to the inefficiencies associated with delay and political bargaining, these implicit bailouts also send important signals to market actors that the federal government cannot allow states to cut expenditures, much less default on their bond obligations. And they encourage state governments to believe that the political pain of adjustment might eventually be shifted to the federal government.

In the most recent recession, the federal government has also taken the unusual step of formally subsidizing and presumably guaranteeing a special class of subnational debt known as "Build America Bonds." It was extremely helpful for states to be able to borrow at subsidized rates, but a danger is that market actors view this as yet another signal of the federal government's ultimate responsibility for the obligations of states, another step along the way to a unitary-style system in which the center arranges the borrowing of the lower-level governments, but without the concomitant hierarchical borrowing restrictions.

In sum, there is a danger that although a spectacular bailout like that of Greece has not yet happened, the federal government's "no bailout" commitment is slowly eroding with each recession. In fact, some astute observers such as Noriel Roubini[1]

[1] "Who Will Default First: Greece or California?" *Wall Street Journal* March 24, 2010.

and Warren Buffett[2] have argued that the central government already provides a strong implicit guarantee, at least to the largest states. They argue that the political importance of California, and the externalities associated with default, are simply too great to imagine a world in which Congress and the president allow it to default. This argument is bolstered by the fact that the federal government has already revealed its taste for bailouts in the private sector.

7. Can Market Discipline Survive?

When a string of states defaulted in the early 1840s, expectations of bailouts in future rounds of the game were somewhere near zero. The perceived probability of bailouts is substantially higher today. But the probability is also surely not equal to one. The crucial question is whether the perceived probability is sufficiently low as to provide incentives for states to adjust. Faced with the prospect of politically painful tax increases and expenditure cuts, are state governments willing to continue on an unsustainable fiscal path while placing their bets on a federal bailout? Are creditors willing to fund this?

If the answer is "no," market discipline can still survive.

First, let us put into proper perspective the growth of federal grants displayed in the figure above. Along with the Canadian provinces and Swiss cantons, the U.S. states are among the most fiscally autonomous subnational entities in the world, and the vast majority of their expenditures are funded by taxes that they levy and collect themselves. It is not at all clear that a cynical strategy of courting disaster while waiting for bailouts would be politically wise for a governor.

It is also not clear that a bailout of selected insolvent states would receive a warm reception in Congress given the current political climate. In fact, it is plausible that voters' widespread anger about private sector bailouts would make a bailout of states politically challenging. Even efforts to raise the federal debt limit to avoid federal government default have been exceedingly rancorous and difficult.

Moreover, as in the 19th century, at the moment the states flirting with insolvency do not come close to constituting a legislative majority. In fact, while it is true that the most troubled states, like California and Illinois, are some of the largest, and hence produce the largest externalities, they are dramatically under-represented in the Senate.

Let us also return to a crucial variable in the analysis above: the identity of the debt holders. Unlike the Latin American and European cases described above, state defaults would not necessarily threaten the survival of the U.S. banking system. In fact, banks are relatively minor players as purchasers of state bonds. State bonds are attractive mostly to state residents because of their tax-exempt status, so state

---

[2] "Buffett Says GM Rescue May Mean U.S. Can't Say No to States," *Business Week* May 5, 2010.

debts are largely held by citizens of the state. Thus compared with other political unions, externalities associated with default might be more limited, and hence the center's commitment more credible, since a significant share of the pain associated with default would be limited to state residents.[3]
Looking beyond the statements of Warren Buffett, how do other market actors assess the probability of federal bailouts? If creditors are increasingly reassured by the central government's implicit guarantee, bond yields, credit default swaps, and credit ratings should be converging.

[FIGURE 2 HERE]

Figure 2 displays data on credit default swaps, and reveals that the opposite is happening. In the wake of the crisis, markets are behaving as if there has been dramatically increased differentiation in the creditworthiness of the states.

[FIGURE 3 HERE]

Figure 3 provides CDS data for selected U.S. states and European member states. The initial pre-crisis clustering of U.S. states and EU member states does suggest a powerful critique of market discipline. Creditors seem to have underestimated the risks associated with these bonds, especially in Europe, where the policies described above allowed creditors to believe that member state debt issues were guaranteed by other member states.

Yet even in the pre-crisis period, there was greater differentiation among U.S. states than EU member states. Moreover, the cost of insuring Greek debt did not surpass that of California debt until very late in the Greek crisis, in spite of a debt burden that was several times higher. Ireland and Illinois were neck and neck until the eve of the Irish bailout.

While market actors may have been asleep at the wheel prior to the crisis, they appear to have awoken with a jerk. In both Europe and the United States, market discipline has returned with a vengeance. In Europe the wake-up call appears to have come too late. Precisely because of panic at the discovery that bonds of EU member states were not risk-free instruments, the rapidly increasing spreads among member states depicted in Figure 3 forced the wealthier member states to step in to stave off Greek default and save their own banks.

In the United States, the increasing bond yields for troubled states did not create a panic, even in 2010 when breathless television analysts began predicting a wave of

---

[3] The impact of the bond insurance industry on bailout probabilities is unclear. One might argue that as long as the insurers are not viewed as "too big to fail," bond insurance reduces the probability of a bailout since it would be politically easier to impose losses on insurers than individual bond-holders, many of whom are voters in the state. In any case, the bond insurance industry essentially collapsed in the wake of the fiscal crisis, and a very small percentage of new issues are now insured.

state defaults. Luckily, bond debt burdens of U.S. states were far lower than those of EU member states going into the crisis (See Figure 4).

[FIGURE 4 HERE]

Of course this does not mean that states are not in serious trouble. As explained in detail in other chapters in this volume, debt to GDP ratios are manageable in part because balanced budget rules have created incentives to borrow from future public retirees rather than bond markets, and unrealistic accounting assumptions allowed states to hide from the problem. Many state pension programs are clearly on an unsustainable fiscal path, and painful reform is needed.

Another problem lies in the municipal sector, where the dynamic bailout game is played between the state and municipal governments. While there is considerable cross-state heterogeneity, for the most part, state governments make rather weak "no bailout" commitments to their municipalities. Municipalities have also gotten into serious trouble in the current crisis, and some face their own unsustainable debt burdens and unfunded pension liabilities. Faced with the prospect of a default of a large municipality, state governments often step in at the last minute with a conditional bailout, as recently happened with Harrisburg, Pennsylvania. Thus purchasers of state general obligation bonds must pay attention not only to the state's debt burden and its unfunded pension liabilities, but also those of its municipalities.

The same can be said for the proliferation of state and municipal bodies that have been created solely to issue debt in efforts to circumvent balanced budget requirements.

These are vexing and dangerous problems, but they need not spell the demise of market discipline. The costs of unfunded pension liabilities are finally coming into focus and are informing the assessments of creditors and rating agencies. States are under enormous pressure to find ways to shore up their pension programs. Moreover, it is straightforward for market actors to incorporate municipal and other potential indirect state liabilities into their analysis of state's creditworthiness.

Indeed, markets have punished the most troubled states, and they have faced burdensome and increasing borrowing costs. Credit default swaps for the most troubled U.S. states have surpassed Latvia and Hungary.

In short, state governments and their creditors may hope for an implicit federal guarantee and assess the probability of an eventual bailout as substantially greater than zero, but their hopes do not appear to be especially high. Governors and treasurers will complain loudly about dramatic cuts in federal assistance as the stimulus and Medicaid supplements run out, and they will continue to lobby for increased transfers.

But there is no evidence that they are throwing up their hands, staying the course, and placing all of their bets on a federal bailout. On the contrary, state governments are making serious efforts at reform. Elected officials from both parties are risking their political careers by calling for hard choices. Both Democratic and Republican administrations are asking public employee unions for large concessions. Although they have a long way to go, some states are attempting to make structural changes to pension programs.

8. Toward a Reform Agenda

The road ahead is extremely rocky. As illustrated by the events in Wisconsin, partisan recriminations and rancor are to be expected. In some states, the battles are between parties, but in others, efforts to achieve fiscal sustainability are creating fissures within rather than between parties. The intensity of these battles reveals that market discipline is functioning quite forcefully.

In fact, in light of draconian and sometimes irrational expenditure cuts in vital areas like infrastructure and especially education, some might argue that it is working all too well.

In another chapter in this volume, Damon Silvers identifies many of the same structural problems with U.S. federalism discussed in this chapter. States implement a good deal of federally funded policy, especially in areas like welfare, education, and health, where one might hope for some insulation from the business cycle. Yet these programs are funded with highly pro-cyclical revenue sources and states are unable to smooth expenditures over the business cycle because of their balanced budget requirements. Thus every recession is met with a combination of draconian cuts that fall disproportionately on the most vulnerable and calls for implicit bailouts while pension obligations go unpaid.

One might also add that booms are similarly accompanied by fiscal expansions, generous new contracts, and very little in the way of savings. The long-term result is inefficient and pro-cyclical spending, a growing debt burden, and insolvent pension programs.

In one view, market discipline and state sovereignty are the problems rather than the solutions. If the problem is a murky quasi-sovereignty for the states, the solution is hierarchy. In this view, Alexander Hamilton's deep skepticism about independent spending and borrowing by states was warranted, and it is time to implement his vision and turn the states into wards of the federal government. To return to the family analogy, the states should be viewed as children rather than adults. The Civil War and then the New Deal placed the United States on a path of fiscal centralization that was left incomplete because of the outmoded trappings of federalism. As the federal government expanded, the states were left with too much fiscal and political power, and the federal government was forced into an uncomfortable partnership with them.

In this view, the federal government should do the following. First, it should assemble wide-ranging new powers to regulate taxation, expenditures, and borrowing in the states, along the lines of a European central governments vis-à-vis its municipal governments. Failing that, it should simply federalize existing programs that are implemented by states, which would presumably require a vast buildup of the federal bureaucracy throughout the country. Echoing Hamilton, some might even call for a clean slate beginning with a federal assumption of state debts and pension obligations.

Leaving partisan ideological debates aside, it is relatively clear that this type of solution is impractical. Above all, it is difficult to imagine such a far-reaching change to the constitutional order. It is not clear where the political impetus for such a major reorientation of American federalism would come from, or how it could possibly be achieved without constitutional change. In the current political climate, and with the federal government itself on a precarious debt path, it is also difficult to imagine a solution that relied on a dramatic expansion of the federal government.

The basic structure of American federalism is probably here to stay, and in any case, a hierarchical solution is not promising in such a large and diverse federation. When the higher-level government has just agreed to a large bailout and revealed to the world that it cannot tolerate defaults, as in the Latin American federations and the European Monetary Union, market discipline is impossible in the medium run, and hierarchy is the only viable option.

In the European case, there are good reasons for skepticism about the prospects for successful hierarchical control of member state budgets going forward. Europe has reached an unfortunate impasse in which Germany and the other wealthy member states guarantee the debts of the weaker member states. As such, it is crucial that the solvent member states gain new tools with which to control the fiscal decisions of the insolvent members. Yet it is difficult to imagine what these tools might look like in a compact like the European Union. The history of the Excessive Deficit Procedure suggests the need for an independent enforcement process that is insulated from politics, yet it is difficult to imagine why the weaker member states would voluntarily agree to submit to such a process. Currently, the EMU can only threaten to withhold future tranches of bailouts, but given that it has already revealed that it cannot tolerate default, such threats have no credibility.

Fortunately, in contrast to the European Monetary Union or the Brazilian federation, the moment of imminent default has not arrived in the United States, and there is not yet any need to explore second-best hierarchical solutions that would likely run into constitutional obstacles.

The lesson from other failed federations is that it is dangerous to rely on a half-hearted hybrid of markets and hierarchy. Given a choice between pure versions of these two strategies, the best option for the United States is also the most practical: bolster market discipline.

There are a number of ways in which a reform agenda can focus on bolstering market discipline while also addressing some of the persistent pathologies of U.S. federalism. One simple goal is to help states manage the business cycle by restructuring existing intergovernmental grant programs so that they are less pro-cyclical. Grants fall off during downturns along with state taxes, and then after a politicized, ad hoc scramble, some temporary and distortionary relief may or may not be provided by the federal government.

A better option would be for the federal government to come up with a rules-based mechanism for smoothing intergovernmental grants over the business cycle, providing at least some counterweight to the boom-bust pattern of state public finance. This need not imply any change in the size of grants as a share of total state government revenue. This would help firm up the center's no-bailout commitment by putting an end to the ad hoc scramble for implicit bailouts, and would help state governments make more rational expenditure decisions.

Market discipline could also be enhanced by efforts to disentangle the obligations of federal and state governments. Efforts to curb federal unfunded mandates would go a long way to enhance the flexibility of states to solve their budgetary problems, as would reforms to distortionary matching provisions in some federal grant programs.

Another interesting possibility is the institution of an orderly default procedure, perhaps along the lines of the proposals made in other chapters of this volume. The federal government can lay out some guidelines about how a default in a state would be handled. One reason why the rising bond yields of Greece and other EU member states quickly turned into a panic was that investors simply had no idea what might be coming next. Not only was there no formal bailout mechanism, but perhaps more importantly, there was also no sense of how a default or restructuring might be handled.

A good way to send a signal to market actors about the credibility of the central government's no bailout commitment is to provide a formal set of rules and procedures for dealing with default. After the initial Greek bailout, the German government briefly attempted to propose an orderly default procedure in an effort to rekindle its "no bailout" commitment, but this only served to fan the flames of the ongoing financial panic.

It is not yet too late in the United States. In fact, the timing might be quite good to clarify once and for all that states can and will default if they do not achieve fiscal sustainability, and to clarify for market actors the rules under which default would take place. Quite simply, an orderly default is preferable to a disorderly default for everyone. By reducing fears of the latter, the federal government can enhance its "no bailout" commitment.

As Levitin (2011) points out, it is insufficient to rely exclusively on an illusory "no bailout" commitment in a modern market economy. Systemic risk cannot be avoided, and no matter how one structures incentives ex ante, a moment might come when the failure of a bank, or the default of a state, would have externalities that are clearly socially unacceptable. Sometimes the costs of allowing an entity to fail are unclear until the moment arrives. In a dynamic situation like the Lehman crisis, the revealed cost of allowing one unit to fail might make it clear that further failures would be unacceptable.

Absolute ex ante commitment may be impossible or undesirable, and the government may eventually find itself deeply involved in the process of loss allocation in the event of a crisis. As the European Monetary Union demonstrates, it is better to be prepared for that moment than to wish it away. By agreeing on a set of rules and procedures now, it might be possible to reduce the possibility of a panic in the future. In order to preserve market discipline, it is important that the loss allocation process be viewed by borrowers and creditors alike as inevitably very painful—something to be avoided under all but the most extreme circumstances.

Finally, reform efforts aimed at bolstering market discipline should focus on bad accounting practices and bad incentives associated with public sector pension programs. It might be possible to envision federally imposed accounting standards and information dissemination requirements, and perhaps even funding requirements, that would not send too strong a signal of federal responsibility.

But the most likely path to improved fiscal discipline in the states lies within the states themselves, and requires that they be treated as adults who ultimately stand on their own. In the summer of 2011, the state governments are behaving far more like adults than the federal government. Their shallower pockets and lack of monetary authority have forced them to respond to market pressure and make hard decisions about how to balance their budgets that have eluded the federal government.

This process will continue to be painful, and we have probably not seen the last of street protests like those in Madison. But the protests in Madison are in many ways preferable to those in Athens. In Madison, the clash is over very different approaches to the question of how the sovereign state of Wisconsin can achieve fiscal sustainability. In Athens, inchoate rage is directed in large part at austerity measures that are viewed as illegitimate foreign impositions from Germany, the EU, and the IMF, who have suddenly become responsible for Greek debt.

While the U.S. system of federalism is under stress, it is in far better shape than the European Monetary Union. In spite of serious flaws, market discipline has worked in the past in the United States, and can work in the future. Reform proposals that would enhance the perception of federal responsibility for state obligations should be resisted. If they are not, the current struggles of the states might look minor to future generations.

References

Aizenman, Joshua and Gurnain Pasricha. 2011. Net Fiscal Stiumulus During the Great Recession. NBER Working Paper 16779.

Bayoumi, Tamim, Morris Goldstein, and Geoffrey Woglom. 1995. Do Credit Markets Discipline Sovereign Borrowers? Evidence from the U.S. States. *Journal of Money, Credit, and Banking* 27, 4: 1046-59.

Levitin, Adam. 2011. In Defense of Bailouts. *Georgetown Law Journal* 99:435-514.

Poterba, James. 1994. State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics. *Journal of Political Economy* 102(4): 799-821.

Rodden, Jonathan. 2006. *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism*. Cambridge: Cambridge University Press.

Rodden, Jonathan and Erik Wibbels. 2010. Fiscal Decentralization and the Business Cycle: An Empirical Study of Seven Federations. *Economics and Politics* 22(1): 37-67

Von Hagen, Juergen and Barry Eichengreen. 1996. Federalism, Fiscal Restraints, and European Monetary Union. *American Economic Review* 86(2): 134-38.

Wibbels, Erik. 2003. Bailouts, Budget Constraints, and Leviathans: Comparative Federalism and Lessons from the Early U.S. *Comparative Political Studies* 36(5): 475-508.

Figure 1: The Growth of federal grants relative to state and local current expenditures

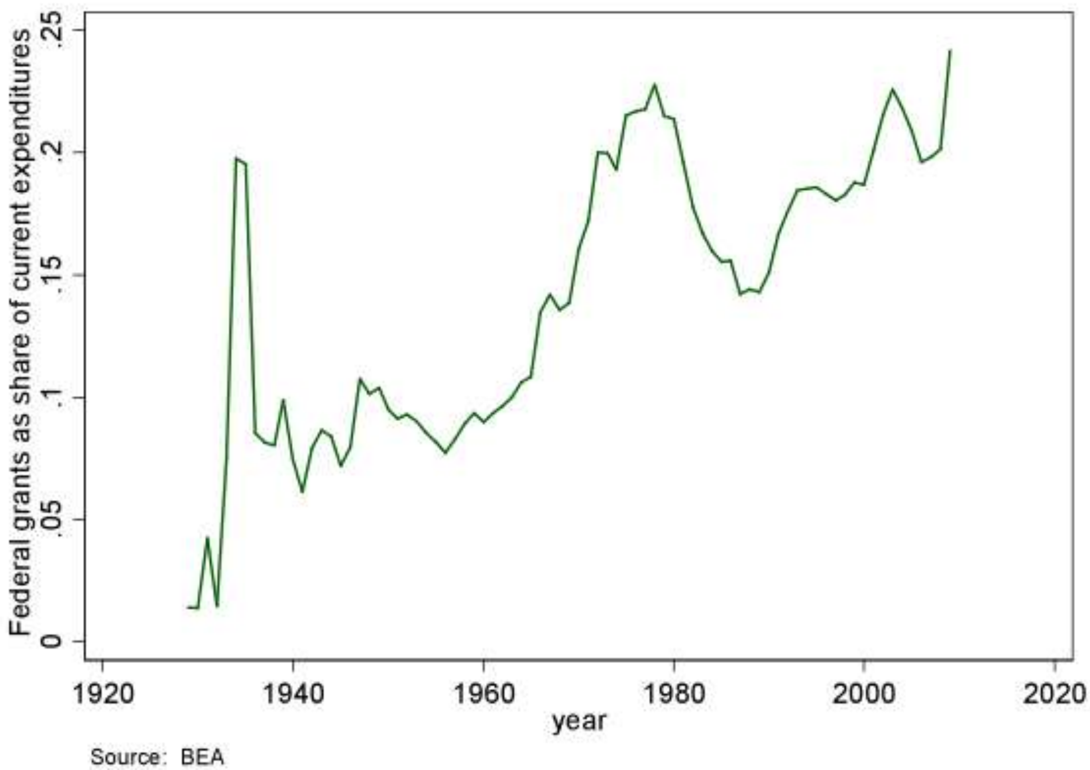

Figure 2: Credit default swaps for selected U.S. States

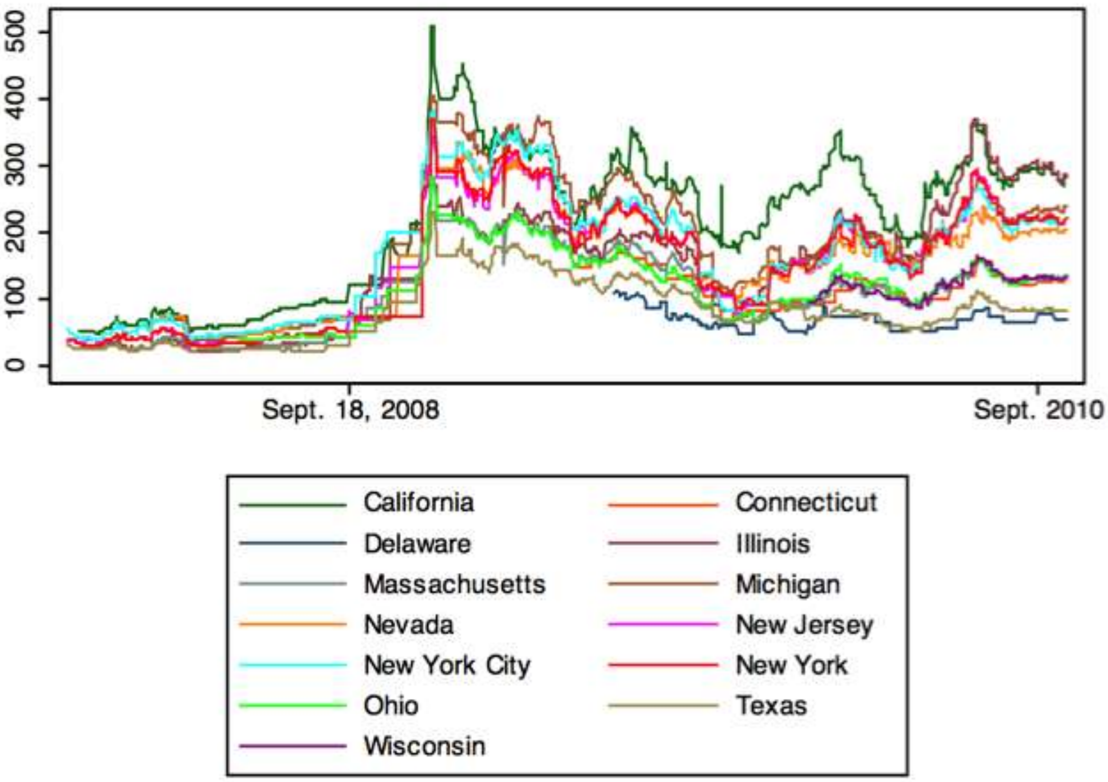

Figure 3: Credit default swaps for selected U.S. states and member states of the European Monetary Union

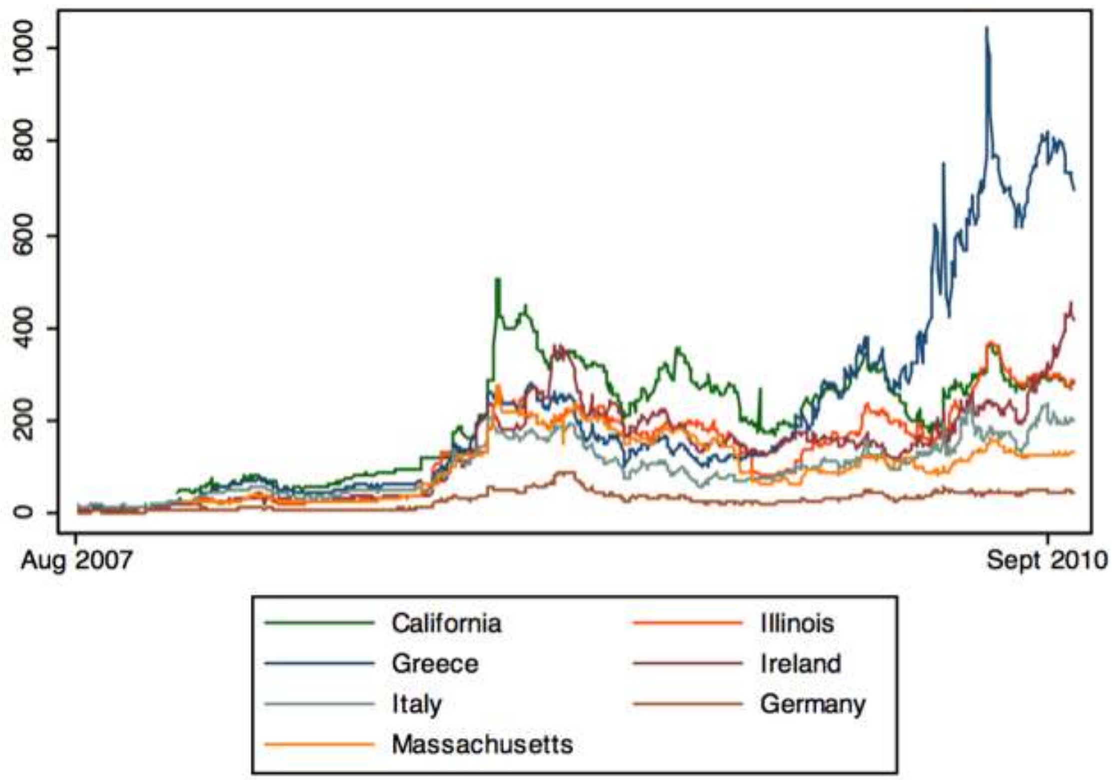

Figure 4: Debt/GDP ratios for European countries and U.S. states