Introduction: The Perennial Crisis for the American States

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In the summer of 2011, people throughout the world watched with rapt attention as Republican leaders in the U.S. Congress and President Barack Obama squared off against each other in a high-stakes, down-to-the-wire negotiation over the fate of the country's ability to issue new debt to fund its many financial obligations. The so-called debt ceiling debate illustrated the toxicity and potency of political-fiscal brinkmanship. Eventually, the crisis was averted – or at least forestalled – as a compromise was reached, new debt issued, and the tarnished credit of the United States relatively unbroken.[1]

In light of the attention paid to the political theater that preceded raising the debt ceiling, many citizens would be forgiven in thinking that the United States exists as a sole economic entity for the purposes of fiscal policy. This, of course, is erroneous. The several states of America independently participate as debtors to a vast array of creditors, from their own employees to the anonymous masses of the bond markets; from targeted lenders to the recipients of the states' safety nets. And while Congress and the President engaged in a time-consuming game of political chicken during the summer of 2011, a phenomenon as central to the American system as federalism itself continues to fly under the radar: The American states, in their individual governmental capacities, are in extraordinary debt.

Although the states' debt problems are not, at present, reported above the fold in leading national newspapers, they persist with a relentlessness that academics, policymakers, and citizens should heed. The unique history, context, and structure of the American states in debt require hard and careful thinking, planning, and action.

1 Although Standard & Poor's did downgrade the U.S. credit for the first time in the credit rating agency's history, markets have continued to treat U.S. debt as among the safest available.

This volume gathers some of the leading scholars and commentators on issues relating to state debt crises to provide that level of thoughtful engagement not otherwise available in a single volume. These academics and practitioners from a variety of disciplines and backgrounds address this basic quandary: How do we understand and navigate the reality that state governments, by all accounts, appear unable to meet their obligations to their many claimants, from employees in the form of wages, pensions, and health care; citizens, in the form of welfare spending, infrastructure, education, and nearly every other government service; investors, in the form of general and specific debt; and indeed, any other individual or institution who interacts with state governments? At stake in this crisis is the very essence of state government, with the difficult and highly contested questions of what state governments ought to be, what state governments presently are, and how any difference between the two can be bridged in a contentious political climate.

Although frequently riding backseat to the more pressing concerns of sovereign – especially the United States – fiscal woes, nearly everything about the question of states' fiscal crises is fraught with urgency and controversy. In 2011 alone, tens of thousands of protesters filled the streets in Madison, Wisconsin, to challenge or support that state's efforts to redefine its relationship to its public employees' unions; legislators in Indiana absconded out of state with hopes to avoid votes on controversial issues on similar matters; the state of California began for a time paying its creditors with IOUs because the state was simply unfunded; Mayor Bloomberg of New York City proposed to lay off thousands of teachers in an already stretched school district to bridge the gap left by state cuts in Albany. And in a recent report, it was determined that the country of Iraq enjoys a higher credit rating than the state of Illinois.

What, then, might be done about these crises? Are federal bailouts of the states political nonstarters or predetermined by the nature of our union? Is serious tax reform a frank and inevitable necessity or so politically toxic as to be dismissed out of hand? Are unions' collective bargaining rights driving the states over a precipice, or are unions nothing but tangential figures in this story, paraded out as easy scapegoats by politicians eager to avoid the harder issues at stake? Would a mechanism for states to restructure their debts, similar to bankruptcy, resolve the problem or make it worse? Is such a mechanism even possible as a matter of law, or, for that matter, politics? What can we learn from the experiences of other public entities who have engaged in debt restructuring, whether foreign sovereigns or municipalities?

The authors who have contributed to this volume address these and related questions. The authors, taken together, agree on very little. Some consider the rhetoric of the conversation in general and even the title of the book overblown. Others think the problems are far graver than this Introduction has described. All authors, however, contribute to some aspect of this conversation and inform readers, challenge conventional thinking, and encourage those who seek to understand these problems to dig deeper than they have already done to understand what, exactly, is the problem in the American states today, and, as importantly, how it can be resolved.

The book is organized, as its subtitle suggests, into three subsections: origins, context, and solutions. In the first section, five scholars provide essentially a historical context for the states' problems, each highlighting different elements of the issues faced. Economic historians John Wallis and Isabel Rodriguez-Tejedo discuss, in illuminating detail, the ways in which states over the last two centuries have responded to fiscal crises and evaluate the current state of the states against that historical backdrop. Olivia Mitchell, the leading economist studying private and public pensions, provides a thorough introduction to the nature of state pensions and the ways in which funding commitments can create ballooning liabilities when the assumptions undergirding those commitments change. The Manhattan Institute's Josh Barro contributes a chapter on the basic mechanics of state budgetary processes. And Damon Silvers, former Deputy Chair of the Congressional Oversight Panel and present Director of Policy for the AFL-CIO, takes a fundamentally different tack, laying the problems facing the states at the feet of the political and economic changes that states have experienced over the last thirty years. Silvers highlights in particular two phenomena. First, the changing nature of recessions, from those that were steep, deep, relatively short-lived, and related to the business cycle, to those that are long, shallow, and the consequence of financial crises. Second, Silvers analyzes the ways in which New Federalism, championed by President Ronald Reagan and his supporters and extended during subsequent Administrations, takes from the federal government the responsibility of massive welfare provision and gives that responsibility to the states – a responsibility they are not always best situated to bear.

In the second section, we learn more about how insolvency regimes have functioned elsewhere in the world and elsewhere in the United States. In his contribution to the volume, Clayton Gillette, a leading scholar of both local and state government law and commercial law, leads readers through the context of municipal bankruptcy, comparing and contrasting the relatively well-established system of municipal bankruptcy with the problem of state insolvency. In the process, he discusses how the fundamentally different relationship between states and the nation on the one hand versus states and their subentities on the other complicates, perhaps irretrievably, the ways in which the solutions for municipal bankruptcy can be made applicable to the problems of state debt.

Of course, cities and states are not the only political entities that face debt crises, as the events in the United States and especially Europe throughout 2011 can amply attest. In this sense, Adam Feibelman, a scholar of bankruptcy and sovereign debt, ably introduces the history and implications of the regimes currently in place to allow sovereigns to restructure their debts in times of crisis. Feibelman's detailed case studies of sovereign default will be of interest to those readers interested in how, specifically, resolving sovereign debt crises can – and cannot – compare to the debt crises facing the states.

Political scientist Jonathan Rodden performs a similar analysis but focuses instead on the theoretical structure of fiscal federalism, a topic he has reinvigorated over the last decade. Rodden views the basic problem of fiscal federalism through the familiar lens of moral hazard in that subnational entities may attempt to displace their debts to the national sovereign, thus avoiding the costs of their debts, both economic and political. Rodden also helpfully compares the structure of the U.S. states to other fiscal federations, most relevantly the European Union, itself in a more acute fiscal-federalist crisis than the United States has yet faced.

In the final section of the book, the authors explore, in some detail, a proposal to allow states to restructure their debts in a process akin to bankruptcy. David Skeel, the volume's co-editor and the leading academic proponent of the proposal, lays out – with specificity not presented in his other writing on this topic – the strong case for bankruptcy and responds to many criticisms that have been lodged against the proposal. The three authors that follow Skeel do not make much of the bankruptcy proposal. Adam Levitin argues, for example, that the problem facing states is not financial, but political, and as a consequence, state bankruptcy proposals are solutions looking for a specific problem. Michael McConnell, former federal appellate judge and leading constitutional law scholar, is, for the purposes of the volume, expressly agnostic as to the policy benefits of state bankruptcy. He does, however, explain the very real constitutional problems that these proposals face, problems not addressed by making state bankruptcy a voluntary procedure.

George Triantis, another leading bankruptcy and commercial law scholar, presents a middle ground. He argues that the concept of a single state bankruptcy regime belies the political, institutional, and financial variation that exists among states. He argues instead that states should pass, themselves restructuring regimes that are more tailored to their own economic and political realities, and that such proposals should be evaluated on their own bases, with reference to the states that pass them.

Finally, stepping out of the context of state bankruptcy, labor law scholars Catherine Fisk and Brian Olney present the case that public unions have been a scapegoat in this process and present a sensible alternative to the widely adopted argument that states need only throw the unions out in order to resolve their crises. Fisk and Olney discuss how labor law – as opposed to bankruptcy law – can help resolve the state debt crises. David Skeel concludes the volume with an epilogue on the state of the states, and the relevance of this project extends beyond the political zeitgeist of any single moment.

This book expends significant energy on assessing the strengths and weaknesses of state bankruptcy proposals. But the book is not about state bankruptcy per se, but something far broader, and more important. The American states face a perennial fiscal crisis, made painfully obvious each time recession devastates the economy. To quote one of Warren Buffett's perhaps overused nuggets of axiomatic wisdom, "You only find out who is swimming naked when the tide goes out." Because of a combination of political, fiscal, and economic factors, the states are chronically swimming naked. This book represents an effort to understand the basic structure of this perennial problem, and, hopefully, point toward mechanisms that would mitigate the problems when they arise.

PART I

The Origins of the States in Fiscal Crisis

1

Fiscal Institutions and Fiscal Crises

ISABEL RODRIGUEZ-TEJEDO AND JOHN JOSEPH WALLIS

I. TAXING, SPENDING, AND BORROWING

American states came into existence as self-constituting legal entities in 1776. Since then they have continued to face the persistent problem of what and how much to tax, on what and how much to spend, and whether some expenditures should be financed through borrowing. These problems are not new nor will they ever go away as long as there are states. The current state fiscal crisis (2009 to 2011) is one in a series of crises that will be repeated in the future. Fiscal crises arise when revenues unexpectedly fall, expenditures unexpectedly rise, or some combination of the two produces a situation in which taxes must rise, spending must decrease, and/or borrowing must increase. Hope springs eternal in America, however, and for close to 200 years, state governments and their citizens have regularly tried to prevent the next crisis from occurring by changing the constitutional rules that constrain state government taxing, spending, and borrowing. The term "fiscal constitutions" includes constitutional provisions regarding taxing, spending, and borrowing. How and why the rules of fiscal constitutions have changed and the interaction of the rules with fiscal crisis over time is our concern.[1]

At three points in the past – the 1840s, the 1870s to 1880s, and the 1930s – one or more states reached a point at which they were forced to default on interest payments on their bonded debt. In several instances states actually went so far as to repudiate their obligations. Although the sound and fury over the predicament of states in the recession that began in late 2007 can make it seem as though the current crisis is unprecedented, it is not. Some states are in a tight spot, but no tighter than they have

[1] This chapter builds on the ideas and information presented in Rodriguez-Tejedo and Wallis (2010).

been on a couple of occasions since the 1930s, and states in general are in much better shape now than they were in the 1840s or the 1930s, or the southern states were after the Civil War. Over the last 200 years, succeeding generations of Americans have had to learn and relearn the lesson that a popular democracy does not automatically guarantee a government capable of sustainable fiscal policies. Americans have been less amendable to learning the lesson that changing the rules to solve the last fiscal crisis may make the next fiscal crisis worse, or at least different. There is a pronounced pattern of crisis and response in the historical record, a pattern that we call "recursive" institutional change, in which new constitutional changes respond to a crisis exacerbated by a previous constitutional change. Rather than admitting that the fundamental underlying problem is that no government can ensure fiscal sanity through constitutional rules alone, Americans keep searching for the magic set of rules. Fiscal sustainability results from mature and realistic politics. Understanding why politics in America is sometimes neither mature nor realistic goes beyond the scope of this chapter, but an important conclusion is that the fiscal crisis facing states in 2011 is a political problem more than a constitutional or economic problem.[2]

In a global context, American state and local governments manage extremely sophisticated systems of public finance. In the first decade of the twenty-first century, state and local governments combined borrow roughly $300 billion a year to finance capital and infrastructure investments. Subnational governments in the countries that are clients of the World Bank, with about 60 percent of the world's population, borrow only about $5 billion a year. American state and local governments rarely default (in the sense of missing interest payments). In a comparative perspective, the American system works very well.

From an economic standpoint, a very desirable feature of American constitutional provisions is that they coordinate who benefits from specific decisions to tax, spend, and borrow with the people who pay the taxes or bear the costs. From the 1840s on, changes in constitutions have often been directed toward ensuring that those who pay taxes to finance debts have a say in whether the debt is incurred (a bond referendum, for example). Where government activity takes place – a state, a county, a city, a school

2 For an excellent discussion of how political forces have generated the current fiscal crisis in California, see Cain and Noll (2010). On May 17, 2011, the *Economist* magazine recently published a series of articles on constitutional change and politics in California, based in part on Cain and Noll's analysis.

district, or a special district – often results from the political advantages of financing infrastructure investment through borrowing in jurisdictions where a majority of the citizens and voters benefit from the investment. This chapter describes how and why these institutional arrangements developed over time. At the conclusion, we provide a few suggestions about which parts of current fiscal constitutions are working well and which are causing problems.

After reviewing state finances in a historical perspective, we examine more carefully what a state budget is to see where decisions are made in the political process about taxing, spending, and borrowing that might be affected by constitutional rules. In section V, we show how states have enacted a series of reforms to their fiscal constitutions. We close with a synthesis of the history that points out why fiscal constitutions have changed over time and a simple proscription for how we might think about changing constitutions in the future.

II. THE STATE GOVERNMENT FISC IN AMERICAN HISTORY

It seems best to determine clearly right from the beginning what a fiscal crisis is and is not. A fiscal crisis is caused when revenues and expenditures change relative to one another in a way that strains the capacity of the government to finance its activities, usually to the extent that a state must deliberately change its taxing, spending, or borrowing policies. Two aspects of the definition are important. One is that a fiscal crisis is largely self-defined by the actions and attitudes of the state in which the crisis occurs – that is, fiscal crises are always political as well as economic events. Second, the definition of a fiscal crisis has nothing to do with the size of the government or with the amount that a government borrows. Big state governments are no more or less likely to find themselves in a fiscal crisis than small governments; what matters is the relative amount of revenues and expenditures. We should be careful not to infer that a state whose taxes and expenditures (TEL) comprise 10 percent of the income of state residents is no more likely to have a fiscal crisis than a state whose (TEL) account for 5 percent of state income. What matters most is the relative size of revenues and expenditures. Likewise, states may borrow lots of money without causing a fiscal crisis. State governments in the United States regularly borrow more than $150 billion a year to finance things like highways, schools, public buildings, and other capital investments without causing fiscal crises. In 2007, the year of the last Census of Governments, total state debt outstanding was $936 billion, and debt issued in that fiscal

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year by states totaled $161 billion ($92 billion in debt was repaid)[3]; 2007 was not a crisis year. Yet, Indiana defaulted on its debts in 1841, when the total debt was only $12 million! Today, the average state has $20 billion in debt.

To meaningfully compare Indiana's $12 million debt in 1841 with its $19 billion state debt in 2007 requires that we appropriately adjust debt figures by population, income, and inflation. Tables 1.1 and 1.2 give basic information on the size of state governments and the size of state debts over time from the 1840s to 2007, where size is kept in perspective by measuring total government revenues and government debt as a percentage of gross domestic product (GDP) in each year. Local and national government revenues and debts are included for comparison. There are many interesting numbers and trends in Tables 1.1 and 1.2. In 1841, on the eve of the default crisis during which Pennsylvania, Maryland, Indiana, Illinois, Michigan, Mississippi, Louisiana, Arkansas, and the territory of Florida defaulted on their bonded debts, state government debt outstanding was 12 percent of GDP, whereas state revenues were only 1 percent of GDP. After the default crisis in 1841 and 1842, state debts as a share of GDP trended down steadily until 1913, whereas state revenues remained around 1 percent of GDP. State governments grew steadily smaller in relation to both local and national governments over the second half of the nineteenth century. In 1913, local government debt was more than double national and state government debt combined, and local government revenues were only slightly smaller than national government revenues. Local governments undertook the lion's share of borrowing for infrastructure investment (roads, schools, and public utilities) in the late nineteenth and early twentieth centuries. The national debt in 1913 was a carryover from financing the Civil War and the Spanish-American War.

In the twentieth century, these patterns changed again. State governments began growing as states assumed responsibility for constructing highways after the invention of the automobile. States took over a much larger share of the responsibility for public welfare services in the 1930s and beyond. State revenues grew from roughly 1 percent of GDP at the beginning of the twentieth century to 9 percent at the end of the century. State debts also grew, from about 1 percent to 6 percent of GDP. State borrowing grew more slowly than state revenue collection (and spending) over the course of the twentieth century (Wallis 2000, 2001).

3 Census of Governments, *State and Local Government Finances by Level of Government and by State: 2006–07*.