Federalism’s Emerging Fiscal Crisis

No pecuniary consideration is more urgent, than the regular redemption and discharge of the public debt: on none can delay be more injurious, or an economy of time more valuable.

—George Washington, message to the House of Representatives, December 3, 1793

It is well understood that defaults, bankruptcies, and fluctuations in interest rates are shaped by business cycles, banking management, and financial engineering. However, credit risk among the lower tiers of government within a federal system also has political determinants and political consequences. Without downplaying the importance of economic conditions and technical considerations, this volume focuses on the political realities that affect the capacity of subnational governments to survive global financial crises. The material explored here serves as a reminder that the founding social science was called political economy and that visionaries from Adam Smith and David Ricardo to John Keynes, Milton Friedman, and Friedrich Hayek all considered themselves as much students of the subject identified by the first part of the term as students of that identified by the second.

Such students of political economy have never been as necessary as they are today. As the title of this book suggests, we are in the midst of a global debt crisis. Economists at the International Monetary Fund (IMF) suggest that the public debt of the ten leading developed nations will rise from 78 percent of GDP in 2007 to 114 percent by 2014. These governments, including those in the United States and in many European nations, will by then owe around $50,000 for every one of their citizens. That translates into more than $10 trillion of extra debt
accumulated in less than ten years. The governments of rich nations have never borrowed so much in peacetime, and their massive debts will likely shape the world economy for decades to come. If current trends continue unchecked, demographic pressures combined with political paralysis will send the combined public debt of the largest developed economies toward 200 percent of their GDP by 2030. As if the 2008 recession did not do enough to overturn national and subnational balance sheets, a far longer-term and less cyclical fiscal crunch is currently in the making: the pension and health-care costs of a rapidly graying population. By 2050 a third of the developed world’s population will be over 60 years of age, and economists estimate that this “demographic bill” is likely to be ten times larger than the recession’s fiscal costs. Politicians in most industrialized nations have failed to confront these fiscal and demographic forces. The debt that they are accumulating portends an even greater financial catastrophe than the one that the international community is still struggling to survive. And so it is that leading economists are now beginning to acknowledge the resurgence of the venerable, if old-fashioned, field of political economy. In an era that until recently was defined by quantitative economics—derivatives, default swaps, and other exotic forms of financial engineering—the quaint field of political economy is seeing a rebirth among leading economists as the lens through which the present global crisis must be viewed to be understood. In 2013, a U.S. Federal Reserve Bank president, Eric Rosengren, criticized a widely circulated and fairly conventional economic model of sovereign credit risk for its oversimplification of the subject and its “parsimoniousness,” especially the extent to which it “omitted” what Rosengren called the “political determinants of risk premiums.” In a sign of just how far the pendulum has recently swung back to the political origins of the field of economics, Rosengren—a leading monetary specialist who, like most of his central bank colleagues, usually exhibits the putatively clinical nonpartisanship of his profession—openly observed, “One frequently sees that credit default rates spike around elections, and that countries that are politically destabilized have difficulty generating the political will to address problems.”

The notion that “political will” is as important as economic capacity in dealing with a crisis, though intuitive to students of political economy, is an important warning coming from a top U.S. central banker and one that may presage the reunification of the fields of politics and economics. Even more strikingly, Rosengren specifies a promising first candidate for close inspection in the realliance of political science and economics, one that also happens to be the overarching subject of this volume—fiscal federalism:

Another political variable that might be relevant [to credit risk] is a variable that captures whether there is stable fiscal federalism in a country.
For example in Spain, debt and banking problems have been exacerbated by the reality of regions that were autonomous but not necessarily fiscally responsible. A variable that might capture this impact is state and local government debt to GDP.\textsuperscript{2}

Echoing those comments, Federal Reserve governor Jerome H. Powell observed, on the same day:

Many advanced economies are in an extended period of slow growth and high deficits, and face long-term fiscal pressures from aging populations. Terribly difficult fiscal adjustments lie ahead. Although there is still time to make them, delay will sharply increase the pain of adjustment. The time to act is now. \textit{In my view, the problem is not principally one of economics or fiscal policy; it is one of governance. The real threat to the fiscal standing of the United States is that of inaction caused by a long period of political polarization and dysfunction. That would be a self-inflicted wound. And that is a problem that can't be derived from the traditional fiscal metrics [emphasis added].}\textsuperscript{3}

This volume takes Powell’s remarks as its point of departure.

\textbf{Tales from Three Cities}

While by now virtually everyone has come to understand that Greece, Ireland, Portugal, and Spain have, in some form or another, defaulted on their sovereign debts, the U.S. cities of Stockton, Vallejo, and Central Falls initially attracted far less attention. For decades, municipal bankruptcies were rare occurrences in the massive $3.7 trillion U.S. municipal bond market. Mostly limited to utilities and over-budget public projects, they were handled in isolation, rarely touched whole cities—let alone states—and posed few deeper questions regarding the political-economic structure of the nation as a whole. Quite apart from the events in Detroit, seven U.S. cities, towns, and counties have filed for bankruptcy since 2010. Prior to that year, no large municipality had failed to fully repay its principal debt since the Great Depression, when about 4,000 municipalities defaulted—including about forty that never fully repaid their debt.\textsuperscript{4} But the modern trend of ultimate municipal creditworthiness might be changing, with several cities and counties having recently attempted to pass on losses to either bondholders or higher tiers of government. Alternatively, they may need to alter their contractual commitments to their employees. While each of the U.S. cities, towns, and counties that have filed for bankruptcy since 2010 has approached insolvency in different ways, the overall options available and the choices that each has made in dealing with the specter of bankruptcy provide a
window into some of the broader national and international themes addressed by this volume.

Stockton, California

Stockton’s 2012 bankruptcy made it the largest U.S. city in history to declare bankruptcy. At its bankruptcy hearing, the municipal government faced a $26 million annual deficit and had incurred a debt of as much as $1 billion—substantial for a city of 290,000. Stockton’s choices were emblematic: either public sector employees or bondholders must take the brunt of the cuts. As the authors in this volume argue, which group Stockton chooses will have implications beyond the city itself; the consequences of its choice will reverberate across America’s federalist structure as a whole.

In the summer of 2012, Stockton indicated that it might try to impose substantial losses on lenders as well as public employees in order to spread losses across both types of creditors. Since at least 1981 and possibly as far back as the 1930s, no U.S. municipality has used bankruptcy to force bondholders to take less than the full principal due, according to Bloomberg. But as Stockton city manager Bob Deis told city council members at a June 26, 2012, hearing, “We’re trying to spread the pain, unfortunately, to others besides employees.” Punishing bondholders has generally been unsuccessful at the municipal level: of the forty-three municipal bankruptcies filed since 1981, thirty-three were either dismissed by a judge or failed to win a court ruling discharging their debt. Court records for the remaining ten do not list the disposition. According to Bloomberg, those cases ended with a cut in the principal owed to lenders. Some cities have avoided trying to force investors to take a loss in court or outside of it since most market analysts have thought that the bond market would punish any future borrowing with higher interest rates or possibly by locking a defaulting municipality out of credit markets entirely. But the fear of credit market discipline is changing. For example, in 2013 Detroit asked both bondholders and pensioners to accept less than the amount originally contracted.

Central Falls, Rhode Island

Central Falls may be the municipality that has been most successful in extracting itself from its debt crisis—and it did so without burning its bridges to the bond market. In September 2012, it won court permission to exit bankruptcy status by repaying bondholders in full (including even their legal costs) while cutting municipal workers’ pensions (by as much as 55 percent, including an additional requirement that pensioners pay 20 percent of their health-care costs until they turn 65 years of age). The court ruling ended a storm of controversy following the passage of a state law, signed by Governor Lincoln Chafee in 2012, that gave investors a lien on the city’s tax and general revenue. Following
the court’s ruling that Central Falls can protect bondholders while forcing its employees to take cuts, the president of one of the Central Falls public sector unions said: “We’ve been pillaged and beaten down . . . we didn’t have the power, the money, to fight it.”

**Detroit, Michigan**

Stockton and Central Falls can be ignored as exceptional instances, but the fiscal collapse in Detroit in the summer of 2013 is vastly more portentous. The nearly $20 billion bankruptcy suit that the city filed in federal court was the inevitable consequence of economic, social, and political trends only slightly more immediate and advanced than those undermining the fiscal well-being of Philadelphia, Chicago, Cleveland, Milwaukee, and many other U.S. central cities. Business and industry are moving to U.S. suburbs, ex-urbs, and rural areas and to countries across the globe. The quality of public services is deteriorating even as per capita costs are rising. Public officials are promising public sector employees health and pension benefits without putting aside the necessary resources to cover the costs. Taxes have been raised to levels that scare entrepreneurs into choosing more promising locations. Detroit’s bankruptcy case can be expected to twist and turn as law, politics, and the fiscal reality on the ground are taken into account over the course of the litigation. All that can be said with certainty is that the competing demands of creditors and pensioners will take years to sort out.

**The Fiscal Crisis of the U.S. States**

The charged emotions surrounding Detroit’s municipal bankruptcy and the city’s and the unions’ radically departing views on which party should bear the brunt of the cuts—the workers or the bondholders—are emblematic of every current sovereign and subsovereign fiscal solvency crisis, from the streets of Central Falls to the streets of central Athens, from the protests in Vallejo, California, to the protests in Valencia, Spain. The same difficult choices that Stockton and Vallejo, Jefferson County, and Central Falls have faced are confronting governments at the state and even national levels, with major consequences for the intergovernmental structure of the two largest and most important federations in the world: the European Union and the United States.

For the first time since the Great Depression, multiple U.S. states might find themselves unable to pay their employees or their bondholders, effectively going bankrupt (for our extended discussion, see chapter 2). As early as March 2010, the *Wall Street Journal* asked, “Who Will Default First: Greece or California?” (the answer was Greece), and in testimony before the Congressional Financial Crisis Inquiry Commission, investor Warren Buffett—who then owned more
than $4 billion of state and local debt—stated that the federal government may ultimately be compelled to bail out states.  

If the failure of commercial banks posed a “systemic risk” in 2008, it will be difficult to argue that the U.S. states are not “too big to fail” in 2013: state and local governments represent more than 12 percent of the nation’s GDP and more than 15 percent of its employment. Millions of public employees stand to lose their jobs if the federal government does not step in. The municipal bond market is more than $3 trillion in size, and state and local governments use it to finance their schools, highways, and other projects. More than two-thirds of outstanding state and local debt is held by small investors and public institutions. Should states require a bailout by the federal government in 2013, it would likely rival the 2008 bailout of the U.S. banking system. Every day the pressure builds: in the summer of 2011, $160 billion in federal stimulus money—given to states and local governments during the financial crisis to keep them afloat—ran out. The average U.S. state budget faced a roughly 20 percent deficit in 2011, with states like New Jersey and Illinois projecting 40 percent and 50 percent shortfalls, respectively.  

Arguments are already being made against such bailouts, ranging from the problem of moral hazard to the fact that it would likely change forever the face of American federalism—which historically considered the fiscal autonomy and independence of states as a defining feature of the federal system. Unprecedented alternatives are being sought: the New York Times reported in January 2011 that lawmakers were looking for ways to circumvent existing constitutional jurisprudence in order to allow states to declare bankruptcy. (They currently cannot.) That sovereign entities may be at risk of default in the coming decades is well understood. It is not just Greece, Ireland, Portugal, Spain, and Italy whose debt situations have become a matter of urgent concern. According to Fred Bergstrom, even the United States has allowed itself to be placed at undue risk, as the net foreign debt of the U.S. central government, in the absence of corrective measures, is projected to rise within the next twenty years from about $14 trillion dollars in 2012 (more than 65 percent of GDP) to $50 trillion, or more than 140 percent of GDP—a level “far above any conceivably sustainable position.” As dramatic as those numbers are, they understate the looming crisis, for they do not include the sovereign debts of the fifty states of the union, which currently amount to more than $1 trillion, or about 7 percent of GDP. Nor do they take into account the value of the unfunded liabilities faced by public sector pension plans: although they are officially estimated at $438 billion by the states themselves, they could in fact be as high as $3 trillion, or about 20 percent of GDP.  

Bankruptcy protection for state governments has been proposed by University of Pennsylvania law professor David A. Skeel Jr., a specialist in corporate and bankruptcy law. In his view, the country needs a federal bankruptcy
law designed specifically for sovereign debts. Such a law, which would “enable a state to restructure [its] obligations,” would be constitutional if state sovereignty were protected by giving states the option to invoke bankruptcy procedures rather than requiring them to enter bankruptcy court if they would otherwise default. Voluntary participation in bankruptcy procedures would give states the opportunity to restructure their obligations to employees, pensioners, and bondholders, much as bankrupt corporations may continue to operate while under the protection of federal bankruptcy law. Bankruptcy protection would not only give states the opportunity “to restructure obligations that are [otherwise] extremely difficult to restructure” but also ensure that “most or all of a state’s constituencies make sacrifices, not just one or two.”18 Jeb Bush and Newt Gingrich have proposed a similar plan that would give states the opportunity to seek bankruptcy protection in the event of a deficit crisis.19

On the other hand, Nicole Gelinas of the Manhattan Institute argues that a “state bankruptcy would create more problems than it would solve.” States do not owe their debt through a single entity, making it difficult for any single bankruptcy court to handle the extraordinary complexities involved. Pension obligations are typically borne by local governments as well as by the state, adding to the number of participants in any bankruptcy procedure.20

In chapter 3, Jonathan Rodden advances the intriguing recommendation that the federal government clarify procedures for orderly default by sovereign states. Noting that states have defaulted in the past, he suggests that even in the midst of the 2008 financial crisis it was the markets, not the federal government, that imposed discipline on the states. He argues that in the United States the moment might be opportune 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. Proceeding from the premise that for all parties an orderly default is preferable to a disorderly default, Rodden shows that by reducing fear of the latter, the federal government can reinforce its “no bailout” commitment.

Seeing a silver lining in the crisis, Rodden observes that while the U.S. system of federalism is under stress (especially from the problem of unfunded subnational obligations to retirees, which he argues is one of the largest policy challenges facing the United States today) and reform is needed at both the federal and the state level, any future reforms can (and should) strengthen rather than undermine the system of market discipline that has characterized U.S. federalism throughout the last century. Rodden contends that reformers should take the large state deficits of 2012 as opportunities to bolster definitively the foundations of market-based fiscal discipline in the states while bearing in mind that the most likely path to improved state fiscal discipline lies within the states themselves. For Rodden, bolstering discipline requires the federal government
to have the courage and the steadfastness to treat states as mature, sovereign-like actors that must ultimately stand or fall on their own.

In chapter 4, beginning a three-part exploration of the problem of unfunded subnational obligations to retirees that Rodden cites as a significant threat to the future of American federalism, Andrew Biggs and Jason Richwine put a price on unfunded pension liabilities. Alarmingly, the authors reveal how public employee pension funds across the nation have come to suffer from unfunded liabilities that a growing number of economists, government agencies, and bond raters suspect are significantly understated. They estimate that if pensions are valued under a fair market approach, state and local pension obligations will increase significantly, moving unfunded liabilities from less than $1 trillion into the $2 trillion to $4 trillion range. These figures swamp reported state debt of $2.8 trillion as of 2010; furthermore, $4 trillion in pension debt is equal to about 27 percent of total U.S. GDP. If pension debt measured at market value as of 2010 is combined with explicit state, local, and federal government debt, U.S. obligations would register at 140 percent of GDP. In chapter 5, Cory Koedel, Shawn Ni, and Michael Podgursky tell us that retiree benefits in the public sector are usually designed as defined benefit plans, which place the full financial risk on the employer. In contrast, most employers within the private sector have switched to defined contribution plans, in which the employee bears the financial risk. Between 1973 and 2005, defined benefit plans declined from 88 to 33 percent of all pension programs while public sector policy remained essentially unchanged. Further, Koedel and Podgursky show that public sector plans tend to be “enhanced” when short-term returns from investments are larger than can be expected over the long run. The authors show how legislative pension “enhancements” that were enacted in the early 2000s—toward the end of an extended bull market in stocks that left many funds with substantial actuarial surpluses—led many states to transform a transitory increase in asset values into a permanent increase in liabilities, placing pension programs at grave risk in the aftermath of the 2008 financial crisis. The authors argue that pension enhancement legislation exposes the extent to which many U.S. state pension plans are open to rent capture by politically powerful entities and the ways in which senior public administrators are not at arm’s length with respect to pension legislation—a highly problematic finding given the potentially potent fiscal impact that pensions and other legacy costs can have on the public enterprises that these administrators are charged with managing.

In chapter 6, Daniel Shoag completes the three-part exploration of the political economy of public pensions. He first identifies precedents for the contemporary public pension financing crisis by exploring the U.S. state defaults that occurred in the nineteenth century when states overinvested in transportation systems. He sees a strong resemblance between the risks taken by states during
that period and the risks being taken by states now, with startling implications, given the disasters that befell many states then. According to Shoag, the risks posed by state and local pensions to fiscal federalism in the United States “are difficult to overstate” because states today, as in the mid-nineteenth century, rely heavily on risky investments to finance themselves, a reliance that in some cases led to state bankruptcy in the past. This does, of course, have deep implications for federalism and the country as a whole. Shoag also points out that many members of state and local pension systems are not currently covered by Social Security. Very likely, retirees who lost state pensions to state defaults would both demand Social Security benefits and pressure the federal government to bail out the defaulting states. Even more worryingly, the interconnectedness of financial markets opens the door for contagion: default by one state could lead to a run on the municipal debt market, making it impossible for other states to finance their obligations and forcing them into default as well. Shoag’s work raises the possibility that the large size of public trust funds—which currently hold roughly 7.5 percent of all U.S. corporate equities—could mean that a rapid sell-off could force down asset prices, which would depress returns and hamper other states as well. In short, the viability of competitive federalism as it is known in the United States might depend largely on the viability of subnational financing and the management of system-wide pension risk.

Federalism in Crisis Abroad

The second half of this volume, which opens with chapter 7, looks at the political economy of federalist systems outside the United States. In chapter 7, Daniel Ziblatt examines the prospects for the continued functioning of fiscal federalism within the European Union (EU). Ziblatt examines whether a robust multi-tiered political system—in which the center and lower-tiered units have constitutionally protected separate spheres of influence and taxing and spending autonomy and in which subunits have representation in a second chamber—can be created and sustained through the institution of the European Union. At stake beyond even the fate of Europe is whether balanced systems of federalism can survive a financial crisis. Noting that all federations form atop local identities, Ziblatt argues that the tendency to view “strong national loyalties” as the major stumbling block to fiscal federalism in the EU is misplaced because federalism represents an effective and normatively attractive method of coping with precisely that sort of loyalty. In examining other less discussed causes of the major problems facing the European Union, Ziblatt draws on past instances of attempts to form larger political unions out of formerly sovereign states—in particular the nineteenth-century cases of German and Italian state formation—to argue that a potentially bigger problem over the long run comes from
the temptation to over-centralize. There is today, just as in nineteenth-century Italy, a tendency to over-centralize in the face of uneven capacity at the lower tiers of a federalist system. EU policymakers repeatedly “rescue” weak states in “one-off” agreements that provide financial aid on the condition that centrally imposed austerity measures are adopted, thereby usurping lower-tier budget autonomy. As the European Union intrepidly pursues fiscal centralization without federalism, it runs the risk of centralization without political accountability, which could induce a crisis of a much higher order.

Turning to the largest federation within the European Union, in chapter 8 Henrik Enderlein and Camillo von Müller show the extent to which the German bond market’s assessment of the risk of German Länder (state) bonds during the economic crisis has depended on the political climate within each state. Like many of the other federations covered by this volume, Germany is facing pressure to undergo fiscal centralization in response to the debt crisis, and it seeks at the very minimum to adopt mechanisms that would fiscally constrain the Länder, a move that places the already precarious German system of federalism in further jeopardy.

An even more rapid centralizing process is occurring in Spain, which César Colino and Eloísa del Pino explore in chapter 9 and Carlos Xabel Lastra-Anadón examines in chapter 10. Together, these chapters show the way in which the particular constitutional design of a federal system established as part of the democratizing processes of the 1970s encouraged lower-tier governments to run debts that now place them at risk of default. The crisis has been aggravated by the misplaced policies of national political leaders who were dependent on the support of regionally focused political parties. The authors suggest a need for a form of competitive federalism, with greater devolution of both taxation authority and fiscal responsibility to the Spanish regions. That would likely require a new constitutional arrangement that reflects both changing regional identities in several parts of Spain and continuing loyalty to the Spanish regime as a whole. Lastra-Anadón concludes that a form of competitive federalism similar to what was once enjoyed by the United States—with adequate oversight from the European Union—may be the best, if an imperfect, way forward for Spain.

Chapter 11 ends the volume with a surprisingly optimistic account of how a developed system of federalism might operate in a time of fiscal crisis. Richard Simeon, James Pearce, and Amy Nugent challenge the idea that high levels of fiscal decentralization necessarily lead to fiscal irresponsibility or incapacity. In their discussion of the impact of the global crisis on Canadian federalism, the authors offer what might be called the “Canadian paradox,” a functional response to global financial crises by one of the most decentralized federations in the world. Canada grants its provinces sweeping fiscal autonomy, extraordinary freedom
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to tax and spend with minimal federal monitoring or regulation, and unlimited
capacity to borrow in global credit markets. Furthermore, the country has seri-
ous linguistic divisions and highly uneven regional growth of the sort that has
paralyzed other federal systems. Yet neither the country’s robust decentralized
federalist structure nor its economic growth rate was seriously disturbed by the
massive tremors that have shaken the world economy since 2008. Why? While
Canada’s resource-based economy was admittedly well positioned to minimize
the effects of the crisis, the authors show that political and institutional factors
also played an important role: Canada’s long experience in managing intergov-
ernmental relationships and its surprisingly homogeneous ideological views on
the role of government were critical in forming the national consensus on a
coordinated federal-provincial response to the crisis that has eluded its neigh-
bor to the south. The authors conclude that the strong tradition of fiscal coordi-
nation between federal and provincial treasuries in Canada—cooperation that
arises not from federal coercion but from shared values—helped Canada stand
apart during the global crisis and emerge with both its finances, and storied
federalist structure, largely unscathed.

The Canadian experience shows that despite the overall warning sounded by
this volume, there may still be cause for hope and time for change. Some of the
countries that historically had been most associated with bloated public sec-
tors and fiscal profligacy—think both Canada and the Nordic countries in the
1990s—are now serving as models to other developed nations with regard to
how to rein in deficits, bring down debt, and cultivate efficient and responsive
governance. Politicians around the world can therefore take some solace in the
fact that no matter how bleak the global debt crisis seems at the moment, real
solutions that bring down debt and increase government’s fairness, efficiency,
and responsiveness are possible—and that systems of competitive federal-
ism may have a longer life than currently seems likely given the experiences in
Spain, Germany, and the United States. But finding those solutions requires the
political will to face up to the reality of financial problems and make them the
responsibility of the current generation instead of future ones.

Notes

   2013/022213/index.htm).
2. Ibid., pp. 4–5.
   Monetary Policy,’” February 22, 2013 (www.federalreserve.gov/newsevents/speech/
   powell20130221a.htm).
4. Even New York City in the 1970s eventually fully repaid its debt, albeit with the help of New York State.


6. Ibid.


10. Ibid.

11. Ibid.

12. Ibid.

13. Ibid.


15. Strictly speaking, states cannot declare “bankruptcy” (Chapter 9 of the U.S. Bankruptcy Code).


