Time for *a* New Fiscal Federalism

Three reforms deserve attention.

BY MANSOOR DAILAMI

American fiscal federalism, a novel political innovation of the founding era, continues to inspire and intrigue policymakers and scholars after close to two-and-a-half centuries. Europe is now invoking a "Hamiltonian moment" to create an $858 billion recovery fund to rescue EU economies from the ravages of the Covid-19 pandemic, with the money to be raised on the capital markets on behalf of the Union and disbursed to member countries as loans and grants. Meanwhile, in America itself, federalism has become a watchword in the politics of Congressional debate and partisan rift over the pandemic response, rendered more dramatic by the severe budget crises overwhelming state governments. As of this writing, negotiations over a new stimulus plan have reached an impasse, even as state governments brace for deeper budgetary cuts.

More consequential for the states' ability to hold the line in the battle against the pandemic is the inherent irony in the functioning of American fiscal federalism. Even while state power is protected by the U.S. Constitution through the Tenth Amendment, and state interest is held up by the forces of national politics ("political safeguards of federalism") and by judiciary intervention, states are not vested with the necessary fiscal

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power to safeguard their finances from business cycle fluctuations or shocks from extreme events, such as a pandemic or a natural disaster.

One key drawback of current fiscal federalism is the "fiscal mismatch" in state-federal relations that leaves states with procyclical tax revenues, but countercyclical spending obligations. The other relates to states' own balanced budget and debt rules that arose from state defaults in the 1840s and the tax revolts of 1970s but continue today to limit their ability to borrow and run deficits.

The burdens on state budgets have been considerable volatility and periodic crises. Following the 2008 global financial crisis, state governments faced a cumulative budget shortfall of $690 billion spread over fiscal years 2009–2013, according to the Center on Budget Policy and Priorities. While emergency federal aid and state reserve withdrawals helped close the gap, states could not avert large cuts in spending and raising taxes and fees. The Covid-19 pandemic has an added humanitarian dimension that elevates the need for timely state budget protection to a higher national security concern.

The case for states having more robust countercyclical budget policy frameworks is well-documented. The consensus solution under the existing tax assignments and fiscal rules has been for states to self-insure by building rainy day funds to supplement spending during downturns or emergencies. Every state now has at least one rainy day fund, and most have established constitutional or statutory rules and procedures governing the fund size, contribution, and withdrawal practices.

Yet this strategy is not likely to prove up to the task in the face of arguably the worst state fiscal crisis of modern history. Even with great strides to accumulate savings during the decade-long national economic expansion through 2019, states reported total rainy-day fund balances of $75.5 billion as of the end of fiscal year 2019. This amount falls far short of covering the massive anticipated budget shortfalls in the current and years to come. Based on the latest Congressional Budget Office economic projections (July 2020), CBPP estimates shortfalls of $555 billion over state fiscal years 2020–2022. Federal aid to states provided under legislation enacted since March 13, when President Trump declared a national emergency, will cover at most 36 cents of each dollar of estimated state budget shortfalls.

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It is time to approach fiscal federalism in its cooperative flair to advance not only redistributive ends, but also social insurance goals. One of the hallmarks of the twenty-first century will likely be growing extreme event risks, which have the potential to cause large-scale damage to employment, income, and collective security. Such risks are best suited for public insurance management, and in the U.S. federalist system, the federal government. Fiscal federalism has in fact been tasked in U.S. history with such a purpose, notably as part of the New Deal and the war on poverty in response to the economic and social emergencies of 1930s and 1960s, and partly in response to the growing citizen demand for economic security.

Anchored on the authority of Congress to tax and spend for the general welfare (U.S. Constitution, Article I), the federal government provides financial protection against unemployment, disability, old age, and disaster relief, using national taxation to pay for it. For states, this insurance has involved paying high premiums in the form of federal income taxes levied on their residents in exchange for payouts in the form of macroeconomic stabilization and financial protection in times of need.

In fiscal year 2019, the federal government collected $1.71 trillion in individual income taxes and transferred $750 billion in federal grants to state and local

Continued on page 60

Continued from page 43

governments. In parallel, the federal government used payroll taxes to fund Social Security, Medicare Hospital Insurance, and unemployment insurance. Federal outlays for Social Security and Medicare totaled $1.65 trillion in fiscal year 2019 (23 percent of the federal budget). Such insurance programs can serve as the foundation of a new architecture to meet the security needs of the twenty-first century.

To that end, three sets of reforms deserve attention. First, state rules on debt limitations and balanced budget requirements should be updated, bearing in mind the informal constraints that capital markets, voters, and fear of losing rich taxpayers could place on states' fiscal behavior. State fiscal rules have remained because they are intended to signal the political will to exercise fiscal probity and discipline. While restrictions arising out of fear of excessive debt accumulation may have served a useful disciplinary role in the nineteenth century, when there were genuine reasons to be concerned about the ways state and municipal infrastructure investments were financed, this concern is overstated today. Up to one-third of states' total spending is now funded through federal grants, which are subject to Congressional conditions and oversight.

Furthermore, U.S. capital markets have grown in depth and sophistication and interest rates are historically low. The costs borne by states from self-imposed budget restrictions are not just the economic hardship of harsher budget crises, as recognized by many scholars of federalism, but also opportunity costs. States are not able to fully avail themselves of a wide range of financial instruments developed in recent years to transfer catastrophe risk to the broader capital markets, and are missing opportunities to finance long-term investment in resilience and preparedness that could improve their chances of weathering future shocks at lower budgetary costs.

Second, we need to better understand the pattern, timing, and determinants of state-level business cycles, including how closely synchronized they are with the national business cycle, the latter of which provides the basis for decisions about macroeconomic stabilization made by the Federal Reserve, Congress, and the White House. State coincident indexes recently constructed by the Federal Reserve Bank of Philadelphia offer insights into state-level factors that could influence a state's business cycle. For example, the energy-producing states in the Tenth District, which are directly affected by developments in global oil markets, entered a recession in 2015–2016 even as the U.S. economy was in expansion. Research examining the relation between economic downturns and state finances has consistently revealed how state budget problems tend to lag the official ending of the national business cycle. While the Great Recession was declared to have officially ended in June 2009, states continued to face fiscal crunch in fiscal years 2010 and 2011, even as fiscal relief provided under the American Recovery and Reinvestment Act was set to expire on December 31, 2010.

Third, the federal grants-in-aid system requires adjustments to better align the amount and timing of federal fiscal assistance with states' anticipated budgetary needs and capacity. The system, established in cash form in 1879, has been the most powerful fiscal tool to enhance federal-state cooperation in a wide range of public policy areas, including health, education, infrastructure, and income security. As the system has evolved, the balance in the distribution of governmental authority has shifted toward federal policy supremacy not only regarding redistribution, but also social insurance in times of emergencies and disasters, leaving states vulnerable to fiscal strain caused by the swings of national economy or the vagaries of nature. Relative to other advanced economies, the United States has weaker "automatic stabilizers," which means it must rely more on new discretionary legislation to cushion individuals and businesses from economic downturns.

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In the field of disaster policy, much has been learned in disaster preparedness, financing, and recovery. The passage of the Disaster Recovery Reform Act of 2018, which acknowledges the shared responsibility for disaster response and recovery, provides a range of federal assistance to states and localities in the event of a major declared disaster or emergency. Having eclipsed the worst natural disaster that America has ever endured, the Covid-19 pandemic now requires a new attachment to cooperative federalism that served America well during the grave economic crisis of the New Deal era. ◆