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Josh Barro:

This is Josh Barro and this is Very Serious, the podcast. The federal government has run very large budget deficits for the last few years, but the picture in the States has been quite different. COVID was supposed to bring a new round of state and local government budget crises, but incomes and tax revenues held up much better than expected and the federal government gave generous aid to states and localities that combined to produce huge budget surpluses, surpluses in every state. But now that's turning again. Tax receipts are slowing in part because so many states, red and blue, cut taxes in the pandemic. Public employees are demanding raises, often not unreasonably given how short staffed governments are and how tight the labor market is, and deficits are back in some cases yawning ones, $32 billion in California right now, for example.

States must deal with those budget gaps at a time when many categories of government services are struggling and there are related demands to spend more money on things like education and policing. There are also infrastructure needs that are getting more expensive with high interest rates and with tight labor markets. It's all a very tough pickle. So talk about that today. I'm joined by David Schleicher. David is a professor of law at Yale Law School. He's written a new book about state and local budget crises called In a Bad State. It's about how the federal government should respond when localities and states get into fiscal trouble. Hi David. Thank you for joining me.

David Schleicher:

Thanks so much for having me.

Josh Barro:

So what's the nature of the financial problem in state and local governments right now? Because a lot of your book is about solutions to insolvency. It doesn't look to me like we're at the brink of insolvency in any states or any major localities, at least not yet.

David Schleicher:

Yeah, no. The nature of the problem right now is that we've been in this period coming up to now in which the enormous amount of federal aid, and as you noted, the economic conditions, left states having flush budgets for a while. It would've been a very good time to address some of their long-term structural problems that predated the pandemic, things like hiding budget deficits in underfunded pensions or not maintaining public infrastructure. But the federal government when it gave, it didn't insist on any fiscal retrenchment or kind of change in policy. While some states were quite responsible during these flush periods, other states were not.

That's to be expected for two reasons. One is that being responsible stinks and then secondly that the federal aid may have created some reasonable beliefs that the federal aid was going to continue. But we're now seeing the turning of the worm. It's not merely economic situations, but it's also Biden announced that he might even be willing to accept pulling back some unspent ARP money, federal aid to states money as part of a debt limit deal. Even though that money itself is not so important, it signals the end of this enormous period of kind of somewhat unprecedented fed federal direct aid to states non-programmatic.

Josh Barro:

Yeah. So the way states are supposed to deal with these sorts of vicissitudes in their revenues, states are in theory not supposed to run budget deficits for their operations. They can borrow money to spend on capital to build roads and bridges and that sort of thing. Every state except Vermont is required by its constitution to balance its budget every year. Vermont ordinarily does so even though it's not explicitly required to. So when you have a good period like happened for states during the pandemic, this sort of perversely good fiscal period, states are supposed to sock that money away in rainy day funds, especially when it looks like the swings in the revenues have been crazy.

I know you say they may have expected that aid was going to go on forever. I don't know why the aid would've gone on forever. The pandemic was going to end. There wasn't going to be a Democratic administration forever. So the sort of orthodox thing to do if you ran a state government at that time was you're supposed to put the money in a rainy day fund or you're supposed to put it in your pension fund or you're supposed to spend it on durable infrastructure investments. Did we see states doing those things?

David Schleicher:

Yeah. Many states did. Rainy day funds are at all time highs. So it's not that there's no savings in states. There's just a lot of variation. The big challenge when huge amount of money come into states is whether they create programs that will be hard to cut in the future. So you see this with creating spending programs that then you then have employees and firing employees as hard, and sometimes you have contractual obligations that last longer. Also tax cuts are really hard, I mean, to reverse, especially if again, the economic situation changes. The federal aid under the ARP attempted to address this a little, which it created a limit on using ARP money specifically for tax cuts.

Josh Barro:

ARP, this was the big law right at the beginning of the Biden administration that had about 2 trillion in spending, including hundreds of billions of dollars for states and localities.

David Schleicher:

Far more than states needed to plug their budget deficits, which was just an enormous dump of money. Sorry for the jargon.

Josh Barro:

No, that's fine.

David Schleicher:

That law said you couldn't use that money for tax cuts, but that actually got held up in court and also there was other money coming in. It wasn't that effective a limitation. So the question going forward, it's going to be very hard to know right now, is what programs and tax policies were created during the boom times, they're going to be really hard to change going forward. Also, relatedly, there are going to be new types of shocks that mean new types of governments are going to face problems. So the big one that everyone's talked about is transit agencies, which have lost an enormous amount of ridership and that is harming them fiscally in ways that you can't really plan for or it's hard to plan for. Relatedly, downtowns which are going to lose a huge amount of commercial property tax revenue.

Josh Barro:

My sense is that one of the ways states and localities have been managing these budget pressures, in some cases unintentionally managing them this way, is through reductions in services. I mean, you had cutbacks in transit schedules during the pandemic because you had less commuting. That also saves money to run the trains less frequently. States are not hitting their hiring targets for teachers and police and it saves money when you're understaffed, but all of that means crappy service quality, and especially at a time when you have cities that are struggling in certain non-financial ways and trying to reassert that people should come back here and feel safe and feel that it's necessary to go into the office.

It seems like one thing that you might do as part of those strategies is try to spend more on those sorts of services to improve their quality exactly at a time when there's this shortage now. So part of the way that they're dealing with the fact that they cut taxes, they established these new programs, is that they're continuing to have lower service frequencies on transit, for example.

David Schleicher:

Yeah. I mean, I think that's absolutely right, that merely not hiring people is a way that a governor mostly or an executive can avoid some of the fiscal problems created by their legislatures. That's true, but it's also unfortunate on the other hand that declining service quality is what you have to do in order to, or something have to cut somewhere. Particularly because so many of the costs are fixed, or at least substantially fixed, when you don't save for your pension fund, you can't not pay your pension fund. That's a default. Those are contract rights and protected in state constitutions. Similarly, lots of other things can't really be cut in the short and medium run, and so that you end up skimping on things that people really want. Particularly for those jurisdictions that were really heavily indebted, your Illinois and your New Jerseys and what have you, cutting services is really the only tool other than raising taxes.

Josh Barro:

Don't you then get the potential for a vicious cycle there? I mean, you have net outflows from these states, from Illinois, from New York, from California. You can point to a lot of different reasons for that. You have extremely high housing costs in New York and California, you have high tax rates, the weather is warmer down south. A lot of people, they had big life changes due to the pandemic and it made it possible for them to move. A lot of the political sense here around in New York is that we are losing out to Florida even more than before for a combination of those reasons. Also, I mean, during the high pandemic there was a strong sense of some people wanting to go down to Florida for fewer restrictions.

David Schleicher:

For COVID vacation.

Josh Barro:

Yeah, exactly.

David Schleicher:

You could pretend that COVID wasn't happening, right?

Josh Barro:

Right. So to what extent are we seeing those regional effects? I assume that places like Miami that have been seeing this population influx, there must be certain fiscal benefits from that that are making it easier for them to manage these issues?

David Schleicher:

Oh, for sure. I mean, you're seeing wide variation in the cost of these things. Now, why people are leaving your New Yorks and your Chicagos, whatever, is as you noted is multifaceted. I think that housing costs most people think of is the largest of all these factors. But it is also surely the case that it is nice to not walk through, I'm a New Yorker, it would be really nice to not walk through garbage all of the time. The theory would be that what the government should be doing in these periods is, as they're cutting, seeking efficiencies. It's not hard to imagine efficiencies. The cost of government in New York is just much higher than anywhere else. That's traditionally the explanation economists give for why that's the case is that there's just less exit pressure in New York.

Josh Barro:

Less exit pressure. What do you mean by that?

David Schleicher:

Fewer people leave because being in New York is so great generally is a social matter, right? So you see people that you see higher cost of government in places that are just nice generally. So Malibu has an extraordinarily high cost of government. Why is that? Well, Malibu's great. People don't leave. So if the government gets 10% worse, are you really going to leave your gorgeous house in Malibu? No, probably not. But in theory, what you'd like to see is governments responding to this increased pressure, understanding their fiscal limits by making government work a little better. You could have one rather than two train operators on the New York City Subway. You could have, I don't know, somehow spend less than an order of magnitude, the difference between building subways in New York and building subways in Paris is an order of magnitude. Maybe we could fix that. You'd imagine that political pressure would emerge, but that takes time and doesn't necessarily happen.

Josh Barro:

Is it though? I mean, when we talk specifically about the transit agencies, I sort of see three conversations about what to do about the budget gaps. One is that state governments should just throw ever more money into the agencies. They're having a fight about this right now in California, here in New York, they've done another increase in the, I forget what the acronym stands for, but there's like a separate income tax in the MTA region on top of the state income tax and the city income tax. Now we're going to pay more of that. You can shovel more money into the agencies. You can reduce service levels, and a certain amount of that has been done across the country. You can postpone capital projects that you were going to do. I haven't seen any real demonstrations of we found a way to do this thing cheaper, whether that's on the capital side or the operating side. They still have two people driving the trains in New York City Subway, which is extremely unusual globally.

David Schleicher:

Yeah. Oh, I mean, it's a tough problem. A lot of their costs are fixed. The cost of maintaining the subway system just is what it is, as big as it is, even if we don't grow it and the cost of maintaining it remains high. A lot of their other costs are in pensions for retired workers, which again, you can't cut. The political difficulty of getting efficiencies is real and it would require a type of political leadership to really push for this. In the case of New York City, it would probably mean a strike at some point and fighting that fight, and do people have the stomach for that kind of thing. But I mean, in the medium run, you're either going to see a lot more money shoveled in and there's going to be a lot of questions about who should shovel in money.

In New York, the big question is should the state shovel in the money or should the city shovel in the money? You're also going to see, I think, jurisdictions like that question will be put fiscal pressure on whoever the government that is required. Is it can be the state government? If it's the city government, the city government has lots of its own fiscal problems. You see this in other jurisdictions as well. You can imagine kind of these competitive pressures creating really real big difficulties, particularly in the Chicago region or San Francisco. Yeah.

Josh Barro:

Right. I'm interested in the distinction here between Chicago and New York. Because I mean, the other added pressure that these big cities have is a big part of their tax base is commercial real estate and these big office buildings that are just not worth what they were worth before the pandemic. Rents are going to be persistently lower and there's going to be less revenue from that. However, at least in New York, even at some lower rent base, New York is an extremely desirable place to do business and you'll have people doing business in Midtown and it's just that the rent on their office space might be $50 a square foot instead of $100 a square foot for the year.

Chicago, I worry a lot about. Matt Yglesias has been writing a lot about this, that Chicago does not have the sort of buffer that New York has where it's just the price of New York got run up so much, the price can run back down while New York stays really busy and crowded and economically productive. If you have Chicago, you had a teacher strike, you've had declining service quality and policing and a crime wave and you have declining service quality and education and reduced frequency on transit. What is it that causes people to want to come into Chicago? You have a new mayor there who basically thinks they can tax their way out of the crisis that they have there, which I think you can do in New York. It's not really clear to me that you can do that in Chicago.

David Schleicher:

No. I mean, the problems are even a little more... I mean you cast them as severe, but the fiscal problems are even more severe than that. So Chicago is probably our most heavily indebted big city when you count in pension and other types of, but it's also in one of our most indebted counties, Cook County. It has one of our most indebted transit districts and there are a bunch of other overlapping governments and then it's in one of our most heavily indebted states. So you have this kind of conflict among all of these governments that are all going to want to be squeezing juice from the same stone. I think it is quite challenging.

Now right this minute, they're all still kind of fine, but we're getting close to a situation where they're going to have to make some really difficult choices. Chicago has some real structural problems. Now, I mean, there's a little bit, I mean, you want to get, if you want, like a silver lining in that cloud, the prices and demand for office space in Chicago were very high themselves in the inner ring loop. While there's lots of things that are not in demand in Chicago, there's still quite potentially those that seem dynamic you described in New York could happen in the parts of Chicago, whereas other parts of Chicago don't have a dynamic that's much more like your Clevelands or St. Louises or whatever. Chicago's a big place, there's a lot of different things next to one another.

Josh Barro:

Can we talk about how state and municipal governments should be using debt? Because I think Chicago, which we can get into a little bit more, is sort of a what not to do example, but it is important for these governments to be able to borrow. I mean, there's all sorts of things that we rely on that a key part of the financing is that municipalities and states go out and they borrow money.

David Schleicher:

Yeah. The old joke about the federal government is that it's a insurance company with an army. If you can touch something in America, whether it's an employee or a thing, it is built by a state and local government. The federal government will provide fiscal support and both support for borrowing and just direct money. But most of the things you rely on in your everyday life from government are provided by state and local governments and it's almost all infrastructure. That's a structural fact about America that's been true forever. So there was a debate in very early American history, should the federal government be heavily involved in building infrastructure. There's a huge debate about it and all the famous characters that you know from your high school history classes were involved in this debate.

One of the problems that emerged was that whenever America tried to build big infrastructure projects, it devolved into pork for every district in Congress. That was a dynamic that political scientist Barry Weingast called distributive politics. But it's the basic idea is that because America has district legislatures, projects get split among, and as a result, Congress acknowledged very early on that it was not going to be in the business of building major infrastructure projects, either delivering them or kind of choosing them. Sometime they fund things. We have a infrastructure bill, but most of the money for infrastructure gets paid for by states and cities, gets built directly by states and they are mostly paid for by states and cities. For them to do so, they need to be able to borrow, and again, and have always needed to borrow.

Every bit of infrastructure that you think of in America has relied on our unbelievably rich and successful municipal bond market from the Erie Canal to, I don't know, the Second Avenue Subway. In theory, the idea of state and local governments borrowing is that they're supposed to be borrowing to build capital projects, the same way that you would borrow to buy a house. You're going to live in a house for a number of years and you want to pay for it each year you live in it. The idea is that per user of a bridge or a water system or whatever, each year's user should pay a little bit for it.

In recent years though, we've seen a huge flow of debt away from municipal debt, like borrowing to build capital projects, and towards other forms of things you can think of as being like debt but not actual bonds to support the infrastructure projects. The most prominent of these are unfunded pensions. Again, this is like a debt in that you have a requirement to pay them in the future. You've agreed with workers and the state constitutions say these are contracts that you can't break. But unlike a bridge, there's no thing you can touch. It's just the fire services or police services or teacher services that you got in the past.

Josh Barro:

To lay that out for people, because I think part of the reason that states get into trouble with this is that this is not an intuitive concept for people, that basically if you have a teacher and they have a salary of $80,000 a year and they have a health plan for dual coverage and that costs to 14 grand or whatever it is, and then every year they work, they're acquiring pension credits. It means that the longer they work there, the more money they're going to get every year in retirement. If that were a 401K plan, you'd actually have to be socking money into that plan right now and they would draw it out later. Instead, you're making a promise to pay and the actual payments will flow out of the government far in the future, but you're really incurring that expense now. You've made the promise now, you've received their labor in exchange for the promise now and you need to account for that this year.

There's a number of issues both with the way that this is accounted for and with the way the law is around it, the politics are around it. But the upshot is that in many states, and some states are worse offenders on this than others, they'll make the promise and they won't put the money away or they won't put enough of the money away. It's basically borrowing from future taxpayers. You're saying, "I'm going to acquire this labor from this teacher now and I'm going to send the bill to a taxpayer in 2040." So these are implicit liabilities that build up on state balance sheets. They affect state's ability to borrow because people are buying the bonds, they look and they see what the demands are going to be on the state and all these pension payments they're going to have to make in the future. This has become a particular problem in Illinois, New Jersey, Kentucky. There are a few states that have been especially bad offenders on this.

David Schleicher:

Yeah, absolutely. That's exactly right. One of the reasons you see this is that it's confusing. But another reason you see this is that states generally have constitutional limits on how much they can borrow. Sometimes they're procedural, they have to go to a public vote and most people have voted in a bond election before. If you live in a town, you've voted, should we borrow $8 million to build a swimming pool or something? But not saving for your pensions doesn't count towards your debt limits. So this creates a big incentive for governments to underfund the pension system. It's a way to hide their budget deficits as opposed to borrowing, which often they can't borrow to cover operating expenses, but also it's not subject to the same limits. It had a really destructive effect across a number of dimensions.

So one of the things we should have expected to see in the post great recession period when unemployment was high, but interest rates were really low, is state and local government should have been borrowing a lot to build a lot. That would've been a great time to build a lot of stuff, because again, labor was available, the exact opposite of the dynamic we see now, labor was available and borrowing was cheap. Instead of their borrowing capacity going towards investing in stuff, their borrowing capacity went towards not paying, kind of borrowing just to pay for the current services. If you just look back at the last 10 years and ask yourself what are the great public infrastructure projects of the recent past, you're going to find yourself scratching your head and it's because of this dynamic.

Josh Barro:

Yes. I mean, what little we did get, the Second Avenue Subway built during that period, the most expensive subway in the world essentially.

David Schleicher:

Actually, technically it's the second most expensive subway. The most expensive subway is Eastside Access, which is-

Josh Barro:

Also in Manhattan.

David Schleicher:

Also in Manhattan. That one which again captures a little bit of the craziness of governance in New York. It's built underneath Grand Central. It's one of the craziest infrastructure projects you'll ever see in your life.

Josh Barro:

It started as Al D'Amato's pet project and it's finally more than 25 years after Al D'Amato left the Senate, it's finally open.

David Schleicher:

Finally. But also for it's worth, if you're curious what's in third place, you're not going to be surprised. It's the seven train extension into Hudson Yards.

Josh Barro:

Also in Manhattan.

David Schleicher:

Also In Manhattan. Those are the three most expensive. So yeah. But again, you should be asking yourself, how has government transformed the your fiscal... it hasn't, and a large reason why is because it was plowing its debts into not current services basically.

Josh Barro:

What is the pension situation looking like right now? I mean, back during the Great Recession, I personally was writing a lot about that and that was sort of one of the really core focuses of the fiscal problems in states. Part of the problem then was that low interest rates were actually making the pension benefits effectively more expensive to provide. It's more expensive to make promises far in the future when interest rates are low. Has that situation actually been helped by all this inflation and higher interest rates?

David Schleicher:

Oh for sure. It's been helped. I mean, it's been helped in a couple of ways. One is that the flush times, jurisdictions were making their payments. Actually, one of my favorites is you see New Jersey will issue press release that say we meet our annual contribution in pensions. It's like issuing a press release that you made your credit card payments for the year.

Josh Barro:

Not a given in New Jersey.

David Schleicher:

Oh, it almost never happens. So it's a real victory actually. But you saw both kind of structural pressures, which is when the market was doing very well that was helping pension funds, and then inflation has a habit, it normally does that. Also, you saw some jurisdictions plowing a lot of their kind of boom era gains. Connecticut is probably the number one example of this. Connecticut due to some structural political things in their legislature and also due to a very interesting legal mechanism they created to ensure that volatile revenues don't get spent in the short run, ended up putting a huge amount of money into their pension fund. Now Connecticut started off in a really rough place on this front. Connecticut basically didn't save for its pensions for the first 50 years of its pension system at all.

Josh Barro:

Wow.

David Schleicher:

Just assumed that you would keep getting mad men moving to Connecticut and they've never been a need to pay for anything. But eventually that didn't work out. But now they've really been maybe probably the fiscal bright spot of kind of responsible stewardship during the period.

Josh Barro:

Well, so that's a piece of good news then if we have all of these problems with service insufficiency and with these current budget deficits emerging, at least we're not having the same big rerun of the pension problems that we were having last time.

David Schleicher:

Well, the question is how much we fix the problem rather.

Josh Barro:

Right.

David Schleicher:

Depending on which jurisdiction, we've made some progress into it. You've done it a couple other ways. You've seen creations of new classes of employees that get less pensions. So again, there's been some progress across all dimensions. So that's what a boom does is that even if you're a little irresponsible during the boom, it's way better to be coming off a boom than to be in a long period of bust. But the question is, how well did you do? I mean, the Warren Buffett line, when the tide comes in, you see who wasn't wearing their swimsuit, we're going to see a little bit of that with respect to states, which there's just a very varied performance.

Josh Barro:

So what are you watching for in states first over the next couple of years? Again, we don't have insolvencies on the horizon, at least not yet. Are we seeing states making good moves to be able to manage through these budget crises while maintaining quality government services such that people will continue to want to live and do business in states?

David Schleicher:

Again, it's very varied. I mean, so you-

Josh Barro:

So who's doing well?

David Schleicher:

I mean, I'd say the places that are allowing growth are doing well because that's just... Austin doesn't have fiscal problems because it's just getting so many new people and so much new property tax revenue. Then you see jurisdictions of the Connecticut sort that did well during the pandemic in terms of saving, and so they're in structurally slightly better space. So those would be the ones that I think of as a kind of happy stories that are well positioned. But again, America's a big country with lots of, I mean, it has tens of thousands of local governments and 50 states. You should expect to see variation.

But I think that there are real worries come in this next period that you're going to see in jurisdictions that assumed the good times we're going to keep rolling. So again, it's a big country with lots of local governments. One of the things during busts is that jurisdictions [inaudible 00:25:59] structurally different. It's not necessarily the poorest jurisdiction. So we went through the Detroit bankruptcy and Detroit was a very poor city, but it's not as poor as Bramsel, Texas. A lot of this turns on choices as well as kind of structural forces.

Josh Barro:

It's places that got overstretched with liabilities they could no longer serve, which is not necessarily the poorest places.

David Schleicher:

Yeah. Shrinking places have a particular difficulty because you build services and you have pension liabilities built on a formerly large city. So if you're looking for places where you're expecting to see crises, you should see either places where you can look at the political performance and be like, "Eh, that wasn't so good." But also places that are shrinking because shrinking is just a hard thing to do.

Josh Barro:

Yeah. I mean, in your book you have this sort of menu of solutions about how states and localities can manage their funds better. It's sort of funny in that some of these recommendations or the recommendations that come at the end of every book like that they should permit more housing and they should loosen up occupational licensing and sort of that these are Republicans and Democrats talk about these things and they're sort of they're pro-growth things. Certainly when you look at jurisdictions like New York and California, there's a lot of untapped growth potential there where if you just let people build homes, then you're going to get not only population growth, but you're going to get tax revenue growth and that sort of thing. That doesn't work in a lot of places in the Midwest though, right? So what do you do if you're Cleveland?

David Schleicher:

I mean, it's an unbelievably difficult problem. So if you're a Cleveland and you have these boom periods in real state, the pressure is even greater for you to budget responsibly because there's no light at the end of the rainbow in terms of just... You could think about New York and California having this huge excess capacity that they're just choosing not... but if you know you're not in that situation or you could either just hope for some [inaudible 00:27:46]. One of the other real challenge, again, what do you do if you're Cleveland? I'm about to talk about why Cleveland is even more screwed than they would otherwise be.

But it's when things start going badly on this front, it creates political pressure to do crazier and crazier things the same way that you see a bank in down spin. It's kind of a heads I win, tails you lose type phenomenon. You saw this in Detroit pretty dramatically. So Detroit famously, near the end of its time, the mayor entered into this unbelievably strange transaction, kind of modeled on Enron's transactions, took away accounting rules. The mayor eventually went to jail, but for something different.

Josh Barro:

Of course.

David Schleicher:

But it was such a weird transaction that the Bond Buyer, which is the municipal bond newspaper, declared it the Midwest deal of the year. It's never a good sign if you're winning Midwest deal of the year. But the story was that he was just trying to hold on until it was someone else's problem. That is a pretty dangerous dynamic.

Josh Barro:

Well, I mean, you saw stuff like that in Chicago where they sold 75 years of parking meter revenue and basically blew through the money in three years just trying to close operating budget gaps.

David Schleicher:

Oh I mean, that was crazy. It was definitely the end of the Daley administration. He wanted to build some fancy stuff to kind of create a legacy and that was just a form of borrowing. Again, jurisdictions do lots of crazy stuff to borrow when they don't want to actually borrow out. So my personal favorite is the state of Arizona sold its capital building and then entered into a lease and buyback arrangement.

Josh Barro:

Wait, what? Really?

David Schleicher:

Oh yeah. Really. They sold the capital building and then, again, it's one of these things, you see a press release and the press release comes out and says, "Arizona once again owns its own capital building." But it was designed to deal with a short run budget deficit.

Josh Barro:

Yeah, I mean, I sort of think of Rhode Island as the poster child for this weird behavior. Because Rhode Island actually has pretty average income, but it's surrounded by Connecticut and Massachusetts who have very high incomes. So it has a weaker tax base. It has this situation where simultaneously has higher taxes and lower government spending than Massachusetts. So it's always sort of under the gun. Rhode Island lawmakers have done a bunch of truly bizarre stuff over the years trying to build an economic niche for themselves, including most famously lending $75 million to a video game studio owned by Curt Schilling who then defaulted on the debt.

David Schleicher:

Yeah. Rhode Island is also one of your happy stories in some ways. So you have the Gina Raimondo pension reform, which was wide... anyone knows who Eugene Armando is.

Josh Barro:

This is the commerce secretary, they did it, I mean, you call it a pension. It was basically a big cut in pension benefits including a retroactive cut. You were talking about how states are not allowed to reduce pension benefits that were already promised. Rhode Island did that and the State Supreme Court said they were allowed to do it.

David Schleicher:

Well, the State Supreme Court kind of didn't rule on it in the end. That probably wouldn't have been allowed in any other state or it was unclear whether it would've been allowed in any other state. The other thing that they did that's really interesting, and this is much more controversial, they're both controversial, but they created a legal tool which gave bond holders a whats called a statutory covenant. The details of that are not super important, but the idea is that it put bond holders ahead of pensioners in a bankruptcy. When Central Falls went bankrupt, which is a city in Rhode Island, while in other bankruptcies, pensioners did much better than bond holders, so in Detroit pensioners did much better than, in Puerto Rico, pensioners did much better. Rhode Island is the one state where bond holders did much better than pensioners. The basic reason in which they had passed this law and they passed that law because they were so worried about the whole state going under.

Josh Barro:

So I guess why would you do that? The reason you would do that is because it reassures bond holders and therefore you get a lower interest rate when you go out to borrow for projects.

David Schleicher:

Yeah. They were worried that a default in the city would mean that people wouldn't lend to the state government, a problem we call contagion. So that they felt the need to reassure bond holders of this fact. That is a really extreme step because it limits your ability in a default to kind of choose among your creditors which you have some degree of control over.

Josh Barro:

Is that the sort of thing that policy makers need to be thinking about at this point? Because I mean, again, I sort of opened by noting that you talk a lot in your book about insolvencies and how to manage them and you have these competing pressures. There's pressure to bail out governments that become insolvent and that prevents turmoil in the bond markets. But it also creates moral hazard where it encourages irresponsible borrowing or you can have the defaults and cram the cost down on the bond holders, but that might make it more expensive when you want to borrow to do useful things in the future. We were talking about this in the great recession. People were talking about, are we going to see this with Illinois or Chicago? We did see some substantial municipal bankruptcies like Detroit and Stockton. Are you expecting on a five, 10 year time horizon, are we going to see some significant events like that?

David Schleicher:

So I'm not a credit analyst, I'm not in the business of making predictions about individual jurisdictions, but I have to say that my answer is yes. I mean, I think the first place you'd imagine you'd see them is in some specialized special districts. So in your transit districts or in your convention centers or things of that sort. We got really worried about these at the beginning of the pandemic and then the general huge flow of funds stopped this. With that flow of funds stopped, we'll see structurally whether things like the convention business or things like transit agencies are kind of structurally... Now, the other question is all defaults, some defaults are forced, but many are choices. In the sense that the state is deciding not to bail out its cities.

In fact, first the city needs to declare bankruptcy, the state has to directly authorize it to do so. There has to law at the state level to say you can do this. One of the questions to ask, are there going to be defaults, or are states willing to do that? That's a political question about their politics as much as it is about their fiscal condition. So you have to ask questions about state. In a world where we see such a severe polarization between our states and cities, it's not hard for me to imagine a situation in which a state withdraws aid in order to force opposite party city to default. One of the more complicated and weirder defaults of the great recession year was Jefferson County in Alabama.

Josh Barro:

Which is where Birmingham is located.

David Schleicher:

The details of that one are just a monster, involved the sewer system and the EPA. But one of the precipitating events was the state withdrawing and then refusing or court withdrawing and the state refusing to give back the ability to pass a new tax to help fund. That kind of a situation is also I think pretty plausible.

Josh Barro:

I mean, Jefferson County being a heavily Democratic county in a heavily Republican state.

David Schleicher:

Yeah.

Josh Barro:

When people talk about this sort of cascading effect where you have a municipality or even an agency in great fiscal difficulty in a state that decides not to provide it support, you can have those sorts of political disputes. People talk a lot about Illinois though, and the concern about Illinois is that, as you described, you have a number of these pretty fiscally weak entities, the city of Chicago, Cook County. But then it's also a state with an unusually poor fiscal position. I mean, unlike New York, we have a lot of trouble here in New York, but the New York has done relatively well in terms of funding our pension benefits, for example. So the state is actually-

David Schleicher:

At the state level, yeah.

Josh Barro:

Yeah, at the state level. We have a pretty strong fiscal condition at the state. That is not the case in Illinois. You've had bizarre budgeting practices in Illinois for decades where literally the state manages... It's actually kind of similar to the debt limit stuff at the federal level where the state runs out of ability to spend and so it just doesn't send money to Medicaid providers, makes hospital systems lend the state money for months and months and months. So couldn't you have a situation in Illinois where the state lacked the fiscal wherewithal to provide the sort of bailout that you would might have political pressure for?

David Schleicher:

Yeah, sure. So again, there is enough wealth in Illinois to pay off the debts of Illinois. The question is, again, it will in some ways a political determination about whether, but that political determination is sometimes limited by state law. So there's a question, for instance, in Illinois, can they pass a progressive income tax? They can't and they'd have to. But if you think about Illinois more broadly to include the voters, not just the politicians, there are real very, very severe fiscal pressures on a jurisdiction like Illinois.

One of the difficulties when you think about Illinois' relationship to a place like Chicago is on one hand you see things like you saw in Rhode Island where they're extremely worried about fiscal pressure at lower level of government, because they think that the bond market will punish everyone in Illinois, this contagion problem, where we'll just say everyone in Illinois is just off our radar.

So that's one type of thing that would encourage aid. On the other hand, real crisis, they don't want to be the one in the default. They want to be able to blame someone else. That dynamic can happen at multiple levels, in many levels of government. So for instance, the city of Chicago and the school district, which the mayor until very recently appointed the head of are covering the exact same territory, they tax the same tax base, but they are different governments and one can default and the other didn't. If that sounds weird to you, in Detroit, the city defaulted, but the state completely bailed out the school district and so while teachers got 100% of their pensions, police officers and firefighters didn't. I'm like, "Well what's with that? That doesn't make a ton of sense."

Josh Barro:

Yeah. What is the role for the federal government here? I mean, I assume one thing is don't give random excessive bailouts to states when they don't actually need them. That's one of the lessons about ARP back in 2020. We'd also have fewer federal budget problems and fewer inflation problems if we hadn't done that. What can the federal government do going forward to basically help states, help localities make good choices and actually be able to use their revenues to best serve their constituents?

David Schleicher:

Yeah. So one of the things is that they could have created conditions for that money and we could still create conditions, because there's a lot of money going from the federal government to states that could encourage better practices. So one example I give, when New York City went through its fiscal crisis, one of the state's conditions that it put on the variety of structure, which that New York City accounts in accordance with generally accepted accounting principles gap. We could tie a principle that you do that to the ability to get income tax exempt interest payments on your municipal bonds to say you have to follow certain basic accounting rules when in order to access to get the benefits that the federal government gives to a municipal debt. A second thing you might imagine they could do is kind of increase required disclosures for governments that seek to borrow in order to encourage investors to kind of put the thumb down on municipal bond markets.

Josh Barro:

Then I guess one last thing that you had in your recommendations is basically rebalancing certain obligations between states and the federal government, that because the federal government can borrow in order to get through economic cycles, certain highly cyclical things like entitlement programs should be, more of that obligation should be shifted over toward the federal government.

David Schleicher:

Yeah. So I think this would have a couple of... so this is in the spirit-

Josh Barro:

Medicaid, I think we're mostly talking about here.

David Schleicher:

Yeah. In the spirit of the famous Reagan compromise to shift some things to the federal government and some things to the state government and this would've some benefits for democracy also, like you know who to blame for different things having. But the basic idea is that state budgets and local budgets have this very weird feature, which is their pro-cyclical. Because they have to keep balanced budget requirements and limits on how much debt they can issue, when they have more money, they can spend more money. When times are bad, they have to cut. But that's exactly the opposite of what kind of textbook Keynesianism would suggest. They're cutting spending during recessions and that's bad.

We saw how bad this was during the great recession, which is one of the reasons the great recession was so great is as opposed to just being kind of the bad recession is that state and local governments fired so many workers. We didn't see state and local employment go back up to where it was pre-2008 until 2019. So it was a really long time. Removing some of these kind of core social welfare services from state budgets while maybe giving back certain other responsibilities would both improve democracy and improve macroeconomic performance.

Josh Barro:

Why don't we leave it there for this week? David Schleicher's new book is called In a Bad State. He's a professor at Yale Law School. Besides state and local debt, David's an expert in election law, land use and urban development, and he hosts a legal theory podcast called Digging a Hole. Thank you, David.

David Schleicher:

Thank you.

Josh Barro:

As always, we'd like to hear from you. You can reach us at mayo@joshbarro.com. That's mayo like mayonnaise. I await your questions. Very Serious is created by me, Josh Barro and by Sara Fay. Jennifer Swiatek mixed this episode. Our theme music is by Joshua Moshier. Again, I'm Josh Barro. This is Very Serious and I'll be back soon.