



Moral Hazard and the State Budget Crisis

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The next stage of the COVID-19 crisis in the United States will feature cuts to essential public services and the shedding of public employment, creating deeper economic wounds and dragging down any potential recovery. This round of austerity will be driven by budgetary shortfalls among state governments—caused both by the cost of responding to the pandemic, and massive revenue loss from the accompanying cessation of economic activity.

Federal aid to states was inadequate in response to the 2007–9 crisis. Now, with congressional negotiations at a stalemate, the federal government is on track to create dramatically worse budgetary conditions for state governments than those found in the depths of the 2008 recession. Even if political forces manage to deliver the necessary grants this time, the problem will return in the next crisis, and the next. This represents a major structural weakness in the US fiscal response to economic downturns. To move beyond this cycle of policy failure, state revenues must be insulated from swings in the business cycle. Fiscal aid from the federal government to states should be automatic, unconditional, and predictable—tied to economic indicators (such as the deviation of a state’s unemployment rate from some predetermined baseline) rather than the capriciousness of federal legislators.

To build this case for reform of the federal system, we need to dispatch with a widely aired objection to state fiscal aid—an objection that may be habitually deployed in bad faith to cover for ulterior partisan or ideological projects, but is also rooted in the mainstream academic literature. Central to this opposition are arguments that fiscal aid creates situations of moral hazard. Supporting states during economic downturns—so the argument goes—creates incentives for those governments to spend beyond their means. In this story, state governments must be held accountable for the failure to match revenues and expenditures. The argument often takes on a moral cast when wielded in the public square, with state fiscal aid framed as a reward for fiscally irresponsible actors that have overspent in the expectation of being bailed out. Despite the attraction of this morality play, it misconstrues the agency of state governments and misunderstands the incentives of federal politicians.

The former point can be illuminated by a basic concept in corporate finance featured in the work of Michael Pettis, who examines fiscal policy from the perspective of balance sheet dynamics. In *The Volatility Machine*, Pettis compares a government’s ability to reduce volatility in its revenue and expenditure flows to the ways in which corporations aim to create a capital structure (using financial derivatives and other tools) that protects the company’s profitability from changes in revenue or expenditure unrelated to their core business. The goals of creating such a

capital structure are different between governments and corporations, as are the measures employed, but the core idea is to hedge against changes in economic variables outside the institution’s control. In the US context, the question of whether state governments should be considered agents with respect to the business cycle can be said to turn on whether they are similarly able to construct a resilient capital structure.

State budgets are deeply vulnerable to US economic conditions. When things are running well, tax receipts soar while expenditures drop. However, when the economy crashes, revenues fall off a cliff just as expenditures shoot upward. In other words, the difference between expected incomes and expected expenditures (the state budget deficit/surplus), is a function of variables outside the state government’s control. On its own, this might be overcome, were it not for the fact that statutory, constitutional, and institutional barriers prevent states from designing their own capital structure to hedge against this volatility. Under the strictures of balanced budget requirements, states are left with tactics like building up “rainy day” funds—savings that will be wiped out early on in any significant downturn. For state governments, the relationship between income and expenditure at different points in time and under different macroeconomic conditions is beyond that government’s control. From this perspective, states should not be represented as the agents in a moral hazard problem.

In the US, only the federal government is an agent with respect to the business cycle. Shifting the focus in this way reveals that there is in fact a moral hazard problem at work here, but it is not the one commonly averred. Federal politicians have an incentive to act the part of fiscal hawk by refusing to provide grants to state governments, forcing state-level politicians to bear the political price of the resulting austerity. The solution to this moral hazard problem—a problem of political burden-shifting masked as fiscal discipline—is trigger-based state fiscal aid that removes macroeconomic stabilization from the realm of quotidian political calculation. Reforming the system of fiscal federalism in the US would establish macroeconomically sound budget discipline across levels of government. When we properly understand the limitations faced by state governments, it is clear the real hazard lies in failing to provide fiscal relief—and allowing this intergovernmental fiscal-political drama to continue, crisis after crisis.

A more detailed discussion of the issues can be found at levyinstitute.org/publications/moral-hazard-in-a-modern-federation.

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