WebMemo
Published by The Heritage Foundation
No. 2266
February 4, 2009

Stimulus Bill Should Not Bail Out Irresponsible States

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In response to pleading governors and mayors, the House stimulus bill now contains a staggering $200 billion bailout for state and local governments that have spent themselves into deficit.

It is a terrible proposal, on several counts.

"Stimulus" Is a Misnomer. For starters, it is a shell game. Sending federal aid to states would not save taxpayers a dime, because state taxpayers are also federal taxpayers. Hiking federal taxes to keep state taxes from rising is like running up your Visa card to keep the MasterCard balance from rising. Either way, you will pay. All that changes is where you send your payment.

Governors typically respond that a federal bailout is preferable because it could be funded with deficits rather than new taxes, an option that 49 states with balanced budget requirements lack.

But nobody forced these states to enact balanced budget requirements. And they are free to repeal them anytime they can convince their voters to go along. State balanced budget amendments are supposed to force states to budget responsibly. Bypassing those tough decisions and instead demanding countless federal bailouts—and thus raising federal budget deficits instead—renders state balanced budget amendments meaningless. Moreover, a bailout merely taxes responsible states and younger generations to fund the current spending of reckless states.

Furthermore, the inclusion of such a bailout in an economic "stimulus" package makes no sense. State spending does not suddenly become stimulative if it is funded by Washington instead of state governments. Either way, all spending "injected" into the economy must first be taxed or borrowed *out* of the economy. It is a zero-sum transfer that does not create any new demand, regardless of which level of government is doing the taxing, borrowing, or spending. In this case, the economic positive of states adding $200 billion to the economy will be negated by Washington first having to borrow $200 billion out of the economy.

Subsidizing State Spending Sprees. Congress already sends $467 billion a year to state and local government—up 29 percent after inflation since 2000.[1] This is well beyond what is needed to reimburse states for federal mandates (and Washington has imposed few new unfunded mandates on the states since 1996). The feds continue to give heavy subsidies to state health, education, and transportation programs. But apparently that is not enough.

States depend on volatile tax sources such as income taxes, so common sense suggests building rainy day funds during booms to cushion the inevitable recessions. And yet states keep responding to

This paper, in its entirety, can be found at:
www.heritage.org/Research/Economy/wm2266.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
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Washington, DC 20002–4999
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temporary revenue surges with permanent new spending programs. Between 1994 and 2001, states flush with new revenues shunned rainy day funds and instead expanded their general fund budgets by 6.2 percent a year.[2]

All booms eventually end, and these free-spending states left themselves totally unprepared for the 2002–2003 economic slowdown. Yet instead of sufficiently paring back their bloated budgets, the states demanded—and received—a $30 billion bailout from Washington in 2003.

Bailing out someone who has behaved irresponsibly encourages future misbehavior. And that is just what happened: After the 2003 bailout, states went right back to spending—with annual budget hikes averaging 7.2 percent over the next four years.[3] (Some also built up their rainy day funds, but not enough.)

So here our nation is again: another economic slowdown, another round of bailout calls. How will states learn to budget responsibly if they know they can keep returning to the federal ATM?

The biggest losers from a federal bailout are taxpayers who live in fiscally responsible states. They played by the rules and resisted extravagant new spending programs—and will be rewarded with higher taxes to bail out states that went on unaffordable spending sprees.

That is simply unfair. And it encourages responsible states to be less responsible next time. (After all, it is better to get a bailout than to have to help pay for one.) In fact, rather than treating a bailout as a temporary way to make ends meet, states are instead planning on plowing their bailout dollars into ongoing priorities and long-term policy changes. Rhode Island Governor Don Carcieri has stated, "Right now, I'm not thinking of great ways to spend it.… I think we may need it to get through a very difficult spell. If we don't need it.… I would like to see if we could use some of that to help finance the tax changes."[4] Ohio State Senator John Husted, a stimulus critic, complained that "we're going to take all the money that we can take and put it into our ongoing expenses. The stimulus package is in some ways turning into a state and local government bailout package."[5]

Mayors have pledged to spend stimulus funds on items such as a mob museum in Nevada, a polar bear exhibit in Rhode Island, and a program to curb prostitution in Dayton, Ohio. As *National Review* asked, why is one Bridge to Nowhere a national embarrassment, but 1,000 Bridges to Nowhere are a "stimulus"?[6]

Long-Term Challenges Require Reform. Current state budget deficits are not an accident; they are the beginning of an extended structural trend that must be dealt with. The Government Accountability Office estimates that health care and public pension costs will bring sustained budget deficits of 2–3 percent of GDP for state and local governments.[7] Closing this gap will require these governments to confront their health and pension systems, and the band-aid solution of federal bailouts only delays these important reforms.

In health care, Washington can help by encouraging state flexibility to better tailor public health programs to the needs of their recipients. Allowing

1. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2009: Analytical Perspectives* (Washington, D.C.: U.S. Government Printing Office, 2008), p. 113, at *http://www.gpoaccess.gov/usbudget/fy09/pdf/spec.pdf* (February 4, 2009).
2. National Association of State Budget Officers, "Fiscal Survey of States," December 2008, p. 5, at *http://www.nasbo.org/Publications/PDFs/Fall2008FiscalSurvey.pdf* (February 4, 2009).
3. *Ibid.*
4. Ray Henry, "RI Gov May Need Bulk of Stimulus to Balance Budget," Associated Press, January 15, 2009, at *http://www.boston.com/business/taxes/articles/2009/01/15/ri_gov_may_need_bulk_of_stimulus_to_balance_budget/* (February 4, 2009).
5. Peter Slevin, "Ohioans Seek Slice of the Stimulus Pie," *The Washington Post*, February 2, 2009, at *http://www.washingtonpost.com/wp-dyn/content/article/2009/02/01/AR2009020101978.html* (February 4, 2009).
6. "The Week," National Review, January 15, 2009.
7. Government Accountability Office, "State and Local Fiscal Challenges: Rising Health Care Costs Drive Long-Term and Immediate Pressures," GAO-09-210T, November 19, 2008, at *http://www.gao.gov/new.items/d09210t.pdf* (February 4, 2009).

more competition in the provision of low-cost insurance may improve efficiency and streamline costs as well.[8]

Additionally, states can reform their education systems. Federal guidelines often stifle innovation and thus contribute to stagnating student test scores. Granting states emergency powers to flexibly seek ways to get the most value for their education spending can both streamline costs and improve student performance. Innovative states like Florida have shown that such reforms can work.[9]

Do Not Reward Bad Behavior. While Washington can streamline red tape, states must also take action: set priorities, make trade-offs, and reduce unnecessary spending. States that refuse to make difficult decisions and instead insist on deficit spending should amend their own balanced budget laws rather than demand that Washington deficit spend for them. Washington, in turn, should provide these states with the education and health policy flexibility to reform their own budgets.

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8. Dennis G. Smith and Nina Owcharenko, "Bailing Out Medicaid: A Bad Solution," Heritage Foundation *WebMemo* No. 2235, January 21, 2009, at *http://www.heritage.org/Research/HealthCare/wm2235.cfm*.
9. See Dan Lips, "Federal Education Bailout Is Not the Answer," Heritage Foundation *WebMemo* No. 2171, December 12, 2008, at *http://www.heritage.org/Research/Education/wm2171.cfm*.