

Freedom to Fail: The Keystone of American Federalism

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INTRODUCTION

One can hardly imagine how much [the] division of sovereignty contributes to the well-being of each of the States which compose the Union. In these small communities . . . all public authority . . . [is] turned towards internal improvements. . . . [T]he ambition of power yields to the less refined and less dangerous desire for well-being.

—Alexis de Tocqueville¹

It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.

—Justice Louis Brandeis²

It is, of course, no longer politically correct to characterize anything American as exceptional. In days gone by, descendants of the Pilgrim faithful spoke easily of their country as a “city upon a hill,” a “New Jerusalem”³ whose hallowed light shone as a beacon for all nations to see. It was not difficult for nineteenth-century Americans to imagine a national destiny that spread “from sea to shining sea.” Even in the mid-twentieth century, school children learned to sing of a “sweet land of liberty” made beautiful by its “purple mountains,” “spacious skies,” and “amber waves of grain.” Most felt that the United States had been called to end—or at least

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This paper has been prepared for the Understanding Education in the United States: Its Legal and Social Implications Symposium held at the University of Chicago Law School on June 17 and 18, 2011. The authors would like to thank Romain Zamour, Yale Law School, JD Class of 2013, for his research assistance.

¹ Alexis de Tocqueville, *Democracy in America* 141 (Barnes & Noble 2003) (Francis Bowen, ed) (Henry Reeve, trans).

² *New State Ice Co v Liebmann*, 285 US 262, 311 (1932) (Brandeis dissenting).

³ See Cecelia Tichi, *The Puritan Historians and Their New Jerusalem*, 6 Early Am Lit 143, 143–44 (Fall 1971) (discussing Puritan historians’ use of biblical metaphors).

contain—tyrannies of unimaginable villainy in Nazi Germany, the Soviet Union, and Maoist China.⁴ When Americans looked at their nation, they saw an exceptional land upon which God had shed his grace.

In the aftermath of World War II, university scholars joined in a secularized version of the hymn.⁵ They marveled at a pluralist America able to hold its political leadership accountable while avoiding mass uprising that could translate into totalitarian tyrannies.⁶ Such talk now seems antiquated, even self-indulgent. For many today, the United States is better understood as just another society at the advanced stage of capitalism.⁷ American and European problems and politics are converging. If any country is exceptional, it is China, or one of the four Asian Tigers, or perhaps India or Brazil. Or, to state the situation in its most undeniable terms: Every country is exceptional. Each has its own distinct geographical location, origin, history, social composition, and political institutions. The United States is no more exceptional than Canada, or Mexico, or what have you.

I. THE EXCEPTIONAL AMERICAN FEDERAL SYSTEM

Still, it is worth treating as exceptional the country's federal system, with its unique separation of authority between national and state governments. According to a recent count, only 25 of the world's 193 countries are federal systems.⁸ And most of those 25 federal nations circumscribe the authority exercised by lower tiers of government in important ways. In some, the heads of lower offices

⁴ See, for example, Daniel Bell, *Interpretations of American Politics*, in Daniel Bell, ed., *The Radical Right* 39, 50 (Doubleday 1963). See also Samuel P. Huntington, *American Politics: The Promise of Disharmony* 240–45 (Belknap 1981).

⁵ See Louis Hartz, *The Liberal Tradition in America* 4–6 (Harcourt 1955); Huntington, *American Politics* at 27–30 (cited in note 4); Sven H. Steinmo, *American Exceptionalism Reconsidered: Culture or Institutions?*, in Lawrence C. Dodd and Calvin Jillson, eds., *The Dynamics of American Politics: Approaches and Interpretations* 106, 117–24 (Westview 1994).

⁶ Bell, *Interpretations of American Politics* at 58–59 (cited in note 4); William Kornhauser, *The Politics of Mass Society* 121–23 (Free Press 1959).

⁷ See, for example, Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities* 92–94 (Yale 1982); Harold L. Wilensky, *The Welfare State and Equality: Structural and Ideological Roots of Public Expenditures* 52 (California 1975); Phillips Cutright, *Political Structure, Economic Development, and National Social Security Programs*, 70 *Am J Sociology* 537, 549 (1965). But see Harold L. Wilensky and Charles N. Lebeaux, *Industrial Society and Social Welfare: The Impact of Industrialization on the Supply and Organization of Social Welfare Services in the United States* 41 (Free Press 1958).

⁸ Forum of Federations, *Federalism by Country* (2007), online at www.forumfed.org/en/federalism/by_country/index.php (visited Oct 6, 2011). The number is twenty-three, according to one count given in Jonathan A. Rodden, *Hamilton's Paradox: The Promise and Peril of Fiscal Federalism* 39 (Cambridge 2006).

hold office at the pleasure of the central government.⁹ In others, the lower tiers are heavily dependent on the central government for revenue.¹⁰ Except in Canada and Switzerland, state debts in all federal systems in the industrialized countries of the world are implicitly or explicitly guaranteed by the federal government.¹¹

The design of the US federal system owes as much or more to historical circumstances as to theoretical intentions. When writing the Constitution, those gathered in Philadelphia necessarily allowed for autonomous action by state governments for the very practical reason that no other form of government could have won ratification by the supermajority of states required before the founding document could take effect. Unless the national government's powers were limited and states continued to exercise considerable power on their own, the citizenry, more fond of their former colonial governments than the new national entity, would not have agreed to important limits the Constitution did impose upon the states, such as restrictions on their abilities to declare war, coin money, and regulate interstate commerce. The cultural differences between the slaveholding South and an increasingly antislavery North could be contained only if each region was allowed to organize its own domestic affairs. But if the US federal system was initiated to solve a very practical problem, it gradually became an institutional form so appropriate and effective that it persisted into the twenty-first century even after the Civil War had been fought, slaves had been freed, and a much more powerful federal government had been established.

That exceptional federal system, best characterized as competitive federalism, can be sustained only if the lower tiers of government are held accountable to the marketplace—most specifically, to the market for government bonds. Unless lower tiers are subject to independent movements in the interest rates on their bonds, and unless lower tiers remain at risk of default, or something tantamount to default, the central government cannot afford to grant

⁹ See, for example, *Republic of India Public Administration Country Profile* 8 (United Nations Division for Public Administration and Development Management Jan 2006), online at <http://unpan1.un.org/intradoc/groups/public/documents/un/unpan023311.pdf> (visited Oct 6, 2011).

¹⁰ See, for example, Dele Olowu, *Property Taxation and Democratic Decentralization in Developing Countries* *19 (Institute of Development Studies Seminar Paper, 2002), online at <http://www2.ids.ac.uk/gdr/cfs/pdfs/Olowu2.pdf> (visited Nov 6, 2011).

¹¹ Rodden, *Hamilton's Paradox* at 9, 31, 93 (cited in note 8). For a discussion of default risk within the Canadian federal system, see Stuart Landon and Constance E. Smith, *Government Debt Spillovers and Creditworthiness in a Federation*, 33 *Can J Econ* 634, 636, 653–54 (2000). The argument of our paper does not turn on whether the United States is exceptionally different from Canada and Switzerland.

wide discretion to state or local governments. For more than two centuries, the US federal system has survived multiple economic and political crises, but never has the autonomy of the lower tier of government been circumscribed to such an extent that state and municipal bonds do not have their own, independent standing in the marketplace. Yet a striking new political development—the granting of collective bargaining rights to those who work for state and local governments—has posed a dramatically new challenge to the viability of the American federal system as we have known it. Just how that has occurred, as well as its potential consequences for the country’s political institutions, is the topic this paper explores.

II. COMPETITIVE FEDERALISM

Historically, competitive federalism helped to generate the extraordinary growth of the world’s largest economic power.¹² Over the decades, states and localities designed and maintained canals, railroads, highways, sewage systems, schools, parks, and systems of public safety. As Lord James Bryce wrote nearly a century ago,

[I]t is the business of a local authority to mend the roads, to clean out the village well or provide a new pump, to see that there is a place where straying beasts may be kept till the owner reclaims them, to fix the number of cattle each villager may turn out on the common pasture, to give each his share of timber cut in the common woodland.¹³

As compared to the federal government, state and local governments are more sensitive to political market forces, making them better equipped to design and administer those types of programs. Unless local government supplies public services to meet the needs of local businesses and residents, citizens may “vote with their feet” and migrate to a locality better attuned to their needs. Since 12 percent or more of the population changes its residence each year,¹⁴ the effects of policy choices on property values can be quickly felt.

¹² The discussion in this Section draws upon the theoretical statement developed in Paul E. Peterson, *City Limits* 68–72 (Chicago 1981). See also Charles Tiebout, *A Pure Theory of Local Expenditures*, 64 J Polit Econ 416, 422 (1956); Wallace E. Oates, *Fiscal Federalism* 240–41 (Harcourt Brace Jovanovich 1972); Paul E. Peterson, *The Price of Federalism* 18–19 (Brookings 1995). The contributions of local government to rapid economic growth in China are explored in Gabriella Montinola, Yingyi Qian, and Barry R. Weingast, *Federalism, Chinese Style: The Political Basis for Economic Success in China*, 48 World Polit 50, 67–78 (1995).

¹³ James Bryce, 1 *Modern Democracies* 132 (Macmillan 1921).

¹⁴ See US Census Bureau, *Statistical Abstract of the United States: 2012* 37 table 30, online at <http://www.census.gov/prod/2011pubs/12statab/pop.pdf> (visited Oct 7, 2011).

Business and residential choices are influenced by factors other than the quality of local public services, of course. Businesses want to be close to both their sources of supply and the markets for their products. Individual and family residential choices are influenced by family ties, employment opportunities, and the quality of the natural environment. But the quality of publicly provided infrastructure also affects, on the margins, the choices businesses and households make.¹⁵

Since small changes in supply or demand can have a significant effect on price, residents of a community, eager to protect their property values, can be expected to pressure government officials to employ public resources efficiently in order to meet local expectations and facilitate economic development. Poor policy decisions can have rapid and lasting effects on a municipality's property values and corresponding tax income.¹⁶ Therefore, it is reasonable to expect most state and local governments to be relatively competent at designing and implementing developmental policies. Admittedly, lower-tier officials in a system of competitive federalism may exhibit "narrowness of mind and the spirit of parsimony," as Lord Bryce was the first to admit, but if it were otherwise, "there would be less of that shrewdness which the practice of local government forms."¹⁷

State and local government can also facilitate the gathering of information regarding the most efficient way of organizing public services. Each state or city is a laboratory where experiments are tried. If the experiment is successful, other governments will copy it. If the experiment fails, the idea will soon be abandoned. In addition, "states and localities pay close attention to the wages and salaries paid to employees in adjacent communities" and will feel pressure to bring them into line with those of their neighbors.¹⁸ So valuable is the role played by lower tiers of government within the federal system that, despite the growth in the role of the federal government, more than 40 percent of all government spending for domestic purposes was, as late as 2008, paid for out of revenues raised by state and local governments from their own sources.¹⁹ The lower tiers are also the predominant public-sector employer. No less than 87 percent of all

¹⁵ See Peterson, *Price of Federalism* at 18–19 (cited in note 12).

¹⁶ See *id.* at 19.

¹⁷ James Bryce, 1 *Modern Democracies* at 132–33 (cited in note 13).

¹⁸ Peterson, *Price of Federalism* at 19 (cited in note 12). See also Tiebout, *A Pure Theory* at 421–22 (cited in note 12).

¹⁹ See Figure 3.

nonmilitary public-sector employees work for either the state or local government.²⁰

In a system of competitive federalism, state and local governments resist taking responsibility for large-scale redistributive programs.²¹ If states and localities attempt in a serious way to tax the rich and give to the poor, the rich will depart while the poor will be attracted. If the rich leave and the poor migrate into the state, tax revenues will plummet while expenditures escalate. Any debt acquired by state and local governments must be borrowed from investors; if a state borrows too much money, state bond ratings fall and, unless the fiscal situation of the state is corrected, the state will default on its debts.

III. SUPREME COURT JURISPRUDENCE

If a state defaults, it may not be sued without its consent. That state sovereignty implies immunity from private lawsuits compelling payment of debt was established in the early years of the Republic. When the Supreme Court, in *Chisholm v Georgia*,²² ruled that the State of Georgia had to pay a citizen of South Carolina a debt it had incurred,²³ Congress passed the Eleventh Amendment to the Constitution, reversing that decision and “ma[king] it very difficult [subsequently] for creditors to force states to repay debts.”²⁴ Early jurisprudence also established that a state’s own citizens could not file a suit in federal court to secure repayment of debt²⁵ and that a foreign nation could not successfully compel a state to pay its debt.²⁶ A state is not immune from a suit filed by a sister state or by the federal government, but neither entity is likely to be a state bondholder.²⁷ Citizens within a state can file a suit within a state’s own courts, but state courts have historically not had much success in compelling other branches of government to honor their debts so that, as a result, citizens have been “unable to collect on the bonds.”²⁸

²⁰ See Figure 2. See also US Census Bureau, *Statistical Abstract: 2012* at 300 table 461 (cited in note 14).

²¹ See Peterson, *Price of Federalism* at 29–30, 70 table 3-3, 71 table 3-4 (cited in note 12).

²² 2 US (2 Dall) 419 (1793).

²³ *Id.* at 453.

²⁴ William B. English, *Understanding the Costs of Sovereign Default: American State Debts in the 1840’s*, 86 Am Econ Rev 259, 260 (1996).

²⁵ *Hans v Louisiana*, 134 US 1, 14–15, 21 (1890).

²⁶ See *Monaco v Mississippi*, 292 US 313, 330 (1934).

²⁷ Consider English, *Understanding the Costs* at 260–61 (cited in note 24), citing *South Dakota v North Carolina*, 192 US 286 (1904) and *United States v North Carolina*, 136 US 211 (1980).

²⁸ English, *Understanding the Costs* at 261 (cited in note 24).

One might think that ancient decisions dating back to the earliest days of the Republic are no longer pertinent, but despite the array of recent civil rights litigation against states in recent decades, the original conception of the United States as a federal union in which sovereignty is enjoyed by both the federal and state governments has remained altogether relevant for contemporary jurisprudence. In *US Term Limits, Inc v Thornton*,²⁹ Justice Anthony Kennedy, in a concurring opinion, characterized American federalism in words little different from those James Madison might have used:

Federalism was our Nation's own discovery. The Framers split the atom of sovereignty. It was the genius of their idea that our citizens would have two political capacities, one state and one federal, each protected from incursion by the other. The resulting Constitution created a legal system unprecedented in form and design, establishing two orders of government, each with its own direct relationship, its own privity, its own set of mutual rights and obligations to the people who sustain it and are governed by it.³⁰

Nor can the federal government order a state to compensate its creditors. The Rehnquist Court invalidated federal laws said to violate state autonomy by “commandeering” the states. In *New York v United States*,³¹ the majority held that Congress may not simply “‘commandeer’ state governments into the service of federal regulatory purposes.”³² *Printz v United States*³³ applied this reasoning to executive officers as well, holding invalid provisions of the Brady Handgun Violence Prevention Act³⁴ that required state and local law enforcement officers to conduct background checks on prospective handgun purchasers.³⁵ Writing for the majority, Justice Antonin Scalia concluded: “By forcing state governments to absorb the financial burden of implementing a federal regulatory program, Members of Congress can take credit for ‘solving’ problems without having to ask their constituents to pay for the solutions with higher federal taxes.”³⁶

²⁹ 514 US 779 (1995).

³⁰ Id at 838 (Kennedy concurring).

³¹ 505 US 144 (1992).

³² Id at 175 (holding that Congress does not have the authority to force state governments to take title to waste under the Tenth Amendment).

³³ 521 US 898 (1997).

³⁴ Pub L No 103-159, 107 Stat 1536 (1993).

³⁵ *Printz*, 521 US at 932–33.

³⁶ Id at 930.

With the passage of the Fourteenth Amendment, and the application of its Due Process and Equal Protection Clauses to the states, state sovereignty was eroded by a wide variety of civil rights lawsuits that were effectively prosecuted in both state and federal courts.³⁷ But Fourteenth Amendment suits generally have been viewed as constituting exceptions to state sovereign immunity. In *Alden v Maine*,³⁸ the Court reaffirmed the states' immunity to lawsuits filed in state courts.³⁹ Justice Kennedy rooted the decision in "the Constitution's structure, and its history," saying that "sovereign immunity derives not from the Eleventh Amendment but from the structure of the original Constitution itself."⁴⁰ However, Kennedy also said that state sovereign immunity does not extend to suits brought by the federal government itself and those pursuant to enforcement of the Equal Protection or Due Process Clauses of the Fourteenth Amendment.⁴¹

Future attempts to limit state sovereignty can be expected to exploit Fourteenth Amendment exemptions from the doctrine of state sovereignty. Those who seek to compel states to honor state pension and health care policies and collective bargaining agreements can be expected to invoke equal protection and due process arguments. Bondholders will argue that defaults deny them property without due process of law. But it is doubtful that such suits could be successfully pursued in the absence of federal legislation requiring states to honor implied contracts with bondholders, pensioners, or public employees.⁴² In other words, the jurisprudence that allows states to claim a sovereign status within the federal system seems as vibrant today as it has ever been. While the individual constitutions of many states may be interpreted as granting permission for lawsuits by bondholders, pensioners, or those protected by collective bargaining agreements,⁴³ states—as sovereign entities—appear to enjoy today the same legal prerogatives vis-à-vis bondholders and other creditors as states that have defaulted in the past, if they so choose.⁴⁴

³⁷ See, for example, *Fitzpatrick v Bitzer*, 427 US 445, 456 (1976). Courts also got around limitations on sovereign immunity by allowing suits to go forward when plaintiffs sued state entities rather than the state itself. For examples of the courts applying this limitation, see *Brown v Board of Education of Topeka*, 347 US 483, 493 (1954); *Ex parte Young*, 209 US 123, 165 (1908).

³⁸ 527 US 706 (1999).

³⁹ *Id.* at 712.

⁴⁰ *Id.* at 713, 728.

⁴¹ *Id.* at 755–56.

⁴² See, for example, *United States v Sherwood*, 312 US 584, 590–92 (1941).

⁴³ See, for example, Ill Const Art 13, § 5.

⁴⁴ See notes 82–91 and accompanying text.

IV. COLLECTIVE BARGAINING IN THE PUBLIC SECTOR

Since the beginning of the Republic, states have managed their fiscal affairs so well that only in a few instances have they defaulted on their debts. But in the twenty-first century, the risk of default by large and economically significant states has increased dramatically. Among the most important contributors to the altered situation has been the rise of collective bargaining within the public sector. In this regard, events within the field of education are especially instructive, as school personnel are the largest segment of the state and local workforce and education costs constitute approximately one-third of all state and local expenditures paid for out of locally generated revenues.⁴⁵

Public-sector collective bargaining was largely unknown prior to the 1960s. Even Franklin D. Roosevelt, the most significant presidential ally the labor movement has ever enjoyed, rejected public-sector bargaining within the federal government: “All Government employees should realize that the process of collective bargaining, as usually understood, cannot be transplanted into the public service. . . . The employer is the whole people, who speak by means of laws enacted by their representatives in Congress.”⁴⁶ George Meany, the head of the American Federation of Labor, did not disagree. As late as the 1950s, he plainly stated, “It is impossible to bargain collectively with the Government.”⁴⁷ Other organizations that represented government employees took the position that collective bargaining “was demeaning for civil service professionals.”⁴⁸ The National Association of Education (NEA), by far the largest of all teacher organizations, was firmly opposed to the idea.⁴⁹

Collective bargaining was introduced into the public sector in part because the policy fit the political needs of the Democratic Party, which had been closely affiliated with the labor movement

⁴⁵ In 1990 the percentage expended by state and local governments from their own resources (that is, excluding federal grants) for elementary, secondary, and higher education was 34.1 percent. See US Census Bureau, *Statistical Abstract: 2012* at 273 table 435, 300 table 462 (cited in note 14).

⁴⁶ Letter from President Franklin D. Roosevelt to Luther C. Steward, President of the National Federation of Federal Employees (Aug 16, 1937) (American Presidency Project), online at <http://www.presidency.ucsb.edu/ws/?pid=15445#axzz1bRZWSTlq> (visited Oct 21, 2011).

⁴⁷ George Meany, *Meany Looks into Labor's Future*, NY Times Mag 11, 38 (Dec 4, 1955).

⁴⁸ Paul E. Peterson, *Saving Schools: From Horace Mann to Virtual Learning* 106 (Belknap 2010).

⁴⁹ Martin Raymond West IV, *Politics, Public-Sector Unionism, and Education Policy: Explanations and Evaluations* *38 (unpublished PhD dissertation, Harvard University, 2006) (on file with authors).

since the 1930s.⁵⁰ Since the 1950s, private-sector unionization has been on the decline, slipping from roughly one-third to less than 10 percent of the nongovernmental workforce.⁵¹ Mobilizing new recruits to the Democratic coalition became critical, and nothing was more appealing than reaching out to the growing segment of the workforce employed by local, state, and federal governments. Previously, public-sector workers had not shown any particular partisan loyalty other than to the machine that hired them.⁵² The many white-collar professionals working for government were, if anything, more inclined to the Republican side of the aisle.⁵³ But far-sighted union leaders and key Democratic members of Congress, perceiving an opportunity, began to campaign for collective bargaining rights for public-sector workers.⁵⁴ Dwight Eisenhower, a Republican, stoutly resisted all congressional efforts to pass such legislation into federal law, but his Democratic successor, John Kennedy, promised he would take action if elected President.⁵⁵ Since the close balance of power on Capitol Hill precluded passage of collective bargaining legislation, the President signed an executive order giving federal employees the right to bargain collectively.⁵⁶

That executive order, in conjunction with the success of New York City teacher unions in obtaining collective bargaining rights, initiated a decisive transformation of the American public sector. The number of teacher strikes increased from 9 to 107 in just three years, between 1964 and 1967.⁵⁷ Faced with the prospect of school shutdowns and masses of teachers picketing outside once uneventful classrooms, school boards gave in to public pressure to settle strikes quickly and return children to school. Affiliates of the American Federation of Teachers (AFT) won recognition rights in many large cities, including Boston, Chicago, Cleveland, and Philadelphia.⁵⁸ “For the first time . . . since 1918, the AFT threatened to surpass the

⁵⁰ For labor-friendly New Deal legislation, see National Industrial Recovery Act of 1933, Pub L No 73-10, 48 Stat 31, codified at 15 USC § 701–10, terminated by Executive Orders 7252 (Dec 21, 1935) and 7323 (March 26, 1936); National Labor Relations Act, 29 USC § 151 et seq.

⁵¹ See US Bureau of Labor Statistics, Press Release, *Union Members—2010* 1 (Jan 21, 2011), online at <http://www.bls.gov/news.release/union2.nr0.htm> (visited Oct 21, 2011).

⁵² See West, *Politics* at *41 (cited in note 49).

⁵³ See Clem Brooks and Jeff Manza, *Class Politics and Political Change in the United States, 1952–1992*, 76 Social Forces 379, 393 figure 1 (1997).

⁵⁴ See West, *Politics* at *55 (cited in note 49).

⁵⁵ See *id.* at *56–58.

⁵⁶ Executive Order 10988, 27 Fed Reg 551 (1962). See also West, *Politics* at *64 (cited in note 49).

⁵⁷ Peterson, *Saving Schools* at 113 (cited in note 48).

⁵⁸ See *id.*

NEA,” one historian has noted.⁵⁹ That changed when the NEA dropped its principled opposition to collective bargaining as it saw its membership ranks rapidly defect to the AFT. Eventually both organizations prospered, with “NEA membership climbing from 700,000 in 1960 to 3.2 million in 2007, while the smaller AFT grew from under 60,000 to 1.3 million over the same period.”⁶⁰ Scarcely known in education before 1960, collective bargaining achieved predominance in most states outside the South.⁶¹

In present times, collective bargaining is so pervasive within the public sector that few remember Franklin Roosevelt’s objections to such a practice. There remains a handful of critics who argue that collective bargaining subverts the democratic relationship between government and citizens by privileging a particular set of interests—those of government employees. Notably, such critics draw a distinction between collective bargaining in the public and private sector. In the private sector, collective bargaining is often appropriate, such critics argue, because workers may need to bargain collectively in order to prevent a profit-maximizing management from abusing its superior bargaining position vis-à-vis individual employees. When resolute unions bargain with a management indifferent to all but its bottom line, each protects its own vital interests in the collective bargaining process. But within the public sector, such countervailing power cannot be assumed. The “management” in the public sector is made up of elected officials, such as school board members, to whom unions contribute heavily during the election process. Also, school employees participate more frequently than others in “school elections, which are often low-visibility, non-partisan affairs that engage the attention of only the most interested parties.”⁶² Campaign contributions and coordinated voting blocs give employees special influence over the very school board with which they negotiate. Though not quite self-dealing, teachers’ unions are certainly not bargaining with hostile

⁵⁹ Marjorie Murphy, *Blackboard Unions: The AFT and the NEA, 1900–1980* 220 (Cornell 1990).

⁶⁰ See Peterson, *Saving Schools* at 113 (cited in note 48).

⁶¹ See Richard C. Kearney and David G. Carnevale, *Labor Relations in the Public Sector* 38, 60–61 table 3.2 (Marcel Dekker 2001); Randall W. Eberts, *Teachers Unions and Student Performance: Help or Hindrance?*, 17 *Future Children* 175, 178 (2007). For further research on the growth of teachers’ unions since 1950, see Joseph E. Slater, *Public Workers: Government Employee Unions, the Law, and the State, 1900–1962* 193 (Cornell 2004). Hanna Skandera and Richard Sousa, *School Figures: The Data behind the Debate* 106–08 (Hoover 2003). AFT membership includes university faculty, paraprofessionals, and other school employees.

⁶² Peterson, *Saving Schools* at 114 (cited in note 48).

management representing interests in opposition to those of the employees.⁶³

Union political power has been expanded by collective bargaining agreements in other ways as well. Contracts in many districts require an amount equivalent to union dues be deducted from employee paychecks, the use of which is given to the discretion of the employee's union. These deductions include fees that, unless specifically objected to by a member, may be used for political purposes.⁶⁴ With such resources, teacher unions have become among the most influential groups in state politics: in 1985 "teachers' organizations" were identified as the most influential interest group in state politics; in 2002 they were found to be second only to business groups. In both surveys, they outranked such powerful groups as utility companies, insurance companies, hospitals, trial lawyers, manufacturers, and those representing local governments more generally.⁶⁵

Assessing the consequences of collective bargaining within the public sector is a controversial matter. But we do know that since the mid-1960s, per-pupil expenditures on elementary and secondary education have tripled in real-dollar terms—from less than \$4,000 per pupil (in 2006 dollars) to nearly \$12,000 in 2008.⁶⁶ Much of the increment is to be explained by the growth in the number of public school employees both because the number of pupils per teacher fell by one-third (from twenty-five to sixteen) and because many more nonteaching professionals were hired to provide ancillary services and to help manage an increasingly complex system.⁶⁷ In 1960, school districts employed 6 professionals for every 100 students; by 2005 they were employing more than 12 for that same number. Nonprofessional hiring rose at a similar rate—from less than 2 per 100 students in 1960 to nearly 4 in 2005.⁶⁸ Most of the rising cost of education was borne by state and local governments, as the federal contribution did not rise much above 10 percent of the total.⁶⁹

⁶³ Terry M. Moe, *The Union Label on the Ballot Box: How School Employees Help Choose Their Bosses*, 6 *Educ Next* 58, 60 (Summer 2006).

⁶⁴ Peterson, *Saving Schools* at 114–15 (cited in note 48).

⁶⁵ Clive S. Thomas and Ronald J. Hrebienar, *Interest Groups in the States*, in Virginia Gray and Russell L. Hanson, eds, *Politics in the American States: A Comparative Analysis* 100, 119 table 4-1 (CQ 8th ed 2004).

⁶⁶ See Thomas D. Snyder, Sally A. Dillow, and Charlene M. Hoffman, *Digest of Education Statistics, 2009* 100 table 64, 260 table 181 (Department of Education 2010).

⁶⁷ See Thomas D. Snyder and Sally A. Dillow, *Digest of Education Statistics, 2008* 117 table 80 (Department of Education 2009).

⁶⁸ See *id.*

⁶⁹ Peterson, *Saving Schools* at 153 (cited in note 48).

During this period of time, teacher salaries have kept pace with overall wage and salary increases nationwide.⁷⁰ In addition, teachers and other public-sector employees have been guaranteed steep increases in pensions, health care, and other nonsalary benefits, as elected officials choose to reach collective bargaining settlements by rewarding workers with promises of future benefits rather than immediate salary compensation.⁷¹ In most cases, the cost of these benefits was postponed into a future well beyond current election cycles.⁷² For years the growing imbalance between rising costs and increasing liabilities, on the one side, and fiscal resources, on the other, was ignored, except by the Cassandras of the policy world.⁷³ But with the financial crisis of 2008, the possibility of state and municipal defaults shifted from the theoretical to the plausible.⁷⁴

V. STATE FISCAL CRISES

The lower tiers of the US government are facing a contemporary fiscal crisis unprecedented since the days of the Great Depression. While some resource-rich, less populous states—Alaska, Montana and North Dakota, for example—continue to run balanced budgets,⁷⁵ most states are confronting large deficits. New York's deficit for the fiscal year 2012 was estimated in early 2011 to be 18 percent of the previous year's budget, California's to be 29 percent, Texas's to be 32 percent, and New Jersey's to be no less than 38 percent.⁷⁶ The gap in official state budgets was estimated to be at \$121 billion, or 19 percent of the budget in the forty-six states running deficits.⁷⁷ The size of these projected deficits may have attenuated as state economies have recovered, but they would be

⁷⁰ See id at 133.

⁷¹ See, for example, Letter from Daniel W. Hancock, Chairman of the Little Hoover Commission, to Edmund G. Brown, Governor of California, and Members of the California Legislature (Feb 24, 2011) ("Hancock Letter"), in *Public Pensions for Retirement Security First Page* (Little Hoover Commission Feb 2011), online at <http://www.lhc.ca.gov/studies/204/report204.html> (visited Oct 22, 2011).

⁷² See David Stella and Keith Bozarth, *Pension Sustainability—The Wisconsin Example*, 47 *Benefits & Compensation Dig* 32, 33 (Feb 2010).

⁷³ See, for example, Hancock Letter at First Page (cited in note 71); Roger Lowenstein, *The End of Pensions*, *NY Times Mag* (Oct 30, 2005), online at <http://www.nytimes.com/2005/10/30/magazine/30pensions.html?pagewanted=print> (visited Oct 22, 2011).

⁷⁴ See Kevin Hassett, *California Leads Nation to Bond Default Abyss*, *Tulsa World A12* (June 2, 2009).

⁷⁵ Daniel J. Nadler and Sounman Hong, *Political and Institutional Determinants of Tax-Exempt Bond Yields* *3 (Harvard Kennedy School Report No 11-04), online at http://www.hks.harvard.edu/pepg/PDF/Papers/PEPG_11-04_Nadler_Hong.pdf (visited Oct 10, 2011).

⁷⁶ See id at *15 table 1.

⁷⁷ Id at *3.

considerably larger if they were to include the revenues necessary to fully fund state pension and health care obligations.⁷⁸

With the onset of the financial crisis, the bond market immediately took note of the increased risk of sovereign state defaults. In late 2008 investors demanded a higher premium for state and local bonds over safer US Treasury securities, despite the exemption from federal taxation of interest received on most state and local bonds. Although all states were affected by the crisis, the perceived risks of default varied considerably among the states. “Between September and December of 2008, the premium that investors demanded to hold California debt over US treasuries jumped from 24 basis points to 271 basis points, a ten-fold increase.”⁷⁹ (100 basis points equals one percent.) Before the crisis, the difference in the premium paid in California and Texas was only 15 basis points. But by 2011 the gap between the two states had increased to 84 basis points.⁸⁰ Similar jumps in the cost of borrowing occurred in a number of other states as well.⁸¹ Clearly, investors had become increasingly sensitive to the variation in the risk of defaults among the sovereign states.

VI. IMPACT OF COLLECTIVE BARGAINING ON DEFAULT RISK

State and municipal defaults are not unknown to American federalism.⁸² Eight states defaulted or repudiated debt between 1841 and 1843 when a severe economic depression restricted state ability to pay interest on debt that had been assumed primarily for the purpose of constructing canals and railroads.⁸³ The federal government refused to assume responsibility despite efforts by both defaulting states and foreign banks to persuade the federal government to intervene.⁸⁴ While four states eventually repaid all of their debt, three made only a partial repayment, and one, Mississippi, never did.⁸⁵

⁷⁸ Alan J. Auerbach, *Long-Term Objectives for Government Debt* *10–13 (Swedish Fiscal Policy Council Conference on Fiscal Policy and Labour Market Reforms, Feb 2008), online at http://elsa.berkeley.edu/~auerbach/long_term_objectives_govt_dept.pdf (visited Nov 4, 2011).

⁷⁹ Nadler and Hong, *Political and Institutional Determinants* at *4 (cited in note 75).

⁸⁰ See *id.*

⁸¹ See Figure 4.

⁸² In this paper we ignore defaults by municipalities and other lower-tier governments. These units of government do not have status in the US Constitution, and their status varies from one state to the next, depending on state law.

⁸³ See English, *Understanding the Costs* at 261–65 (cited in note 24).

⁸⁴ See Rodden, *Hamilton’s Paradox* at 59–60 (cited in note 8).

⁸⁵ English, *Understanding the Costs* at 265 table 3 (cited in note 24).

The boom-and-bust economy of the 1870s and 1880s provoked another ten defaults, and Arkansas was unable to cover its debts during the 1930s depression.⁸⁶ Bondholders were not the only creditors that states ignored during hard times. During the Great Depression, Chicago teachers were on several occasions paid in “scrip,” because the City could not find the cash in hand to compensate them.⁸⁷ Years later the “scrip” was made good, but few teachers themselves ever received payment in full, as they had used their highly discounted “scrip” to pay monthly bills.⁸⁸

In none of these crises was there much hope that the federal government would come to the rescue of states at risk of default. During the 1840s, some political leaders invoked the precedent established when Congress, prompted by Alexander Hamilton, assumed the Revolutionary War debts incurred by some of the states.⁸⁹ But others argued that the precedent did not hold in that revolutionary war debts had been incurred on behalf of a common cause, while the state debts incurred prior to the 1840s were for the purpose of setting up banking and transportation systems designed mainly for the benefit of the state itself. Neither of the national political parties saw any advantage in coming to the rescue of a few states at the expense of the remainder.⁹⁰

Nor has the US government guaranteed state debts in any subsequent crisis. As a result, each state is held accountable by the bond market in ways that lower-tier governments in most other countries are not. Consider, for example, the differing response of the bond market to the state bonds issued in the United States and in the German Federal Republic. Even though the constitution of the German Federal Republic, adopted in the aftermath of World War II, was explicitly modeled on that of the United States and assigned major responsibilities to state governments, the German federal government has asserted control over state finances and guarantees state debts.⁹¹ For that reason, the spread between German federal and state securities is less than the spread between such securities in the United States. As is shown in Figure 3, the 2008 financial crisis

⁸⁶ Andrew Ang and Francis A. Longstaff, *Systemic Sovereign Credit Risk: Lessons from the U.S. and Europe* *6 (NBER Working Paper No 16982, Apr 2011), online at <http://www.nber.org/papers/w16982> (visited Oct 8, 2011).

⁸⁷ See Paul E. Peterson, *The Politics of School Reform, 1870–1940* 179 (Chicago 1985).

⁸⁸ See William J. Grimshaw, *Union Rule in the Schools: Big-City Politics in Transformation* 64 (Lexington 1979).

⁸⁹ See Rodden, *Hamilton's Paradox* at 57, 60 (cited in note 8).

⁹⁰ See *id.* at 62–63.

⁹¹ See *id.* at 91. See also *id.* at 83–87 table 4.1 (reporting that the variance in the credit ratings of lower-tier governments in Germany is much smaller than in the United States).

had an impact on the perceived default risk of the average German state relative to that of the German Federal Republic. The average yield spread between the two types of securities from 36 basis points to 112 basis points between June 2008, the eve of the financial crisis, and December 2008, when the crisis was at its peak. But during that same period, the average yield spread for US states relative to federal securities increased from 19 basis points to 129 basis points. Clearly, the bond market perceived that the risk of default by a state in Germany was attenuated by the guarantee supplied by the German Federal Republic.

In the United States, investors were willing to accept lower interest rates on state debt securities relative to US Treasuries due to their federal-tax-exempt status. After the financial crisis, however, the yield on state bonds rose above that for comparable federal securities, as any tax advantages were overwhelmed by perceived increased risk.⁹² Rates of return on state bonds before the financial shock trailed those for Treasury securities because federal taxes need not be paid on the returns from most state and municipal bonds. But after the financial crisis, the spread between state and federal bonds turned from negative to positive, as the relative risk from state investments outweighed any tax advantages. Moreover, the yield spread between state and federal bonds varied significantly from state to state, indicating that the market perceived greater default risk in certain states.⁹³

Notably, investors' perceptions of the risk of default were correlated with the unionization rate of the public-sector workforce.⁹⁴ As shown in Figure 5, the relationship between union membership and default risk was noticeably weaker in June 2008, prior to the financial crisis, than it was over the next six months. Figure 5's vertical axis shows the spread for federal securities and state bonds that will mature in one year, while the horizontal axis shows the unionization rate for the state's public sector. "The relationship between the two variables, modest in June 2008, becomes pronounced by June 2009, as bondholders became highly sensitive to a state's perceived political capacit[ies] to take actions needed to bring budget deficits under control."⁹⁵ The differences in the steepness of the slopes taken by the regression lines in Figure 5

⁹² Nadler and Hong, *Political and Institutional Determinants* at *8 (cited in note 75).

⁹³ See Figure 4.

⁹⁴ See Nadler and Hong, *Political and Institutional Determinants* at *8 (cited in note 75).

⁹⁵ *Id.*

describe the strengthening of the simple relationship between the union share of the public-sector workforce and default risk.⁹⁶

This relationship persists when other factors are controlled, as has been shown by Daniel Nadler and Souman Hong.⁹⁷ In this study, unbiased estimates of the impact of political variables on state default risks are estimated with models that solve for the endogenous relationship between credit and yield, and that also take into account the economic factors that James Poterba and Kim Rueben have shown to be associated with a state's default risk: change in its unemployment rate, Gross Domestic Product (GDP), and deficit-to-GDP ratio.⁹⁸ Nadler and Hong present estimates of the impact of a range of state-level political variables—such as the union share of the public-sector workforce and partisan representation in the legislature—on state municipal bond yield spreads in the context of the unexpected deficit shocks seen following the 2008 financial crisis. In particular, they evaluate the impact of the union share of the public-sector workforce and partisan representation in the legislature using “separate models, because unionism and partisan balance are highly correlated with one another, making it difficult, with the small number of observations available, to identify the independent impact of each within a single model.”⁹⁹

Their results are reproduced here in Table 1. According to Nadler and Hong, unexpected deficit shocks of the size that took place in 2008 especially affect state yield spreads when certain political conditions are present. As can be seen in Table 1, a 1 percent difference in union membership in a state is associated with an additional 2.02 basis point change in state borrowing costs, if the state has experienced a billion-dollar change in its unexpected deficit shock. In other words, a twenty percentage-point difference in the share of the public-sector workforce that is unionized (one standard deviation) is associated with an additional increase in the

⁹⁶ Unlike the simple relationship between union share of the public workforce and bond yield spreads, the simple relationship between yield spreads and the partisan composition of the state legislature does not increase in the wake of the fiscal crisis. The impact of this political factor is detectable only after estimating the model presented in Table 1.

⁹⁷ Nadler and Hong, *Political and Institutional Determinants* at *6–7 (cited in note 75).

⁹⁸ See *id.* at *6, 8. Since the relationship between decisions to issue state bonds and yield spreads are endogenous, an unbiased estimate of the factors affecting yield spreads cannot be obtained by an ordinary least-squares regression. However, if a change in the size of the deficit is unexpected, the demand for credit changes regardless of the price of the bond, permitting unbiased estimates. The model thus estimates the interaction between deficit shocks and the key political variables included in the models. The model follows those used by James M. Poterba and Kim Rueben, *Fiscal News, State Budget Rules, and Tax-Exempt Bond Yields*, 50 J Urban Econ 537, 539–44 (2001).

⁹⁹ See Nadler and Hong, *Political and Institutional Determinants* at *9 (cited in note 75).

level of state bond spreads of 40.4 basis points, for every billion-dollar change in unexpected deficit shock that a state experiences.¹⁰⁰

Similarly, Nadler and Hong found that a one-percentage-point increase in the Democratic share of a state legislature is associated with an additional 3.02 basis point increase in state borrowing costs for every billion-dollar change in a state's unexpected deficit shock. This suggests that an increase in the Democratic legislative representation by twenty percentage points is associated with a 60.4 basis point increase in the state-to-federal bond yield spread in the context of a billion-dollar deficit shock. "The cost to the state taxpayer of a standard deviation shift in either variable is, roughly speaking, about one half of one percent on a five-year security note."¹⁰¹ As Nadler and Hong argue, "That amount is non-trivial. In Illinois, an increase in the yield spread of that magnitude on its debt of \$145.5 billion amounts to \$727 million dollars in additional interest costs annually."¹⁰²

However, one should not reify these two indicators of a state's political situation. Union share of the public-sector workforce and partisan representation in the legislature are actually indicators of a broader set of factors affecting a state's risk of default.¹⁰³ As Nadler and Hong's work makes clear, the unionization rate of the public-sector workforce is correlated with factors such as whether a state has a right-to-work law and whether the legislature has permitted public-sector collective bargaining, both of which are correlated with the magnitude of bond yield spreads. In addition, the percentage of the legislature that is Democratic is highly correlated with the percentage that is Democratic in each house of the legislature, which also are correlated with bond yield spreads.¹⁰⁴ (However, as Nadler and Hong note, that data shows that the partisan affiliation of the governor is not correlated with yield spreads, "suggesting that governors have broader constituencies than do members of the legislature.")¹⁰⁵

The two interval variables emphasized by Nadler and Hong—public-sector unionization and political orientation of the legislature—

¹⁰⁰ Id.

¹⁰¹ Id.

¹⁰² Id.

¹⁰³ Variations in state expenditures on Medicaid, a "highly redistributive program that might be considered a default risk factor, were not correlated with yield" spreads. Bondholders apparently think that expenditures incurred outside of collective bargaining agreements are more easily managed. See Nadler and Hong, *Political and Institutional Determinants* at *9 n 16 (cited in note 75).

¹⁰⁴ Id. at *9.

¹⁰⁵ Id.

should be understood as useful proxies for a broader set of collective bargaining and partisan factors that affect bond yields. Economic factors—growth, change in the deficit-to-GDP ratio, and change in the unemployment rate—are also strongly associated with the substantial interstate variation in yield spreads that occurred in the wake of the financial crisis. But in addition to the impact of these economic factors, political realities are clearly also taken into account by bondholders: Nadler and Hong found that, when both are entered into the same equation, the political variables seem to be at least as important in explaining post-crisis interstate variation in yield spreads as are core economic indicators such as state-level growth in GDP and changes in state unemployment rates.¹⁰⁶

VII. DEFAULT RISKS AND COMPETITIVE FEDERALISM

A system of competitive federalism has long been extolled as a permanent feature of American government.¹⁰⁷ Both early and modern Supreme Court jurisprudence has recognized states as sovereign entities that exercise autonomous power—and incur concomitant risks—within the sphere allocated to them by the Constitution.¹⁰⁸ States and localities play a major role in the raising of revenue, the delivery of services, and the servicing of public debt. Nothing is as quintessentially American as the dual sovereignty granted both to states and to the federal government.

Yet in *Hamilton's Paradox*, a recent study of federal systems, Jonathon Rodden argues that attempts to sustain systems of competitive federalism usually fail, attributing to Alexander Hamilton a similar appreciation of competitive federalism's fragility.¹⁰⁹ When sovereignty is divided, lower-tier governments are tempted to run debts that place themselves at grave risk of default in times of financial crisis.¹¹⁰ And central governments, both to safeguard their international credit rating and to respond to internal political pressures, cannot resist providing the assistance necessary to safeguard bondholders and other creditors from loss.¹¹¹ Central governments do not offer a helping hand without at the same time asserting their authority, however. If they rescue states and localities they will feel more than entitled to take preventative measures

¹⁰⁶ See *id.* at *10–12.

¹⁰⁷ See note 12.

¹⁰⁸ See, for example, *Hans v. Louisiana*, 134 US 1, 21 (1890); *New York*, 505 US at 175.

¹⁰⁹ Rodden, *Hamilton's Paradox* at 2 (cited in note 8).

¹¹⁰ See *id.* at 8.

¹¹¹ See *id.* at 78–79.

designed to preclude future defaults.¹¹² Irresponsibility at the state and local level thus undermines the dual sovereignty essential for the survival of competitive federalism. Celebrated in theory as an efficient government of Herculean proportions, competitive federalism is but a ten-pound weakling in practice. To prove his claims, Rodden inquires into the functioning of three large and important federal systems—Australia, Brazil, and Germany. Based on his findings, he recommends that new states be constructed either as unitary systems or designed in such a way as to give the central government undisputed fiscal authority.

So it is of considerable interest that Rodden does not apply his argument to the United States. That exceptional nation, Rodden suggests, can still enjoy the benefits of a system of competitive federalism, because the arrangement has been woven so deeply into the fabric of the society that it cannot be torn asunder. In the 1840s, the national government stood aside when multiple states defaulted, and it has never intervened to help them out in the decades since.¹¹³ Other factors have contributed to a stable system of competitive federalism as well: the size of government has been relatively small, the lower tiers of government have been responsible for a fairly large share of all domestic spending, grants from the federal government have remained only a moderate proportion of total state and local spending, and debts have made up a small percentage of most states' GDP.

Yet within five years of the publication date of Rodden's insightful study, competitive federalism in the United States seems more fragile than it has ever been. Many of the stabilizing factors are gradually being whittled away. In recent years, the size of federal, state, and local government has grown from less than 30 percent to over 35 percent of GDP, the federal share of overall domestic expenditures has been on the increase,¹¹⁴ intergovernmental grants are making up a greater share of total lower-tier expenditures, and state and national debt is escalating at an astounding rate. In the spring of 2009, Congress, as part of the stimulus package, transferred hundreds of billions of dollars to states and localities, and tens of billions in additional aid were appropriated the following year.¹¹⁵ Though presented as legislation that would protect public-sector

¹¹² See *id.* at 271.

¹¹³ See Rodden, *Hamilton's Paradox* at 62, 67 (cited in note 8).

¹¹⁴ See Figure 1.

¹¹⁵ American Recovery and Reinvestment Act of 2009, Pub L No 111-5, 123 Stat 115.

jobs,¹¹⁶ the monies were most valued by governors and mayors as mechanisms for reducing fiscal deficits.¹¹⁷ Though not a federal guarantee against default, the stimulus packages provided a dramatic example of the way in which federal aid can ameliorate state and local distress when states find themselves at risk of default.

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. Even the US government is at risk, as the net foreign debt of the US central government, in the absence of corrective measures, is projected within the next twenty years to rise from about \$5 trillion dollars in 2011 (about 33 percent of GDP) to \$50 trillion, or more than 140 percent of GDP,¹¹⁸ a level “far above any levels that could be considered sustainable.”¹¹⁹ Those numbers do not include the sovereign debts of the fifty states of the union, a debt that is currently about 7 percent of GDP.¹²⁰ Nor do they take into account the value of the unfunded liabilities faced by public-sector pension plans, officially estimated at \$438 billion by states themselves but which could in fact be as high as \$3 trillion dollars, about 20 percent of GDP.¹²¹

Within the United States the sovereign state default crisis is for some states—Illinois, California, and New Jersey, for example—serious enough that Washington policy makers are currently debating the policy and constitutional implications of three alternatives: federal loans that would bail out states at risk of default,¹²² bankruptcy procedures,¹²³ and simple defaults of the kind

¹¹⁶ See The White House, Press Release, *State Governments Expected to Credit Recovery Act with Creating, Saving at Least 250,000 Education Jobs Nationwide* (Oct 19, 2009), online at <http://www.whitehouse.gov/the-press-office/state-governments-expected-credit-recovery-act-with-creating-saving-least-250000-ed> (visited Oct 9, 2011).

¹¹⁷ See William Murphy, *Stimulus Helps Shrink Deficit*, *Newsday* A20 (Aug 6, 2009).

¹¹⁸ William R. Cline, *Long-Term Fiscal Imbalances, US External Liabilities, and Future Living Standards*, in C. Fred Bergsten, ed, *The Long-Term International Economic Position of the United States* 11, 24 table 2.3 (Peterson Institute for International Economics 2009).

¹¹⁹ C. Fred Bergsten, *The Global Crisis and the International Economic Position of the United States*, in Bergsten, ed, *Long-Term Economic Position* (cited in note 118). See also *The Current Account Deficit and US Foreign Debt Hearing before the Senate Budget Committee*, 110th Cong, 1st Sess 3 (2007) (testimony of C. Fred Bergsten).

¹²⁰ See Steven Maguire, *State and Local Debt: An Analysis* *5 (CRS Mar 31, 2011), online at <http://www.nasbo.org/LinkClick.aspx?fileticket=4sLYo0HTYI8%3D&tabid=81> (visited Oct 23, 2011).

¹²¹ Andrew G. Biggs, *The Market Value of Public Sector Pension Deficits* 5 (American Enterprise Institute for Public Policy Research, Apr 2010), online at <http://www.aei.org/files/2010/04/06/2010RPOno1g.pdf> (visited Nov 5, 2011).

¹²² See, for example, Douglas Turner, *Serious Budget Troubles Brewing in Many States*, *Buffalo News* A8 (Jan 10, 2011).

that occurred during the 1840s.¹²⁴ Representative Patrick McHenry, chairman of a subcommittee of the Committee on Oversight and Government Reform says that “already state and municipal governments are coming to Washington, hat-in-hand, expecting a federal bailout.”¹²⁵ Berkeley School of Law Dean Christopher Edley has proposed that the federal government bail out states by lending them federal money at low interest in the expectation that it will be paid in due course.¹²⁶ The Obama administration’s proposal to loan monies to states to help them cover deficiencies in their state unemployment insurance accounts sets a precedent for larger and more consequential federal actions in the future.

Bankruptcy protection has been proposed by University of Pennsylvania law professor David Skeel. In his view, the country needs a federal bankruptcy law designed specifically for sovereign debts that would “enable a state to restructure [its] obligations.”¹²⁷ Such a law, he argues, would be constitutional as long as state sovereignty were protected by giving states the option to invoke bankruptcy procedures rather than mandating them to enter bankruptcy court if they would otherwise default.¹²⁸ 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. Not only would bankruptcy give states the opportunity “to restructure obligations that are [otherwise] extremely difficult to restructure,” but it would “ensure[] that most or all of a state’s constituencies make sacrifices, not just one or two.”¹²⁹ Jeb Bush and Newt Gingrich have proposed a similar plan that would give states

¹²³ See, for example, Jeb Bush and Newt Gingrich, *Let States Declare Bankruptcy: Reorganization Allowing Breaking of Union Contracts May Be the Best Way for Some*, Baltimore Sun A13 (Jan 31, 2011).

¹²⁴ See, for example, Jeff Segal, Martin Hutchinson, and Rob Cox, *California’s Only Option*, NY Times B2 (June 10, 2009).

¹²⁵ *State and Municipal Debt: The Coming Crisis? Hearing before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs of the House Committee on Oversight and Government Reform*, 112th Cong, 1st Sess 1 (2011) (“*State and Municipal Debt Hearings*”) (Rep Patrick McHenry).

¹²⁶ Christopher Edley, *Let Treasury Rescue the States*, NY Times A25 (July 8, 2010).

¹²⁷ David A. Skeel Jr, *States of Bankruptcy*, 79 U Chi L Rev *18 (forthcoming 2012), online at <http://ssrn.com/abstract=1907774> (visited Oct 9, 2011).

¹²⁸ *Id* at *23–25.

¹²⁹ *State and Municipal Debt Hearings* at 5 (testimony of David A. Skeel Jr). See also Skeel, *States of Bankruptcy* at *19–20 (cited in note 127).

the opportunity to seek bankruptcy protection in the event of a deficit crisis.¹³⁰

Nicole Gelinas of the Manhattan Institute argues that “state bankruptcy would create more problems than it would solve.”¹³¹ Most states do not owe their debt through a single entity, making it difficult for any single bankruptcy court to handle the extraordinary complexities involved. For example, pension obligations are typically borne by local governments as well as by the state, adding to the number of participants in bankruptcy procedures.¹³²

None of the three proposed options are attractive, but if the state fiscal crisis becomes increasingly severe, as could happen if projected deficits in pension and health care accounts materialize, then the federal loan option may prove to be the most politically palatable. Multiple state and municipal defaults would likely provoke a nationwide political crisis and could affect the credit of the US government, especially if its debt-to-GDP ratio continues to rise. Passage of bankruptcy legislation could allow for a more managed imposition of costs on the full range of creditors, including bondholders, pensioners, and beneficiaries of collective bargaining agreements, but bankruptcy could also affect US credit in world markets and would create a legal nightmare, given the complexity of state contractual arrangements with its creditors. By comparison, federal loans provide an attractive option to those elected officials aligned with public-sector unions, a constituency at risk in any bankruptcy proceeding. Even if power in Washington is divided between the two political parties, the fear of international consequences could induce compromises that require substantial federal contributions to states along the lines of the stimulus package passed in 2009.

The current contemporary flirtation with default, coupled with demands for a federal rescue, poses a threat to the system of competitive federalism. The threat comes not so much from the accumulation of debt as the obligations that have been incurred as part of the collective bargaining process, many of which may be enforceable in court. So it is probably not surprising that a state’s default risk, as judged by the contemporary bond market, is related both to the share of the public-sector workforce that is unionized and to the percentage of the members of the state legislature affiliated

¹³⁰ See Jeb Bush and Newt Gingrich, *Better Off Bankrupt: States Should Have the Option of Bankruptcy Protection to Deal with Their Budget Crises*, LA Times A19 (Jan 27, 2011).

¹³¹ *State and Municipal Debt Hearings* at 1 (testimony of Nicole Gelinas).

¹³² See *id.* at 1–2.

with the Democratic Party.¹³³ If that party is in control of the federal government, it can be expected to look favorably on requests that it rescue states in need. In the midst of the latest crisis, Warren Buffett, a prominent investor with a large stake in the state and municipal bond market, expressed the hope that such federal action would be forthcoming, conceding that “[t]he bond insurers . . . have extraordinary liabilities,” but doubting that “the federal government [would] turn away a state that is having extreme financial difficulties when in effect it honored” the debts of corporate entities, including General Motors.¹³⁴ Later, in an interview with the congressional Financial Crisis Inquiry Commission, he qualified that assessment, saying, “I don’t know how I would rate [state bond default risks] myself. . . . It’s a bet on how the federal government will act over time.”¹³⁵

Making a bet on the federal response to a state sovereign debt crisis is beyond the scope of this paper. We claim only that the introduction of collective bargaining has magnified the risk of state sovereign defaults, complicated the resolution of deficit problems that provoke such crises, heightened the likelihood of a federal intervention if such crises materialize, and set the conditions for a transformation of the country’s federal system. The costs of such actions are greater than just the dollar numbers explicitly on the bargaining table. Within the past decade a system of competitive federalism that once enjoyed an exalted, even Olympian, standing in American political culture has now been placed at risk.

¹³³ This Section draws upon the findings and analysis presented in Nadler and Hong, *Political and Institutional Determinants* at 7 (cited in note 75). Their analysis is based on data from the twenty states for which daily yield spreads are publicly available. It extends a previous analysis of the economic and legal determinants of state bankruptcy risks by Poterba and Rueben, 50 *J Urban Econ* at 537 (cited in note 98).

¹³⁴ Svea Herbst-Bayliss and Jonathan Stempel, *Buffett: US Can Bail Out States, Insurers Pained*, Reuters (May 1, 2010), online at <http://www.reuters.com/article/2010/05/01/berkshire-buffett-ratings-idUSN0118355720100501> (visited Oct 9, 2011).

¹³⁵ Ianthe Jeanne Dugan, *Investors Looking Past Red Flags in Muni Market*, Wall St J C1 (June 14, 2010).

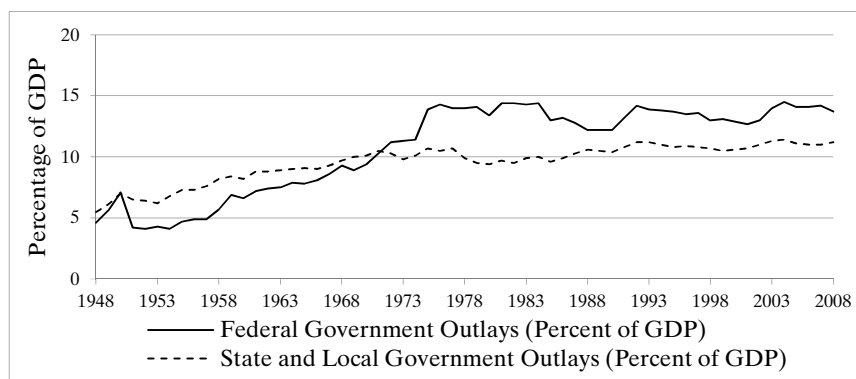
TABLE 1. THE EFFECT OF UNEXPECTED DEFICIT SHOCKS, POLITICAL, AND LABOR INSTITUTIONS ON CHANGES IN STATE BOND YIELDS (MODEL 2).

	(1)	(2)
Δ Defshock	24.17 (14.25)	-11.02 (11.51)
Δ Defshock \times Union membership	2.02*** (0.61)	
Δ Defshock \times Dem. share in State Legislature		3.02*** (0.96)
Δ Unemployment rate	37.41 (23.11)	57.65* (27.48)
Δ Real GDP	131.5 (177.0)	-128.3 (139.2)
Δ Deficit to GDP	8.598** (3.335)	13.23*** (4.267)
Constant	-100.3*** (31.96)	-131.9*** (40.42)
N	20	20
R^2	0.702	0.723

Source: Nadler and Hong, *Political and Institutional Determinants* at *16 (cited in note 75).

Note: Standard errors are in parentheses, * $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$. Data are for 2007–08 for 20 states. The independent variables are changes from 2007 (before crisis) to 2008 (after crisis) for twenty states, which include the fifteen largest states. The dependent variable has a six-month lag and thus is a change from June 2008 to June 2009. A six-month lag was used, allowing for the fact that there might be some delays in market response. However, the results are highly robust and do not depend on whether they use lagged dependent variables. The twenty states were California, Connecticut, Florida, Georgia, Illinois, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, Texas, Virginia, Washington, and Wisconsin.

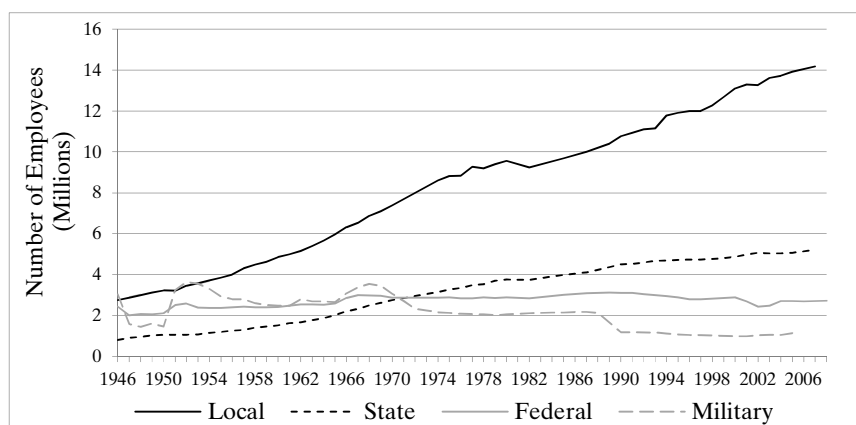
FIGURE 1. DOMESTIC EXPENDITURE OF FEDERAL AND STATE-LOCAL GOVERNMENTS IN THE UNITED STATES, 2010



* Domestic expenditure, defense and interest payments excluded

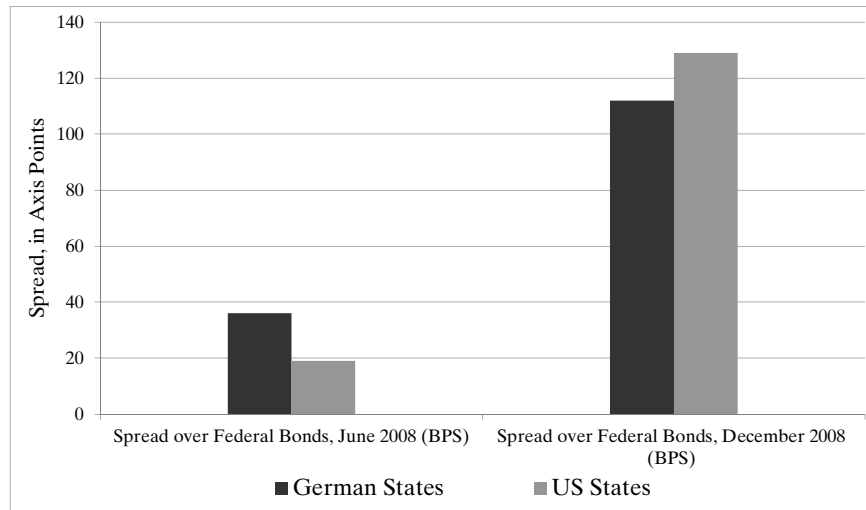
Source: Office of Management and Budget, *Historical Tables: Budget of the U.S. Government* 330–31 table 15.5 (GPO 2010), online at <http://www.gpoaccess.gov/usbudget/fy10/pdf/hist.pdf> (visited Oct 23, 2011).

FIGURE 2. EMPLOYMENT BY FEDERAL AND STATE-LOCAL GOVERNMENTS IN THE UNITED STATES, 1946–2008



Source: US Census Bureau, *Historical Statistics of the United States: Colonial Times to 1970* 1100, 1141 (GPO 1975); US Census Bureau, *Statistical Abstract of the United States* 318 table 519, 375 table 611 (GPO 101st ed 1980) (describing state and local government payroll numbers and numbers of Department of Defense Personnel, Payroll, and Military Retirees, respectively, from 1950 to 1979); US Census Bureau, *Statistical Abstract of the United States* 339 table 552 (GPO 110th ed 1990) (detailing the number of people in the Department of Defense from 1950 to 1988); US Census Bureau, *Statistical Abstract of the United States* 338 table 534, 367 table 587 (GPO 119th ed 1999) (listing the number of persons on government employment and payrolls from 1980 to 1997 and the number of military personnel on active duty from 1990 to 1996, respectively); US Census Bureau, *Statistical Abstract of the United States* 296 table 447, 322 table 482, 330 table 493 (GPO 127th ed 2008) (calculating the number of government employees from 1982 to 2005, federal civilian employment and annual payroll by branch of government from 1970 to 2006, and military and civilian personnel and expenditures from 1990 to 2005, respectively); US Census Bureau, *Statistical Abstract of the United States, 2010* tables 449, 484 (GPO 130th ed 2010). Modification of graph presented in Morris P. Fiorina, et al, *The New American Democracy* 397 figure 14.1 (Longman 7th ed 2011).

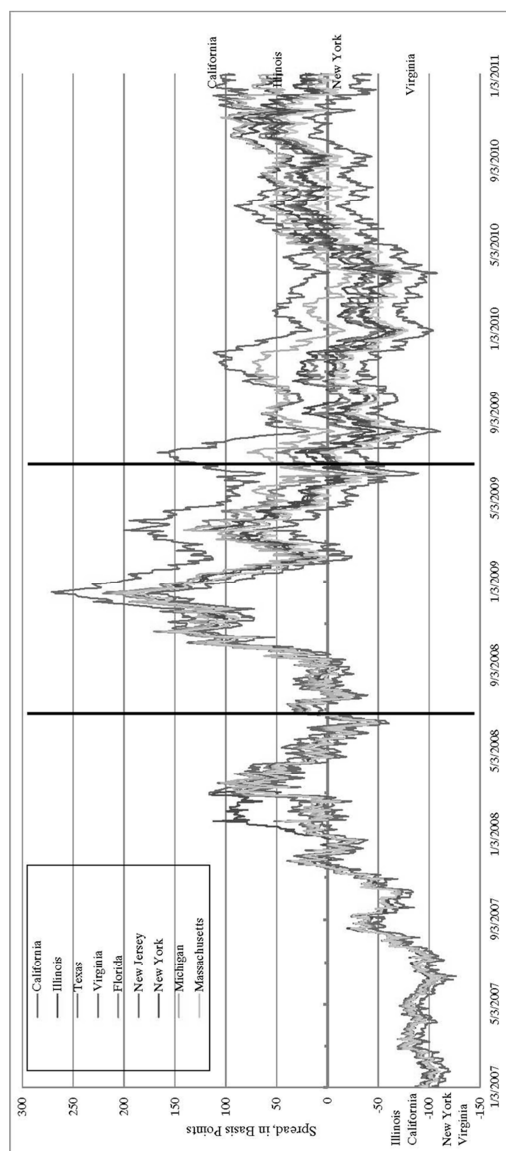
FIGURE 3. AVERAGE YIELD SPREAD BETWEEN US AND GERMAN STATE AND FEDERAL BONDS, JUNE–DECEMBER 2008



Note: Five-year notes or equivalent maturity classes. In the eighteen months following the global credit seizure in 2008, the peak divergence between two German states (North Rhine Westphalia and Hamburg) was 120 basis points. During this same period, the peak divergence between two US states (California and Virginia) was almost 200 basis points.

Source: Reconstructed from Bloomberg and Thomson-Reuters data, June–December 2008.

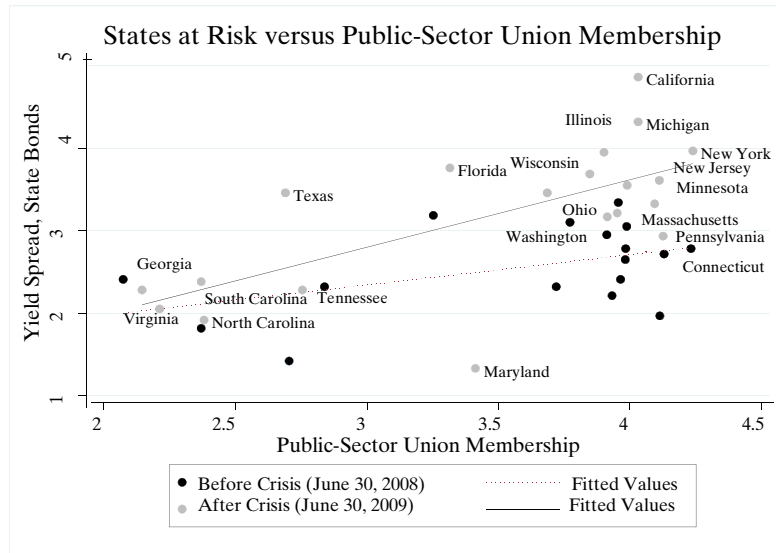
FIGURE 4. YIELD SPREAD OF FIVE-YEAR BONDS OF
SELECTED US STATES VERSUS FIVE-YEAR US TREASURY BONDS,
OCTOBER 2006–DECEMBER 2010



* Solid vertical lines designate the date of pre-crisis and post-crisis measurement (June 30, 2008, and June 30, 2009, respectively) in the Harvard study. The graph was reconstructed using Bloomberg data.

Source: Nadler and Hong, *Political and Institutional Determinants* at *22 (cited in note 75).

FIGURE 5. SIMPLE RELATIONSHIP BETWEEN UNION SHARE OF PUBLIC-SECTOR WORKFORCE AND STATE BOND YIELD SPREAD, JUNE 2008 AND JUNE 2009



* Variables are log transformed to make units of analysis visually comparable.

** June 2008 spread data are all shifted upward by thirty basis points to make it visually comparable with June 2009 data.

Source: Nadler and Hong, *Political and Institutional Determinants* at *23 (cited in note 75).