How the Federal Reserve Should Help States and Localities Right Now

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How the Federal Reserve Should Help States and Localities Right Now

by Darien Shanske and David Gamage

The COVID-19 pandemic is a giant catastrophe, but the Federal Reserve can still mitigate the looming fiscal crises facing state and local governments. This article — a contribution to Project SAFE (State Action in Fiscal Emergencies) — builds on our prior background essay explaining state and local budget issues.¹

In this installment of Academic Perspectives on SALT, the authors show how the Federal Reserve could support state and local governments during the COVID-19 emergency to prevent drastic spending cuts.

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In the American system of federalism, states and localities are at the forefront of providing basic government services, but without the monetary or financial powers of the central government. This has worked well enough in ordinary times, and in most national emergencies the federal government has taken the lead. But states and localities are in the lead in this national emergency, and they need the federal government’s financial support. The reason is simple: States are governed by balanced budget rules, but the federal government is not.² There are good reasons for this difference, but it means that the federal government must step up in times of crisis.

And the federal government has started to act. For instance, $150 billion in section 601 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act has been allocated to states and localities for “necessary expenditures” in connection with COVID-19. And section 4003(b) of the CARES Act provides up to $434 billion in loans to states, local governments, and private businesses. The Fed has used $35 billion of this $434 billion as an equity contribution to launch a $500 billion lending program for the states and larger localities.³ This number is appropriate, as the National Governors Association has estimated that states will need $500 billion.⁴

Yet those steps are insufficient. Even if $150 billion is the exact amount as to how much states and localities will pay in necessary COVID-19 expenditures, that will not cover the precipitous budget shortfalls caused by shutting down large

¹Gladriel Shobe et al., “Introducing Project SAFE (State Action in Fiscal Emergencies),” Tax Notes State, Apr. 27, 2020, p. 471.


parts of the economy, which is estimated to result in a shortfall of $500 billion or even more.\(^5\)

The Fed has offered to purchase $500 billion in notes, but they have a three-year limit.\(^6\) What happens then? Also, the current program expires on December 31, 2020.\(^7\) What happens when states and localities realize that their deficits will continue to grow?

There are even more problems to consider. How does the Fed’s short-term lending program help an airport bond issue that falls behind on its payments or a mass transit agency wishing to issue new bonds for a desperately needed project (that would also create jobs)?

We will address how the Federal Reserve can assist the municipal bond market in a future essay. But here, we will focus on the more immediate need of helping state and local governments avoid being forced to make drastic spending cuts.

The best answer is for Congress to provide much greater support for the states and localities in general. There are many ways this could happen, including direct grants\(^8\) or increased federal support for unemployment insurance.\(^9\) Unfortunately, Congress seems unlikely to act either quickly or sufficiently. But that isn’t necessarily the end of the story. Another actor, the Federal Reserve, can and should step in to save the day.

I. What the Federal Reserve Can Do

As noted, the Federal Reserve will lend $500 billion to states and localities in the form of short-term (up to three-year) notes. But the problem here is that three years is just too short of a time frame; the states will need to be able to pay back these loans over a much longer term if they are to meaningfully help in preventing dramatic, harmful budget cuts. Therefore, the core of our proposal is that the loans (or notes purchased) be extended for a longer term and at a reasonably low rate — say a 20-year term at the federal government’s cost of funds, which was 1.02 percent on April 29.\(^10\)

Note that prominent economists\(^11\) such as Ben Bernanke\(^12\) have endorsed using monetary policy to shore up demand under extreme circumstances. In the case we are making, the Federal Reserve would not be creating new demand in the economy so much as preventing its needless destruction.

II. Does It Have the Legal Authority to Make Those Loans?

We should acknowledge that our expertise is in tax law and public finance, not banking law or the powers of the Federal Reserve. Nevertheless, with that caveat, our understanding is that the Federal Reserve does have the power to make those loans, but with two complications.

First, to offer the current short-term lending facility, the Federal Reserve acted under the authority of section 13(3) of the Federal Reserve Act.\(^13\) There is nothing in section 13 that dictates that the loans must be short term. However, section 13 was revised by the Dodd-Frank Wall Street Reform and Consumer Protection Act to require more transparency and accountability. Of particular importance, the Federal Reserve “may not establish any program or facility under this paragraph without the prior approval of the

\(^{5}\) Michael Leachman, “New CBO Projections Suggest Even Bigger State Shortfalls,” Center on Budget and Policy Priorities, Apr. 29, 2020. (Noting prior estimates “that states would face $50 billion in state shortfalls in fiscal years 2020 through 2022,” and then revised estimates of “shortfalls totaling $650 billion, substantially deeper than during the Great Recession,” and emphasizing that these revised estimates are “for state budget shortfalls only; it does not reflect the additional shortfalls that local governments, territories, and tribes face. Federal aid provided to date will help cover some of these shortfalls but it is not nearly enough. Only about $65 billion of the aid provided in earlier COVID-19 packages is readily available to narrow these shortfalls. Using that aid and the $75 billion that states have in rainy day funds would leave states with about $510 billion in unaddressed shortfalls.”)

\(^{6}\) The Fed increased the limit from two years to three, which we take to be a hopeful sign. U.S. Federal Reserve Board, “Federal Reserve Board Announces an Expansion of the Scope and Duration of the Municipal Liquidity Facility,” Apr. 27, 2020.

\(^{7}\) Id.


\(^{9}\) Brian Galle et al., “States Should Quickly Reform Unemployment Insurance,” Tax Notes State, May 4, 2020, p. 635.

\(^{10}\) U.S. Treasury Department, “Daily Treasury Yield Curve Rates.”


\(^{13}\) Codified at 12 U.S.C. section 343(3); “Municipal Liquidity Facility,” supra note 3.
Secretary of the Treasury.” Accordingly, the current short-term program was approved by the secretary of the Treasury.14

Thus, for the reasons outlined earlier, the Treasury secretary may promptly approve a longer-term lending program. But what if he fails to do so? Could the Federal Reserve still act on its own?

We believe the Federal Reserve could use its powers under section 14 of the Federal Reserve Act even without the express approval of the Treasury secretary15 — because the Federal Reserve’s power under section 14 does not require approval from the secretary. There is, however, a significant limitation: Under section 14, the notes cannot have longer than a six-month maturity.

But how much of a limitation is this really? Could the Federal Reserve just commit to permitting states the option to roll over their debts during the crisis and for a fixed, but significant period thereafter (again, say 20 years)? Once the crisis was over, states could only roll over a decreasing amount of principal each period. The steadily declining amount of the reduction could function as a kind of amortization schedule.

The Federal Reserve could even have upfront rules as to the amount of debt it would be willing to purchase from a state or locality based on the size of the projected deficits compared with a recent historical baseline. That seems a reasonable safeguard, as a matter of both politics and fiscal federalism. After all, this program should not be about bailing out underfunded pension programs.17

Federal tax law already has a model for what this calculation might look like.18 That is because states and localities regularly borrow for cash flow purposes, but if they were to borrow too much, this would turn their borrowing into an arbitrage bond or would require rebate of the arbitrage. Accordingly, federal tax law delves into the definition of a cumulative cash flow deficit. These rules won’t necessarily translate perfectly to the context we discuss here, but they should at least provide a neutral baseline with which to begin.

III. Can the States Take the Money?

As noted, states face balanced budget constraints and may not be able to borrow from the Federal Reserve — at least not without a vote. In some states, voters can be asked to approve borrowing.19 But there are also well-worn exceptions to the debt limitation rules, which mean that states and localities could borrow from a Federal Reserve lending program even without a vote. One notable and widespread exception from the requirement for an election is for short-term borrowing,20 so extending the states’ renewable short-term financing could work well for both the Federal Reserve and states.

Other exceptions might apply, such as the special fund exception,21 whereby the state must commit some special stream of revenue to pay off a debt rather than general taxes. Perhaps states and localities could pledge to use some part of revenue streams that are now very depressed, such as from hotel taxes, in order to secure needed loans now. Or, as we plan to elaborate in a future essay, states may wish to adopt a new, future revenue source (such as a wealth tax or mark-to-market reform) to pay off current borrowing.

In sum, the Federal Reserve appears to have the legal authority needed to act to help states and localities, and the states and localities appear to have the authority to accept that help. The mechanics are somewhat convoluted, and making it all work will require planning. Thus, as cuts start being made across the country, the Federal Reserve must swiftly begin this process.


See, e.g., Riley v. Johnson, 219 Cal. 513 (1933); Riley v. Johnson (Riley v. Johnson II), 6 Cal. 2d 529 (1936).

See, e.g., California Housing Finance Agency v. Elliott, 17 Cal. 3d 575 (1976); California Educational Facilities Authority v. Priest, 12 Cal. 3d 593 (1974).

IV. Whither Federalism?

Would our proposal be proper on federalism grounds? Some have expressed concerns that the federal government should not bail out “profligate” states.\(^{22}\) However, we don’t think those concerns are well placed, for at least two reasons. First, these are meant to be emergency measures. It is clearly possible to design aid to state and local governments that helps them through the current crisis without bailing out past mistakes.

Second, and more fundamentally, the system of American federalism is far from operating as it should. It is entirely consistent with the theory of federalism that the federal government should step in and use its superior financial firepower during national economic downturns. It has always been a theoretical weakness of our system of federalism that states, which have balanced budget constraints, are also tasked with partially financing enormous procyclical expenses for Medicaid and unemployment insurance. The problems with this arrangement were clear enough during the Great Recession, but they are even more apparent now.

V. Conclusion

It is not too late for the Federal Reserve to act to head off debilitating state and local budget cuts. It acted boldly to rescue systemically important entities during the Great Recession. State and local government spending programs are at least as important during this pandemic, and the Federal Reserve should step in to save them.