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"Too Big to Fail" States Is Our Constitutional Order Broken - Structural and Doctrinal Questions in Constitutional Law: Equal Protection Protection Doctrine and Structural Federalism

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Essay

"Too Big To Fail" States

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This Essay explores the constitutional implications of a threatened default by a large state. Much like the huge financial institutions that became distressed in 2008, a large state might well be deemed too big to fail. If that kind of state seeks a federal bailout, it would hold most of the cards in any negotiation because Congress lacks the power to compel a state to pay its debts. After outlining this hold-up issue, the Essay concludes by assessing some possible responses by Congress, such as invoking the Guarantee Clause or imposing future fiscal penalties under the Spending Clause.

ESSAY CONTENTS

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I. INTRODUCTION

In 2008, the financial system was brought to the brink of collapse by the debts of institutions that were deemed "too big to fail."[1] While many of these firms were reckless and deserved to go under, their bankruptcies would have triggered a cascade of defaults with dreadful consequences. The Treasury and the Federal Reserve negotiated to save these troubled lenders on an ad hoc basis because no clear rules were in place on how to address the problem.[2] In 2010, Congress responded by creating a framework for the regulation and the orderly liquidation of private institutions that are seen as too big to fail.[3]

Unfortunately, there was a significant omission from this reform that could precipitate a future economic and constitutional meltdown—state governments.[4] Some of our largest states, most notably California, face crushing debt burdens due to the severity of the Great Recession and their own poor governance.[5] If one of these states were to default on its bonds, then the contagion effect on other states, investment banks, and pension funds could be similar to what resulted from the disappearance of Lehman Brothers three years ago.[6] Worse still, an irresponsible state is in a

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[1] *See generally* ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES (2009) (providing an in depth account of the financial panic).

[2] *See, e.g.*, Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 465, 468 (2009) (noting that the bailout package—or lack thereof—given to each firm during the panic was different and hammered out under duress).

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

[4] For an essay that advocates amending the federal bankruptcy code to include states, see David Skeel, *Give States a Way To Go Bankrupt*, WKLY. STANDARD, Nov. 29, 2010, at 22. I am sympathetic to this proposal, but I doubt that Congress will do anything about this until there is another crisis.

[5] *See* Michael Cooper & Mary Williams Walsh, *Mounting Debts by States Stoke Fears of Crisis*, N.Y. TIMES, Dec. 5, 2010, at A1 ("Not just small towns or dying Rust Belt cities, but also large states like Illinois and California are increasingly at risk."). This Essay will not go into detail about the state constitutional flaws that are contributing to these deficits. It is worth noting that California voters recently approved Proposition 25, which allows a majority in each legislative chamber to enact the budget instead of the two-thirds that was required previously. Wyatt Buchanan & Justin Berton, *Prop. 25, Fiscal Initiative, Passes*, S.F. CHRON., Nov. 3, 2010, at A17.

[6] *See* Cooper & Walsh, *supra* note 5 ("Analysts fear that at some point—no one knows when—investors could balk at lending to the weakest states, setting off a crisis that could spread to the stronger ones . . . ."). A similar concern is driving the rescue packages being given to precarious economies in

powerful bargaining position to secure a generous federal bailout package because that state would know that Congress could not afford to allow a default and could not simply mandate state debt repayment.[7]

This Essay examines the constitutional implications of a game of chicken involving a spendthrift state, and concludes that Congress should be given some latitude under the Spending Clause to make a distressed state accept a line of credit.[8] While the Tenth Amendment protects a state's "right to default" in the sense that Congress cannot order a state to raise taxes or cut spending, that principle should not be carried to the point where a state can hold the country hostage to get a better loan.[9] Instead, courts should defer to a congressional act depriving a renegade state of other federal funds if it will not accept a rescue package. This reading of the Spending Clause preserves state sovereignty but gives federal officials the leverage they need to deal with too-big-to-fail states.[10]

II. A REVERSE UNFUNDED MANDATE

The best way to understand a prospective default by a large state is that it acts as a reverse unfunded mandate. In a standard unfunded mandate, Congress imposes an obligation on state or local governments and makes them find the money for those initiatives.[11] When a state with crippling debts comes looking for a federal bailout, it is essentially trying to foist its promises onto the rest of the nation, backed by the threat that the failure to provide assistance will cause an economic catastrophe.

The first predicate for the problem of too-big-to-fail states is that a state must be able to make a credible claim that its bankruptcy would pose a systemic risk to the financial system. Rhode Island or Hawaii cannot do this. Consequently, they will be unable to externalize the costs of their borrowing. A small state will default and pay a much higher interest rate on its future bonds, or it will be forced to take a federal bailout with

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the European Union, such as Greece and Ireland. *See id.* (noting that this type of "turmoil in Europe has spread from country to country").

[7] There is also a moral hazard problem here, as states or private institutions that think they will be saved no matter what are more likely to be irresponsible. This Essay does not address the point, except to say that Congress needs some credible way to discipline too-big-to-fail states.

[8] U.S. CONST. art. I, § 8, cl. 1; *see also* South Dakota v. Dole, 483 U.S. 203, 207–08 (1987) (setting forth the test for the exercise of Spending Clause authority).

[9] *See, e.g.*, New York v. United States, 505 U.S. 144, 145 (1992) (holding that Congress may not commandeer a state legislature). Arkansas did default on its bonds during the Great Depression, but the state did not get a federal bailout and there was no financial crisis as a result. Mary Williams Walsh, *Cities in Debt Turn to States, Adding Strain*, N.Y. TIMES, Oct. 5, 2010, at B1.

[10] Given the ambiguity of the law in this area, Congress could certainly make a plausible threat to penalize states that play hardball. If this Essay makes that threat more credible, then I will be satisfied.

[11] *See, e.g.*, Julie A. Roin, *Reconceptualizing Unfunded Mandates and Other Regulations*, 93 NW. U. L. REV. 351, 352–54 (1999) (describing the concept of unfunded mandates).

significant strings attached.[12] States such as California or Illinois do not face this choice. They can try to haggle for an unconditional loan.

The second condition that gives some states the power to hold up the federal government is that it would be unconstitutional to order them to pay their debts.[13] Under the Supreme Court's anti-commandeering decisions, the Constitution does not "confer upon Congress the ability to require the States to govern according to Congress' instructions."[14] It is hard to think of a clearer example of federal commandeering than a federal statute ordering an unwilling state to keep paying its bonds, as that would require direct control of that state's internal budget decisions.[15] Consequently, large states can resist a stringent federal bailout because they cannot be forced to the negotiating table.

While we can hope that states will not engage in brinkmanship when financial conditions are fragile, there are good reasons to think that one eventually will. First, one party may control the state seeking aid and the other party may hold the purse strings in Washington, which would tend to increase the chance of a standoff. Second, state politicians will probably face harsh retribution from their voters if they make concessions that include legal changes, higher taxes, or spending limits dictated by federal authorities. Third, any injury to that state's credit rating would be insignificant if easy federal credit was extended, as that would convince future bondholders that lending risks are minimal. Nevertheless, the nation would be harmed (and probably angry) if states were able to get away with this opportunistic behavior. The question is what Congress can do to prevent that kind of abuse.

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[12] The Spending Clause gives Congress broad discretion to attach conditions to the receipt of federal funds. *See Dole*, 483 U.S. at 207–08 (providing the following limits on the Spending Power: (1) the exercise must be in pursuit of the general welfare; (2) Congress's intent must be unambiguous so as to allow states to exercise their choice knowingly; (3) the federal grants must be related to federal interest in the project or program; and (4) there must not be an independent constitutional bar to the grant of federal funds).

[13] There is the possibility that state bondholders might bring a successful federal takings claim in the event of a default, but that would take many years to resolve and hence would not avert a financial panic.

[14] *New York*, 505 U.S. at 162; *see also* Fed. Energy Regulatory Comm'n v. Mississippi, 456 U.S. 742, 761–62 (1982) ("[T]his Court never has sanctioned explicitly a federal command to the States to promulgate and enforce laws . . . ."); Hodel v. Va. Surface Mining & Reclamation Ass'n, 452 U.S. 264, 288 (1981) (stating that Congress may not take over "the legislative processes of the States by directly compelling them to enact and enforce a federal regulatory program").

[15] The First Congress did assume pre-existing state debts, but as far as I can tell, no state government objected to that scheme. *See* RON CHERNOW, ALEXANDER HAMILTON 298–300 (2004) (describing the Treasury Secretary's debt assumption plan enacted in 1790).

III. A BAILOUT THEY CAN'T REFUSE

The search for sticks to bring recalcitrant states into line centers on two constitutional provisions: the Guarantee Clause and the Spending Clause.[16] While Congress can claim that a state facing default lacks a republican form of government and thus should be put into federal receivership, that action would be unprecedented and disproportionate.[17] A more modest (and practical) solution is for Congress to declare that a large state asking for a bailout would face drastic cuts in federal outlays if it refuses to accept the terms of an emergency bridge loan.[18] Such a fiscal penalty would, in my view, be constitutional under the Spending Clause in dire conditions.

The Guarantee Clause is the only textual authority that Congress can wield to eliminate state autonomy, but using that power in a debt crisis would be unsound. Bad government is not unrepublican unless it is akin to anarchy. A state default does not deprive its citizens of fundamental liberties or democracy. Indeed, a choice to suspend debt payments would probably be consistent with majority opinion in that state. Furthermore, declaring that a state is no longer entitled to govern itself is a dramatic measure that will not increase confidence in a period of economic stress. While the threat of using the Guarantee Clause is a tool that Congress can use to stake out its negotiating posture on a bailout, savvy state leaders will know that this is not a realistic option.

Spending reductions for a stubborn state, however, are more tangible and politically feasible. If Congress were to slash education, highway, or Medicaid funds for a state, then local officials could not externalize their borrowing costs. More important, these cuts cannot be dismissed as a bluff because they can be made binding over the long term. In other words, even if Congress felt the need to extend lavish credit to a reckless state to avert a panic, tight spending caps could be imposed afterwards for as long as Congress deems necessary to send the message that there is no free federal lunch. This situation should give pause to any state official seeking

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[16] *See* U.S. CONST. art. IV, § 4 ("The United States shall guarantee to every State in this Union a Republican Form of Government . . . ."); *id.* art. I, § 8, cl. 1 ("The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States . . . ."); Gerard N. Magliocca, *Huey P. Long and the Guarantee Clause*, 83 TUL. L. REV. 1, 26–36 (2008) (exploring the last serious effort to invoke the Guarantee Clause).

[17] Under current doctrine, a decision by Congress to exercise its Guarantee Clause authority is a political question and hence not reviewable by courts. *See* Pac. States Tel. & Tel. Co. v. Oregon, 223 U.S. 118, 143–50 (1912) (discussing the Court's previous decisions in which it stressed the "inherent political character" of a decision by Congress to exercise Guarantee Clause authority).

Granted, one could analogize a state in default to a bankrupt company or municipality that is put under the supervision of a trustee. But appointing a czar to oversee Pennsylvania, for example, while it gets its fiscal house in order would be fraught with political and constitutional problems. I thank Steven Bainbridge for drawing this point to my attention.

[18] The Treasury could not unilaterally withhold appropriated funds or assert that none would be appropriated in subsequent years.

to ransom the federal treasury, but it would also honor that state's constitutional right to default by leaving the ultimate choice in its hands.

The only remaining issue is whether this kind of fiscal reprisal is valid under the Spending Clause. Attaching strings to the receipt of federal funds is one thing, but providing that a state will forfeit other money if it does not accept a federal gift is another. Nevertheless, courts should defer to a congressional decision in this respect. The Supreme Court has stated that there is a germaneness or relatedness limit to the imposition of spending conditions by Congress but has refused to define that boundary.[19] In my hypothetical, there would be a link between the bailout and the spending cuts, as the latter is the enforcement mechanism for the former. This connection might well be insufficient for ordinary legislation, but as a solution to the extreme case of a too-big-to-fail problem, such a relationship should be adequate. If not, then the Guarantee Clause presents the only means for Congress to rein in bloated states, and forcing Congress to exercise its Guarantee Clause authority would do far more harm to our constitutional structure.

IV. CONCLUSION

The best time to start planning for a crisis is not after it starts. States in our federal system that face dramatic budget deficits cannot obtain a bailout from the International Monetary Fund—they must go to Congress. Thinking through how that kind of rescue request might play out should be a top priority in the coming years if we want to avoid a broken constitutional order.

[19] South Dakota v. Dole, 483 U.S. 203, 208–09 n.3 (1987).