

THE GLOBAL FINANCIAL CRISIS: CONTINUITY IN U.S. FEDERALISM

John Kincaid

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The Global Financial Crisis: Continuity in U.S. Federalism

John Kincaid

Robert B. & Helen S. Meyner Professor of Government and Public Service. Director of the Meyner Center for the Study of State and Local Government, Lafayette College.

The U.S. recession, now sometimes called the Great Recession, began in December 2007. It was precipitated by a financial crisis that reared its head in September 2007. Officially, the recession ended in June 2009, and a noticeable recovery did become evident in summer 2009. GDP growth reached 5% in the fourth quarter of 2009 but then declined to 2.0% by the third quarter of 2010, with unemployment being 9.6% in October. “Overall, the total value of loans in the American banking system fell from \$7.996 trillion to \$7.395 trillion” summer 2008 to mid-2010, “a drop of \$600 billion.” This decline might be due to banks’ unwillingness to lend to marginal borrowers, increases in corporate cash holdings that reduce loan needs, and higher capital requirements mandated by regulators. Because of the latter, especially, banks were sitting on money rather than lending it (Bove 2010), and corporations were sitting on cash rather than investing it. The recovery was stalling in 2010. *The Wall Street Journal’s* forecasting survey found economists pessimistic. Most did not expect unemployment to fall below 9% until after June 2011. Even so, 30 of 48 economists said the U.S. economy did not need more fiscal and monetary stimuli (Izzo 2010).

Polarization Around Key Policy Issues

The United States was the epicenter of the global financial crisis. The federal government was the epicenter of responsibility for the crisis, and the federal government is the epicenter of the U.S. governmental responses to the crisis. This is about all the agreement one can find in the United States about this crisis. Virtually everything else is a matter of dispute.

There is no disagreement that the federal government is the epicenter of responsibility for the crisis. No one blames the states or local governments, but there is deep disagreement over the nature of federal responsibility for the crisis.

Generally, Democrats and liberals attribute the key cause of the crisis to federal regulatory failures. Federal deregulation of banks and other financial institutions since the early 1980s created a lax climate of casino capitalism characterized by excessive risk-taking rooted in exotic investment products not fully understood even by the so-called Wall Street experts. Financial regulators failed to prevent this large build up of risk. Furthermore, major bank consolidations over the last 50 years, for example, gave rise to four banks that controlled two-thirds of all mortgages and credit cards in the United States. When the crisis emerged, most such institutions were deemed too big to fail; consequently, the federal government felt compelled to bail out such institutions, which are now euphemistically called 'systemically important financial institutions' (SIFIs).

Generally, Republicans and conservatives attribute the key cause of the crisis to federal housing policies that fostered the emergence of a subprime mortgage market that permitted people to purchase homes at inflated prices that were beyond their financial means. These high-risk mortgages were re-packaged and sold in various forms to investors around the world and also used as collateral for exotic investments. When this scheme collapsed in the fall of 2007, 27 million high-risk mortgages had originated in the United States, thus triggering a broader financial meltdown that produced the recession that began in December 2007. The prime culprits in the crisis were the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). These are corporate enterprises set up and sponsored by the federal government 40 years ago. They are private companies, but they have government support in the event they get into financial trouble. Basically, they were authorized to borrow at low rates, invest at higher rates, and hold little capital. Fannie and Freddie, along with the Federal Housing Administration, guaranteed more than 95% of all new mortgages. The financial collapse exposed the huge risks taken by these institutions, and they almost collapsed. They were placed under federal conservatorship in September 2008. So far, they have cost taxpayers about \$150 billion in bailout money, with this cost expected to become much larger.

Similarly, although there is agreement that the federal government must be the epicenter of responses to the crisis, there are deep disagreements over the proper responses.

Generally, Democrats and liberals support Keynesian policies of vastly increased government spending as the best way to restart the economy. Given that Democrats controlled both the White House and the Congress during 2009-2010, economic stimulus spending was the predominant federal response to the crisis. Congress also enacted a sweeping financial-regulation law in 2010. However, Fannie Mae and Freddie Mac are exempted from this new law, mainly because these institutions benefit low-income home buyers, an important constituency for the Democrats. Nevertheless, President Barack Obama has acknowledged the need to reform Fannie Mae and Freddie Mac and has pledged to push Congress to do so.

Generally, Republicans and conservatives advocate so-called supply-side policies, principally tax cuts, to re-stimulate the economy, along with government spending cuts to reduce deficits. Given that Republicans were the minority party in 2008-2010, they did not achieve these objectives. A major tax battle is now underway because tax cuts enacted under President George Bush in 2001 will expire at the end of December 2010, at which time the federal personal-income tax, estate tax, and several other taxes will revert to their much higher 2001 levels. Most Republicans want to make Bush's tax cuts permanent. President Obama has proposed a temporary extension of the Bush tax-cuts, but only for people earning less than \$250,000 a year. Congressional Democrats are divided on this issue. Generally, Republicans also believe that the new financial-regulation law is deeply flawed in many ways and that the new law should have abolished Fannie Mae and Freddie Mac, along with many other direct and indirect government subsidies. Despite the fact that the Bush administration supported bailouts of systematically significant financial institutions in 2008, many Republicans oppose such bailouts.

Another important factor in these policy debates was the rise of the Tea Party movement in 2010, which opposed the bailouts of financial institutions and other corporations, government stimulus spending, tax and spending increases, and congressional earmarks (funds specified in law by individual members of Congress for specific 'pork-barrel' purposes). The Tea Party movement had a surprisingly strong impact on the November 2010 elections in which Republicans captured the U.S. House of Representatives and increased their membership in the U.S. Senate.

These policy disagreements reflect the polarization of political elites in the United States today. Measures of party polarization in Congress for the past 130 years show polarization now at its highest level ever. Party polarization began to

skyrocket during the 1970s (Polarized America 2010). Related indicators include the increase of ideological homogeneity within each party, decline of split-ticket voting by citizens, and dramatic increase of Senate filibustering (Koger 2010). In the 1960s, only 8 per cent of bills faced a filibuster; today, about 70 per cent do so (Zuckerman 2010). Polarization is not unique in U.S. history, but contemporary polarization is unique in being multidimensional. It involves “*not just the newer ‘cultural’ issues such as abortion and gay rights, but also the racial and civil rights issues that emerged in the 1960s and the economic and social welfare issues that originated with the New Deal*” (Layman et al. 2010: 324).

Missing from all this policy combat, however, is federalism. Federalism and intergovernmental relations are, at best, footnotes in these policy debates. This is consistent with the rise of coercive federalism since the late 1960s (Kincaid 1993, 2008), which has rendered federalism and intergovernmental relations irrelevant to most policy debates. The policy objectives of both Democrats and Republicans in Washington, D.C., always trump federalism principles. Consequently, even though the financial crisis has had a tremendous fiscal impact on all of the governments in the federal system, it has produced no reappraisals of federalism and no proposals for statutory or constitutional reform of federalism from federal, state, or local officials. Instead, the federal government’s policy responses have been largely embedded in and consistent with existing intergovernmental programs and structures, although there have been some interesting innovations and variations on old themes. In turn, governors, whether Republican or Democrat, have not been outspoken critics of the federal responses to the financial crisis, although Mitch Daniels, Republican governor of Indiana and possible presidential candidate, has publicly criticized President Obama’s ‘big-government’ policies (Daniels 2010).

There is ferment in federalism, although it is not directly related to the financial crisis. Twenty-one states have filed suit in federal courts challenging a major overhaul of the nation’s health-care system (i.e., the Patient Protection and Affordable Care Act, PPACA) that was enacted in March 2010. The states argue that the federal government had no constitutional authority to enact the law and that the law violates the Tenth Amendment to the federal Constitution. Many states also have been butting heads with the federal government over education policy, immigration policy, and other matters. Most publicized has been a conflict between the federal government and Arizona over Arizona’s 2010 immigration law. However, these matters are not directly related to the financial crisis except insofar as the attention given to these issues by President Obama and congressional Democrats alienated many voters, who believed that the president and Congress should have focused much more on rejuvenating the nation’s economy. Consequently, voters punished the Democrats in the November 2010 elections.

Selected Indicators of Crisis Impacts on the National, State, and Local Governments

The financial crisis has taken a terrible toll on the nation and on state and local governments. For example, unemployment, which exceeded 10% on several occasions, stood at about 9.6% near the end of 2010 and had been, at that time, above 9% for 18 consecutive months. The real unemployment rate, however, is about 18%. Among 18-24 year old, unemployment was about 19.1% in late 2010. When Congress enacted President Obama's stimulus program in February 2009, the White House predicted that the stimulus would prevent unemployment from exceeding 8 per cent. High unemployment is a key reason why Obama's popularity declined during 2010.

Only about 25% of Americans in 2010 expected their income to increase in 2011. The official poverty rate increased from 13.2% in 2008 to about 14.3% for 2009, the highest since 1994. Today, about 1 in 6 Americans receive some type of government aid. More than 50 million receive Medicaid, which is health insurance for the poor (up by 17% since December 2007), more than 40 million get food stamps (subsidies to purchase food), nearly 10 million receive unemployment benefits, and more than 4.4 million get other welfare support.

Overall, having faced budget shortfalls each year since 2007, states again expect to face about \$144 billion in shortfalls for fiscal year 2011. State tax revenue did increase by about 2.2% in the second quarter of 2010, but this is unlikely to be sustained in a stalled recovery. Also, for example, from September 2009 to September 2010, state and local government employment declined by 1.3% while federal employment grew by 3.4% (Cauchon 2010).

Many local governments are worse off, and quite a few are on the verge of bankruptcy. For example, on 31 August, Harrisburg, the capital city of Pennsylvania, said it would skip a \$3.29 million general-obligation bond payment due on 15 September in order to pay for city services. The announcement alarmed the \$2.8 trillion municipal bond market. The city has a \$4.3 million deficit and \$288 million in debt from an incinerator project. The governor of Pennsylvania, however, accelerated the delivery of enough state grant funds and loans to enable Harrisburg to make the bond payment (Varghese 2010). In 2005, Buena Vista, Virginia, with a population of 6,222, borrowed \$9.2 million to refinance a municipal golf course. It pledged its city hall and police station as collateral. Because of the global financial crisis, the city is defaulting on payments, and creditors might seize city hall and the police station.

The financial crisis also has severely damaged state and local pension funds. Using widely accepted government accounting standards, state and local government pensions are underfunded by \$1 trillion. Using corporate accounting standards, they are \$2.5 trillion short. Using a measure advocated by some econo-

mists, they are \$3.5 trillion short – an amount equivalent to one quarter of U.S. GDP (Kramer 2010). In addition, underfunding of retirement health-care costs is thought to be larger. These dire conditions could produce political pressure for a federal bailout, which some Democrats support but Republicans oppose.

In August 2010, the federal Securities and Exchange Commission (SEC) filed fraud charges against New Jersey to compel it to stop hiding the underfunding of its pension system by misrepresenting its financial obligations and misleading investors about its bonds. This was the first-ever such fraud charge against a state. The problem originated in 1996 when New Jersey borrowed \$2.8 billion and put it in its pension fund rather than use tax revenues to fund the pension system. Then in 2004, New Jersey borrowed \$2 billion to cover a budget deficit. The state projected annual investment returns of 8-12% that would more than pay off these loans. Of course, these schemes failed spectacularly, leaving the state's pension fund and operating budget in deep trouble (Malanga 2010).

Indeed, the crisis has driven a wedge between citizens and state-and-local-government employees. Governor Arnold Schwarzenegger of California accused his legislature of wanting a government of the employees, by the employees, and for the employees rather than a government of the people, by the people, and for the people (2010). Amity Shlaes (2010) wrote that the United States is divided between two types of workers: *“The first is the private-sector worker, the vulnerable one who rides the business cycle without shock absorbers. The second worker, who works for the government, lives a cushioned existence in which terminations take years, pension amounts are often guaranteed, and recessions are only thunder in the distance. Yet worse than this division is the knowledge that the private-sector worker will pay for public-sector comfort with ever higher taxes.”*

State and local governments have responded to the crisis by increasing taxes (by about \$24 billion in 2009) and fees; decreasing spending; selling or leasing assets such as highways, hospitals, parks, zoos, and parking meters; seeking corporate sponsors for public facilities such as parks (e.g., California has received nearly \$6 million in corporate sponsors, though its total park budget is \$300 million); borrowing money; and engaging in creative accounting.

Because state and local governments normally spend more than \$2 trillion a year and account for about 12% of U.S. GDP and 14% of U.S. employment, state and local tax increases and spending cuts can be a tremendous drag on the economy. Consequently, the federal government has undertaken a number of programs to counteract the recession, bolster state and local economies, and maintain state and local spending.

Federal-Government Responses to the Crisis Under George W. Bush

The first major federal response to the crisis was a \$168 billion program of federal spending and temporary tax rebates enacted in February 2008 under President Bush.

A second major response was the Housing and Economic Recovery Act (HERA) of July 2008, which addressed the subprime mortgage crisis. It authorized the Federal Housing Administration to guarantee up to \$300 billion in new 30-year fixed rate mortgages for subprime borrowers if commercial lenders write-down principal loan balances to 90 per cent of the current appraisal value of homes. HERA was intended to restore confidence in Fannie Mae and Freddie Mac by strengthening regulations and injecting capital into these institutions. States were authorized to refinance subprime loans using mortgage revenue bonds. HERA also established a Neighborhood Stabilization Fund (\$6 billion) that helps local governments purchase foreclosed properties. However, as of July 2010, more than \$1 billion of these funds remained unspent and might be rescinded by the federal government. Confusion over rules were part of the problem, but a bigger problem is that cities cannot move as fast as private companies to buy foreclosed homes. In September 2010, the U.S. Department of Housing and Urban Development (HUD) announced a First Look program, which gives cities a 48-hour head start to buy foreclosed properties at a 1% discount. However, banks will not likely offer many of their foreclosed properties to the program.

State housing finance agencies have long made affordable housing loans without the foreclosure problems associated with federally backed subprime loans. Recently, Fannie Mae has stepped in to help fund an Affordable Advantage initiative based on the state programs. So far, Idaho, Massachusetts, Minnesota, and Wisconsin have signed on.

The third big response was the Troubled Asset Relief Program (TARP) of October 2008. TARP was enacted to buy toxic mortgage derivatives, but being unable to price those derivatives, the U.S. Treasury invested TARP funds in banks and other financial and nonfinancial firms, thus acquiring equity in those firms that would allow these businesses to gradually write off those assets against profits earned from the Federal Reserve's zero interest rate. Over time, the federal government hopes to recover its funds and perhaps make a profit, too, by selling its equity shares. As of late 2010, the federal government had recovered most of its TARP funds, as well as interest income.

These programs, however, failed to stem the tide of recession and revulsion against Bush, thereby sweeping Obama into the White House. TARP was deeply resented by many Americans as a bailout of Wall Street fat cats that left the average American still mired in financial straits.

Federal-Government Responses to the Crisis Under Barack Obama

Obama's first major congressional action was reauthorization of the State Children's Health Insurance Program (SCHIP) at \$31.5 billion over four and a half years. The act increased program beneficiaries from about 11 million to 15 million and was renamed simply CHIP. The expansion is to be financed by a 61-cent federal-tax increase on each carton of 200 cigarettes.

American Recovery and Reinvestment Act

The president's biggest economic legislative accomplishment was a \$787.2 billion (now estimated at \$862 billion) 1,100-page American Recovery and Reinvestment Act (ARRA) stimulus enacted in February 2009, which provided about \$250 billion to state and local governments for specific functions, of which about \$130 billion was targeted for immediate fiscal relief, mostly for Medicaid and education.

Rather than establish a separate ARRA bureaucracy, the president's Office of Management and Budget (OMB) is coordinating with 15 federal implementing agencies overseeing 215 funding lines and 86 existing grant programs. Most ARRA funds, therefore, are being distributed through existing formulas for federal-aid programs, which usually require state and local matches. Although these established programs and formulas allowed for rapid disbursements of funds, the formulas did not always reflect current economic realities; consequently, states and localities hit hardest by the recession have not necessarily received the most stimulus money.

The leading criticism is that ARRA failed to create many jobs and to prevent unemployment from exceeding 8%, although the president contends that ARRA has saved or created three million jobs. ARRA also contains many provisions associated with coercive federalism that weakened its impact. For one, health, education, and welfare spending for individuals outpaced other stimulus spending in 2009 and 2010. This pattern is consistent with the shift of federal aid from places to persons under coercive federalism (Kincaid 2001). This spending preserved some jobs in health, education, and welfare and cushioned the recession's blows for many people, but it weakened ARRA's impact on private-sector unemployment. Indeed, by the summer of 2010, the word 'stimulus' had become a political epithet assiduously avoided by the president and congressional Democrats.

ARRA may also have been weakened by its boldness. The president and Congress sought to use ARRA to transform the country. That is, ARRA contains major initiatives to develop clean energy, address global warming, reform health care, improve education, and promote other economic transformations. For example, it made the U.S. Department of Energy a \$90 billion venture-capital

fund for clean energy, and it provided \$5 billion to weatherize homes, money to expand broadband access, funds to sequence more than 2,300 human genomes compared to only 34 sequenced with all earlier aid, \$8 billion for a high-speed rail network, \$4.35 billion for Race to the Top education grants to competitively eligible states, and \$20 billion to digitize health-care records. These initiatives may have long-term social payoffs but not short-term stimulus benefits.

Another problem is that as of August 2010, less than one-third of the \$230 billion ARRA funds allotted for infrastructure had been spent. Republicans, moreover, want to rescind that money and apply it to reducing the federal government's mounting debt. Such rescission may be difficult, however, because most of the funds were legally obligated by the end of 2010, even though being still unspent.

Disbursements of stimulus funds also were delayed by federal regulations and administrative hurdles associated with coercive federalism, such as (a) ARRA's Buy American rules, which preempted many state and local procurement rules, (b) maintenance-of-effort rules imposed on state and local spending in about 15 of the major programs, (c) rules forbidding reductions of Medicaid benefits below levels in effect on 1 July 2008, (d) expanded Davis-Bacon (prevailing wage) requirements, (e) historic-preservation standards, and (f) rules prohibiting federal money from substituting for state or local money. ARRA also includes general language about states and localities not spending money on 'imprudent' projects, and Obama warned that if state and local officials wasted stimulus money, he would chastise them. Thus, ARRA required states to take many large spending programs off the cutting table and to increase or maintain their spending despite plummeting tax revenues.

ARRA established unprecedented oversight and accountability mechanisms for state and local governments; OMB promulgated specific guidance rules establishing detailed procedural requirements and review procedures for ARRA funding; and Vice President Joe Biden and his special Recovery Cabinet act as the fiscal 'sheriff' policing state and local uses of ARRA funds. Indeed, in the first year, the vice president was said to have "*blocked some 260 skate parks, picnic tables and highway beautifications that flunked his what-would-your-mom-think test*" (Grunwald 2010).

Some governors and legislators balked at accepting funds that might commit their states to long-term spending increases. For example, ARRA provided up to \$7 billion to extend unemployment benefits to people who lose low-wage, part-time, and seasonal jobs. A few states (e.g., Alabama and Mississippi) declined to accept the funds because ARRA requires states to 'modernize' their unemployment laws to make more people eligible for benefits. Many governors objected to provisions requiring a \$25-per-week increase in benefits that states could be politically compelled to pay for after the expiration of stimulus funding.

A notable success, though, has been ARRA's taxable Build America Bonds (BABs) by which the federal government subsidizes the interest payments that local governments make to investors, increasing their yield by 35 per cent. Since the program was implemented in 2009, states have borrowed about \$160 billion through BABs. Critics, however, maintain that BABs merely encourage state and local governments to accumulate more debt (Malanga 2010).

Generally, ARRA's economic outcomes are consistent with analyses of previous federal efforts to assist states during recessions, which suggest that such programs are less than optimal because they are not usually well timed, adequately triggered, and effectively targeted (Mattoon 2009).

ARRA also generated a few constitutional controversies involving state-federal relations and the separation of powers when Governor Mark Sanford of South Carolina, a Republican, refused to accept \$700 million for education (Sanford 2009). Congress enacted an ARRA amendment introduced by Representative Jim Clyburn (Democrat-South Carolina) in response to Sanford's threat authorizing a state legislature to override its governor by adopting 'a concurrent resolution' to accept ARRA funds. This provision intrudes upon state constitutional budget procedures. Furthermore, while Congress enacts concurrent resolutions that do not require the president's signature, many states do not have 'concurrent resolutions,' and Nebraska's unicameral legislature, of course, has no 'concurrent' procedures.

The South Carolina legislature included the stimulus money in the state's budget and overrode the governor's budget veto. The legislature also approved a concurrent resolution accepting the money. Sanford filed suit in federal court arguing that ARRA authorized only governors to apply for the money. He contended that legislative usurpation of this power vested in the governor by ARRA violated the supremacy clause of the federal Constitution as well as the separation of powers mandated by the state's constitution. The Obama administration criticized the governor for refusing the funds but supported his lawsuit. In June, however, Sanford requested the federal funds after the state supreme court, in response to lawsuits filed by a student and school administrators, ordered the governor to comply with the legislature's budget law. That month, moreover, the governor was politically crippled when it was revealed that he had been engaged in an extramarital affair with a woman from Argentina.

ARRA also is problematic because the provision establishing the State Fiscal Stabilization Fund, which provided \$53.6 billion for education and other government functions, says, "*The governor shall use...*" This language contradicts state constitutional rules on spending money.

Some interstate disputes arose as well under ARRA when some states were accused of attempting to use stimulus money to lure businesses from other states.

Stimulus Policies for the Automobile Industry

President Obama also sought to rescue the once huge automobile manufacturer, General Motors, from bankruptcy. The rescue provided substantial benefits to the automobile workers' union (UAW), an important constituency for the Democratic Party. On 30 March 2009, the president proposed a restructuring plan for General Motors to recover financial health by revising its business plan, accelerating the restructuring of its operations, and cutting its outstanding liabilities more deeply. The U.S. Treasury and Export Development Canada loaned the company \$8.4 billion. The principal bailout mechanism, however, was the acquisition of a 60.8% stake in the company by the U.S. Treasury (at a cost of \$52 billion) and 11.7% stake by Export Development Canada. In April 2010, General Motors made a payment of \$4.7 billion to the U.S. Treasury and \$1.1 billion to Export Development Canada. The full \$8.4 billion loan must be paid off by 2015. In November 2010, General Motors launched an IPO of 478 million shares of stock at \$33 per share, which reduced the U.S. Treasury's stake in the company to less than one-third. The stock price was \$34.26 on the second day of trading (19 November 2010), but the U.S. Treasury's remaining equity in the company must be redeemed at about \$53 per share in order for the federal government to recover all of its bailout money. The IPO was criticized, however, for making it virtually impossible for small investors to buy the stock; instead, large institutional investors purchased most of the stock.

Another federal program, Cash for Clunkers, a short-term program that ended in August 2009, offered up to \$4,500 of federal money for people to trade-in an old automobile for a new, more fuel-efficient vehicle. Some 690,000 new vehicles were sold under the program, but it has been estimated that 565,000 of those vehicles would have been sold anyway without the subsidy. A total of \$3 billion was provided for the rebates, and the average rebate was \$4,000, thus costing the federal government about \$24,000 each for the 125,000 vehicle sales that would not have occurred without the subsidy. Because the old vehicle had to be destroyed, the program cut the supply of used cars, driving their prices up by about 10% by mid-2010.

Other Federal Fiscal Responses

The federal government also enacted two tax credits for home buyers, the last of which expired in April 2010. These programs increased home sales temporarily, but home sales declined significantly after April 2010. In addition, the federal government has launched several mortgage-assistance programs for homeowners at risk of foreclosure. The programs, however, have not been very successful.

Another federal response was to extend unemployment benefits. These benefits, which ordinarily last only 26 weeks and which involve both federal and

state funding, were extended to 99 weeks by the federal government. By late November 2010, congressional Democrats and President Obama wanted to extend benefits again, but congressional Republicans and some Democrats were blocking an extension by insisting that any benefit extension be offset by comparable spending reductions elsewhere in the federal budget.

In August 2010, Congress enacted the Education Jobs and Medicaid Assistance Act, a \$26.1 billion program to provide \$16.1 billion to extend for another six months the increased Medicaid assistance to the states that was provided in ARRA and \$10 billion to prevent layoffs of school teachers. Democrats said it would save jobs. Republicans said it would let states postpone painful decisions to balance their budgets (Urahn 2010). One cost of this program is that it eliminated a 13.6% increase in food-stamp benefits that was included in ARRA.

The Patient Protection and Affordable Care Act of 2010 includes a student loan-forgiveness program. If a person graduates from a college or university with student loans and then works at least 30 hours per week for a public service organization, and makes 120 monthly student loan payments while working at that job, then any unpaid loan balance will be forgiven by the federal government. The program, however, privileges public sector and nonprofit sector work supported by taxpayers and donors who receive tax exemptions. Students who secure private sector work or engage in entrepreneurship do not qualify for the program.

In September 2010, President Obama proposed to spend \$50 billion in the upcoming year on road, rails, and runways and to create an infrastructure bank that would pool federal and private dollars to make low-interest loans to local governments for transportation projects. European countries spend about 5% of GDP on infrastructure and China about 9%, while the U.S. spends about 2.5%. The president proposed also to expand and make permanent a research and experimentation tax credit for businesses, and also allow businesses to write off 100% of investment spending on plants and equipment in the first year rather than over 3-20 years. This tax break would be available through 2011. Many businesses, however, want major changes in the corporate tax code and also an extension of Bush's tax cuts.

Federal Reserve Board Actions

There have been other federal responses, including actions of the Federal Reserve Board (the U.S. central bank), which has cut interest rates to nearly zero and purchased some \$2 trillion in mortgage-backed securities and other assets. In November 2010, the Federal Reserve initiated a second round of quantitative easing (nicknamed QE2) by announcing that it would purchase \$600 billion of long-term U.S. treasury securities (i.e., government bonds) at a rate of \$75 billion per month through June 2011. The key purpose of QE2 is to push down

yields on U.S. securities so as to make loans cheaper throughout the economy in order to induce businesses to increase investments and consumers to increase purchases. A major concern is that the policy will generate unprecedented inflation. At the G20 summit in early November 2010, most of the member countries criticized the QE2, fearing that it will flood the world economy with cash while doing little to revive the U.S. economy.

Financial Regulatory Reform

Another major federal response to the crisis was enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that overhauled the nation's financial-regulation system. With respect to federalism, the principal issue in formulating this law was the extent to which the federal government would preempt (i.e., displace) state financial regulatory powers. The United States has had a dual (i.e., federal and state) banking system since the 1860s. This pattern was followed also in dual regulation of financial services, consumer protection, and telecommunications, among others. In addition, states have always been the primary regulators of the insurance industry. Although there were some significant attempts to preempt many areas of state regulation even though the financial crisis was not precipitated by state regulatory failures, the law generally protected extant state regulatory authority in areas of consumer protection and banking. It even reversed some Bush-era preemptions, especially broad Bush preemption policies.

The law allows states to enforce some federal consumer protection laws on national and state banks, and a new consumer protection agency – the Consumer Financial Protection Bureau housed in the Federal Reserve – can examine state banks only jointly with state bank supervisors. The law also often treats federal consumer law as a floor not a ceiling, thereby allowing states to establish consumer-protection laws that are stronger than the equivalent federal law. A majority of states together also can petition federal Consumer Financial Protection Bureau to issue new protection rules. The law also does not explicitly preempt exclusive state regulation of insurance, and state insurance regulators will still oversee equity-indexed annuities, which the law exempts from SEC regulation. The law did create a new Office on Insurance in the U.S. Department of the Treasury, but it will not regulate state-regulated insurance or securities products. “*The act did, however, establish federal authority to create new national standards governing how states regulate the reinsurance market and how states collect taxes for highly specialized and unique risks, known as ‘surplus lines’*” (Conlan and Posner 2010). Hedge funds and other investment advisors handling less than \$100 million will be regulated by the states, not the SEC. The previous threshold was \$25 million. “*The SEC estimates about 4,000 investment advisors will switch to the states*” (Scannell 2010).

Thus, this law did not accelerate, and may have slightly eased, the prevailing preemption trends of coercive federalism. A major reason for this lenient treatment of the states is that, in contrast to strong business pressures to preempt state powers because business would rather be regulated by one 500-pound gorilla in Washington, D.C., than by 50 monkeys on steroids, most Democrats wish to maintain state regulatory powers over many facets of consumer protection and the economy. Consequently, Democrats either oppose these kinds of preemptions or they support partial preemptions whereby the federal government establishes minimum regulatory standards and allows willing states to establish higher or more stringent regulatory standards. By contrast, Republicans more often support total federal preemptions of state laws affecting business, arguing that the national marketplace should not be fragmented by 50 state regulatory regimes.

In addition, the U.S. Federal Reserve Bank system, which consists of the national Federal Reserve Bank plus 12 independent, private regional banks, preserved its structure and most of its powers. The presidents of the 12 regional banks lobbied strongly to retain one of their major functions, which is to supervise small and medium-sized banks. As one former regional bank official put it, losing the authority to supervise these banks would be “*a huge shift in power away from*” the regional banks to Washington, D.C. (Sloan 2010: 1963).

The 2010 Midterm Federal and State Elections

Despite the efforts of President Obama and the Democratic majority in Congress to revive the economy and promote major social reforms such as the Patient Protection and Affordable Care Act of 2010 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, persisting levels of high unemployment, rising federal deficits, and fears that federal policies were creating unacceptably ‘big government’ led voters to punish the Democrats in the 2010 midterm elections. In this cycle, all 435 seats in the U.S. House of Representatives were subject to election. Republicans gained control of the House by winning 61 additional seats, giving them a total of 240 House seats (55%). One-third of the U.S. Senate’s seats were subject to election. In this chamber, Republicans captured six more seats, bringing to 47 the number of seats they hold in the 100-member Senate. Also, 37 states held elections for governor, and Republicans won seven more governorships, giving them gubernatorial control of 29 states. Republicans also won majority control in 19 more state legislative chambers. The new flood of Republicans into federal and state offices will take effect in January 2011.

Virtually all Republican candidates for these federal and state offices promised to cope with the economic crisis primarily by cutting both taxes and spending. Many Republicans in Congress also wish to repeal the Patient Protection and Affordable Care Act and substantially revise the Dodd-Frank Wall Street Reform

and Consumer Protection Act. With regard to the health-care law, they contend, among other things, that Congress lacked constitutional authority to enact the law and that the law tramples on federalism by violating the Tenth Amendment to the U.S. Constitution. With regard to financial reform, however, the Republicans are likely to endorse substantial preemptions of state powers.

Given that Obama remains in the White House and Democrats still control the Senate, it is not clear how much progress can be made on major economic issues during the next two years. Already, many prominent Republicans are positioning themselves to run for the presidency in 2012, and many disgruntled Democrats are looking for an alternative to Obama, including possibly Hillary Clinton.

Longer Term Prospects

The long-term prospects for the U.S. economy are neither bright nor dark, but somewhere in between. Unemployment is likely to remain high (by U.S. standards), and economic growth is likely to be slow for the foreseeable future.

Longer-term prospects for the fiscal future of the federal system, however, are gloomy. The U.S. Government Accountability Office (GAO) projects that *“absent policy changes, the federal government faces an unsustainable growth in debt”* (2010a, 1). The recession has aggravated the crisis, and government anti-recession programs have added about \$3 trillion to the federal government’s debt load. The GAO concludes that *“debt held by the public as a share of GDP could exceed the historical high reached in the aftermath of World War II by 2020 – ten years sooner than our simulation showed just 2 years ago”* (2010a, 1). Debt could grow to 85% of GDP by 2018 and exceed 100% by 2022 (Peterson-Pew Commission 2009). If Congress wishes to keep debt over the next 75 years from exceeding its 2010 level (53% of GDP), it will have to increase revenue by 50% or reduce non-interest spending by 34 per cent. Under current policies, the GAO expects that demographic changes (mainly a growing senior-citizen population), rising health-care costs, and deficit spending will require the federal government’s major entitlement (i.e., welfare) programs, plus net interest payments, to consume *“93 cents of every dollar of federal revenue”* by 2030 (2010a, 6).

The GAO also projects a steady fiscal decline for state and local governments through 2060, with revenue growth as a percentage of GDP likely remaining flat (2010b). If state and local governments wish to stem this decline, they will have to reduce spending by about 12.3% annually for the next 50 years or increase revenues by a comparable level. The primary driver of this fiscal decline is health-care costs – mostly Medicaid and health insurance for state and local government employees and retirees. In addition, state and local governments face

huge pension liabilities, as well as other social-welfare costs (e.g., CHIP, TANF, and unemployment).

The GAO further contends: “*Countercyclical federal assistance provided by the Recovery Act (ARRA) and other federal programs to address the current recession will not alleviate the long-term structural fiscal challenges facing state and local governments*” (GAO 2010b, 33). Consequently, state and local governments may not have the fiscal and administrative capacity to implement federal programs, even if the federal government provides substantial portions of the funding.

Conclusion

Although the global financial crisis has had an enormous impact on the fiscal condition of all governments in the U.S. federal system, it has not yet had a substantial impact on the balance of federal-state power, the constitutional or legal structure of federalism, or the long-term trajectory of federalism and intergovernmental relations. Combined with other developments, however, the financial crisis could, if it produces a decade of anemic economic performance, accelerate intrusive federal policy-making and erode the fiscal condition of state and local governments to a point of nearly total dependence on the federal government. Party control of the federal government will significantly shape the balance of federal-state power as well. Democrats will likely support continued subsidies for state and local governments along with restrained preemption in some policy fields. Republicans will likely support broader preemptions of state powers in many policy fields and oppose subsidies for state and local governments on the grounds that federal subsidies aggravate state and local governments’ addiction to unwise spending policies and that all governments in the federal system should be downsized or, as one advocate of smaller government put it, drowned in a bathtub.

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Abstract

This article describes briefly the impacts of the U.S.-originated global financial crisis on the national, state, and local governments in the United States and then examines the stimulative and regulatory responses to the crisis undertaken by the federal government under Presidents George W. Bush and Barack Obama, while highlighting the polarization between Democrats and Republicans over how best to re-

spond to the crisis. Government efforts to rejuvenate the national economy have not been very successful. Unemployment is likely to remain high and economic growth is likely to be slow for the foreseeable future; however, the prospects for the future of fiscal federalism are gloomy. Nevertheless, thus far, the United States has responded to the crisis through the traditional institutions and practices of its federal system, and the crisis has not produced any significant changes in the form or functions of American federalism.

Résumé

Cet article décrit brièvement l'impact de la crise financière globale, originaire des États-Unis, sur les niveaux de gouvernement américain national, fédéré et local. Il examine ensuite les réponses à la crise sous les présidences de George W. Bush et Barack Obama, visant à stimuler et réguler l'économie. L'article met en avant la polarisation entre Démocrates et Républicains sur la meilleure façon de répondre à la crise. Les efforts gouvernementaux pour rénover l'économie nationale n'ont pas été très fructueux. On estime que le chômage restera élevé et la croissance économique lente dans un avenir prévisible ; cependant que les perspectives d'avenir du fédéralisme financier sont sombres. Malgré tout, jusqu'à présent, les États-Unis ont réagi à la crise au travers de leurs institutions traditionnelles et des pratiques de leur système fédéral, et la crise n'a produit aucun changement significatif dans la forme ou les fonctions du fédéralisme américain.