A Fed Bailout Is Wrong for States and Cities.

The central bank should adjust its lending methods to prevent abuse by profligate local governments.

The Federal Reserve recently announced a huge expansion of well-designed lending facilities for companies and local governments. But its Municipal Liquidity Facility will purchase up to $500 billion in short-term notes from the largest cities and all states—even if they have been mismanaging their finances for years. To minimize the program's risk, the Fed should buy these short-term notes at discounts based on the issuer's financial condition and should resist the urge to buy long-term bonds from local governments.

To fund the MLF, the Fed will establish a special-purpose entity, backed by $35 billion from the Treasury, to buy notes with maturities of up to 24 months from any state or city with more than one million residents, or county with more than two million. That means the 10 largest cities and 15 largest counties in the U.S.

Yet the MLF lacks some of the protections against losses that are built into other Fed lending programs. Many of the emergency facilities require that assets being purchased hold an investment-grade rating, either currently or right before the pandemic hit. The MLF has no such requirement.

The Main Street Lending Facility will purchase loans made to midsize companies from participating banks, which must retain 5% of each loan. That gives the banks a powerful incentive to assess each borrower's ability to repay. By contrast, the MLF will purchase notes directly from governments, without due diligence by any private-sector lender.

Although these short-term notes are backed by state and local taxes, revenue will likely plunge over the next two years. The MLF's maximum amount of notes purchased is set at 20% of a government's revenues from the prior fiscal year. Yet that maximum doesn't account for the expenses the government incurred in the same period, including obligations to fund pension plans and employee health care.

Some cities and states have worked hard to manage these obligations, while others let them mushroom. Accounting under reasonable assumptions, in 2017 these obligations consumed less than 20% of revenues in New York City and San Antonio but more than 60% in Chicago and Dallas. There's a similar variety across states, where pension funding equaled 99% of liabilities in Wisconsin and 97% in South Dakota, but only 31% in Kentucky and New Jersey.

Fortunately, the Fed has indicated that it will base MLF prices on a government's credit rating at the time of purchase. Details haven't been announced, but ideally the Fed would offer much better prices for notes from governments with investment-grade rather than junk ratings. It should also amend its current plan by charging different origination fees depending on a government's credit.

In addition to these improvements, the Fed should avoid taking the program in a dangerous direction. In announcing the MLF, the Fed said it would monitor the market for longer-term municipal bonds, implicitly suggesting it might extend the facility to the larger market for bonds with maturities of 10 to 30 years. The central bank's independence would be undermined if it became a big purchaser of long-term bonds from financially weak but politically influential local governments. How would the Fed respond if a major city defaulted on its bonds?

States and cities will lobby hard for more federal assistance in the aftermath of the pandemic. If Congress decides to give such assistance, it should approve substantial appropriations for local governments in the next stimulus package rather than hidden subsidies through the Fed. Legislative appropriations would be in plain view of American voters, who could then hold cities and states accountable for how they use federal funds.

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By Robert C. Pozen

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Mr. Pozen is a senior lecturer at the MIT Sloan School of Management and a former chairman of MFS Investment Management.