The Case for Allowing U.S. States to Declare Bankruptcy.

States can't seek legal protection from their debts, but there's a move on to change that.

Puerto Rico is trapped in a financial crisis so deep that President Obama says the only way out for the territory is to make it eligible for a bankruptcy-like process to shed some of its debts. None of the 50 states is nearly as bad off as Puerto Rico. But some influential people are arguing that if a state does get into deep financial trouble, some kind of bankruptcy would be the best option—certainly better than a taxpayer bailout.

States, unlike cities and counties, currently can't declare bankruptcy. The case for allowing it is that a well-run proceeding apportions losses fairly and fast. Lenders and bondholders absorb some of the pain, but so do government workers and retirees. Taxes go up and government services are cut back, but ideally not as severely as in an uncontrolled default. The result is a government that's streamlined, not gutted.

"Bankruptcy lets you get ahead of the problem," says David Skeel Jr., a professor at University of Pennsylvania Law School and a leading advocate of giving federal bankruptcy protection to states. Without that option, he says, "what inevitably happens when you're in deep financial distress is that you have to cannibalize other stuff. You cut police, schools, other services. You reinforce the downward spiral."

In another scenario, a state that goes broke and has no recourse to bankruptcy may end up seeking help from the federal government. "We want to cut off the politicians from assuming that at the end of their wild overspending they can just dump the responsibilities on other taxpayers," says former House Speaker Newt Gingrich.

Gingrich and Jeb Bush co-wrote an op-ed in the Los Angeles Times supporting state bankruptcy in 2011, the last time it was seriously debated. At the time, states were reeling from the aftereffects of the financial crisis. During a congressional hearing that year, Senator John Cornyn (R-Texas) raised the issue with then-Federal Reserve Chairman Ben Bernanke. (Bernanke responded that states "have the tools to deal with their fiscal problems and debt.")

Public employee unions and their supporters trashed the bankruptcy option last time around, afraid that it would give states an easy way to slash their pension obligations. State governments said they didn't want to be eligible for bankruptcy, fearing that the very possibility would spook investors in municipal bonds and drive up their borrowing costs. And some analysts worried that it would reduce the pressure for budget action. "If you had this out, it would make it a little bit more difficult to persuade people that they need to raise taxes or cut programs," says Elizabeth McNichol, a senior fellow at the Center on Budget and Policy Priorities.

Treasury Secretary Jacob Lew is seeking to wall off federal relief for Puerto Rico from the explosive question of state bankruptcy. In a letter to House Speaker Paul Ryan on Jan. 15, he pointedly didn't ask Congress to make Puerto Rico eligible for protection under the federal bankruptcy code. Instead, he said Puerto Rico needs "an orderly process to restructure its debts," coupled with "strong, independent fiscal oversight." Something like that could be done through the federal law governing Puerto Rico and the other territories, sidestepping the bankruptcy code. Ryan has given lawmakers until March 31 to act.

There are some tricky constitutional issues with state bankruptcy. Juliet Moringiello, a professor at Widener University Commonwealth Law School in Pennsylvania, says it could violate the contracts clause, which prohibits states from interfering with contracts, and the 10th Amendment, which says states are sovereign. (Bankruptcy would put states under the authority of a federal judge.) Penn's Skeel thinks these objections could be surmounted—for one thing, it would be voluntary for states. But he's not sure how current Supreme Court justices would rule.

Legalities aside, the strongest argument for state bankruptcy is that it clearly signals to bondholders that they could lose money if a state behaves badly. Knowing that, investors will demand higher yields from states with bad budget problems, thus encouraging the states to get their financial houses in order. With the notion of state bankruptcy in the air again, "municipal investors should no longer assume that state governments themselves will never have access to protection" from creditors in bankruptcy court, Matt Fabian, a partner in the research firm Municipal Market Analytics, wrote to clients in December.

The principle that states are responsible for their own debts goes back to the 1840s, when Congress refused to assume the debts of states that had overborrowed to finance a canal- and railroad-building craze. Chastened by the episode, many states passed balanced-budget amendments and took other steps to keep their debt under strict control. It was "a pivotal moment in the history of U.S. federalism," Jonathan Rodden, a political scientist at Stanford and the Hoover Institution, wrote in a 2012 paper.

The effects have lasted into the present. A state hasn't defaulted since Arkansas, in the throes of the Great Depression, in 1933. When states behave badly, their borrowing costs rise. The cost of protection against default by the financially troubled state of Illinois is now three times as high as that of California.

Market discipline may be weakening, however. The federal government relies on the states to carry out some programs, such as Medicaid. Investors and state governments could start to conclude that Washington has an implicit duty to come to their rescue if they get in trouble. If so, states would be tempted to overspend and bond investors to overlend. If Washington were on the hook for the states' problems, it would naturally want control over their finances—but under the Constitution, it can't have that.

Making bankruptcy a last-ditch option, writes Stanford's Rodden, would reinforce the U.S. tradition of market discipline. "It is not too late," he wrote in a chapter for a 2014 book, The Global Debt Crisis: Haunting U.S. and European Federalism. "In fact, the timing might be quite good to clarify once and for all that states can and will default if they do not achieve fiscal sustainability."

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by Peter Coy

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