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States See No Immediate Sign of Financial Help.

Governors are pushing Congress for $500 billion in aid; Sen. McConnell says he supports states using bankruptcy protection

States across the country face an increasingly grim financial outlook due to the coronavirus pandemic shutdown—with no near-term sign the federal government will come riding to the rescue.

House lawmakers on Thursday approved another round of aid, but there was no direct help for states. The $484 billion bill, which the Senate approved Tuesday, replenishes two depleted small-business relief programs, offers additional assistance to hospitals and funds an expansion of testing capacity nationwide.

States are hemorrhaging money responding to the public-heath crisis at the same time tax revenues are cratering because of widespread stay-at-home orders and business closures. Some governors have already frozen or cut billions of dollars in spending.

The nation's governors are pushing Congress to give states $500 billion to make up for lost revenues. The bipartisan National Governors Association is also asking Congress to help with health-care costs, unemployment-insurance payments and access to test kits and protective equipment.

Senate Majority Leader Mitch McConnell poured cold water on the pleas this week. The Kentucky Republican said he supports letting states use bankruptcy protection to cut their debts rather than providing more federal aid.

Aid to state and local governments will likely be a hotly debated aspect of the next round of coronavirus legislation on Capitol Hill. House Speaker Nancy Pelosi said Democrats will push to include money for local governments when lawmakers return in early May.

Mr. McConnell said he didn't want to subsidize the high state pension obligations that predate the coronavirus crisis. In many cases, those obligations were negotiated years ago by governors and state-employee unions.

"There's not going to be any desire on the Republican side to bail out state pensions by borrowing money from future generations," he said.

State officials called the idea of filing for bankruptcy a nonstarter.

"You want to see the market fall through the cellar?" New York Gov. Andrew Cuomo said during his daily briefing on Thursday. "Let New York state declare bankruptcy. Let Michigan declare bankruptcy. Let Illinois declare bankruptcy. Let California declare bankruptcy. You will see a collapse of this national economy."

Congress previously passed a $2 trillion aid package with $150 billion for state and local governments, but the money can be used only for coronavirus-related expenses. States say they need additional funding to plug budget holes, and some want greater flexibility when it comes to spending the $150 billion already approved.

The National Association of State Budget Officers says a cash influx would help the national economy rebound and warns states might have to cut essential services if Congress doesn't approve more aid.

"States are currently facing revenue impacts that could dwarf what was observed in the last recession," Marc Nicole, the association's president, wrote in a letter Wednesday to President Trump and congressional leaders. States project declines of as much as 20%, as the pandemic hammers their biggest revenue sources, income and sales taxes, Mr. Nicole said, whereas total general-fund revenue fell 11.6% over two years during the 2007-2009 recession.

Mr. McConnell also suggested states could raise taxes to bring in more revenue. Unlike the federal government, almost all states are required to balance their budgets. That means that any new spending has to come from tax revenue or federal aid, rather than from borrowing.

Allowing states to file for bankruptcy would require congressional action and would almost certainly face legal challenges, said David Skeel, a University of Pennsylvania law professor. For one thing, it could be seen as violating a constitutional provision barring states from interfering in contracts. It could also run afoul of provisions protecting state sovereignty, he said.

David Adkins, executive director of the Council of State Governments, said he thought Mr. McConnell's comments were a posturing tactic in continuing negotiations with Capitol Hill Democrats. Sooner or later, he said, Congress is going to have to direct significant funds to state and local governments to prevent a wave of public-sector layoffs.

Mr. McConnell "has some vulnerable Republicans in states," Mr. Adkins said. "He does not want those vulnerable Republicans to be blamed for 20% cuts to public schools."

States' fortunes have changed at a dizzying speed. Just a few months ago, many governors rolled out lists of new proposals, buoyed by strong growth and robust revenue projections. States also sat on replenished rainy-day funds.

Though Washington state has roughly $3.5 billion in reserves, budget officials say projected revenue shortfalls over the next three years would wipe that out. Even with federal aid, the state would face major budget cuts, said David Schumacher, director of the state's Office of Financial Management.

"That's going to be a huge driver of whether we have bad budgets and significant cuts, or catastrophe," he said of the federal aid.

Cities are bracing for a budget crunch, too. More than 2,100 cities expect shortfalls, according to a recent survey by the National League of Cities and U.S. Conference of Mayors.

In response to the crisis, governors in some states have moved to limit spending by paring teacher raises and property-tax relief, and cutting higher-education funding. Virginia, for example, cut $500 million from outlays in the final quarter of the current fiscal year, which ends June 30, and froze $2.3 billion in planned new spending over the next two fiscal years.

Aubrey Layne, the state's finance secretary, said certain limits on new aid would make sense, such as a ban on pumping any of it into state pension systems.

"I understand this money shouldn't just be a blank check to go and bail out bad mismanagement over the years," he said. "A lot of what is happening now is simply because the economy is shut down."

Mr. Layne said bankruptcy wouldn't be an option for Virginia because "constitutionally we have to balance our budget."

State and local government bankruptcies are extremely rare with 0.16% of municipalities rated by Moody's Investors Service defaulting over a five-year period. That rate has increased from 0.09% prior to the last recession, which delivered huge hits to property-tax revenues and pension-fund savings.

U.S. states in particular are generally viewed as extremely creditworthy, and their bonds pay out interest at rates fairly close to U.S. Treasurys. Exceptions are Illinois, New Jersey and Mr. McConnell's home state of Kentucky, which struggle with unfunded obligations to police, teachers and other public workers.

Roughly half of states allow their cities to access bankruptcy protection, and a few have used the process to reduce obligations to pensioners and bondholders. Puerto Rico entered bankruptcy in 2017 after Congress passed a law giving it permission to do so.

Detroit, the largest city to file for bankruptcy, emerged from bankruptcy protection in 2014 after a year and a half, but it continues to struggle with longstanding challenges like high liabilities and reliance on the auto industry.

Prices on Illinois and New Jersey tax-backed debt that doesn't come due for 15 or more years fell Thursday afternoon, with yields on those bonds rising by roughly a 10th of a percentage point relative to triple-A debt, according to Refinitiv data.

Refinitiv analyst Greg Saulnier said investors were probably reacting less to the possibility of bankruptcy for those states than to Mr. McConnell's apparent opposition to a large state aid package in the near future.

"It illustrated that he is in favor of delaying any additional state and local government relief, which could amplify credit problems," Mr. Saulnier said.

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By Scott Calvert and David Harrison

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—Joseph De Avila and Heather Gillers contributed to this article.