# Bond Case Briefs

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## Letting States Declare Bankruptcy: Debunking the Bond Argument

I've drawn on David Skeel's work before in writing about giving states the option of declaring bankruptcy. He makes the case for the idea in the new *National Affairs*. Here he responds to a common objection from the right:

> Republican concerns that state bankruptcy would cripple the bond markets are similarly unfounded. Ironically, this objection is often made by market enthusiasts, yet it is based on an implicit assumption that markets don't work well. If bond markets were unable to distinguish between financially sound states and states that are at risk of default, perhaps all bonds would plummet if a state-bankruptcy option were enacted. But this is contrary to everything we know about the market for state and municipal bonds (known as the "municipal-bond market," even though it includes state debt as well). Although the market for state debt is far from perfectly efficient, it does distinguish between good and bad risks. When Utah recently issued bonds, for instance, the bonds had an interest rate 0.40% above the five-year Treasury bond rate. For Illinois, which issued bonds the same week, the difference was 5.25%.
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> If the enactment of a state-bankruptcy option had any negative effect on bond prices, that effect would stem from the decreased likelihood of states receiving a federal bailout, since the bankruptcy option would exist as an alternative. This effect should be applauded. As work by scholars such as Stanford University's Jonathan Rodden has shown, the expectation of receiving a federal bailout gives states a powerful incentive to overspend. A state-bankruptcy option would send the opposite signal.

He concludes that legislation to aid the states for pandemic-related costs should include a bankruptcy option. It's hard to see a Democratic House agreeing, notwithstanding Skeel's solid arguments.

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