States Are Already Empowered To Cure Their Fiscal Ills **January 21st, 2011**

On January 20th, 2011, the New York Times published a front page article entitled "*Path Is Sought for States to Escape Debt Burdens*". The lead sentence states: "Policy makers are working behind the scenes to come up with a way to let states declare bankruptcy and get out from under *crushing debts*, including the pensions they have promised to retired public workers". Headlines and lead sentences are designed to grab your attention. Facts and more reasonable perspectives are sometimes harder to come by.

Consider the following:

- Currently, 96% of all states are rated in the "Aa" to "Aaa" category -- only California and Illinois are rated in the "A" category.
- "Aa" to "Aaa" rated states are not in need of bankruptcy relief.
- High grade investment-rated bonds in the two highest credit categories, by definition, do not have "crushing debt", as described by the NY Times.
- The issues confronting the states are revenue and expenditure issues, either structural or cyclical (in the aftermath of the recession), and are not debt-related.
- Annual debt service payments for state and local governments range within 5% to 10% of budgets.
- The Center on Budget and Policy Priorities ("CBPP"), using U.S. Census Bureau data, puts interest payments on debt as a percentage of state and local spending at 4% - *a percentage equivalent to 1979 figures.*
- CBPP also using federal statistics cites state and local municipal debt at 16.7% of GDP – a percent similar to the averages during the 1980 and 1990 decades. *Greece's governmental debt is in excess of 100% of GDP.*

This is not to say that public finances have not been extremely stressed in the wake of the worst recession since 1929. Nevertheless state governments as "sovereign entities" are already empowered to cure fiscal ills. State governments have already confronted budget shortfalls from fiscal year 2009 to present that have totaled at least $425 billion. Such shortfalls have been addressed by combinations of now-expired federal stimulus monies, reserve draw downs, tax and revenue increases, and by significant expenditure cuts.

Is Bankruptcy a Viable Option for States, and is it Needed?

- At present, states do not have the ability to declare bankruptcy.

- Nor, are any governors publically seeking that ability.
- We cannot presently envision any scenario whereby a governor and / or state legislature would voluntarily seek bankruptcy protection, or assume the market taint that action would ultimately precipitate.
- Nor, do highly-rated states require bankruptcy protection given their sovereign powers to raise taxes or cut expenditures. Constitutional issues would have to be addressed before a bankruptcy court would be allowed to impose its will on a state.

The argument from many pundits supporting the bankruptcy proposal is based on the premise that the granting of such ability would forestall the need for further bailouts from the federal government, or the need for additional federal stimulus programs. This is a political argument and statement, and not an argument based on policy or the demonstrated fiscal need of states.

The other argument for allowing state bankruptcy is that such ability could allow states to either abrogate or renegotiate their existing pension agreements. Nevertheless, the number of states encountering severe pension issues is relatively small. Even in the most stressed states, with large unfunded pension liabilities, there is no immediate liquidity issue with most plans having resources capable of covering benefits over the next 15 to 20 years. Virtually all states are negotiating with their unions to revise pension and benefit contracts, and many have already taken actions to reduce benefits for current and future employees. The expense of Vallejo, California's bankruptcy filing and proposed settlement is often cited as being exorbitant, and one that could have also been accomplished more reasonably and at less cost by negotiation, as opposed to a Chapter 9 filing.

Currently, the two most fiscally strapped states are California and Illinois. Indicative of the ability of sovereign states to address their fiscal issues is the budget plan announced by California Governor Brown, and the tax increases enacted by Illinois. Governor Brown has outlined $12b of budget cuts, excluding local education cutbacks, to address a projected $26 billion deficit, and will be asking voters (in June) to approve an extension of existing "temporary tax increases" estimated at $9 billion. The governor has stated that failure to extend the tax increases will result in significant cuts to local education. In Illinois, the corporate income tax rate was recently raised 30%, and the personal income tax rate by 66%, to a flat 5%. These "stressed states" implemented severe fiscal strategies, that do not require bankruptcy protection.

Summary and Conclusion

- State bonded debt is one of the strongest sectors of the tax-exempt market, with all states, except

California and Illinois, rated “AA” or better.

- Since the Civil War only one state ever defaulted -- Arkansas during the great depression (with restitution made).
- While fiscal issues remain, states have confronted the fiscal challenges endured during previous recessions.
- States do not need bankruptcy protection.
- The ability to pay debt service is not, and has not, been an issue.
- The states are fully dependent on debt markets for investment capital.
- The NY Times headline: “*Path is Sought for States to Escape Debt Burdens*” provides an exaggeration, of the facts regarding the fiscal health of state governments.

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