Hearing
"State and Municipal Debt: The Coming Crisis?"
February 9, 2011
Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs
Committee on Oversight and Government Reform
House of Representatives

Testimony of
Nicole Gelinas, CFA
Searle Freedom Trust Fellow
Manhattan Institute for Policy Research
ngelinas@manhattan-institute.org
(646) 839-3353

Chairman McHenry, Ranking Member Cummings, and members of the Subcommittee, good morning. Thank you for inviting me to testify today on this important topic.

As federal stimulus runs out and states from California to New Jersey face a third year of multi-billion-dollar budget deficits, Congress is right to worry about how to avoid bailing out states and their investors. The bad news is that a federal statute allowing for state bankruptcy is unlikely to be the answer. The good news is that Congress can still act to avoid the choice between bailing out states and watching as they repudiate their long-term contractual, legal, and constitutional obligations to bondholders and other creditors, including labor union members.

Proponents of a bankruptcy statute for states believe that special interests such as unions and hospital lobbies have taken over the political process in many state capitals and are thwarting states' ability to control their costs without an external force. Proponents also believe that bankruptcy could be this external force. In this scenario, states could threaten bankruptcy to wring concessions from creditors, particularly labor unions, to whom states owe hundreds of billions of dollars in future pension and healthcare commitments. Bondholders, worried about the prospect of losses in bankruptcy, would help this process along.

As a practical matter, though, state bankruptcy is unlikely to help states solve their fiscal problems. Nor would bankruptcy allow the federal government to avoid the bailout question. Bankruptcy also does not address the key drivers of states' fiscal problems—provision in their laws and constitutions that restrain states from balancing their books, and federal grants for programs like Medicaid and education that encourage higher spending.

There is good reason to expect that a state bankruptcy would create more problems than it would solve. For one thing, states have made their commitments to creditors not through single "state" entities that could go before a bankruptcy judge with one voice, but through hundreds, in some cases thousands, of legal entities. Each of these legal entities has its own pre-existing agreements with bondholders and other creditors, set out in individual contracts and in state laws.

An illustration: When many people think of state bond obligations, they think of "general obligation" debt—that is, debt for which states have obliged their "full faith and credit" to pay. But a state such as New York, for example, with one of the highest per-capita debt burdens in the nation, owes only $3.5 billion in "general obligation" debt. New York owes the remainder of its $78.4 billion in debt through hundreds of special “authorities,” including the Transitional Finance Authority, Metropolitan Transportation Authority, the Dormitory Authority, and others.

Legally, each of these authorities is not a government agency reporting to the governor and the legislature, but a “public-benefit corporation.” Each has its own board, its own rules, and its own contractual agreements with creditors, from bondholders to, in some cases, union members. Under some agreements, the state allows bondholders the first claim on certain tax revenues, even before the state allows itself to use these revenues for public services. Under other agreements, bondholders depend only on speculative revenues, such as those from tolls, for repayment.

As a practical matter, a bankruptcy judge could not take the gross amount that New York owes to bondholders and other creditors through these hundreds of corporations and put it all in one large pool along with pension and healthcare obligations to pare back all three categories of commitments, at least not without violating many pre-existing private contracts, bond covenants, and precedents. Bondholders who had lent money to a specific state authority under specific covenants would be concerned that the federal government had changed the rules mid-game.

Just as states do not owe their debt through a single entity, they do not owe their pension obligations through a single entity. In fact, though state governments often run large pension funds through state trusts, including Calpers and CalSTRS in California, it is local governments, including cities, towns, and school districts, not the state governments, that owe the bulk of what people think of as “state” pension benefits. Cities, towns, and school districts, however, can already declare bankruptcy, if their home states allow it, so state bankruptcy would add no benefit here.

Another practical problem for state bankruptcies is the fact that it is difficult to understand how a federal judge could overturn the real obstacle to sound state budgeting practices: state constitutions and state laws. California's Constitution, for example, mandates that tax revenue must first pay California’s education costs, and second pay its general-obligation debt costs. New York's constitution mandates that the state uphold its commitments to all pensioners, past and future. New York law mandates that when some labor contracts expire, the workers covered by such agreements continue to get automatic pay raises.

State laws that ensure burdensome pension benefits and union-contract outcomes may be bad practice, but no one has argued that they violate the U.S. Constitution. Therefore, a federal judge cannot overturn them – only state legislatures, governors, and voters can do that. With no ability to overturn bad state statutes and constitutional provisions against the will of governors and state lawmakers, a federal bankruptcy judge would have little power. Furthermore, states would have to opt into a federal bankruptcy code—if state lawmakers are unwilling to repeal these laws, why would they pass a law allowing a federal judge to disregard them?

Relatedly, one of the issues that has plagued state finances—and, indeed, that plagues democracy in general—is that no single elected official speaks for a state. In a corporate bankruptcy, a CEO or his designee, backed by a small board, is authorized to speak for the entire company. In a state bankruptcy, though, a governor could not simply assume powers that rightly belong to individual lawmakers and alone speak for the state.

Because each state differs from every other state in its constitution and body of law, the prospect of state bankruptcies would not offer much predictability to bondholders who might hope to take one bankruptcy case and apply its lessons to another. If, for example, New Jersey were to declare bankruptcy under a new federal statute, and New Jersey's governor and legislator were able to work with creditors under a judge to pare back liabilities under the unique constraints of New Jersey's Constitution and body of law, the blueprint would not be of much practical help to California bondholders, who would have to consider how bankruptcy would work in the context of that state's unique constitution and body of law.

As for avoiding bailouts: state bankruptcy is far from a sure thing here. We remember, of course, that Chrysler and General Motors declared bankruptcy and received federal bailouts. Moreover, the Bush and Obama White Houses offered the two automakers tens of billions of dollars in taxpayer money not for market reasons but for political and social reasons: neither president wanted to run the risk that the automakers and their suppliers would exacerbate the recession by laying off millions of workers. Similarly, should states run into such acute trouble, the White House and Congress would have to make a political and social decision about how much aid, if any, to offer to avoid mass layoffs and service cuts. Tweaking laws that govern financial markets could not eliminate the need for this hard decision.

Fortunately, the prospect of state bankruptcy is unnecessary for states to change their ways. As my colleague E.J. McMahon has written, states already possess the tools to pare back their future liabilities before these commitments grow even more burdensome. For one thing, lawmakers and governors across the nation can change the laws that allow state workers to collectively bargain their wages. Similarly, lawmakers and governors can change constitutions and laws to pare back retirement benefits for future workers (and, in some cases, current workers).

Congress can help states take the right steps. States spend the vast majority of their taxpayer money on education and healthcare (including labor costs for these functions). These costs are driven in part by federal mandates and federal matching dollars. Congress could gradually convert the federal Medicaid program into a block-grant program, rewarding states for saving money rather than spending it. Congress could also tie some future education aid to changes in states' treatment of local teachers' retirement benefits, ensuring that funds are directed to students, not to labor unions. Further, in its upcoming transportation-bill reauthorization, Congress could offer more capital investment money to states whose governors and lawmakers take steps to pare back future workforce liabilities so that they can afford to maintain the infrastructure that they hope to build or upgrade with federal money.

Finally, if Congress wants to raise the prospect that a state could someday default on its debt, it would have to raise the prospect that a large bank or money-market fund, too, could suffer large losses as a result of that default. After all, banks own $229 billion in state and local debt, and money-market funds own another $332 billion. Creating a process for a state or multiple states to default on debt obligations without first ensuring that a large bank can go through the bankruptcy process could create economic chaos, forcing Congress, in the end, to save the state or the bank. This is hardly a good choice.

Thank you, again. I am happy to take questions and comments.

[Further reading:
Nicole Gelinas, “The Market Won't Fix States' Woes,” *Boston Globe*, January 23, 2011.
EJ McMahon, “State Bankruptcy is a Bad Idea,” *Wall Street Journal*, January 24, 2011.
Nicole Gelinas, “Bankruptcy: No Cure for Broke States,” *New York Post*, January 24, 2011.
Nicole Gelinas, “Better Stimulus for States: Cash for Cuts,” *Investors Business Daily*, July 12, 2010.]