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# Allowing States to Declare Bankruptcy is a Destructive Idea

Former Speaker of the House Newt Gingrich has called on Congress to create a bankruptcy option for the states in order to avoid federal bailouts and give states the ability to abrogate contracts with public sector unions. California State Treasurer, Bill Lockyer, correctly termed the idea "a cynical proposal, intended to incite a panic in response to a phony crisis."

States currently have the ability and willingness to make their debt payments. It has been 75 years since a state has failed to make a bond payment.[1] There is no conceivable wisdom in allowing states to default on their debts. State-level debt burdens are modest as a percentage of Gross State Product (averaging 2.8% nationwide). Allowing a state to declare bankruptcy and not make debt-service payments would typically have a minimal economic benefit to the state over the short run, but it would have devastating long-term results by making future financings extremely difficult:

**Higher Borrowing Rates for States:** The passage of a state bankruptcy bill would certainly lead to a "market penalty." That penalty would be the lowering of a state's credit rating resulting in higher borrowing costs and downward pressure on the value of the state's bonds. The situation could even result in states not being able to sell bonds at all. States would be hard pressed to meet capital and short-term borrowing needs under this scenario.

**Higher Rates Mean Job Losses:** Most state debt is used to finance infrastructure investments. Making the financing of those projects more expensive will mean there will be less of them, harming private contractors, which means less jobs in the short term and weaker economic growth in the long term.

**Harm to Local Economies:** Given the tax-free nature of state and local bonds, the likely holders of state debt are local residents of the issuing state or locality. Defaulting on the bonds would cause these local citizens monetary losses that would act as a brake to local economic activity. Jobs would be lost and the government's fiscal situation would deteriorate further.

**Expensive Judicial Procedures:** Nicole Gelinas of the Manhattan Institute writes that state bankruptcy would prove so legally messy as to be unworkable. She offers the example of New York State, which owes very little debt directly, instead owing smaller amounts through tens of thousands of legal entities called "public-benefit corporations." Each of these entities has its own contractual agreement with creditors. So, were a state to declare bankruptcy, it is not at all clear what the repercussions would be for the individual entities without going through a long and painful court process.

States are currently solving short-term problems with painful spending cuts and unwelcome tax increases. Giving the states the option of declaring bankruptcy not only will cause the fiscal situation to worsen, but it masks the need for states to overhaul out-of-date tax systems and solve their structural deficits.


[1] In 1933 Arkansas failed to make a $10.5 million highway bond debt-service payment; the issue was refunded the subsequent year.