A Better Alternative to State Bankruptcy or Default

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By John S. Baker Jr.
And Robert T. Miller

With tax revenue crashing and expenditures soaring, states face severe financial problems. Illinois has already requested a federal bailout of its pension system, and last month Senate Majority Leader Mitch McConnell suggested that Congress should enact legislation allowing states to go bankrupt.

Thankfully, Mr. McConnell appears to have dropped the idea. Allowing states to declare bankruptcy would fundamentally contradict the federal structure of our constitution. In that structure, the states are self-governing entities. But as anyone who's endured the bankruptcy process knows, bankruptcy protection means the bankruptcy court is in charge. Federal bankruptcy protection would greatly constrain a state's sovereignty, or power to govern itself, which the Constitution guarantees.

But if states are free to govern themselves, they're also free to make poor choices. Decades of fiscal mismanagement left some states in a precarious financial position before the pandemic. Before Congress grants hundreds of billions of dollars to states—a step Mr. McConnell now says he'd entertain in exchange for legislation guaranteeing liability protection for businesses—it should consider an alternative grounded in prudence and reflection on American history.

States have struggled with indebtedness since American independence. One major argument against ratifying the Constitution was the fear that states could be sued for defaulting on their debts. The Supreme Court held in *Chisholm v. Georgia* (1793) that they could, but the 11th Amendment, ratified in 1795, makes clear that states enjoy sovereign immunity from being sued by citizens of another state in federal court.

Default is one option for states that can't cut spending enough to make up for declining revenues. Nine states were in default following the Panic of 1837 and 10 after the 1873 panic, economists Carmen Reinhart and Kenneth Rogoff write in "This Time Is Different" (2009). But if a state defaults and can't be sued, bondholders get nothing,

Bond contracts that waive sovereign immunity can provide cash and some much-needed discipline.

which greatly increases the risk they bear and the interest rate they will demand. Default offers state governments momentary relief, but it harms creditors and limits states' future borrowing prospects.

Fortunately, there is a better path for cash-strapped states: more borrowing. States can put investors at ease by waiving their claim to sovereign immunity in the contract under which the bonds are issued. States routinely give such waivers, and courts enforce them.

States can do more. They can agree that the contract under which the bonds are issued will be subject to the law of another jurisdiction and that they themselves may be sued in courts of that jurisdiction. This helps attract investors, because just as creditors generally don't trust a court in a country with poor credit to enforce the terms of a bond contract against that country, many wouldn't expect, say, a California court to enforce a California bond contract. States could agree to abide by New York law and submit to federal courts sitting in New York—and New York could turn to Delaware for enforcement of its bond contracts.

States could reduce the interest rates they would otherwise pay by providing bondholders with credit enhancements. The simplest one would involve offering some state property as collateral, which would require an additional waiver of sovereign immunity. Another would be to set up a "sinking fund," which would require the state to deposit a certain percentage of its tax revenue into a trust located in another jurisdiction for the benefit of bondholders.

Borrowing in the capital markets allows states to solve their own problems. It preserves states' sovereignty and avoids a federal bailout, which would perversely reward spendthrift states. Suddenly, states would have large real obligations enforceable against them, which would teach financial discipline.

Covid-19 isn't the states' fault. But the states least able to weather its financial consequences got that way through decades of profligate spending and confiscatory taxation. Borrowing and timely repayment, not default or bankruptcy, is the best way for states to deal with the current crisis while getting their financial affairs in order. The essence of sovereignty is self-government, which entails a measure of responsibility.

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Notable & Quotable

Justice Elena Kagan writing for a unanimous U.S. Supreme Court in Kelly v. U.S., May 7:

Federal prosecutors may not use property fraud statutes to "set[] standards of disclosure and good government for local and state officials." . . . Much of governance involves (as it did here) regulatory choice. If U.S. Attorneys could prosecute as property fraud every lie a state or local official tells in making such a decision, the result would be . . . "a sweeping expansion of federal criminal jurisdiction." . . . The property fraud statutes . . . do not "proscribe[] schemes to defraud citizens of their intangible rights to honest and impartial government." . . . Not every corrupt act by state or local officials is a federal crime.

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