States Don't Need Chap. 9, Critics Tell Congress

By Lynn Hume

WASHINGTON - States strongly oppose Congress drafting legislation allowing them to file for bankruptcy protection, which is not needed and would actually hurt them as well as the markets, economists and a representative of the National Governors' Association warned members of the Senate Budget Committee Thursday.

"No governor or state is requesting this authority, and it is also true that such authority will likely increase interest rates, raise the cost of state governments, and create more volatility in financial markets," Raymond Scheppach, executive director of the NGA, wrote in testimony provided to the panel.

Asked about the issue by Sen. Mark Begich, D-Alaska, Scheppach said: "I can tell you that we've discussed it and ... governors are pretty united in opposition to that legislation. Nobody's asking for it. Nobody wants it."

The mere discussion of it is adding a risk premium to muni bonds, he added.

Several Republicans in the House and Senate have been exploring the possibility of writing legislation that would permit states in severe fiscal distress to file for bankruptcy protection so that they could renegotiate their debt, pension plans, union contracts, and other obligations.

"I don't think that's a good idea," Mark Zandi, chief economist of Moody's Analytics,told committee members. "The states have all they need and this would be an error."

Chris Edwards, director of tax policy studies at the Cato Institute, also pooh-poohed the idea in his written testimony. "I am also skeptical of calls for intervention in the form of a new federal bankruptcy statute for state governments," he wrote. "Such an intervention is not needed because the states already have the power to mend their finances without help from Washington."

Edwards added: "I'm uneasy about the idea that the federal government would make it easier for state governments to stiff their bondholders and other creditors."

After hearing from the witnesses, Begich said: "No one's asking for it - really, it's just a very bad thing."

Scheppach gave a bleak picture of state finances, but said their governments can handle the stress.

The Great Recession, which began in December 2008 and was officially declared over in June 2009, was "a huge game changer" for state governments, he said.

From 1978 to 2008, states experienced average annual revenue growth of 6.5%. But between the last quarter of 2008 and the last quarter of 2009, revenue decreased in five consecutive quarters by 4.0%, 12.2%, 16.8%, 11.5%, and 4.0%, respectively, Scheppach said.

While revenues have grown for the past three consecutive quarters, by 3% on average, they would have been flat had it not been for major tax increases in California and New York.

In response to the revenue declines, states have cut spending by $75 billion and have enacted fee and tax increases of $33 billion from fiscal 2008 through 2010, he said.

The cuts "would have been much more draconian" if the American Recovery and Reinvestment Act and its extensions, which provided stimulus funds, had not been enacted, according to Scheppach.

But states are still facing shortfalls of about $175 billion from 2011 through 2013, he said, "with a definite cliff at the end of state fiscal year 2011," in July, when enhanced Medicaid funds will no longer be provided to states.

Scheppach said the recession will play out in three stages: the impacts from huge revenue losses and the explosion in Medicaid rolls will be felt from 2010 through 2012; the jobless recovery will prevent states from returning to 2008 revenue levels until 2013 to 2015; and beyond 2015, states will have to meet needs that were deferred from the previous six years.

One big problem for states is that they have outdated tax systems that were built for the manufacturing economy of the 1950s and not the high-tech, service-oriented, international economy of today, the NGA executive director said.

For example, sales tax - which generally represents about 40% of state revenue - only applies to goods, not services, and not to many goods sold over or downloaded from the Internet.

Medicaid "is the 400-pound gorilla" for states, Scheppach said. States will have to pay an additional $190 billion over the next 10 years to take care of the millions of people that will be added under this program.

Unfunded pension liabilities have grown substantially because of both the lower rates on investment returns and the fact that many states stopped contributions to pension plans and health care trust funds during the last few years.

In 2000, state and local pension obligations were essentially fully funded with an assumed 8% discount rate. But by 2009, unfunded liabilities were about 15% of obligations and by 2010 will be about 23%, Scheppach said.

Nevertheless, states are making changes to reduce their unfunded pension liabilities. Between 2005 and 2010, 30 states made pension changes, and in 2010 at least 20 states made further changes.

"I am optimistic that they will be able to put solutions in place," Scheppach said.

Given that states are facing shortfalls of $175 billion over the next several years, governors and state legislators understand they will have to continue to downsize and consolidate their governments. But that it is not enough, he said.

"They also have to redesign the delivery system of all major functions of state governments, from prisons to elementary and secondary education to higher education, to make state government more efficient and sustainable over the long run," Scheppach wrote in his testimony.