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The Good and Bad about Bankruptcy for States

Last year, 1.5 million Americans filed for bankruptcy. Some cities and counties had also done so. But what about states? Constitutionally, states cannot file for bankruptcy protection because they are independent sovereigns according to the constitution and therefore cannot come under bankruptcy supervision of the federal government.

But now a few lawmakers are lobbying for states to have the right to file for bankruptcy with the reason that that would make it less likely for them to seek federal bailouts for their financial problems. Former House Speaker Newt Gingrich, one of the foremost advocates for state bankruptcy, said that bankruptcy would reduce the clout of labor unions. Patrick Gleason of the Americans for Tax Reform, another supporter of state bankruptcy, said unions would “face a much more dire outcome in bankruptcy court than they would if they renegotiated.”

In bankruptcy, a bankruptcy judge could compel lenders and public workers to accept less in repayments and salaries. Existing agreements could be changed to lower the states' financial obligations giving them a vital lifeline in their financial survival.

Furthermore, it is clear that many states cannot afford their long-term commitments to pay pension funds and medical care for retirees. Without filing for bankruptcy, the states would be forced to raise taxes and cut public services like transportation.

However taking that route does have its own detriments. A state could be locked in court battles for extended periods of time with creditors and trustees that might bring about little benefit in the end. All this would inevitably frighten potential investors of state-issued bonds. Already, at the end of last year, investors pulled $21 billion from funds that were meant for municipal bond investments when they thought that cities and local governments might default. This figure represented twice the number during the 2008 credit crisis. The investors still in the market are demanding high interest rates for their investments.

Standard and Poor's said that if states are allowed to file for bankruptcy, it would affect their credit ratings. A lower rating would force states to raise interest rates. Likewise the same would happen if investors start selling their bonds. All these would contribute to a higher cost of financing bonds.

Another fear is the domino effect. When one state files for bankruptcy, others might be encouraged to do the same. This would not be good for the economy in the long run.

If you are interested in filing for bankruptcy for yourself or your business, call us at (813) 200 4133 for a free consultation.