“Congress Moves to Allow State Bankruptcy”

-*Financial Times,* January 22, 2011

While the economy continues to improve little by little, the crisis among state and local government actually appears to be getting worse. How bad is it? As the *Financial Times* reports, the U.S. House of Representatives has actually considered amending the bankruptcy code to allow for the bankruptcy of a state!

As the law stands now, individuals, companies, and municipal bodies can use the bankruptcy code to eliminate or modify their debts, but states cannot. States are presumed to have enough taxing power to make good on their obligations—even if it means giving their residents a good squeeze.

The House’s recent move is a tacit admission that this no longer holds—the states have debts that are simply un-payable!

On the upside, if a large state like California were to declare bankruptcy, the taxpayers of the state would be spared years of painful austerity, and the Federal government would be spared the costs of a major bailout. But the bondholders, many of whom are regular Americans living off of the bond interest, would see their wealth evaporate and their retirements wrecked. The same would be true of municipal workers, who would likely see their generous pension and health benefits scaled back or lost altogether. It is true that many state workers enjoy benefits that are arguably too high (at least relative to their counterparts in the private sector), but tell that to the 60-year-old lifetime state employee who now has to move in with his kids because the state failed to deliver what it promised.

The possibility of bankruptcy could also cause bond yields to soar, as investors would demand a greater return for shouldering the risk. Higher yields means more funds dedicated to paying interest.

So, while some might advocate throwing the bondholders under the bus and encouraging highly indebted states to declare bankruptcy, this may not be the easy way out that they imagine.

Is it likely that a U.S. state will go bankrupt? It can’t be ruled out. The Pew Center on the States, a research group, has estimated a funding gap for pension, healthcare and other non-pension benefits of at least *$1 trillion.* It’s hard to imagine that getting paid as planned.

Whether actual bankruptcy happens or not, a couple things are clear. Americans will have to depend on themselves and their families more than ever to meet their retirement needs. The government—federal, state, or local—will not have the funds to help you.

With good planning, you can be prepared or you can at least mitigate the effects. But you need to start, if you haven’t already. The better you plan today, the better positioned you will be to ride out the potential storm.

Sincerely,

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