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THE WALL STREET JOURNAL.

WSJ.com

OPINION | JANUARY 18, 2011

A Bankruptcy Law—Not Bailouts—for the States

We can see the fiscal crisis coming from miles away. Congress has no excuse not to act.

By [DAVID SKEEL](#)

Last week, Gov. Andrew Cuomo pledged to implement an "emergency" agenda because "the state of New York spends too much money." Governors across the country are making similar promises, but the obstacles to achieving fiscal sustainability in many states are far too deep. To help overcome these obstacles, Congress needs to enact a law that will enable states to declare bankruptcy.

California is first on most lists of troubled states—and for good reason. Thanks to decades of implausibly generous promises to public union employees and other fiscal misdeeds, the state's budget deficit for the next 18 months could exceed \$20 billion. According to Stanford University's Center for Economic Policy Research, the state's pension funds are underfunded by more than \$500 billion.

Illinois was looking at a \$15 billion deficit before its huge new tax increase. Its pensions, according to a study by Andrew Biggs of the American Enterprise Institute, are underfunded by \$208 billion. New York and New Jersey are in similarly dire straits.

While the recognition by states that they are in crisis is the first step to recovery, a new bankruptcy law for states is the help they really need.

Is there anything states can do in bankruptcy that a well-motivated governor can't do without it? You bet there is.

First, the governor and his state could immediately chop the fat out of its contracts with unionized public employees, as can be done in the case of municipal bankruptcies. In theory, the contracts could be renegotiated outside of bankruptcy, and many governors are doing their best, vowing to freeze wages and negotiate other adjustments. But the changes are usually small, for the simple reason that the unions can just say no. In bankruptcy, saying no isn't an option. If the state were committed to cutting costs, and the unions balked, the state could ask the court to terminate the contracts.

Second, the state could reduce its bond debt, which is nearly impossible to restructure outside of bankruptcy. While some worry about the implications for bond markets, the alternative for the most highly indebted states—complete default—is far worse. Randall Kroszner, a former Federal Reserve governor now at the University of Chicago Booth School of Business, showed in a 2003 study that the price of corporate bonds

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went up during the New Deal when the Supreme Court upheld legislation that reduced payments to bondholders. The reduction increased the prospect that bondholders would get paid. The prospect of state bankruptcy could have a similar effect, and even if it didn't a reasonable reduction in state bond debt is essential to restructuring their finances.

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Third, state bankruptcy could even permit a restructuring of the Cadillac pension benefits that states have promised to public employees. These are often "vested" under state law, and in some states, like California, are protected by the state constitution. Under state law, little can be done to adjust them to more reasonable amounts.

Although the law is somewhat murky, there is a strong argument that bankruptcy could provide for an adjustment of these obligations. Unless the state's "guarantees" were construed as a property right protected by the Takings Clause of the Constitution (which is doubtful if there is no collateral or other indicia of a property right), the federal bankruptcy law would trump contrary state law under the Constitution's Supremacy Clause.

There is little doubt that a federal bankruptcy law for states, based on a similar federal law enabling cities to declare bankruptcy (Chapter 9 of the Bankruptcy Code), would be constitutional. As the Supreme Court ruled in *United States v. Bekins* (1938), the key requirements are that a city not be forced to file for bankruptcy against its will, and that the law doesn't usurp its political decision-making authority. A state bankruptcy law that honored these principles would be equally sound.

Congress could let the states decide who can file for bankruptcy, and the process would work best if the governor and legislature were fully committed to using it to get the state's finances in order. Is there any solution if they aren't all on board? In some states, the governor may be able to make the decision himself if this is consistent with state law. Even more intriguing is the possibility that voters could force their politicians' hands. In a state like California, which allows for voter referendums, the voters almost certainly would have the power to make this decision.

Even if voters triggered a bankruptcy filing, it wouldn't ensure that the leaders would make the most of bankruptcy. But this too could be addressed in the fine print of the law. If Congress were willing to be especially bold, it could include provisions providing for automatic adjustments to contracts in the event the parties didn't reach agreement within a specified period of time. Or it could automatically reduce payments as of the date of the bankruptcy filing—perhaps to 80% of amounts provided for in the contracts—until the parties reached an agreement.

Even if Congress enacted a much more basic bankruptcy law for states, the new law would provide the tools that the most troubled states need. The collapse of the big banks in 2008 took the country by surprise, and regulators concluded that they had no other choice than to bail them out. This time we can see the crisis

before it is too late, and we have a real choice. Rather than bailing the states out, Congress should give them a fresh start by enacting a new chapter of the bankruptcy laws for states.

Mr. Skeel, a law professor at the University of Pennsylvania, is the author of the recently published book, "The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences" (Wiley).

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