Joint Economic Committee
Republicans
Representative Kevin Brady *Vice Chairman*
Senator Jim DeMint *Senior Republican Senator*

REPUBLICAN STAFF STUDY

STATES OF BANKRUPTCY

Part II: Eurozone, USA?

May 15, 2012

INTRODUCTION

As economic policies in the 50 states continue to diverge, so too do their economic destinies. Many states that model their policymaking on European-style social democracies – with high tax rates, heavy regulation, large bureaucracies, and generous welfare systems – are finding themselves in fiscal situations resembling those of the struggling Eurozone.

Divergence of economic policies among the 50 states has led to divergence of economic destinies.

The principle of federalism embodied in the U.S. Constitution gives states wide latitude to adopt the kinds of economic policies they like. And ideally, this policy experimentation in the "laboratories of democracy" should both respect Americans' unique intellectual and cultural diversity and, over time, give policymakers everywhere a better understanding of what works and what does not.

But the virtue of this arrangement breaks down when the costs of one state's policy mistakes are imposed on the citizens of more prudent or successful states. As both the 2008 financial crisis and the ongoing Eurozone collapse demonstrate, bailouts never solve anything. They only create more problems – moral outrage on one side, and moral hazard on the other.

The virtue of individual states serving as "laboratories of democracy" breaks down when the costs of one state's policy mistakes are imposed on the citizens of more prudent or successful states.

And yet, if current trends continue, the United States may be heading toward a two-tiered, European-style economic system, where taxpayers in prudent, prosperous states are forced by Washington to subsidize the imprudent and improvident governments of neighboring states.

With the $15.7 trillion U.S. national debt now larger than our entire economy, state and local debt topping $3 trillion,[1] as much as another $3 trillion in unfunded state and local government pensions, the $1.8 trillion cost of Obamacare,[2] and tens of trillions of unfunded federal

Not only does the United States face tens of trillions in debt and unfunded obligations, but a recent NBER study estimated America's true fiscal gap at $211 trillion with a 35% chance that the U.S. will face fiscal collapse within 30 years.

entitlement program liabilities, every level of American government is heading toward fiscal crisis. A recent study published by the National Bureau of Economic Research (NBER) assessed America's true fiscal gap at $211 trillion -- nearly 14 times our current GDP – with a 35% chance that the United States will face fiscal collapse within 30 years.[3] Filling this gap would require an immediate 64% increase in tax revenues, but such a tax hike would cripple the economy and hasten the collapse. There simply is not enough money to keep the promises politicians have made *and* create jobs to grow the economy.

To their credit, many state policymakers have recognized the unsustainability of high-tax, high-regulation welfare-state economics. But just like in Europe, many of the states in the deepest trouble seem least interested in reform – either out of incompetence, ideological blindness, or a cynical expectation that when a crisis hits, someone else will bail them out.

State pension systems serve as a window into the broader context and consequences of states' policymaking and priorities.

As Part I of this series showed, state pension funds – already as deep as $3 trillion in the hole – may well be the catalyst that ultimately triggers the Eurozone-style splitting of the American economy between contributory and dependent member states.

Part II will continue to use state pension policies as a window into states' policymaking and priorities, and also look at the broader context and consequences of those priorities. As our Euro-style fiscal crisis looms, which states are taking prudent steps to reform their long-term economic competitiveness and fiscal shortfalls, which states are lagging behind, and, most worrisome of all, which states seem content to pretend there is no crisis for which to prepare?

THE STATE PENSIONS WINDOW

Governments that impose high taxes, burdensome regulations, and large bureaucracies on their citizens tend also to mismanage their long-term fiscal responsibilities.

The state pensions crisis is not the only difficulty the states face today, but the status of each state's pension fund serves as an indicator of broader state policies that affect economic vitality and fiscal stability. As this analysis will show, governments that impose high taxes, burdensome regulations, and large bureaucracies on their citizens tend also to mismanage their long-term fiscal responsibilities.

Because of the size and imminence of the state pensions crisis – estimated at as much as $3 trillion in unfunded liabilities with some state pension plans facing insolvency within five years – as well as the constitutional guarantee of most state pension benefits, pending pension costs could overwhelm state budgets.[4] Professor Joshua Rauh of Northwestern University has estimated that the cost of providing pension benefits after state funds run dry could amount to

30% of current state revenues.[5] Drastic, Greek-like austerity measures to support pension costs in many states could drive successful businesses and individuals away, further draining the tax base and exacerbating the fiscal crisis. States that confront their problems sooner rather than later, and that do so without shifting the burden onto taxpayers, will be more likely to maintain and attract successful businesses and individuals that will help expand their economies.

Public sector pension costs could overwhelm state budgets, lead to drastic, Greek-like austerity measures, and cause the most irresponsible states to seek federal bailouts.

Without significant and immediate reforms, the combination of a constitutional guarantee for most state pension benefits and the inability of states to declare bankruptcy sets the stage for a massive federal bailout. If this occurs, the most irresponsible states will be first to knock on Washington's door, thus destroying all incentives for other states to act responsibly, as taxpayers in the most prudent states will be forced to pay the costs of their recklessness. On the contrary, the incentive will be to go broke quickly so as to be first in line for the bailouts.

WHAT DISTINGUISHES RESPONSIBLE STATES FROM IRRESPONSIBLE STATES?

Facing a looming fiscal crisis, what does it mean for a state or nation to be responsible or irresponsible, prepared or unprepared? How should states and nations prepare their citizens and taxpayers? How should they craft their economic policies?

As policymakers on both sides of the Atlantic continue to confront a global economic downturn and looming fiscal crises, a review of the economic trajectory of the 50 states ought to offer insights into those questions.

Economic wellbeing is synonymous with economic growth. In order for people to enjoy a rising standard of living, for workers to have jobs, for future generations to be better off than past ones, and for the government to collect the taxes it needs to operate, the economy must be growing, and growing at a sufficient rate. But what makes an economy grow? Freedom. Freedom empowers people and businesses to make unencumbered choices that best meet their own needs – as well as those of their families, their customers, and their employees – while freeing up resources to allow for a continual rise in the standard of living.

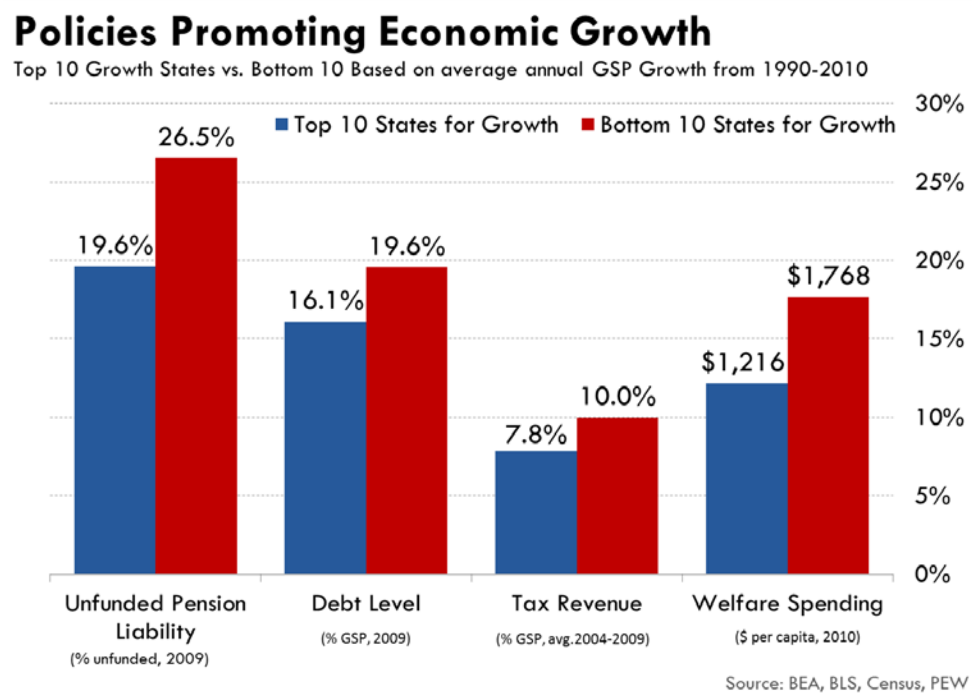
Freedom is the crux of economic growth and stability. Freedom empowers people and businesses to act in ways that are best for them and that produce a rising standard of living.

Governments that burden their citizens and businesses with high taxes, excessive regulations, excessive welfare benefits, and paternalistic intrusion into private lives will generally experience

People are voting with their feet and moving to states with more economic and personal freedom.

lower economic growth than those governments offering lower taxes, fewer regulations, and limited government intervention. A study by the Mercatus Center examined state and local government intervention in more than 150 distinct public policies spanning "from income taxation to gun control, from homeschooling regulation to drug policy."[6] After taking into account the number of people affected, the intensity of preferences on the issue, and the importance of state policy variation, each state was assigned a freedom ranking. The Mercatus study found that economic freedom is correlated with income growth and that people are voting with their feet by moving to states with more economic and personal freedom.[7] If the less free

Over the past two decades, the 10 states with the highest economic growth had: 26% smaller unfunded pension ratios; 18% lower debt ratios; 22% lower tax revenue; and 31% lower welfare benefits compared with the 10 states with the lowest economic growth.



states experience lower or negative income growth and continue to lose citizens, they will be facing a downward spiral that no level of taxation will be able to cure.

Just as the wrong economic policies can produce a downward spiral, the right economic policies can produce an upward spiral in which freer economies, limited government, lower taxes and spending, and prudent fiscal decisions can help generate lower unemployment, lower fiscal burdens, and higher income growth. These are the elements that provide the economic conditions for further growth-enhancing policies, such as tax cuts, and an upward economic spiral.

Analysis by the Republican staff of the Joint Economic Committee confirms the potential for an upward spiral across states. As the graph above shows, the 10 states with the highest annual economic growth over the past two decades had, on average: 26% smaller unfunded pension ratios; 18% lower debt as a percent of Gross State Product (GSP); 22% lower state and local tax revenue; and 31% lower welfare spending compared with the 10 states with the lowest economic growth.[8]

Taxes reduce the incentive to do or purchase that which is taxed. Taxes on growth-producing activities, such as work and investment, impede economic growth.

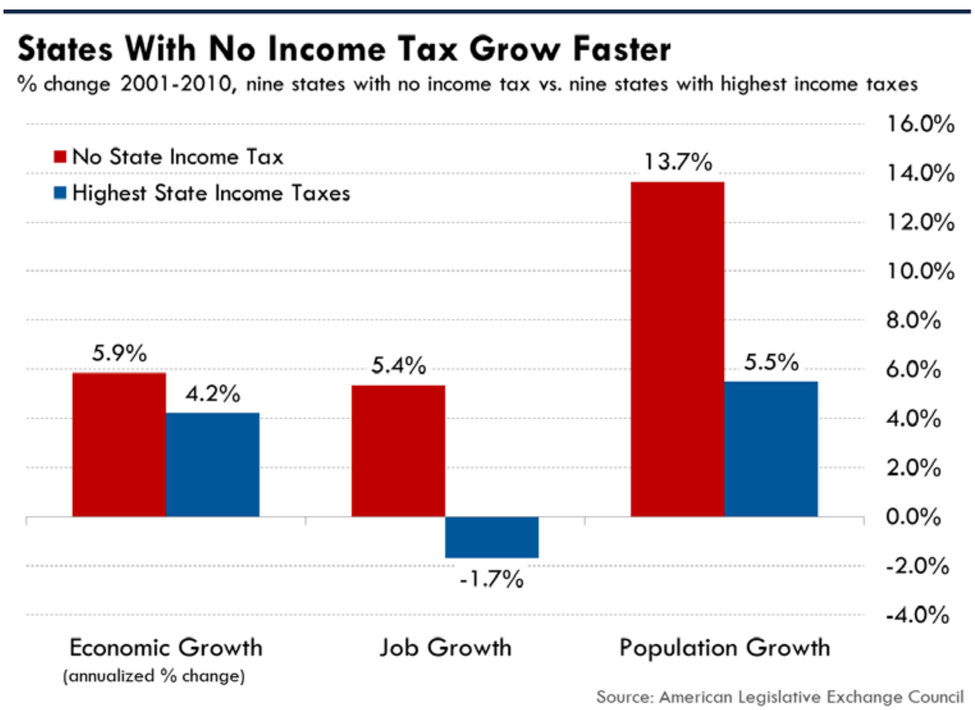
TAXES

Numerous studies have concluded that state taxation levels and policies impact economic growth. More specifically, higher income taxes lead to lower economic and income growth, and high marginal income tax rates, in particular, impose the greatest drag on economic growth.[9,10]

Why do taxes hinder growth? Income taxes reduce the incentive to work, to invest, and to take entrepreneurial risks, all the while leaving less money in the hands of individuals and businesses who would otherwise use that money to increase consumer spending, to fund capital ventures, to hire employees, or to develop new products. Just because an individual or business has profits and can "afford" to be taxed at high rates does not mean the economy can afford to lose the spending, investment, jobs, and economic growth that this taxation prevents.

High-income individuals and businesses may be able to "afford" higher tax rates, but our economy cannot afford to lose the spending, investment, jobs, and economic growth that this taxation prevents.

A study by the American Legislative Exchange Council (ALEC) examined the nine states with no income tax – Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming – compared to the nine states with the highest marginal income tax rates – New York, Hawaii, Oregon, California, New Jersey, Vermont, Maryland, Maine, and Ohio.[11] The



A comparison of states with no income tax to states with the highest income tax rates reveals that those with no income taxes experienced: 39% greater GSP growth; significant job gains compared to job declines; and more than twice the rate of population growth.

data confirmed that higher taxes hamper economic growth. From 2000 to 2010, the nine states with no income tax experienced: 39% greater GSP growth (58.5% in the no income tax states versus 42.1% in the highest income tax states), a significant gain in jobs (5.4%) versus a net decline (-1.7%), and more than twice the rate of population growth (13.7% vs. 5.5%).

Taxes in New York – on everything from bottled water to boxing matches to sliced bagels – have no doubt contributed to a 13.5% decline in New York's relative population share.

An example of the consequences of high taxes can be seen in New York, the state with the second highest taxes per capita in the nation. High taxes in New York – which include high marginal income taxes, onerous property taxes, and a miscellany of sales taxes on everything from bottled water to boxing matches to sliced bagels – have no doubt contributed to the state's relative decline in population over the past decades. Between 1990 and 2011, New York experienced a 13.5% decline in its population relative to that of the United States (in 1990, New York accounted for 7.22% of the total U.S. population, compared with 6.25% in 2011), placing it 8th amongst the states in terms of relative population loss.

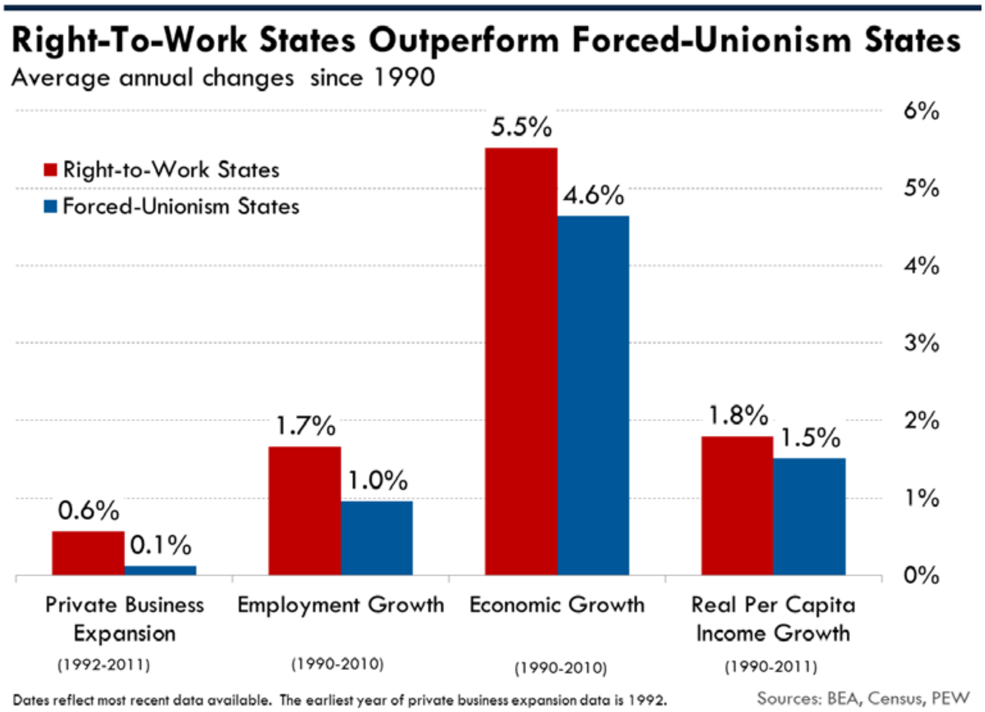
LABOR

A key component to economic growth is low unemployment and high labor force participation. The more people there are working in an economy, the greater the output, the fewer people unemployed, and the lower the level of government welfare spending. Thus, attracting businesses that will employ workers and increase output is crucial to states' welfare and prosperity.

Job growth is crucial to economic growth and states with right-to-work laws attract businesses that create jobs.

In the United States, 23 states currently have right-to-work (RTW) laws that guarantee citizens the right to choose whether or not to join a union as a condition of employment.[12] These laws are meant to protect both employees and employers from the powerful hand of unions who may not be representing workers' desires and best interests. Right-to-work laws encourage business development and employment growth by helping ensure that businesses setting up shop in a RTW state will be free to negotiate with employees on their own terms, which typically results in lower costs.

The average pace of business expansion from 1992 to 2011 was nearly five times higher in RTW states (0.56%) than it was in forced-unionism states (0.12%).[13] A byproduct of greater business expansion is higher employment growth. From 1990 to 2010, the pace of employment growth was nearly 75% greater in RTW states (1.7%) versus forced-unionism states (1.0%), while economic growth was 20% greater in RTW states (5.5%) compared with forced-unionism ones (4.6%). Finally, the pace of real per capita income growth from 1990-2011 was almost 20% greater in RTW states (1.8%) versus forced-unionism states (1.5%).



Over the past two decades, right-to-work states have experienced nearly five times greater business expansion, 75% greater employment growth, 20% higher economic growth; and 20% greater income growth.

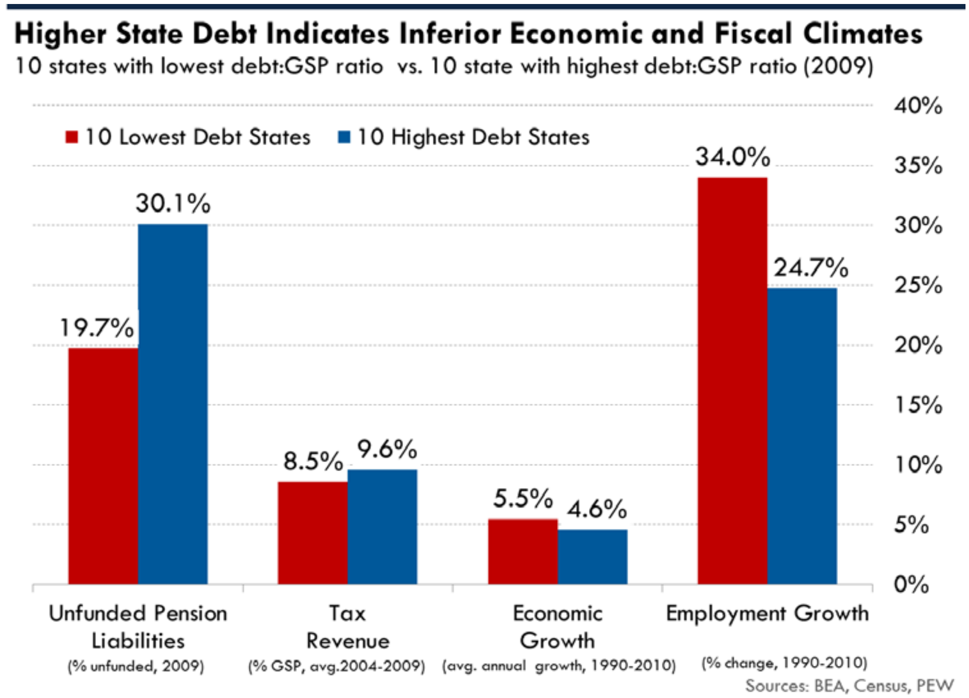
With public-sector union membership rates (37%) more than five times that of the private sector (6.9%), and public-sector union members representing more than half of all union members, it is not surprising that forced-unionism states also tend to have high public-sector pension burdens.[14] In FY 2010, forced-unionism states spent an average of 1.4% of total GSP on pensions compared to 1.1% among RTW states, and pensions consumed 6.5% of all outlays in forced-unionism states as compared to 5.1% among RTW states.[15] These higher pension costs (27% higher as a share of GSP and total outlays) necessitate higher taxes, hindering economic growth, and reducing funds that would otherwise be available for other government services such as education, infrastructure, and law enforcement. A study by the Tax Foundation found that the states with the highest percentages of government union workers also have the highest state and local tax burdens, as taxpayers are forced to foot the bill for public employee benefits unheard of in the private sector.[16]

Forced-unionism states have high public-sector costs, including pension burdens that consume a 27% greater share of both GSP and total outlays.

Taxpayers foot the bill for public sector employee and pension costs through higher state and local taxes.

Right-to-work laws, as well as other policies related to economic growth and freedom, are causing people to vote with their feet. Since 1980, forced-unionism states have lost 25 seats in the U.S. House of Representatives to right-to-work states.

As businesses and workers flock to labor-friendly states, forced-unionism states have lost 25 seats in Congress to right-to-work states.



DEBT

The 10 states with the lowest debt-to-GSP ratios had: 35% lower unfunded pension liabilities; 11% lower taxes; 20% greater economic growth; and 38% greater employment growth than the 10 states with the highest debt-to-GSP ratios.

Among the states, there is a similar correlation between economic freedom and sound fiscal policy. Some of the states facing the largest deficits and debt today are also among the states with the greatest unfunded pension liabilities, the highest taxes, and the lowest economic and employment growth.

A comparison of the 10 states with the lowest debt-to-GSP ratios for 2009 versus the 10 with the highest debt-to-GSP ratios shows that the states with lower debt had, on average: 35% lower unfunded pension liabilities; 11% lower taxes; 20% greater economic growth over the past two decades; and 38% greater employment growth over that same time.[17]

LESSONS FROM EUROPE

The Eurozone crisis is a warning to the U.S. against high taxes, bloated pensions, ballooning entitlement programs and dependence on government.

The crisis in the Eurozone is a warning to the United States. High taxes, bloated pensions, ballooning entitlement programs, and the resulting dependence on government all contributed to the perfect storm that is the European debt crisis. As in the U.S., public pensions in Europe are only a part of the problem: rather they are a symptom of a broader pattern of economic and fiscal irresponsibility.

Although it has taken a crisis to bring about reform, European nations have finally come to grips with the fact that they cannot avoid public pension reform if they want to avoid a Greek-like crisis. Spain has increased its retirement age by two years and has proposed ending

Cost of Living Adjustments (COLAs).[18] Greece has increased the retirement age for some workers and changed certain benefit calculations such as years of service.[19] Britain raised the retirement age to 68 for many workers and will put new enrollees into partial defined contribution plans.[20] France has increased the full retirement age for its pensions by two years, from 65 to 67.[21] Of course, so ingrained is the sense of entitlement engendered by the social democracy model that in response to budget cuts, riots broke out in all of these countries.

Just as the most imprudent European nations have required bailouts from the Eurozone, the most imprudent states might soon come to Washington seeking bailouts.

Not yet at European levels, state pension costs in the U.S. are nonetheless rising rapidly and pose a serious threat to the fiscal health of states. Without sufficient reforms, state pension benefits, which in many states carry a constitutional guarantee, could be the straw that breaks the states' budgets. Without sufficient revenue to pay pension benefits and also maintain crucial services such as law enforcement and education, states may come to Washington for a federal bailout just as countries like Greece have done with Brussels in the Eurozone.

MORAL HAZARD

The Eurozone crisis, and bailouts in general, present a classic case of moral hazard: the reckless are in effect rewarded for their irresponsibility while the prudent are penalized for their discernment.

The crisis within the Eurozone has put the more prudent countries, Germany especially, in a bind: either continue to bail out the countries that spent and borrowed the continent into economic chaos, or else risk the widespread consequences of a collapse of the Eurozone. This is a classic case of moral hazard: the reckless are in effect rewarded for their irresponsibility while the prudent are penalized for their discernment.

Bailouts create an environment that encourages recklessness and discourages difficult but necessary reforms. Since states do not have the explicit ability to declare bankruptcy, it seems all but inevitable that there will come the day when one or more of the states ask for and receive a federal bailout. If this happens, there will be no reason left for state policymakers to do the right thing. Imagine if a bill were passed wiping away all credit card debt in the United States paid for with a new tax on people who have no debt. What incentive would be left to do the right thing?

A federal bailout could incite a new struggle between the fiscally reckless states seeking bailouts and the fiscally prudent ones forced to finance those bailouts.

Today, amidst a culture of bailouts and the Administration's calls for "shared sacrifice" (which would, ironically, include massive tax hikes on a small subset of individuals and businesses), the imprudent actions and policies of some states are threatening the freedom of others. If poor economic policies, fiscal recklessness, and ignored pension liabilities lead the imprudent states to seek a federal bailout, it could incite a new struggle between the fiscally reckless states seeking bailouts and the fiscally prudent ones forced to finance those bailouts. Such has already been the case at the municipal level, as many cities and localities have recently entered bankruptcy or required state-level bailouts.

ALREADY BANKRUPT U.S. CITIES

The root causes of most municipal bankruptcies can be traced to excessive government liabilities (often the result of public-sector unions), government attempts to take activities on better left to the private sector, corruption, and irresponsible political promises.

Although states in the U.S. do not have the explicit ability to enter bankruptcy, municipalities can file for Chapter 9 bankruptcy, and since 1937, more than 600 municipalities have done so.[22] Recent years have witnessed a slew of prominent municipal bankruptcy filings in the U.S. The root financial troubles of most municipalities can be traced back to excessive government liabilities and promises, such as public employee pensions and benefits (reforms to which have been prevented by powerful unions), government attempts to take on activities for which they are not equipped and could be better performed by the private sector, and corruption. Most important, perhaps, are the political promises made with the next election, rather than the state's long-term well-being, in mind.

Only through bankruptcy was the small town of Central Falls, RI able to make cuts to onerous and previously non-negotiable public-sector retiree and employee benefits.

Last summer, the small town of Central Falls, Rhode Island filed for bankruptcy. Large and growing government employee benefits and pensions served as the tipping point for Central Falls' troubles.[23] When tax increases and significant cuts to services proved insufficient to fill the town's fiscal imbalance, bankruptcy became its only, and arguably best, option. Through bankruptcy, Central Falls has been able to make cuts to previously non-negotiable public-sector retiree and employee benefits. Although the public-sector unions and employees might have been better off making concessions that would have prevented a bankruptcy filing, they have now lost control of the process to a state-appointed receiver. Furthermore, a law passed in Rhode Island specifies that, in the case of a financial shortfall, bondholders are the first to be paid off, before pensioners. Although not yet tested in court, other states may choose to follow suit with similar laws that reduce bondholders' fears and eliminate many of the risks of bankruptcy.[24]

Following on the heels of the Central Falls bankruptcy filing was that of Jefferson County, Alabama, the largest municipality in history to declare bankruptcy. At the root of the county's fiscal crisis was a sewer deal featuring both corruption and attempts by politicians to profit from complicated financial products beyond their comprehension that left the city with an unmanageable debt.[25]

With the economy just barely recovering from the recent recession and state and local pension obligations rising, municipal bankruptcies are likely to become more common. A number of municipalities (including Camden, NJ; Strafford County, NH; Riverdale, IL; Salem, NJ; Harrison, NJ; and Pontiac, MI) are already on the path towards bankruptcy. And Detroit, Michigan, recently avoided bankruptcy – at least for the time being – through an agreement in which the state stepped in to help Detroit meet its obligations (more on Detroit below).

WHICH STATES ARE LIKE GERMANY?

Germany is Europe's model of fiscal prudence. While other nations ran up massive debt during the recent recession, Germany's debt as a percent of GDP grew only 3.6 percentage points from 2007 to 2011. In contrast, Greece's debt over that same time increased 71.2 percentage points, Italy's rose 18.6 percentage points, Spain's increased 23.3 percentage points, and the United States' jumped 34.6 percentage points.[26] And while most nations have gone on stimulus spending sprees, Germany's spending has increased by an average of just 3.2% over its 2007 level, compared with a 20% increase in Greece, a 10% rise in Italy, a 21.1% jump in Spain, and a 23.2% increase in the United States.[27]

Germany is Europe's model of fiscal prudence: since the recession, its debt-to-GDP ratio has increased only 3.6 percentage points and its annual spending has increased only 3.2%. The United States' debt-to-GDP ratio jumped 34.6 percentage points as its annual spending rose 23.2%.

Some state legislatures have taken Europe's experience to heart and – like Aesop's ants – have begun to make the necessary provisions to prepare their budgets and their citizens for the fiscal winter ahead.

In 2011, Utah took action to curb its unfunded pension liabilities by moving many new hires into defined contribution retirement plans, similar to those offered in the private sector. [28,29] Now, new hires in Utah have the option to choose between a defined contribution plan or a defined benefit plan, with the state contributing 10% of employees' salaries to either plan. This one reform is projected to eventually cut Utah's $6.5 billion unfunded pension liability in half.[30]

Like Germany, some states are taking prudent actions: Utah, New Jersey and Rhode Island have enacted public-sector pension reforms that significantly reduced their unfunded pension liabilities and generated substantial taxpayer savings.

Since his term began in 2010, New Jersey Governor Chris Christie has been leading an effort to enact pension reform in the state. Under Christie's tenure, New Jersey has increased public employees' pension contributions from 2% to 7.5% of their salaries, eliminated COLAs for current retirees, mandated annual payments by the state into the pension system, and ended collective bargaining for health benefits. These reforms, which were passed in June 2011, are projected to save local governments $267 million this year alone and $120 billion over 30 years.[31]

Rhode Island's pension system was recently among the most troubled in the nation, with only a 48% funding ratio (meaning, its current assets were projected to cover only 48% of its current liabilities). [32] However, State Treasurer Gina Raimondo took on the difficult task of structural pension reform and enacted significant reforms with bipartisan support. According to Raimondo, the Rhode Island Retirement Security Act will reduce the state's unfunded pension liability by approximately $3 billion (from a level of $7.3 billion in 2011) and raise the pension funding ratio from 48% to 60% percent.[33]

Wisconsin's elimination of collective bargaining for public sector employees has generated huge taxpayer savings while also preventing teacher layoffs and allowing for a reduction in property taxes.

Upon taking office in 2011, Wisconsin Governor Scott Walker quickly eliminated a $3.6 billion budget deficit without raising taxes. And perhaps most importantly, his budget eliminated collective bargaining for benefits by public sector employees. This provision is particularly important for future costs because the Wisconsin Retirement System, the ninth largest public pension fund in the United States, faces huge unfunded liabilities (in 2010, the plan was only 80% funded with $2.2 billion in unfunded liabilities).[34] The elimination of collective bargaining on benefits has allowed significant cost-saving reforms to be enacted. While most state employees previously paid nothing towards pension benefits and only 6.2% of health benefits, they are now required to contribute 5.8% of their salaries toward pension benefits and to pay for 12.4% of their health insurance benefits, while also now having to wait five years before becoming eligible to receive a pension.[35]

Governor Walker's Administration has estimated that the new employee contributions will save taxpayers $724 million annually.[36] Furthermore, the ability to choose health care benefit providers, rather than being forced to purchase from a company affiliated with the teachers' union, could save school districts in the state hundreds of millions of dollars while also preventing teacher layoffs.[37] Already, lower state spending on local school districts has been credited with contributing to a decline in Wisconsin's property taxes for the first time in over a decade.[38]

WHICH STATES ARE LIKE GREECE?

California continues to expand its public sector through higher taxes and deficit spending, causing residents to flee the state.

Even before the recent financial crisis and worldwide recession, California has continually confronted significant budget shortfalls which continual tax hikes have failed to curb, and the growing welfare state and highly regulated environment have hindered economic growth. Just last year California faced its own debt crisis, which resulted in a credit downgrade. Among the primary culprits in California's crisis were its public sector unions and a state pension system that itself accounts for more state government spending than the entire University of California education system.[39] In 2008, Democratic State Treasurer Bill Lockyer criticized the Democrat-dominated legislature's ties to the public sector unions, saying, "It's impossible for this Legislature to reform the pension system and if we don't it will bankrupt the state. And I don't think anybody can do it here because of who elected you."[40] Flawed economic policies, a large and growing public sector, and poor fiscal management have caused California to be a less attractive state for people to live. From 2000 to 2009, 1.5 million more residents moved out of the state than moved into it.[41]

Illinois is another state that has been making headlines for the wrong reasons. Illinois' pension system is among the most troubled in the nation. Just the Illinois Teachers' Retirement System component of public pensions alone will cost more in 2011 ($5.7 billion) than total general state aid to schools ($4.6 billion).[42] That is, Illinois' taxpayers spend more money on retired teachers than on current students. Despite the establishment of a two-tier system offering less generous benefits to new hires, Professor Joshua Rauh estimates that even assuming 8% annual returns, Illinois's pension system will go broke in 2018.[43]

Illinois spends more on retired teachers' pensions than it does on total state aid to schools. Its recent 67% tax hike on individuals and 30% tax hike on businesses will likely exacerbate Illinois' 10% decline in population share over the past two decades.

In addition to pension troubles, Illinois has consistently faced large budget shortfalls, which it has filled by raising taxes. In January 2011, Illinois raised its individual income tax by 67% (from 3% to 5%) and its corporate income tax by 30% (from 7.3% to 9.5%, including a 2.5% surtax).[44] Not surprisingly, from 1990 to 2011, Illinois' share of the total U.S. population declined 10% (from 4.56% in 1990 to 4.13% in 2011).

Michigan is another prime example of the downward spiral that can result from poor economic policies, unrealistic promises, and poor fiscal management. Since 1970, the state has experienced a 27% decline in its population relative to that of the U.S. as a whole (in 1970, Michigan accounted for 4.37% of the total U.S. population versus 3.17% in 2011). Long known for its auto industry, many of the state's current troubles mimic those confronted by the auto companies a few years ago, which required an $80 billion federal bailout in 2009 just to stay afloat. Like the auto companies, Michigan and many of its cities have become overly burdened by legacy costs (such as healthcare and pension benefits) for its retirees as well as often non-negotiable union contracts that require tremendous employee benefits unheard of among the private sector taxpayers who pay for it all. Just as competition prevented the auto companies from raising prices

Michigan's difficulties resemble those of its troubled automakers as legacy costs for retirees and tremendous, union-led benefits for current employees have become overly burdensome.

enough to cover their excessive employee costs, the ability of individuals and businesses to move out of the state has prevented Michigan from being able to raise taxes enough to cover its bloated government sector.

Once Michigan's prized jewel, Detroit has become ground zero for this fiscal death spiral. Over the past several months, the city was on the verge of bankruptcy, seeking a state bailout with no strings attached. At the mercy of its public employee unions, the city has been operating under a bloated government sector, including lavish employee benefits and pensions. Attempts to finance these benefits through property and income tax increases (to the highest level in the state) have instead resulted in *lower* tax revenues, as successful individuals and businesses flee the city.[45] Detroit's finances are in shambles: annual debt payments are 10% greater than its primary tax revenues; employee benefits consume more than half the city's general fund; it has $12 billion in long-term debt and a debt-to-asset ratio of more than 33-to-1; it is financing the retirement benefits of more than twice as many retirees as it has current government workers; and the two largest employers in the city are its schools and city government.[46,47]

A state bailout just saved Detroit from bankruptcy, but with annual debt payments exceeding primary tax revenues, employee benefits that consume half the city's general fund, a debt-to-asset ratio of 33-to-1, and politicians immobilized by public-sector unions, it is only a matter of time before Detroit requires another bailout.

Despite massive public-sector union opposition, Detroit has avoided bankruptcy, for the time being, through a consent agreement with the state of Michigan that will allow the city to borrow the $137 million it needs to maintain basic services through June of this year. In exchange, a newly appointed, nine-member financial review board will oversee reforms to reduce city costs primarily through changes to employee benefits and outsourcing or privatization of some city services. Although the alternative to handing significant control over to a board is the *complete* loss of city control to a manager appointed by Republican Governor Rick Synder, public employee unions have done all they can to prevent the consent agreement from taking hold. Greek-like responses to even relatively minor cutbacks (such as the city's unionized mechanics immobilizing the bus system by refusing to repair broken buses) suggest that the new financial review board will have its work cut out for it when trying to negotiate with the city's unions.

Having already been bailed out by the state, it seems the city's Administration now has its sights set on a federal bailout. While the city seeks to cut $250 million in spending and lay off 2,500 workers, the mayor of Detroit has signed a $330,000 contract with a team of Washington lobbyists to give the city a voice on Capitol Hill.[48] Furthermore, the city's congressional representative, Hansen Clarke

(D), has already lobbied both Congress and President Obama for as much as a $1 billion bailout for Detroit.

CONCLUSION

Despite the tried-and-true nature of some simple principles of economics – e.g., taxes discourage the activity being taxed and produce a deadweight loss, there is no free lunch, there is a cost to borrowing, and numbers don't lie – many states are acting as though they might somehow be able to escape economic reality.

The above examples of prudent and imprudent state policies and fiscal management shed light on some of the ways certain states are making difficult decisions and sacrificing short-term indulgence for future growth, while other states are simply putting off necessary reforms and fiscal discipline to the long-run detriment of their economies. If states do not get their fiscal houses in order, obligations such as unfunded pension liabilities could push the states to Washington's doorstep, asking for a federal bailout. In that case, moral hazard will flourish, as states that followed the often-difficult path to fiscal discipline will have to pay for the states that neglected to do so.

The next and final report in this series will examine what Washington can do to prevent a federal bailout and to ensure that fiscal responsibility by some states is not punished by the recklessness of others.

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[12] Indiana joined the ranks of Right-To-Work states in 2012. Because the time periods included in the analysis are all prior to 2012, Indiana is included in the data as a forced-unionism state.
[13] This data series did not begin until 1992 and therefore varies from the other comparisons which go back to 1990.
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[15] Data for FY 2010 from usgovernmentspending.com.
[16] "State and Local Tax Burdens 1977-2009," The Tax Foundation, February 2011, http://www.taxfoundation.org/taxdata/show/336.html#sl_burdens_byyear_1977-2009-20110223.
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