McConnell Is Wrong: Forcing States into Bankruptcy Defies Logic

Senate Majority Leader Mitch McConnell said recently that the federal government should deny state governments funding to fight the coronavirus and its destructive economic impact. Instead, claiming to be concerned about the federal deficit, he said that he "would certainly be in favor of allowing states to use the bankruptcy route."[1] He later tried to explain his statement saying "we're not going to let [the states] take advantage of this pandemic to solve a lot of problems that they created themselves [with] bad decisions in the past."[2]

McConnell was widely excoriated for his comments. Republican Governor Larry Hogan of Maryland proclaimed that "the last thing we need in the middle of an economic crisis is to have states all filing [for] bankruptcy all across America and not [be] able to provide services to people who desperately need them."[3] Kentucky Governor Andy Beshear said "bankruptcy for a state would be disastrous."[4] Republican Governor Chris Sununu of New Hampshire called it "a ridiculous statement," and New York Governor Andrew Cuomo said it is "one of the dumb ideas of all time."[5] Nobel Prize-winning economist Paul Krugman called it "stupid on multiple levels," arguing that it "could cause a national financial crisis."[6]

The Majority Leader's comments are deeply misleading and require closer examination.

States are paying a high price for President Trump's failure to contain the coronavirus

The U.S. economy is in the most serious recession since the Great Depression—the Congressional Budget Office projects that the unemployment rate will average close to 14 percent and GDP will drop 40 percent on an annualized basis in the second quarter.[7] This is partly a result of the president's six-week denial that the pandemic would reach the United States and his failure to take even minimal steps to contain the virus during the early stages as it was spreading exponentially; to adopt a clear strategy for testing, tracing and isolation; and to ensure that enough tests were provided to the states.[8] The consequences of these failings have hammered the states, with longer periods of social distancing required, higher public health costs and more job losses and business closures.

The coronavirus pandemic puts states in a severe fiscal squeeze

The coronavirus outbreak has forced states to spend billions of dollars to fight the coronavirus and cover rapidly expanding Medicaid and other public assistance costs. In the six weeks ending April 25th, nearly 28 million Americans have filed for unemployment insurance (UI) benefits—a devastatingly high number that also understates the total amount of job losses.[9]

Meanwhile, the severe recession caused by the coronavirus has pounded state economies, causing tax revenues to shrink dramatically. States depend on sales and income taxes for 70 percent of their tax revenue, according to the Center on Budget and Policy Priorities (CBPP).[10]

Both have plummeted as people are forced to stay home, lose their jobs and spend less. As a result, it is estimated that states will see $650 billion in budget shortfalls over fiscal years 2020-2022.[11]

Forcing states to declare bankruptcy would worsen their current fiscal crises

Bankruptcy is not a tool that would help states address the fiscal challenges they currently face, and it would only make the situation worse.[12] It is a tool used to restructure debt, but as CBPP points out, state debt isn't even high by historical standards.[13] States are expected to be able to meet their obligations to creditors once the economy returns to normal. Bankruptcy would also send a terrible signal to investors in the bond market, and it would significantly raise interest rates for the bonds that states use to finance infrastructure and other projects.[14]

In his comments about state bankruptcy, Senator McConnell also said that "there's not going to be any desire on the Republican side to bail out state pensions by borrowing money from future generations."[15] Pinning states' current fiscal challenges on state employee pension benefits is a red herring. State employee pensions are not the cause of the current fiscal crisis, and additional federal aid would go into states' general funds, which would be used to cover increased costs from the crisis and certain budget shortfalls. States do not pay pension benefits for retirees out of their general funds but out of separate trust funds.[16] Furthermore, though there are remaining challenges for some, every state has adopted pension reforms over the last decade, which have actually lowered benefits for new employees in many states from past levels.[17]

States need additional federal aid for increased public health, Medicaid and other public assistance costs, amid falling revenue and looming budget shortfalls. Anything short of the amount of federal aid state and local governments need could have catastrophic effects, including severe budget cuts. That would hurt workers and families; lead to job losses for teachers, health care workers, firefighters and others; and make the recovery more difficult. The National League of Cities estimates that between 300,000 and 1 million public-sector workers could soon lose their jobs or be furloughed.[18]

States cannot borrow to cover emergency expenses—even if it is in their long-term interest

Unlike the federal government, which can run a deficit when necessary, every state except Vermont is constitutionally or statutorily required to balance its budget.[19] This means that they generally cannot use borrowed funds even to spend money to fight a pandemic.

However, not spending the money required to fight the coronavirus would cause untold human misery and far greater economic damage in the future. If states can't borrow money and can't get help from the federal government, they will be forced to slash other necessary spending or raise taxes. This would have disastrous effects at a time when so many people are relying on government services and losing income, and it will only prolong and deepen the recession.

During the Great Recession, states faced budget shortfalls of more than $600 billion, and state tax collections plummeted by $100 billion from 2008 to 2010. In response, states cut spending by $290 billion and raised taxes by $100 billion to help close their budget shortfalls.[20] These spending cuts hurt K-12 and higher education, public assistance and infrastructure, among other spending areas, and they were a drag on the economy's growth for years after the Great Recession ended. In fact, it took more than 10 years for state and local government employment to reach its pre-recession level, making the hole for the private sector to dig out of that much deeper.[21]

Many states had prepared for an economic downturn

The states are not "tak[ing] advantage of this pandemic to solve a lot of problems that they created themselves," as Senator McConnell has claimed.[22] They face a mounting fiscal crisis because of the unprecedented public health and economic crises. Only one state has ever defaulted on its general obligation debt, and it was during the Great Depression.[23] States have healthier rainy day fund and unemployment insurance trust fund balances (which support state unemployment benefit programs) than they did heading into the last recession.

Rainy day funds reached a record 7.6 percent of state budgets just before the crisis began, and total state reserves equaled about 13 percent of state budgets—both well above their pre-Great Recession levels.[24] Similarly, 38 states had healthier UI trust funds entering this fiscal crisis than they did entering the Great Recession, and the majority of state trust funds met the U.S. Department of Labor's minimum solvency standards for recession preparedness.[25]

Additionally, many states had not returned to pre-Great Recession levels of spending before the current downturn—that is to say that they were actually *underspending* in many key budget areas, such as education. Between 2008 and 2018, state funding for higher education was down 13 percent per student on average, after adjusting for inflation.[26] In 2017, 22 states and the District of Columbia still spent less on K-12 education than they did in 2008.[27]

McConnell expressed no concern for the debt when he passed almost $2 trillion in tax cuts

While Republicans in Congress are criticizing states for spending decisions now, they did not act so fiscally responsibly themselves when they passed the Tax Cuts and Jobs Act in 2017 in the middle of a record expansion—a bill that was heavily skewed toward the wealthy and big corporations and that will add $1.9 trillion to the national debt.[28]

McConnell is wrong to call federal aid to states a "blue state bailout"

Although many of the cities and states that have been hardest hit so far are along the East and West coasts, some Southern and Midwestern states also have been deeply affected. In addition, some rural areas in both red and blue states have suffered devastating outbreaks. Inevitably, COVID-19 will hit red-leaning areas harder as well, just on a longer timeline.

Rural areas already have begun to face severe outbreaks in recent weeks. In mid-April, a meat plant in Sioux Falls, South Dakota became the worst coronavirus hot spot in the country. Earlier in March, Albany, Georgia had the most coronavirus cases per capita outside of New York, New Jersey and Massachusetts, but had a significantly higher fatality rate than the hardest-hit cluster of counties in those three states.[29]

Red states may end up facing worse fiscal crises than blue states

Blue states largely are most reliant on state income taxes for revenue, while many red states are reliant on sales taxes. Workers across the country are losing their jobs, but if a relatively high proportion of high earners in blue states keep their jobs, the revenue hit for blue states will be lower. Several red states do not have state income taxes, and depend mostly on sales taxes, which likely have been plummeting as people are forced to stay home and generally are spending less.[30] Many red states that do have state income taxes are often still heavily reliant on sales taxes, and in some cases, significantly more so than other types of taxes.[31] Spending has likely been falling across income levels, which is particularly bad for red states. In a few months, the likely hit to red states' budgets will become more evident.

State and local governments need more aid from the federal government

The economic crisis caused by COVID-19 is not a result of mismanagement by states. Forcing them into bankruptcy would not address the challenges states currently face and would be an abdication of the federal government's responsibility in the wake of the unprecedented public health and economic crisis caused by COVID-19. The National Governors Association has called for an additional $500 billion in state stabilization funding, as well as a further increase in the federal government's share of Medicaid funding, and the U.S. Conference of Mayors has requested $250 billion in aid for local governments.[32] Congress and the Trump administration must include additional aid for state and local governments in the next coronavirus relief bill.

Additional reading

Massive Aid to State and Local Governments Needed to Slow Economic Damage," U.S. Congress Joint Economic Committee Democratic staff

States Need Significantly More Fiscal Relief to Slow the Emerging Deep Recession, Center on Budget and Policy Priorities

Federal Fiscal Aid to Cities and States Must Be Massive and Immediate, Brookings Institution

At Least $500 Billion More in Coronavirus Aid Is Needed for State and Local Governments by the End of 2021, Economic Policy Institute

McConnell Says States Should Consider Bankruptcy, Rebuffing Calls for Aid, *New York Times*

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