Excessive State Debt: A New Approach to a Growing Problem

Vincent Buccola
University of Pennsylvania, buccola@wharton.upenn.edu

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Excessive State Debt: A New Approach to a Growing Problem

Summary
Economists and political observers agree state governments defaulting on their debt obligations is a growing concern. How best to aid struggling states, however, is a point of contention. This Issue Brief makes a case against ex post restructuring measures, specifically bankruptcy modeled on Chapter 9 of the U.S. Bankruptcy Code, and in favor of ex ante debt mitigation action. In particular, it introduces tax-credit borrowing (TCB) as a potential commitment device for states that would allow for the creation of super-priority, risk-free debt. TCB ensures that states internalize the risk of default and avoids the moral hazard problem of states assuming that the federal government will, in a fiscal crisis, use taxpayer money to offer a bailout. It also incentivizes better monitoring of the borrowing decisions made by state officials, as the fiscal ramifications of excessive debt would move from state creditors to taxpayers and voters. Small changes to federal tax policy and likely a subsidy (relative to traditional debt) would be necessary to encourage tax-credit borrowing, but this new approach can solve the sticky problem of debt prioritization that continues to mystify states and municipalities.

Disciplines
Bankruptcy Law | Economic Policy | Public Policy | Taxation | Taxation-State and Local

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Since the beginning of theGreat Recession and for the first time since the 1890’s, many academic and political commentators have begun to voice serious concerns about the possibility of state governments defaulting on their debt obligations.

Several of the most fiscally troubled states in the country, specifically California, Illinois, and New Jersey, have struggled with and continue to face eroded tax bases and higher levels of spending on countercyclical welfare programs. With less revenue at their disposal, many states now massively underfund their pension obligations and borrow at excessive rates, all of which has led credit rating agencies to downgrade these states’ general-obligation ratings on a regular basis (see Figure 1).

A frequent refrain from commentators is the proposal to aid states by allowing them to restructure or even eliminate some of their debt through a formal, federal bankruptcy process modeled on Chapter 9 of the Bankruptcy Code. The rationale, quite simply, is that bankruptcy is preferable to a bailout, as a federal bailout would explicitly institutionalize the moral hazard of over-borrowing at the state level, which state administrators may already assume exists implicitly. In essence, if states are “too big to fail,” as many argue, then the federal government will have to intervene and redirect revenues from non-failing states to prevent a state’s default. With the threat of contagion...
and spillover effects to other states, bailouts are unavoidable absent an alternative path forward. Therefore, so the thinking goes, bankruptcy at the state level must be made available. But academics and politicians alike have had mixed reactions to this proposal, and for good reasons. One in particular is that it ignores the less than obvious reality that states would never willingly concede to undergo formal bankruptcy proceedings, even if they were forced to default on their debt obligations.

States already have the power to alter their debts unilaterally by extending the maturities of their bonds or by reducing the principal or interest rates they choose to repay. The constitutionality of these actions actually does not matter because states are protected by the doctrine of sovereign immunity. Lenders have no legal recourse in the event of a default on state debt or even in the case of (arguably illegal) unilateral debt re-composition. Additionally, states can take advantage of de facto Chapter 9 protections right now, but none choose to do so.\(^2\) In a bankruptcy, states would have to relinquish their power to externalize risk (i.e., redirect risk to other states), but being contagious is valuable for states—as noted above, it underlies the notion that they are too big to fail. Regardless, no entity, not even the federal government, can require a state to avail itself of that recourse, especially given its potential uselessness, which stems from Chapter 9’s insolvency requirement. The bankruptcy approach could very likely be too little, too late. Ultimately, any solution to curb excessive state borrowing must be ex ante, as states would never consent to ex post federal restructuring measures.

The problem necessarily requires pre-default mitigation. This Issue Brief presents such an approach in the form of “tax-credit borrowing.”\(^3\)

TAX OFFSETS IN LIEU OF CASH OUTLAYS

Tax-credit borrowing (TCB) is a financing mechanism (similar to but in place of traditional forms of state debt) that can act as a commitment device for a state, ensuring that it

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**NOTES**

1. A useful definition of excessive debt is debt that results in socially wasteful spending—projects that the polity, however defined, values at less than cost.

2. A state could leverage the Bankruptcy Code’s generous definition of “municipality,” and create a municipality whose sole purpose would be to issue all debt for the entire state. It would issue general-obligation bonds, back state employees’ pension rights, and reimburse trade creditors. This entity would not be the state itself, but rather its sole financing arm, funded through appropriations. As such, this new municipality could declare bankruptcy, even though the state itself is ineligible for bankruptcy relief under Chapter 9.


4. This is mathematically true, but the relevant players in the markets and at the polls may not see this the same way. For a divergent opinion, see David Gamage and Darien Shanske (2011), “Three Essays on Tax Salience: Market Salience and Political Salience,” 65 Tax L. Rev. 19.

5. A 2012 study by Anna Gelpern published under the title “Bankruptcy Backwards: The Problem of Quasi-Sovereign Debt” in the Yale Law Journal reveals that 40 of the 50 states bar money-damages suits in their own courts, and no state consents to damages actions in federal court. Of the 10 states that do allow money-damages actions, the
meets all of its debt obligations as originally composed. Through the issuance of tax-credit bonds, TCB circumvents the protections offered to a state by sovereign immunity, and it internalizes financial risk, which likely would lead to a reduction in borrowing overall.

The concept can be explained in this way. If a state were to no longer repay its creditors with cash outlays from its revenue (according to terms it could unilaterally alter), but instead creditors were compensated for the capital they lent to a state by lowering their tax burdens through tax credits linked to these new tax-credit bonds, any attempt by a state to collect that revenue would force the state to assume the role of plaintiff in court. This circumvents the sovereign immunity doctrine, which treats states as unassailable defendants but does not substantively privilege them as plaintiffs. TCB would give the creditors who invest in tax-credit bonds the legal recourse to be made whole, especially in times of extreme fiscal hardship for states, without actually requiring the intervention of courts. Creditors would merely offset their taxes by the amount a state owed them.

Logistically, an extra dollar payable by a state is the same as an uncollected dollar receivable within the same reporting window. Therefore, the difference in this approach is not financial but legal, as TCB would require a state, rather than the creditors, to invoke judicial process. If a state were to pursue collective action, the U.S. Constitution’s Contract Clause would defend the tax-underpayment actions of creditors. As a result, TCB would enable the creation of super-priority, risk-free debt. Here is why.

**FISCAL POLICY IMPLICATIONS**

Despite the recent experiences of the Detroit bankruptcy and the sovereign debt defaults in Puerto Rico, practitioners in the sphere of public finance still cannot solve the problem of how a state or territory can credibly issue debt that is arranged by priority of payment obligation. Distinguishing debt on a seniority or secured basis is ubiquitous in the private sector, but sovereign immunity at the state level (i.e., no judicial remedy) negates all attempts at structuring state debt portfolios with such distinctions. In turn, if another default were to occur, it is not clear when (if ever) and which (if any) lenders, vendors, or employees would be compensated. The lack of prioritization makes debt more expensive because lenders demand a premium for accepting higher levels of financial risk, which stems from the political risk of default and a subsequent rejection of judicial remedy. But without the obstacle of sovereign immunity, and with minimal changes to federal tax policy, tax-credit borrowing becomes a risk-free alternative to traditional debt.

With TCB, states assume the financial risk of all their borrowing decisions. This not only protects lenders and reduces borrowing costs, but it is also a better cure than bankruptcy for the aforementioned moral hazard problem (real or perceived), and it could mitigate the political agency problem many commentators believe to be a cause of excessive state debt.

Beginning with the moral hazard problem, it is plausible that the excessive over-borrowing by states is the result of state administrators assuming that their respective states are too big to fail. If this theory is true, as state bankruptcy proponents contend, states are effectively externalizing some of the risk of default—at least on the margins and to a degree that affects state policy—and placing a burden on the federal government (i.e., taxpayers).

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**NOTES**


7. Because tax-credit bonds can lower a state tax bill, an individual would end up paying higher federal income taxes, since municipal income and state taxes are eligible federal income tax deductions. For TCB to be viable, the Tax Code would need to allow for adjustments to federal taxes for the theoretical taxes a tax-credit bondholder would not have paid had they simply owned traditional state debt. This can be accomplished through a new IRS regulation and does not require Congressional approval.

from other states). In this case, TCB by its nature would ensure that states internalize this risk, as discretion over whether or not to take advantage of tax credits linked to tax-credit bonds is completely up to creditors. The possibility of default disappears entirely, although the potential for fiscal distress remains. But it is simply the case that there is no empirical consensus that risk-externalization is the sole or even the primary cause of excessive borrowing.

A more general question, therefore, may be of greater interest: what might TCB look like in a world where states are inclined to over-borrow? This is not explicitly a question about risk. There are many competing theories about state borrowing practices, and many stem from the standard agency problem.

The agency problem in this instance posits that politicians over-borrow because they are not effectively monitored. Voters tend to reward near-term spending and tax-relief initiatives at the expense of future solvency. Those who will be most affected by a state’s long-term financial prospects often do a poor job of reigning in borrowing. In short, over-borrowing is a problem of political dysfunction. TCB would work by shifting the monitoring incentive to voters because it first shifts the responsibility for the financial risk associated with state debt from the state’s creditors to its taxpayers and residents. This should lead to lower levels of borrowing. But it begs the question of whether such a shift is normatively preferable. The answer: it depends. It depends on, among other things, the expected effects from the shift on state financial decisions, including states’ borrowing, taxing, and spending policies.

If the concern truly is one of misaligned political incentives, TCB could help to correct the current monitoring deficiencies. As it is, the current monitors of political agents—the creditors—only care about risk-adjusted returns, so the point at which they will simply stop lending is not likely related to optimal fiscal policy.

**OBJECTIONS TO TAX-CREDIT BORROWING**

1. **FEDERAL TAX POLICY**

It can reasonably be asked why, if states will not accept ex post bankruptcy for the reasons outlined above, they would begin issuing tax-credit bonds ex ante. There are two possible motivations: political altruism and/or a federal subsidy. Regarding altruism, many state administrators likely would prefer to make responsible borrowing decisions to protect against future fiscal troubles, so TCB appears a rational course of action. But when a crisis hits, officials begin to make rash, compromised decisions, as this is when lobbying efforts from a variety of competing interest groups are the most concentrated. But for those who don’t subscribe to this rosy view, the adoption of TCB would require a carrot. At a minimum, the Tax Code would need to be amended to undo what is, in effect, a relative subsidy of traditional bond borrowing (i.e., the income tax exemption for interest on state and municipal bonds). Proponents of TCB would need a corresponding provision that excludes from taxation the interest “income” provided by a tax-credit bond in the form of a reduced tax liability. With such a provision, TCB is much more attractive than bankruptcy, given its ability to reduce borrowing costs.

Whether there is any uptake of TCB absent the threat of financial distress probably depends on two things. The first is consolidated interest groups wielding their collective political influence to spur the adoption of tax-credit bonds in the marketplace. The example of state pensioners is explored below.

The second is recognition that parity with traditional debt is likely not enough for TCB to gain traction. State administrators may require an incentive, such as a relative subsidy of TCB, for forgoing their natural interest in risk-externalization. Quantifying the size of a TCB subsidy would require experimentation, but investors would be able to self-sort in the marketplace and would home in on an acceptable subsidy amount in short order. But even if states adopt the use of tax-credit bonds, there is another concern once these instruments are in the marketplace.

2. **SECONDARY MARKET LIQUIDITY**

It is also appropriate to ask whether the scope of TCB could ever be wide enough to have a meaningful impact on a state’s political economy. Do investors have a sufficient appetite for tax-credit bonds? A robust secondary market is critical to support large issuances of tax-credit bonds. For traditional municipal and state bonds, the secondary market is highly liquid and efficient. But tax-credit bonds have intrinsic value only to the extent that market participants expect to owe taxes to the issuing state. This liquidity concern is more pronounced for smaller, less populous states.

One response to this concern
is simply convertibility. If tax-credit bonds were issued as traditional debt but with an additional option to convert, then the liquidity problem would be solved. A convertible tax-credit bond would trade at a discount relative to a traditional bond, particularly when issued by a smaller state or in times of distress, but the difference would be negligible for solvent and “trustworthy” states. A different but complementary response would be to allow smaller states to form an interstate compact to develop a national secondary market—a reciprocity agreement that would be enforceable in federal court.

**TCB AND PENSIONS: A PRACTICAL APPLICATION**

Tax-credit borrowing has a history, albeit limited, in the United States. In 1997, Congress authorized state and local governments to issue “qualified zone academy bonds,” or QZABs. These QZABs granted lenders tax offsets in exchange for the use of their capital, which was designated to support specific infrastructure development projects. Passing over the irrelevant details, the takeaway is that tax-credit bonds were issued to fund preferred state and local activities.

There is reason to believe that TCB can work again and on a grander scale as a means of creating risk-free debt. And one way to introduce tax-credit bonds into the marketplace could be by earmarking the borrowed capital for the support of a vulnerable group. One obvious example of a worthwhile interest to protect, in the state context, is pension holders. Assumptions vary widely, but pension shortfalls alone account for between roughly one and three trillion dollars of debt (see Figure 2). TCB could work to close that gap. As a form of risk-free, prioritized debt, tax-credit bonds would be cheaper to issue, and assuming the concerns raised in the previous section are addressed, pensioners themselves would benefit from knowing that their retirement savings are better protected against default. As attributes is that it allows creditors to sort themselves through trade. Lenders who believe themselves relatively powerless politically or who have lower risk tolerance levels (e.g., pension funds) would be inclined to buy tax-credit bonds. On the other hand, lenders with great political influence or who have higher risk tolerance levels (e.g., large municipal investors) would prefer traditional debt. TCB need not be wholesale, and the protection of specific, vulnerable people or classes may be a good entry point for this new approach to the problem of excessive state debt.

**CONCLUSION**

In the last few years, the perilous financial conditions of many Ameri-

**FIGURE 2 MARKET VALUE OF UNFUNDED PENSION LIABILITY ($ BILLIONS)**

Note: These four states alone account for 31% of all unfunded pension liability in the country. From the Mercatus Center’s 2016 “Ranking of States by Fiscal Condition” report.
can states have come into clearer focus. Recent cases of fiscal distress in places like Detroit and Puerto Rico have led many academics and politicians to consider options for debt relief should an imminent threat of default emerge at the state level. This Issue Brief makes a case against ex post restructuring measures, specifically bankruptcy modeled on Chapter 9 of the U.S. Bankruptcy Code, and in favor of ex ante debt mitigation action. In particular, it introduces tax-credit borrowing as a potential commitment device for states that would allow for the creation of super-priority, risk-free debt. Tax-credit borrowing precludes the opportunity of default by reversing the plaintiff/defendant distinction that protects states under the doctrine of sovereign immunity. With super-priority, risk free debt, there would be better monitoring of the borrowing decisions made by state officials, as the fiscal ramifications of excessive debt moves from state creditors to taxpayers and voters. Small changes to federal tax policy and likely a subsidy (relative to traditional debt) would be necessary to encourage tax-credit borrowing, but this new approach can solve the sticky problem of debt prioritization that continues to mystify states and municipalities.
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CONTACT THE PENN WHARTON PUBLIC POLICY INITIATIVE

At Penn
Steinberg Hall-Dietrich Hall, Room 3012
Philadelphia, PA 19104-6302
+1.215.898.1197

In Washington, DC
440 First Street, NW, Suite 810
Washington, DC 20001
+1.202.503.3773

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