FAQ: COVID-19 and State Bankruptcy

While the U.S. federal government responded to the economic blow dealt by COVID-19 with a massive relief package aimed to keep small businesses and individuals afloat, states face a stark and uncertain economic reality.

In this FAQ, 1919 Investment Counsel addresses whether states can declare bankruptcy, the likelihood of this scenario, and ways states can raise revenue while facing an indefinite timeline of a return to "normal."

Can states declare bankruptcy?

Current federal law does not permit states to declare bankruptcy.[1] Congress would have to pass a law giving states the power to do so; the majority of Congressional Republicans and Democrats have said changing the law would have a very negative impact on states. With Democrats controlling the House, we see a very low probability of this law changing.

Furthermore, current bankruptcy law requires entities to fail a solvency test, proving their inability to generate sufficient revenues to honor their debt obligations. Given that states have the authority to increase tax rates and to create new taxes and fees for services and purchases, we believe it is extremely unlikely that a state would fail this test.

How likely are states to declare bankruptcy?

In a hypothetical scenario where states could declare bankruptcy, it would entail restructuring their debts and forcing bondholders to take haircuts on their investments. This restructuring would eliminate states' access to the nearly $3.8 trillion municipal capital market for several years. Any large scale infrastructure projects (e.g. roads, bridges, public buildings, etc.) and grants to local governments would be unable to secure funding. Recall from recent history that when Detroit declared bankruptcy in 2013, they were shut out of the capital markets and unable to issue bonds for five years. At a state-wide level, the ramifications would be severe.

Prior to the pandemic, the vast majority of states were in better financial shape than on the eve of the last recession. Currently, the biggest challenges for states are the severity of revenue decline and the unknown duration and increased expenses from COVID-19. Without tax increases, many states will be forced to reduce expenditures to account for lower revenue and to provide fewer services and less funding to local governments. For the vast majority of states, debt service payments account for less than 5% of their operating budgets, a relatively small portion of their annual expenditures.

Two methods of federal support for states are also being considered. On May 11th, the Federal Reserve announced a municipal lending facility (MLF) to preserve liquidity for state and local governments. The Fed will purchase securities directly from issuers in the primary market. Additionally, Congress is proposing a sizable federal aid package to assist state budgets.

[1] U.S. Constitution, Article 1, Section 10 contracts clause

Can states and issuing authorities default on specific bonds without declaring bankruptcy?

Technically, the answer is yes. However, as discussed in the previous question, if they elected to do so the fallout would be severe. Beyond substantial downgrades for all related and parity debt, the issuer would face extreme challenges accessing the capital markets for new projects. In addition, some states (including Texas and New York) establish in their constitutions that revenues coming in must first be used for general obligation debt service.

In terms of default versus bankruptcy, the last state to default on their bonds was Arkansas in the aftermath of three straight catastrophic events: a significant flood, the Great Depression, and a widespread drought forced the state to restructure their debt in 1933. Arkansas is the only state to default on their bonds in the 20th century.

In addition, there are two main avenues for states to increase recurring revenues: increase existing taxes and fees or create new taxes and fees. Increasing a current tax or fee is much more likely than introducing a new tax or fee. The two main taxes are income tax and sales tax. States can increase the tax rate or limit the increase to only specific items. For example, Maryland's general sales tax is 6%, but the sales tax on alcohol is 9% and tobacco is 30%. Fees such as motor vehicle registration fees and driver license fees could be increased. Finally, states can also reduce expenditures to balance their budgets. Some state and local governments have already started to temporarily furlough employees and cut jobs; however, they were slow to take this route during the last recession.

We acknowledge the concern among bondholders and investors regarding state solvency. While states' revenues have taken a hit across the board, we believe that the likelihood of a municipal bond default is low. 1919 Investment Counsel will continue to monitor state income and sales tax revenue levels to assess the impact on respective state budgets.

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