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Hiding State's Debt Doesn't Make it Any Less Real

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By Nathan B. Oman , For the Deseret News
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Alas, state fiscal responsibility is largely an illusion. To be sure, some states manage their finances well. Many, however, do not. Rather, they find ways to circumvent their own bans on deficits and in so doing borrow billions of dollars in expensive and dangerous ways. (Shutterstock.com)

As the federal government skitters at the edge of the "fiscal cliff," many look wistfully at the rectitude of the states. After all, 49 state constitutions (Vermont is the sole exception) require balanced budgets each year.

Alas, state fiscal responsibility is largely an illusion. To be sure, some states manage their finances well. Many, however, do not. Rather, they find ways to circumvent their own bans on deficits and in so doing borrow billions of dollars in expensive and dangerous ways.

Many state constitutions simply prohibit bonds that cannot be retired by the end of the fiscal year. Of course, one can always simply "roll over" the debt, paying off short-term loans by taking out new short-term loans.

Just as it is stupid to buy a house with a variable rate credit card, it is stupid for states to structure their debts this way. Because the debt is short term, they cannot lock in interest rates and the necessity of rolling the debt over each year will create a crisis if bond markets spook and stop lending.

Churning short-term debt, however, is far from the most serious problem. According to the Pew Center for the States, state governments owe $1.38 trillion in retirement benefits to public employees. Because this debt does not take the form of bonds, it does not run afoul of balanced budget requirements. The legal distinction, however, is economically meaningless. States simply owe hundreds of billions of dollars to public employees unions rather than bond markets.

The $1.38 trillion number, however, assumes that we can trust states' accounting. No one believes this. In particular, government accountants assume that the investments of state pension funds will have dazzlingly unrealistic rates of return. Once one makes more plausible assumptions, the debt mounts to something more like $2.5 trillion. In Ohio and Illinois, the burden is over $35,000 per household.

This is unsustainable. States will either default on their promises to pensioners, decrease government services or raise taxes; most likely, all three. There is another option. The states can ask the federal government for a bailout.

There is historical precedent. The federal government began its life by bailing out state governments, when George Washington's Treasury Secretary, Alexander Hamilton, successfully pushed to assume all state debts from the American Revolution.

During the Panic of 1837, however, Andrew Jackson refused a bailout, triggering a fiscal meltdown for state governments. States responded with the constitutional bans on deficits that have now been thoroughly circumvented.

More recently, New York City faced bankruptcy in 1975. President Ford refused a bailout, prompting the headline "Ford to City: Drop Dead." In less than a month, however, political pressure forced federal taxpayers to rescue the city's creditors.

What can be done? First, states should abandon the charade of fiscal probity. Balanced budget amendments don't balance budgets. They simply encourage legislators to structure debt in complex, expensive and opaque ways. The solution lies not in constitutional amendments but in fiscally responsible political choices. Once states are honest about the size of their debts, they can start crafting realistic budgets.

Second, federal lawmakers need to act. Under current law, cities can file for bankruptcy — as the City of Bakersfield, Calif., recently did — but there is no orderly system for state governments to restructure their debts. In the absence of such a system, the pressure for a federal bailout when the crisis comes will be virtually impossible to resist.

As recent experience from Greece to Wall Street should have taught us, hiding debt doesn't make it any less real. It just makes it more dangerous.

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