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Insuring Bankruptcy

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A guaranteed road to fiscal ruin

If you were in debt, would you be more or less likely to increase your liabilities if you knew someone else would pay them off? Many children can quickly figure out the answer to this question, but it seems to be a real stumper for members of the House Financial Services Committee, chaired Rep. Barney Frank, Massachusetts Democrat. They are considering having the federal government reinsure municipal bonds. Such fiscal madness likely would make even citizens of banana republics blush.

Many state and local governments are having difficulty because of the drop-off in tax revenues caused by the recession. Responsibly managed state and local governments established rainy-day funds during the boom of recent years to tide themselves over and also reduced expenditures. Other state and local government leaders foolishly did not put away reserves and are being forced to make deep budget cuts. Some are increasing taxes (a really destructive act, particularly during a recession).

California is the poster child for irresponsible management and, as a result, is about to run out of money. Its credit rating is so bad that the state is almost at its borrowing limit. As would be expected, members of the California congressional delegation are trying to get increased handouts from the rest of us, including guarantees of their local government bonds.

If California is bailed out, other governors and mayors are going to think, "Why be prudent if the Feds will rescue me if I am irresponsible and overspend?" If that occurs, there will be no limit to the liabilities that ultimately will be dumped on the American taxpayer. Those of us who live in relatively well-managed states like Virginia will be responsible for all of those who have been less responsible -- without end.

Furthermore, the Feds are "out of money," as President Obama says (even though he keeps proposing more spending). The federal government already is guaranteeing (insuring) bank deposits, money-market funds, 401(k) accounts, etc., etc. The Feds are engaged in exactly the same behavior that got American International Group Inc. in trouble: insuring financial assets without having adequate resources to pay off all of the potential insurance claims. Such behavior can be viewed as criminally irresponsible.

Total state and local debt is about $2.5 trillion at the moment, but this number will explode if the federal government decides to insure -- directly or indirectly -- part or all of it. The American Legislative Exchange Council (ALEC), an organization made up of state and local government officials, just published a study on state competitiveness, "Rich States, Poor States,"authored by Arthur Laffer, Stephen Moore and Jonathan Williams. The study clearly shows that most low-tax states tend to have much stronger economies and perform better than most high-tax states.

The empirical data belie the claims of many politicians in high-tax states, such as California, New Jersey and New York, that their problems stem from a lack of tax revenue. Texas beats California on almost every measure of success, including school test scores and road conditions, although California has a much higher tax burden, including a maximum individual tax rate of more than 10 percent, while Texas gets along perfectly well without any state income tax.

The low-tax states tend to have higher income growth and lower unemployment rates than do the high-tax states, as can be seen in the accompanying table. And, as would be expected, people move -- particularly the most productive and the highest-income earners -- to lower-tax states as they increasing flee high-tax states.

HIGH-TAX VERSUS LOW-TAX STATES (Nine States)		
	With No Personal Income Tax	**With the Highest Marginal Income Tax Rates**
Average Top Personal Income Tax Rate	0.00%	9.17%
Personal Income Per Capital Growth (1997-2007)	58.7%	52.7%
Net Domestic in-Migration as % of Population (1997-2007)	+4.47%	-2.20%
Unemployment Rate (April 2009)	7.7%	8.7%
Note: The states without a state income tax are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. The states with the highest state income tax rates are Ohio, Hawaii, Maine, New Jersey, Oregon, Maryland, Vermont, California, and New York.		

Past financial disclosures by members of Congress have shown many of them own state and municipal tax-free bonds. If any members of Congress vote to insure, reinsure or provide any other form of bailout for such bonds, they will have a very direct conflict of interest because they will be voting to bail out their own portfolios (and/or those of friends and family), all at the expense of the taxpayer. Hopefully, taxpayer watchdog groups and responsible media organizations will demand full disclosure of any such bond holdings -- directly or indirectly -- by any members of Congress and their immediate families.

It is hard to envision a more fiscally irresponsible act than for the federal government to insure (in any form) state and local government bond holders, because that would only lead to higher and higher rates of inflation and, finally, fiscal ruin.

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