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How Effective are State Bankruptcies?

At present it is not possible for states to file for bankruptcy protection as it is against the law. But this may change if a group of conservative lawmakers have their way in Washington. There is an initiative to get Congress to amend the law and permit states to file for bankruptcy. At present, about half of the municipalities in the states are allowed to do so.

Those who propose the idea say states with huge budget deficits like California would welcome it. These states are facing massive unfunded healthcare and employee benefit hence when they are allowed to file for bankruptcy, it would permit them to have all their deficits laid out and a systematic plan for recovery plotted out.

One strong advocate for state bankruptcy is Americans for Tax Reforms (ATR). The group lobbies for pensions and healthcare benefits to be curtailed upon bankruptcy of the state. But they are heavily opposed by the workers' unions, for obvious reasons. Some unions see the ATR

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agenda as targeting the unions in their biggest representation, the government. Some 37% of government employees are members of unions whereas only slightly more than 7% of private sector workers are.

The American Federation of State, County and Municipal Employees are of the opinion that the ATR and groups like them are pushing for the right of states to file for bankruptcy as a means of reneging on their collective-bargaining agreements.

On the other hand, former House Speaker and potential Republican presidential candidate Newt Gingrich favors the right for states to file for bankruptcy because it is a means to get state governments not to go to the federal government for financial aid. Gingrich singled out California, Illinois and New York as three states most likely to ask for a bailout.

But as the debate rages on, investors are already scurrying away from financial markets. In November last year, the bond market experienced a rise in interest rates in long-term bonds and a rapid rise in new bond issuances by various states and municipalities. A second blow came when investors' concern over deteriorating state and local government budgets and the talk that some borrowers could back down on their debts sent municipal bond prices tumbling recently. When Wall Street banking analyst Meredith Whitney went on national television to predict a rise in municipal bond defaults, the market got really frightened.

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Against this backdrop, proponents of state bankruptcy are driving investors further away.

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