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State and Local Government Debt and COVID-19

Debt (often in the form of bonds) represents a promise by the issuer (borrower) to pay interest income to lenders on the principal (the amount of money borrowed) until that principal is repaid. In light of the economic downturn accompanying the COVID-19 outbreak, there are growing concerns about state and local governments' ability to make payments on outstanding debt, and general concern about the fiscal capacity of those governments. The CARES Act (P.L. 116-136), signed into law on March 27, 2020, included provisions that may offer fiscal relief to state and local governments. This In Focus briefly describes the nature and characteristics of state and local debt issuances in light of recent economic and legislative developments.

Mechanics and Federal Support

State and local governments typically issue debt to finance the construction of capital facilities (e.g., buildings, roads, and airports). Because capital facilities provide benefits over a long period of time, debt instruments may allow the timing of payments to better match those benefits. Debt may also be used for cash-management purposes, though the capacity to respond to unexpected budgetary developments is typically limited.

Unlike the federal government, which has no enforceable balanced budget restriction, state and local governments generally must balance their operating budgets every one or two years. Though debt issuances are typically accounted for in capital budgets not subject to balanced budget restrictions, budget shortfalls can force state and local governments to choose between sudden spending decreases, tax increases, or breaching contractual payments on debt issuances (described as being in default). This is one reason why state and local debt may be perceived as riskier than federal debt to lenders. For more information, see CRS Report RL30638, *Tax-Exempt Bonds: A Description of State and Local Government Debt*.

The federal government subsidizes the cost of many state and local bonds by exempting any interest income they earn from federal income taxation. Certain goods and services, including capital projects, provided by state or local governments benefit both residents, who pay local taxes, and nonresidents, who pay little to no local taxes. Because state and local taxpayers are unlikely to provide these services to nonresidents without compensation, certain state and local services may be underprovided without outside intervention. In theory, the exemption of interest income compensates state and local taxpayers for benefits provided to nonresidents and residents alike, and encourages increased provision of borrowing-financed projects.

Interest rates vary with the creditworthiness of the borrower, the terms of repayment, the length of repayment (or maturity), and general economic conditions. The tax exemption on interest income lowers the cost of debt for state and local governments by reducing their interest costs. All else equal, a lender in the 35% marginal income tax bracket would be indifferent between a taxable (or corporate) bond with an interest rate of 5.00% and a tax-exempt bond with an interest rate of 3.25%, because the bonds' after-tax income would be identical. State and local governmental bonds, or those that meet the statutory definition of having a "public purpose," receive this tax exemption without restriction.

Nongovernmental (or private activity) state and local bonds also receive a federal tax exemption if they are included in the statutory list of activities eligible for qualified private activity bonds. Tax credit bonds, which provided a federal tax credit or direct payment in lieu of the tax exemption, were a former alternative to the federal tax exemption for state and local debt. Authority to issue tax credit bonds was repealed by P.L. 115-97 (commonly referred to as the "TCJA") beginning in 2018, though some previously issued tax credit bonds are still outstanding. Current law prohibits the federal government from providing loan guarantees (wherein the government assumes responsibility for debt should the borrower be unable to make payments) on any tax-exempt bond.

Current Characteristics

Federal Reserve data indicate that in September 2019, state and local governments had approximately $3.05 trillion in outstanding debt. Much of that debt remains outstanding for several years, as data from the Municipal Securities Rulemaking Board (MSRB) show state and local governments issued $0.46 trillion in new debt (roughly 15% of the total stock) in 2019. Debt instruments finance projects across a variety of policy areas. MSRB data on issuances from 2009 through 2018 show significant resources devoted to education (26% of all debt issued), transportation (13%), utilities (10%), and health care (8%), with an additional 31% in issuances for general purpose projects (including broad capital improvement initiatives).

Figure 1 (next page) shows the level of combined state and local government debt recorded in 2017, measured as a percentage of total annual state and local revenues (including intergovernmental transfers); in other words, it shows what those governments owe as a share of their annual "income." Nationwide, state and local government debt issuances equal 78% of annual revenues, and state figures range from 20% (Wyoming) to 105% (Texas). Local governments (98%) generally have a larger ratio of debt to annual revenues than state governments (46%). State and local debt is smaller than the federal debt burden of $16.80 trillion in publicly held debt at the end of FY2019, or 485% of annual revenues.

State and local government debt generally involves higher interest rates than comparable federal debt. March 2020 data from The Bond Buyer showed 30-year yields (interest rate benchmarks) of 1.46% for Treasury securities (federal debt) and 3.40% for municipal securities. Distinctions in how projects are financed and reduced monetary policy influence are other reasons states and localities may be charged higher interest rates than the federal government.

Recent Developments

There has been a sudden decline in economic output amid the COVID-19 outbreak. State and local government revenues tend to decrease as economic growth declines (because taxes are paid on economic activity, such as sales). Moreover, the COVID-19 crisis is likely to lead to additional demand for spending programs, particularly in the health sector. That combination is expected to increase the frequency and intensity of state and local budget deficits, which may lead to a decline in state and local spending and a rise in default rates as policymakers attempt to comply with statutory balanced budget restrictions. More information on this issue is found in CRS Insight IN11258, *State and Local Fiscal Conditions and Economic Shocks*.

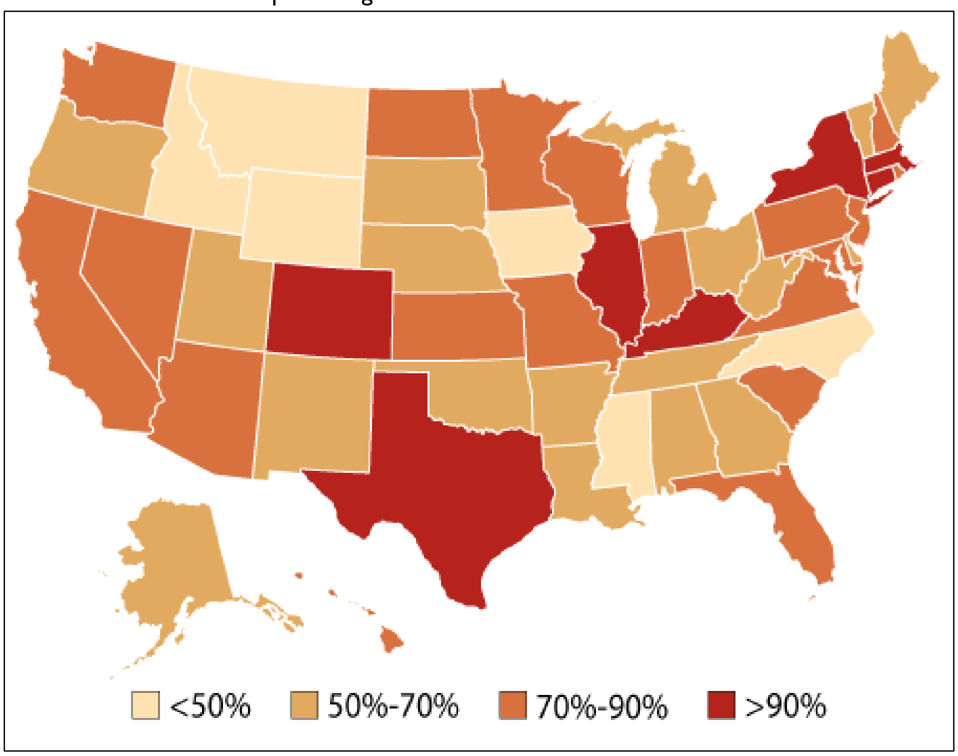
The CARES Act included two provisions offering federal assistance to state and local governments that, depending on their implementation, may ease their debt burden in the current economic climate. Section 4003 of the CARES Act *provided* at least $454 billion to the Federal Reserve to support state governments, local governments, and eligible businesses—but did not *require* it. Support may be provided through purchases of debt issuances from outside creditors or the issuance of new loans to borrowers that will allow for debt repayments. Oversight of the loan program is tasked to the Federal Reserve and Treasury. For more on this provision, see CRS Report R46301, *Title IV Provisions of the CARES Act (P.L. 116-136)*.

On April 9, 2020, Treasury and the Federal Reserve announced that, through CARES Act authorities, they had established a Municipal Lending Facility (MLF) that would provide direct financing to states, counties, and city governments. The announcement stated that Treasury would make a $35 billion equity investment into the MLF that would support up to $500 billion in direct financing.

Section 5001 of the CARES Act established the Coronavirus Relief Fund, which provides $150 billion in federal payments to state, local, tribal, and territorial governments. Most of those payments are initially provided to state governments, though local governments with underlying populations of at least 500,000 people may apply for some direct federal assistance. Fund payments must be used for necessary and unexpected expenses in 2020 related to the COVID-19 emergency. While such funds cannot directly be used to alleviate the state and local debt burden, they may indirectly allow government revenues that would otherwise have been used for COVID-19 to be used for debt repayment. For more information, see CRS Report R46298, *The Coronavirus Relief Fund (CARES Act, Title V): Background and State and Local Allocations*.

Figure 1. 2017 Combined State and Local Government Debt

As a percentage of annual state and local revenues



Source: U.S. Census Bureau. CRS calculations.

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