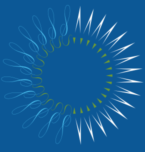

THE PEW CENTER ON THE STATES

ISSUE BRIEF

The Debt Ceiling Debate:
How a Federal Default Could Impact States and Cities

If President Obama and congressional leaders cannot reach a deal to raise the federal debt limit by August 2, the federal government might be unable to borrow to meet its financial obligations. Federal policy makers, opinion leaders and the media have focused on how a federal default might affect the national economy and global markets. But at a time when states and cities are still feeling the effects of the Great Recession, not enough attention has been paid to how a default could impact their efforts to balance their budgets or borrow for critical needs.

Background on Government Debt: Federal Versus State and Local

If the federal government does not collect enough revenue to meet all its spending obligations, it must borrow to make up the shortfall. Federal debt includes all securities—bills, notes and bonds—issued by the Department of the Treasury and other government agencies.

The debt limit, or debt ceiling, is the legal limit on the amount of gross debt the federal government can issue. According to the Government Accountability Office (GAO), the debt limit has been raised 74 times since 1962, including 10 increases in the past decade.[1]

The Treasury reached the current limit, about $14.3 trillion, in May. Since then, the government has taken various measures to avoid borrowing more. The Treasury estimates that on August 2, it will have exhausted these measures and will have to issue more debt. (See the Pew Fiscal Analysis Initiative's *Fiscal Facts: The U.S. Debt Limit* for answers to frequently asked questions about the debt ceiling.) If the debt limit is not raised, the Treasury might have to hold back federal salaries, Social Security checks or aid to states in order to pay back bondholders. Even if the government were to give bondholders their money, it would be in default if it did not meet any other financial obligations, according to the Treasury.

Unlike the federal government, states and localities typically do not borrow money to close budget shortfalls. Nearly all states are constitutionally required to balance their budgets and, in the past four years, have cut spending and raised taxes to close budget shortfalls totaling nearly $480 billion.[2] Local governments also have made substantial cuts to compensate for shrinking property tax revenue and declining aid from states.[3]

State and local debt—also known as municipal debt—includes securities, bonds and notes from state and local issuers. Most of these are used to finance new schools, roads and bridges and other critical capital projects such as utilities, water systems, government buildings and hospitals. Most municipal bonds pay investors interest that is exempt from federal income taxes, although Build America Bonds (BABs), which were introduced to help state and local governments get credit during the Great Recession, were a notable and sizable exception (BAB issuers received a federal subsidy).

State and local governments issued $433 billion in long-term municipal bonds in 2010 and $117 billion through June 2011.[4] States and cities almost never default on bonds, in large part because they are wary of jeopardizing their ability to access capital for vital infrastructure projects. No state has defaulted on a bond payment since Arkansas in 1933, and local defaults are extremely rare.

Despite the fundamental differences between federal and state and local debt, a federal default significantly would affect state and local borrowing and budgets.

How a Federal Default Could Affect State and Local Borrowing

Treasury securities are backed by the full faith and credit of the U.S. government, and they play a critical role in global financial markets because of their perceived safety. The interest rate on Treasury securities is sometimes referred to as the "riskless" rate. It is the benchmark against which many other financial assets are calculated in terms of additional risk. Because Treasury securities are considered to be so safe, ratings agencies give them a bond rating of AAA or its equivalent. Fifteen states and more than 400 local governments also hold that rating.[5]

A federal default might shake investors' confidence in *all* government-held assets—including municipal bonds. Investors might see a default as a sign that U.S. taxpayers—as represented by their elected officials in Washington, D.C.—are unwilling to make good on federal debts under all circumstances. The same question could be raised about the willingness of taxpayers, and the state and local lawmakers who represent them, to live up to state and local debt obligations.

A federal default "would be hugely disruptive to global financial markets, and of course the municipal market would get swept along in the wreckage," said Matt Fabian, managing director of Municipal Market Advisors, a Massachusetts-based

research advisory firm. Historically, municipal bond interest rates have been tied closely to Treasury securities, so if the federal government defaults, municipal borrowers might see higher borrowing costs and limited access to credit. "If we are not smart, we will create a cloud of contagion," said James Spiotto, a Chicago-based municipal bankruptcy lawyer and leading expert on state and local finance.[6]

Moody's Investors Service recently announced that if the federal government loses its AAA grade, the agency would downgrade at least 7,000 top-rated municipal credits and $130 billion in municipal debt directly linked to the United States—also included for review are mortgage-backed bonds secured by the federal government and by agencies such as Fannie Mae and Freddie Mac. In addition, Moody's has declared that a U.S. downgrade would prompt it to review other state and local credits, including those issued by housing authorities and nonprofits.[7]

A U.S. default could make municipal debt *more* attractive, as investors search for a safe asset to replace Treasuries. Since 2001, major credit ratings agencies have allowed sub-national borrowers—states, localities and authorities—to hold a higher rating than their sovereign government (for states, the sovereign is the federal government; for local and authority borrowers, it is their state). But few governments—1.4 percent of all S&P-rated issuers and 3.8 percent of Moody's-rated issuers as of 2009—hold a higher rating than their sovereign.[8] This means that, regardless of their strong credit histories, some AAA-rated state and local government issuers might be downgraded. A lower rating would make it more expensive for them to borrow money. That could have important consequences—for instance, for their efforts to repair and replace roads, bridges and other infrastructure vital to the safety and economic vitality of communities across the nation.

How a Federal Default Could Affect State and Local Budgets

In August, the Treasury expects to make 80 million payments totaling $306 billion—including $29 billion in interest on the federal debt, $14 billion in salaries for federal employees, $3.9 billion in tax refunds, $49 billion in Social Security benefits and $50 billion in payments to Medicare/Medicaid providers.[9] The Bipartisan Policy Center projects that if the debt ceiling is not raised, the Treasury will be unable to make 44 percent of its August payments—meaning that the federal government might have to choose from among its financial commitments.[10] If the government stopped paying federal workers or held back Social Security checks, the resulting loss of individual income could have a profound effect on state and local tax revenues.

The federal government also transfers hundreds of billions of dollars each year to state and local governments: $478 billion in 2010 alone.[11] They use that money to help pay for everything from unemployment benefits and Medicaid to community development and higher education.[12] Delaying these transfers would present serious challenges. Take tuition aid: The academic year begins in August, and the federal government owes $10.4 billion in tuition assistance for that month. States have slashed higher education budgets four years in a row, and colleges could have a hard time accommodating students whose federally subsidized loans are late.[13] Postponing federal payments to Medicaid providers would present another sizable challenge, and might force states to intervene. In fact, Virginia Governor Robert McDonnell is formulating a contingency plan that could involve a loan from the state treasury to cover the federal portion of these payments.[14]

It is highly unlikely that states and localities would shut down as a result of a default on the national debt.[15] But because they have figured federal money into their fiscal year 2012 budgets, delayed payments could create a cash-flow problem. They might have to borrow from banks to meet ongoing expenses. "Not only would states and locals have to pay higher borrowing costs because of the bump in Treasury rates, but the payments they had anticipated to use to make interest payments with would not materialize," said Frank Shafroth, a municipal finance expert and director of the Center for State and Local Government Leadership at George Mason University. California Treasurer Bill Lockyer, for example, is considering seeking a bridge loan from Wall Street to pay the state's bills until it can issue revenue anticipation notes in late August.[16]

Beyond the Debt Ceiling Crisis: Federal Deficit Reduction and States and Localities

The debt ceiling debate has intensified the broader battle over how to reduce the $1.4 trillion federal deficit projected for fiscal year 2011. Many deficit-cutting measures that Washington is considering could dramatically affect the budgets and borrowing of states and cities—yet, as with the debt ceiling debate, potential consequences have received little attention.

For instance, deficit-cutting actions and proposals have targeted grants to states for infrastructure, housing assistance, community development and homeland security, among other funds. On July 15, the House approved a fiscal year 2012 budget for the Department of Energy and related agencies reflecting $1 billion in cuts below the fiscal year 2011 spending level, with reductions to the Army Corps of Engineers for general administrative

expenses and scaled-back funding for Yucca Mountain, a project to bury and store nuclear waste.[17] President Obama's fiscal year 2012 proposals as well as final appropriations for fiscal year 2011 made significant cuts to the Community Development Block Grants, a program designed to help mayors improve housing options for low- and moderate-income families, and to the Low Income Home Energy Assistance Program, which provides grants to states to help homeowners with heating and cooling costs.[18] States are particularly concerned about possible cuts in Medicaid, the federal–state matching program that in 2009 made up 21 percent of states' budgets.[19] The federal government currently contributes 56 percent of Medicaid's total cost, but some proposals would result in states picking up more of the tab or cutting coverage or eligibility.[20]

Other proposals could make it more expensive for state and local governments to borrow money for infrastructure. For example, both the president and House Republican appropriators have proposed significant cuts to the Clean Water and Drinking Water State Revolving Fund programs, which provide capital to state funds that lend money for improvements in wastewater and drinking water infrastructure.[21] Cities and states also worry that the federal tax exemption for newly issued municipal bonds could be eliminated. Some deficit panels, including the National Commission on Fiscal Responsibility and Reform (the Simpson-Bowles commission), have suggested scrapping the exemption, which the Office of Management and Budget estimates will cost the federal government $230.4 billion over the next five fiscal years (2012 through 2016).[22] Without the exemption, investors would demand better returns to buy municipal debt, making borrowing more expensive for cities and states.

Some budget experts also have called for ending or modifying the mortgage-interest deduction, a popular, middle-class tax break that cost the federal government nearly $80 billion in fiscal year 2010.[23] Although this proposal has not generated significant interest on Capitol Hill, it could have a major impact on states and localities through lower home prices, property tax assessments and collections, and consumer spending.

Conclusion

A federal default could have a serious impact on states and cities by constricting their borrowing and budgets while they are still feeling the aftershocks of the Great Recession. Meanwhile, their reliance on federal money means they will feel the pain of budget cuts. As policy makers in Washington debate the debt ceiling and options for reducing the federal deficit, understanding how states and cities might be affected is crucial.

Endnotes

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