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State and Local Government Debt Is Soaring

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It is well-known that the federal government is amassing large amounts of debt, but state and local governments are piling up debt as well. Figure 1 shows that total state and local debt was stable during the 1990s but soared from \$1.19 trillion in 2000 to \$1.85 trillion by 2005, an increase of 55 percent.¹ About 39 percent of the total is state debt and 61 percent is local debt.²

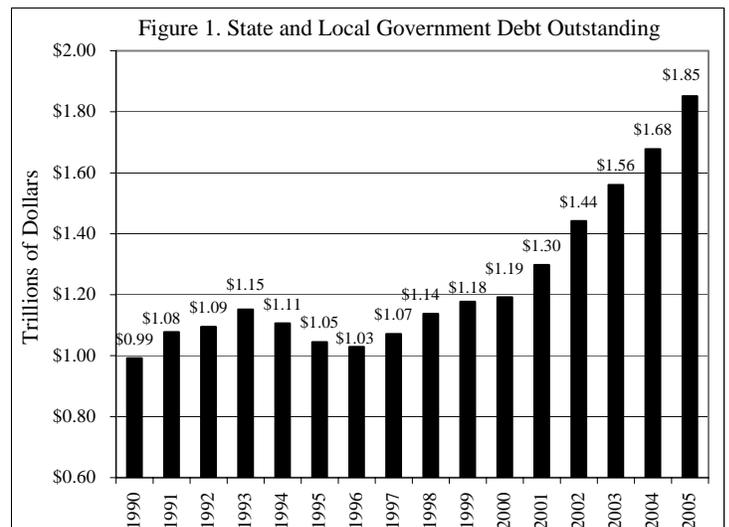
Most state and local debt takes the form of long-term bonds (“municipal bonds”). Issues of municipal bonds raised an average \$230 billion annually in new funds between 2001 and 2005, up sharply from the \$152 billion average between 1996 and 2000.³

Turning Future Revenues into Piles of Debt

There are two main types of municipal bonds: general obligation (GO) bonds and revenue bonds. GO bonds are backed by general taxation and are often subject to constitutional limits. Issues of GO bonds usually need to be approved by voters. Revenue bonds are backed by particular sources of revenue and are usually subject to fewer restrictions. GO bonds are about 39 percent of long-term municipal debt and revenue bonds are 61 percent.⁴

Revenue bonds are financed by receipts of future taxes, fees, lease payments, federal grants, lottery earnings, or tobacco settlement payments. The idea is to securitize expected streams of cash to allow state and local officials to spend now rather than later. The trend to securitize and spend is called “innovative finance” in state budget circles. An industry journal, *The Bond Buyer*, is full of stories on the latest Wall Street methods to help officials put their jurisdictions further into debt.⁵

A growing trend is to securitize future federal aid for highways, housing, and other items in “grant anticipation” debt. Federal aid has long spurred overspending by the states, but such debt innovation is exacerbating the problem. Recent federal legislation has included new ways for states to go further into debt, such the creation of three types of municipal “tax credit bonds.”



Source: Federal Reserve Board.

Private Activities Should Be Private

Interest payments on municipal bonds are generally exempt from the federal income tax. State and local debt is thus tax-favored over private debt, creating an economic distortion. Debt issued to finance government schools, airports, parking lots, and other facilities is favored over debt to finance similar private facilities. Thus, tax law encourages monopoly government ownership and is biased against private-sector competition and innovation.

The tax advantage for municipal bonds also creates an incentive for private groups to lobby government officials to issue debt on their behalf. In 1986, Congress tried to clamp down on this problem by imposing limits on the issuance of tax-exempt “private activity bonds.” But in a series of tax bills since then, Congress has reversed course and embraced economic micromangement by creating additional types of tax-favored private purpose debt.⁶ Bureau of the Census data show that “public debt for private purposes” is 23 percent of total municipal debt, but the efficient amount of such debt would be zero percent.⁷ It

makes no sense that dozens of major sports stadiums have been built with tax-exempt municipal debt but that private projects that are the real backbone of the economy, such as oil refineries, must be built on taxable finance.

Downfalls of Debt

Governments can finance capital projects by issuing bonds or by using current revenues, which is called pay-as-you-go financing. For state governments, most capital investment is funded on a pay-as-you-go basis.⁸

Governments in a few states, such as Idaho and Wyoming, issue very little debt and seem to do just fine.

In theory, it might make sense for governments to finance capital projects with debt, as private businesses often do. But in practice, when politicians are given the power to issue debt, they have an incentive to issue far too much because it allows spending without the political constraint of having to tax current voters. The private interests that benefit from spending encourage officials to issue excess debt, and they push for passage of bond issues at the ballot box in voter referenda.

From the perspective of average taxpayers, debt financing should be minimized. It is more costly than pay-as-you-go financing because of the interest payments incurred. It also comes with an overhead cost in the form of the large municipal bond industry, which employs tens of thousands of lawyers and finance experts in underwriting, trading, advising, bond insurance, and related Wall Street activities.

Another problem with debt is that mixing big government with big finance usually causes corruption. The municipal bond industry has had many scandals. In “pay-to-play” schemes, bond underwriters use bribes or campaign contributions to win bond business from state and local officials. There are federal laws to prevent such abuses, but violations are common. A recent pay-to-play scandal in Philadelphia resulted in criminal sanctions against the city’s treasurer and allegations that the mayor’s office often chose the bond firms for big debt issues.⁹

High levels of debt make government finances less transparent to citizens. People don’t appreciate the high costs of projects that officials are pursuing if they don’t feel the bite of current taxes. And if concerned citizens look into their government’s debt situation, they may find it very difficult to understand. A recent “debt primer” by the State of California is 606 pages long.¹⁰

Perhaps the best reason to start reducing debt is that large financial burdens are looming over the states. Medicaid costs are growing rapidly and breaking state budgets. Pension plans for state and local employees have

huge funding shortfalls that could total \$700 billion, according to Barclays Global Investors. Even more costly may be the generous retirement health care plans promised to state and local workers. An estimate by Mercer Human Resources put the unfunded costs of those plans at \$1 trillion. Finally, disasters such as hurricanes might always impose added budget stress on the states in the future. To budget in a conservative manner, debt loads should be reduced to create room for such contingencies.

Recommendations

State and local tax revenues are currently growing strongly, thus now is a good time to start reducing debt loads. There is no particular optimal level of government debt, but there should be a strong bias in favor of pay-as-you-go financing for infrastructure because it is cheaper, more transparent, and more prudent given the large costs that face the states in coming years. Routine capital projects, such as school construction, should be financed on a pay-as-you-go basis. Debt financing is more appropriate for large and unforeseen needs, such as rebuilding after disasters.

State and local governments should cease issuing debt for private purposes. Investments that generate streams of income, such as stadiums, airports, and parking lots should be privatized, not subsidized by issuance of government debt. The federal government should repeal the tax exemption for municipal bond interest, perhaps in exchange for reducing overall tax rates on savings. For their part, citizens need to remember that government debt simply represents deferred taxes and charges, and they will have to bear the burden sooner or later.

¹ Federal Reserve Board, “Flow of Funds Accounts of the United States,” June 8, 2006, Table D.3. Federal Reserve data show that total “municipal” debt was \$2.23 trillion in 2005, which includes certain debt issued by non-government entities.

² Based on U.S. Bureau of the Census data for 2004 available at www.census.gov/govs/www/estimate.html. Note that Census data for total “state and local” debt is similar in magnitude to Federal Reserve data for total “municipal” debt.

³ Thomson Financial data published in *The Bond Buyer*. These figures exclude bonds issued for refinancing.

⁴ U.S. Bureau of the Census.

⁵ www.bondbuyer.com.

⁶ See Joint Committee on Taxation, JCX-14-06, March 14, 2006.

⁷ U.S. Bureau of the Census.

⁸ National Association of State Budget Officers, “State Expenditure Report 2004,” 2005, Table 47.

⁹ Elizabeth O’Brien, “Philadelphia Mayor Seeks Formalized Process for Bond Teams,” *The Bond Buyer*, November 28, 2005.

¹⁰ See www.treasurer.ca.gov/cdiac/debtpubs/primer.pdf.