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Why Isn't Muni Tax-Supported Debt Growing?

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In an article in the Bond Buyer last week, we were asked why net tax-supported debt has virtually stopped growing. As noted in the article, "Total net tax-supported debt (NTSD) grew 1.2% for 2018 Moody's Investors Service revealed in a report out this week, marking a half-decade in which the number has grown by less than 2% annually. The NTSD numbers are based on 2017 issuance and debt service data. Analysts weren't surprised by the slow growth, and said that subdued infrastructure spending and other policy decisions would also keep that growth rate slow for the foreseeable future. Total NTSD grew to $522 billion from $516 billion last year, Moody's said, increasing in 24 states. Illinois was a key driver, having the largest increase in debt at $5.2 billion. That 16.3% year-over-year increase was largely due to issuing long-term debt to finance payment of its bill backlog, Moody's said. Debt ratios declined for the third consecutive year, as median NTSD per capita fell by 4.3% to $987. Median NTSD as a percentage of GDP fell to 2.1%, its lowest level since 2006."

The article included several of our answers, but there is considerably more to cover in the context of the ongoing shortfall in infrastructure spending. The following include our answers, but then we add a few additional notes, especially in light of the new report by Arthur Laffer and his team that was the subject of an op-ed in the Wall Street Journal last week.

The key points that we stressed in our discussion with the Bond Buyer included the following:

1. **Many governments are still catching up, budget wise, coming out of the Great Recession.** In their often-unsuccessful struggle to increase services back to pre-recession levels, room to pay for major projects using tax-supported debt remains limited.
2. **Pension requirements—current and future—tightening available revenues.** The conflict between the need to maintain and/or catch up with growing pension funding requirements will be the single greatest challenge to infrastructure funding capacity for state and local governments, in a great majority of states. We see lots written about infrastructure, and lots about the pension crisis, but not nearly enough about how the two are going to interact.
3. **A Republican-based philosophy: The ideology of reducing taxes versus enhancing services or building/rebuilding infrastructure.** Let's face it, in a very large number of states, budgets have been kept incredibly tight through limits on taxes, and this doesn't leave much room for supporting needed debt for infrastructure maintenance or expansion. It's not the policy choice we would make, given infrastructure needs, but it has been the dominant theme in large parts of the country with Republican governors and one or both houses of the legislature also Republican. The major new Laffer Report, "Rich States, Poor States," discussed below, is directly and aggressively focused on a philosophy that states achieve "success" by gutting taxes—even if that means significantly diminished services (e.g., schools), and inadequate capacity to fund infrastructure.
4. **An increasing political decision at many governmental levels to focus on near-term needs, rather than long-term ones, such as infrastructure.** This has long been an issue: the

money that gets spent now to provide services has often had more political "kick" than the money used for 40-year projects. ("If the bridge falls down after I leave office, it's not my problem.") However, the counterweight to public spending as discussed in the Laffer report has actually accelerated in recent years: ribbon-cutting on new projects was once considered a net positive, that stimulated job growth and expanded economic activity. Now, it is often politically something to be avoided, and done in the dead of night with no observers, so that taxing and spending in general can be minimized. We suspect that the pattern may be in the early stages of reversing, but certainly during recent years, when tax-supported debt didn't grow nearly in keeping with GDP growth, it was a key factor.

5. **A need to transition to user fee-supported projects.** Policy-wise, this has always been the case, but getting voters to approve capital spending for these projects has been difficult. The classic case is the Interstate, where the attitude is often "this was already paid for," despite the fact that major maintenance now will cost 10-20 times as much as the original project in its entirety. There are also entrenched political resistances to user-pay strategies, such as from trucking companies on interstate highways, but this is a transition that will have to happen, in our view, and as it does, should lead to a continued transition away from reliance on tax-supported debt.
6. **With tight budgets at the Federal level and little focus on supporting state/local activities, state and local governments are being forced to choose between capital spending and maintenance of services.** As the school/teacher battles suggest, it isn't an easy choice. Yes, we desperately need to pay teachers more, but where do we then get funding for infrastructure?
7. **Very early starts in a transition to a bigger private role.** In future reports we will discuss why, in our view, this transition appears to be imminent—even if a Trump infrastructure plan is never enacted. When that happens, you will see less tax-supported activity, not more? In simplified fashion, the point here is that properly planned P3s in conjunction with a design/build format (as opposed to design/bid/build) will become increasingly important as technological change continues to accelerate. As new examples, we point to the NYS budget which authorizes expanded design/build contracting for the Brooklyn-Queens Expressway and the construction of borough-based facilities to facilitate Rikers prison closure plans.
8. **Lack of leadership toward a stronger emphasis on many parts of the infrastructure "equation."** Who is making the case for competing effectively on environmental spending, efficient mass transit, implementation of modern technology? China, with a control economy, does lots of wasteful spending, but they can also prioritize modern infrastructure needs, including climate change-related activities and preparation for automated electric vehicles.
9. **Very slow wage growth, despite low unemployment and the tax cut.** This slow growth generates resistance to higher taxes along with slower tax base growth.
10. **Going forward, the limit on state/local tax deductibility will increase resistance to supporting projects with taxes.** In many environments, including many red states, it's the taxpayers who will be most affected by the SALT limit who have the most influence on many spending decisions.
11. **Detroit.** In the aftermath of the Detroit Bankruptcy, and its resolution, it has become increasingly clear that only the most pristine tax-supported debt is safe in tight budgetary environments, and that special revenue debt (despite Puerto Rico concerns) has credit protection advantages that often lead to lower borrowing costs.
12. **The long-term nature of infrastructure projects.** A last reality for now is that tax-supported debt tends to be shorter in maturity than user-pay funded systems, and this difference means that it is easier to match debt retirement with the useful life of a project by using revenue bonds. This has always been the case, but with budgets so tight, the case for stretching out debt service closer to a project's expected life has been enhanced.

Now back to the massive new Laffer report entitled “Rich States, Poor States” by the American Legislative Exchange Council. Under the viewpoint espoused in this massive report, the view is largely “lower taxes good, higher taxes bad,” with state by state grades on each state’s tax outlook largely based upon tax levels and trends. Now, most of our readers are, we suspect, aware that most of the positions in the report have been widely discredited.

Our key point is that, in many red states, the philosophy toward cutting taxes, gutting spending, and keeping services and infrastructure spending low remains intact—but that this is a philosophy at the legislative/leadership level that is losing favor at the electorate level.

Nevertheless, the state-level trend toward tight taxing/spending is still a factor in the level of tax-supported bonding, and quality of services.

The teacher demonstrations are good news in the sense of signals for more reasonable levels of state/local services, but the near-term impact in some states will be to respond to this single issue, without increasing available budgetary resources—so that infrastructure capacity will actually decline until budget patterns reverse. Very simply, taxing/spending patterns haven’t moved away from the viewpoint of Laffer-like fiscal conservatism as yet in many states, leaving infrastructure spending capacity at the tight levels that were reached after 1) the Great Recession, and 2) the dominance of fiscal conservatives at the state level after powerful election victories, particularly in 2010 and 2014.

In other words, for many types of infrastructure projects to go forward, they will need:

1. More budget capacity as tax-cutting pressures subside;
2. More reliance on user-fee supported structures;
3. A stronger, more well-defined Federal role; and,
4. A more effective private sector role.

We expect much of this to occur over time, but not overnight.

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