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Has 'Debt' Become a Four-Letter Word?

States and localities are afraid to take on new debt these days, missing a golden opportunity to invest in infrastructure and other long-term projects.

As states and localities have adjusted to a slow-growth economy, one of the main casualties of the shift has been investments in infrastructure and other long-term programs. In other words, governments aren't taking on new debt these days. It's a surprising development since interest rates are at historic lows, making it cheaper than ever to borrow.

State debt has slowed so much that Iowa State Treasurer Michael Fitzgerald is urging cities, counties and the state to borrow more. "Our infrastructure continually needs to be improved, whether it's schools, roads, even prisons," Fitzgerald told the Des Moines Register earlier this year. "With interest rates as close to zero as you're ever going to find them, we could be missing an opportunity."

Still, by all indications, the debt shrinkage will continue in 2015 as governments focus much of their bonding efforts on refinancing rather than issuing new debt. "We've seen a political anti-debt sentiment build up in parts of the country," said Emily Raimes, a state government analyst with Moody's Investors Service. "It's partly due to the federal debt ceiling that's made people very aware of the issues around having a lot of debt and partly due to the mood around pensions and issues of funding being a real long-term burden."

So has debt become a four-letter word for states and localities?

While there are many kinds of healthy debt, there's also no such thing — despite Fitzgerald's pleadings — as too little debt from a credit perspective, said Raimes. "To the extent states pay for projects with cash on hand and not with long-term debt," she said, "we do not see that as any kind of credit negative."

Different kinds of long-term debt can mean different things for a government's health and outlook. Most of this debt is viewed as reasonable in the sense that it is typically issued for a public institution or a project that will continue to be a benefit to the community over the lifetime of the debt. And, of course, there are nuances. For example, Moody's last month downgraded Bristol, Va., largely because the agency saw the city as over-leveraged in risky debt.

But there is one kind of debt that many agree is the equivalent to sending out a distress flare: long-term debt to cover budget shortfalls, also called deficit financing. Governments that take on this type of debt are usually doing so under extreme duress. It's not unusual for governments to issue short-term debt to cover cash flow throughout the year. That process is akin to a consumer using a credit card to cover payments, then paying off the card at the end of the month when his paycheck comes in. But deficit financing can mask systemic problems with a government's budget.

Chicago issued roughly $9.8 billion in bonds between 2000 and 2012. An investigation by The Chicago Tribune found that less than a third went to fund capital improvements while nearly half went to meet short-term budget needs like equipment purchases and one-time legal expenses. Chicago's money troubles have led to multiple downgrades and a deteriorating pension system.

A big unfunded pension liability can also entice lawmakers to issue bonds to pay down that liability. But such a move carries the risk that the government could pay more in bond interest than that investment will earn in the pension system.

What's important when it comes to debt is what a government can handle financially and politically. California suffered downgrades during the Great Recession as the state faced a budget crisis with little wiggle room to fix it. The state has a volatile income tax revenue stream, a tax hike requires a two-thirds approval from the legislature and it has statutory school funding requirements. Since then, California has passed two major ballot measures that raised taxes and established a new funding formula for its rainy day fund that manages against the state's revenue volatility. Both of these have significantly contributed to the state's improved credit picture.

It's also important not to take on too much debt. Generally analysts like to see states leverage no more than 15 to 20 percent percent of their general fund to service debt. But there are exceptions. A decade ago, Loudoun County, Va., had a substantially higher debt burden, says Moody's local government analyst Julie Beglin. But it was also the fastest-growing county in the country. "It was clear that a lot a developments were going in and they had a very high debt burden because of that," she said. "But we did not take down their rating because we thought they could afford it."

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