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States Contemplate Borrowing to Help Manage Pandemic's Fiscal Impact

Short-term financing, Federal Reserve program may buy time, but budgets will need adjusting

As Illinois lawmakers in May considered a budget for the fiscal year that starts July 1, they already faced an estimated $7 billion combined revenue shortfall for fiscal 2020 and 2021, in large part attributable to the COVID-19 pandemic. To help close that gap, the General Assembly adopted a spending plan premised on borrowing up to $4.5 billion from the Federal Reserve's new Municipal Liquidity Facility (MLF)—with the hope that the state will be able to repay those funds with federal budget aid not yet approved by Congress. On June 2, the state announced an initial $1.2 billion of borrowing from the MLF.

Although it is not clear whether federal aid targeted to help states will materialize, the plan illustrates the measures policymakers are considering in response to an unprecedented dive in tax revenue and new demands on spending. Borrowing could help, but it would be only one component in a broader strategy that will require other budget adjustments.

States generally have two options for borrowing money: long-term bonds and short-term notes.

Long-term bonds mainly finance long-lived infrastructure projects. They are often repaid over years or decades and represent the vast majority of municipal debt.

Short-term borrowing most commonly takes the form of "anticipation notes." These are used to manage cash flow because tax revenue tends to arrive in periodic large amounts while spending demands are spread throughout the year.

States face challenges and limitations using either approach to respond to fiscal emergencies such as those caused by the coronavirus. Creating a long-term liability—as with bonding—to pay for immediate, short-term operating costs is generally considered unsound practice, with potentially negative credit rating implications. Some governments constitutionally or statutorily prohibit it.

Short-term anticipation notes can help states address revenue delays, such as those created by moving the tax filing deadline to July 15 this year. But they are not a budget solution. Anticipation notes require sufficient future revenue to borrow against; however, states will probably have few uncommitted income streams that they can use to fill new, unexpected budget gaps.

Moreover, states usually require that anticipation notes be repaid within 12 months or by the close of the fiscal year. Rhode Island's constitution, for example, stipulates the latter. This means that notes issued to meet current costs may need to be paid back too soon to make a difference in closing the gap.

And neither short- nor long-term borrowing can solve the harder problem of dramatic revenue declines driven by an economic downturn. Ultimately, balancing state budgets will require longerterm solutions such as spending cuts, tax increases, drawing on rainy day funds, or federal aid. Borrowing can provide immediate cash and buy time to make those decisions but will have to be repaid with interest.

Despite the limitations of borrowing, the current crisis presents such a challenge to state finances that policymakers will likely need to employ a range of tools to weather the storm. Although state rainy day funds, on average, are in better shape now than going into the Great Recession, they will not be enough for most states. Borrowing then may need to be one part of a package of state budget and policy responses.

This time, there is also a new borrowing option for policymakers to consider. In response to unprecedented turmoil in the municipal bond market in March linked to the pandemic, the Federal Reserve announced a plan to purchase up to $500 billion worth of short-term debt from state and local governments through the newly created MLF.

The program will purchase notes directly from all 50 states, counties exceeding 500,000 residents, and cities with more than 250,000. In states with no counties or cities meeting those requirements, governors can designate up to one county and one city to participate. Borrowers can use the funds to help manage revenue delays and declines as well as increased expenses linked to the pandemic, or to lend to governments that don't meet the size restrictions. The total note size is limited to 20% of the borrower's 2017 own-source revenue.

In addition, the MLF can purchase notes with maturities of up to three years, longer than typical anticipation notes. That could provide policymakers with more time to decide on sustainable budget solutions—without creating an obligation that weighs on budgets many years into the future, such as with long-term bonds. However, in order to benefit, some states would have to modify their rules to allow borrowing for operating expenses for this length of time.

Borrowing costs could play an important role in determining whether governments will take advantage of the MLF. The Fed requires prospective borrowers to certify that interest rates demanded by the market are higher than normal. After a turbulent March, the muni market stabilized and yields dropped to more ordinary levels, meaning states might not currently meet the requirement.

Further, the laws governing the Fed require it to charge borrowers a "penalty rate" above the typical market rates seen in normal circumstances. This rule is intended to ensure that would-be borrowers turn to the MLF only as a last resort when market rates are substantively above normal. In that event the program might provide a cheaper borrowing opportunity, but until then states may hesitate to tap into the facility.

The Fed has unveiled MLF details on a rolling basis, with additional clarifications and changes still possible. Despite that uncertainty, the significant fiscal challenges that states face because of the pandemic make it likely that policymakers will consider borrowing, whether from the MLF or the market. Understanding the trade-offs of the various options will help them make sound budget decisions.

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