State and Local Governments Relied on Debt for Budgetary Help In 2020.

More borrowing likely in 2021, market analysts suggest

State and local governments have sought a variety of ways to cope with the fiscal fallout of the COVID-19 pandemic and recession, including borrowing on the municipal bond market. But municipal bonds are commonly used to pay for major, long-lasting projects, so whether—and how—to use them to borrow for immediate budgetary relief can be a challenging question for government officials.

Matt Fabian is a partner and Lisa Washburn is chief credit officer and managing director with Municipal Market Analytics (MMA), a research and consulting firm that specializes in the U.S. municipal bond market. Founded in 1995, the company—which has worked with The Pew Charitable Trusts to support Pew's research on state fiscal health—helps investment firms, banks, and financial advisers navigate the nearly $4 trillion market. This interview with Fabian and Washburn has been edited for clarity and length.

Q: We know that state and local governments cut spending and, in some cases, raised taxes to try to close their budget gaps in 2020. What else did they do?

A: State and local governments faced severe 2020 and 2021 budget crises because of the COVID-19 pandemic. So, they used the municipal bond market to reduce or postpone annual expenses, raise operating capital, and restructure otherwise damaged finances. All of these activities could, collectively, be called deficit financing—that is, paying for government expenses through borrowing.

These are not typical uses of the municipal bond market, where an overwhelming majority of financing is for long-term infrastructure projects. But last year, with state and local governments seeking as much as possible to avoid cutting spending, raising taxes, or postponing pension payments, they shifted their emphasis to short-term and temporary solutions. As the pandemic continued and federal stimulus money dried up, they increasingly took on debt for budgetary help.

We analyzed 442 municipal bond issuances over $100 million between August and mid-December of 2020, and we found that at least a quarter—and, because in some cases the ultimate use of the money wasn't clear, perhaps as many as half—involved some form of deficit financing.

Q: How did state and local governments use this borrowed money?

A: We saw clear evidence of what we'd call direct deficit refinancing, where the money from bonds or loans is used to replace money that would ordinarily have been collected from taxes to fund regular, ongoing government programs. There was also evidence of what we'd call indirect deficit refinancing, such as using money from bonds to pay for projects that previously were paid for with cash.

The most common method of direct deficit financing was "scoop and toss" refinancings, in which new bonds are sold to retire old ones and a meaningful portion of debt service payments are delayed. It's not exactly the same as what a homeowner might do with a "cash-out" refinancing of a mortgage, but the result is the same in that it frees up cash on hand.

Q: Is deficit financing a good idea?

A: That depends. Deficit financing with debt could, depending on the type of bond issues, create a longer-term budgetary liability to pay for immediate, short-term operating costs. That's generally considered an unsound practice, with potentially negative implications for a government's credit rating. In fact, some governments constitutionally or statutorily prohibit deficit financing.

But this crisis has presented such a severe and abrupt challenge to state and local finances that policymakers looked to use a range of tools to weather the storm. Any response to fiscal emergencies such as those caused by the coronavirus comes with challenges and limitations. In this case, borrowing became one part of a package of budget and policy responses, one that may have allowed governments to avoid, at least for the time being, other harsh measures—such as raising taxes or cutting services.

Q: So, have credit rating agencies in fact downgraded any state or local governments as a result of them using municipal bonds for short-term purposes?

A: So far, the impact on state and local credit ratings has been only minimal, which is a departure from how the credit rating agencies would normally respond. And a few factors may cause this to continue: There's a greater acknowledgment on the part of the agencies of the uncertainty facing governments right now; there's less concern in the current environment over the short-term impact of one-time budgetary fixes that in more normal times the rating agencies might have seen as "gimmicks"; and because state and local governments have been slow to release their financial disclosures, the agencies don't yet have, in some instances, a clear picture of state or local government finances for 2020 and 2021.

However, there's also good reason to assume that rating downgrades are coming this year and next as more governments disclose their financial information. These downgrades would make it more expensive for any entity that's been downgraded to issue bonds, resulting in further budget challenges.

Q: Given the scope of the budget challenges for states last year, did the federal government intervene in the municipal bond markets?

A: Yes. In April, Congress created a lending backstop at the Federal Reserve called the Municipal Liquidity Facility, or MLF, with $500 billion that was available to state and local issuers for deficit financing. The MLF was valuable because it increased liquidity available to state and local governments and reduced the risk that states and cities that were facing fiscal challenges would make bad policy choices (such as selling assets, drastically cutting local aid or social services, or considering debt service payment freezes) or face a cash crisis that itself could lead to market disorder.

At the end of last year, the U.S. Treasury—which is the Federal Reserve's partner in operating and overseeing the MLF—requested that the Fed return to Congress any unused cash from the original $500 billion stake and stop approving any new loans. The loss of the MLF could somewhat hamper the public finance market in 2021 because the program provided state and local governments looking to borrow with a federal assurance of immediate liquidity.

Q: Are there long-term policy implications of governments using municipal bonds for short- and mid-term budgetary needs?

A: It’s too early to say for sure, but there’s reason to suppose that debt incurred now is unlikely to disappear from government balance sheets for years to come. What’s more, because state and local financial conditions this year are likely to be closer to the second half of last year than to 2019, we see no reason not to expect similar borrowing this year.

Last year bond issuers shelved any new projects that could be delayed; they also depended on the lending markets to offset COVID-driven budget losses. It’s reasonable to assume that the same thinking could apply to the next few years. So, we expect that state and local governments, with perhaps a new respect for needing cash on hand, will continue to grow their debt balances over the medium- to long-term.

If that happens, state and local government may find themselves hindered—in particular, in times of crisis—by the lack of financial flexibility resulting from the rising expenses that come with larger debt balances. State budget writers and other officials could minimize that by more effective debt management strategies and a longer-term outlook when it comes to budget planning.

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