Assessing the Affordability of State Debt

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Motivation

- State governments issue debt in the form of notes and bonds primarily to fund capital projects like roads and schools
- In the wake of the Great Recession, conflicting views on state debt emerged:
  - On the one hand, low interest rates and federal subsidies (e.g. BABs) argue for more debt issuance
  - On the other, fiscal crisis generating questions about states' ability to meet financial obligations
- How can states gauge what is an **affordable** level of debt?

What is debt affordability and why does it matter?

- Refers to a state's ability to meet debt service requirements **without:**
  - Raising tax rates to uncompetitive levels
  - Negatively impacting provision of ongoing public services
- Has implications for:
  - Fiscal sustainability
  - Economic competitiveness
  - Credit ratings

Assessing affordability: Debt burden

- Can be described as a simple ratio:

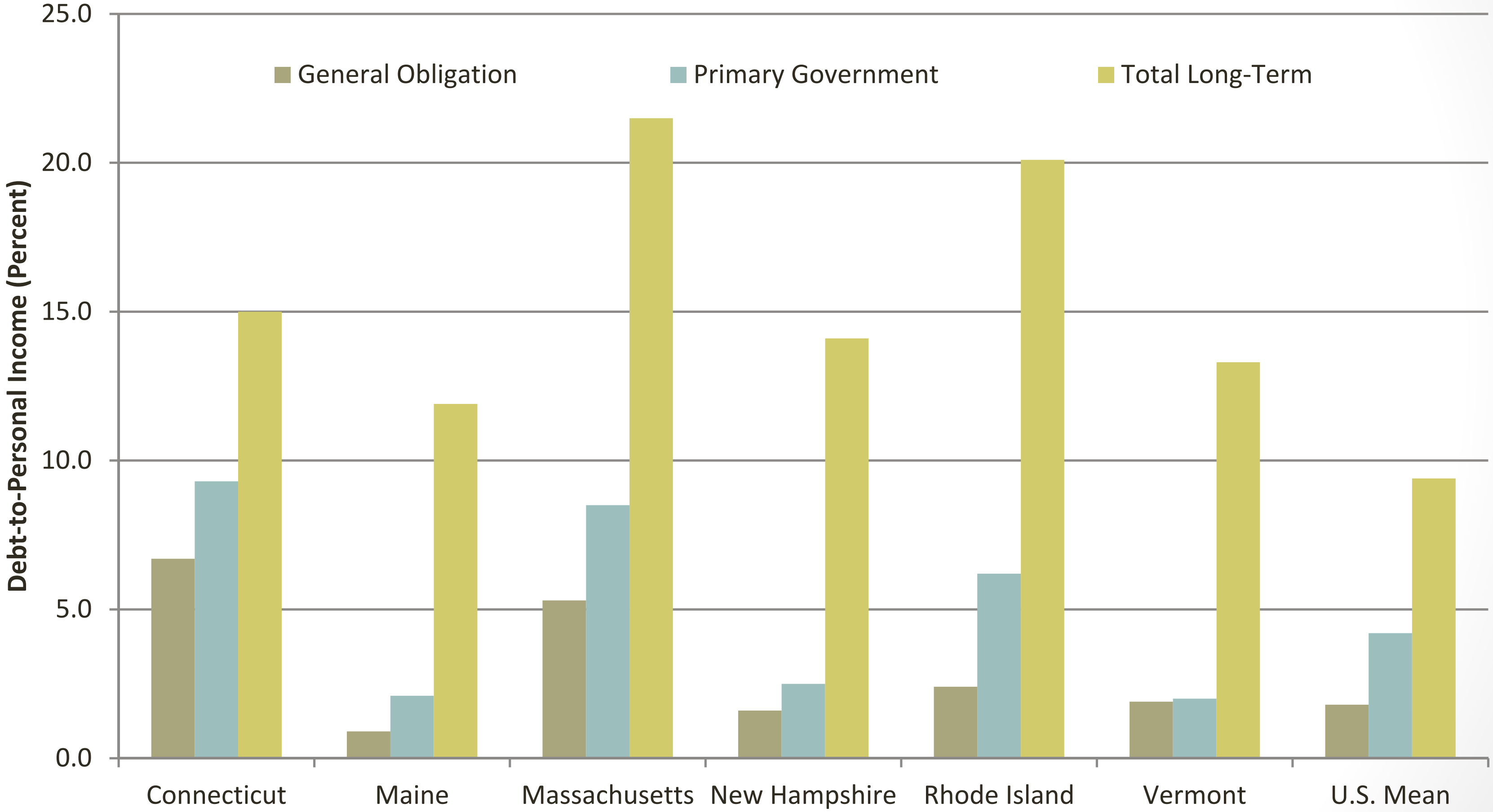
$$Debt\ burden = \frac{Debt}{Resources}$$

- Issues to resolve:
  - What should be included as state debt?
  - Should it be measured as a stock (outstanding debt) or flow (debt service)?
  - What should be included as resources?

Defining state debt: Classifying obligations

- Several ways to classify bonded debt, including, but not limited to:
  - **By issuer:** primary state government, state agency, public authority
  - **By security/pledge:** general obligation, revenue, hybrid
  - **By revenues:** general taxes, dedicated taxes, user fees
  - **By purpose:** public, private (conduit debt)

Illustrative comparison of debt definitions



Source: Author's calculations using state CAFR, U.S. Census Bureau and U.S. BEA data.
Note: General obligation and primary government debt for FY 2012 year-end; Census data for FY 2011 year-end. Does not include local government debt.

Defining state debt: Which debt should be counted?

- Common focus on debt directly supported by state taxes
  - Excludes self-supporting and contingent debt
  - Competes most directly for scarce tax dollars
- Arguments for also considering a broader definition
  - A default on other types of state debt may still have negative implications for state's credit rating
  - All draw on same pool of resources for repayment

Debt outstanding versus debt service?

- Level of debt outstanding
  - Stock variable
  - Influenced by economic, political, institutional, and service demand factors
- Annual debt service
  - Flow variable
  - Influenced by: level of debt, speed of amortization, and interest rates

Measuring resources

- Resources available under current policy
  - Revenues
  - Expenditures
- Underlying resource base
  - Population
  - Personal income
  - State GDP
  - Value of property
  - Revenue capacity

Commonly-used debt burden ratios

Metric	States Employing Metric as Limit or Guideline
Debt Service-to-Revenues	AK, DE, FL, GA, HI, LA, ME, MD, MA, NH, NY, NC, OH, OR, RI, SC, TN, TX, VT, VA, WA, WV
Debt Service-to-Expenditures	IL, MA (pre-2013)
Debt-to-Revenues	CT, DE, FL, MS, PA, VA
Debt-per-Capita	GA, VT, WV
Debt-to-Personal Income	GA, MD, MN, NY, NC, RI, VT, WV
Debt-to-Value of Property	NV, NM, UT, WI, WV, WY

Multiple metrics can offer different perspectives

	Pros	Cons
Debt service-to -revenues: Captures near-term affordability	• Includes principal and interest costs • Most relevant to budget discussions • Policymakers control numerator and denominator	• Annual debt service affected by term of bonds and structure of payments • Revenue dependent on current policy choices and poses measurement issues
Debt-to-personal income: Captures longer-term affordability	• Not dependent on bond term or payment structure • Denominator better reflects long-term ability to pay • Personal income consistently measured across states	• Only captures principal component of debt • Less relevant to budget discussions • Personal income does not include all types of income that may generate state revenues

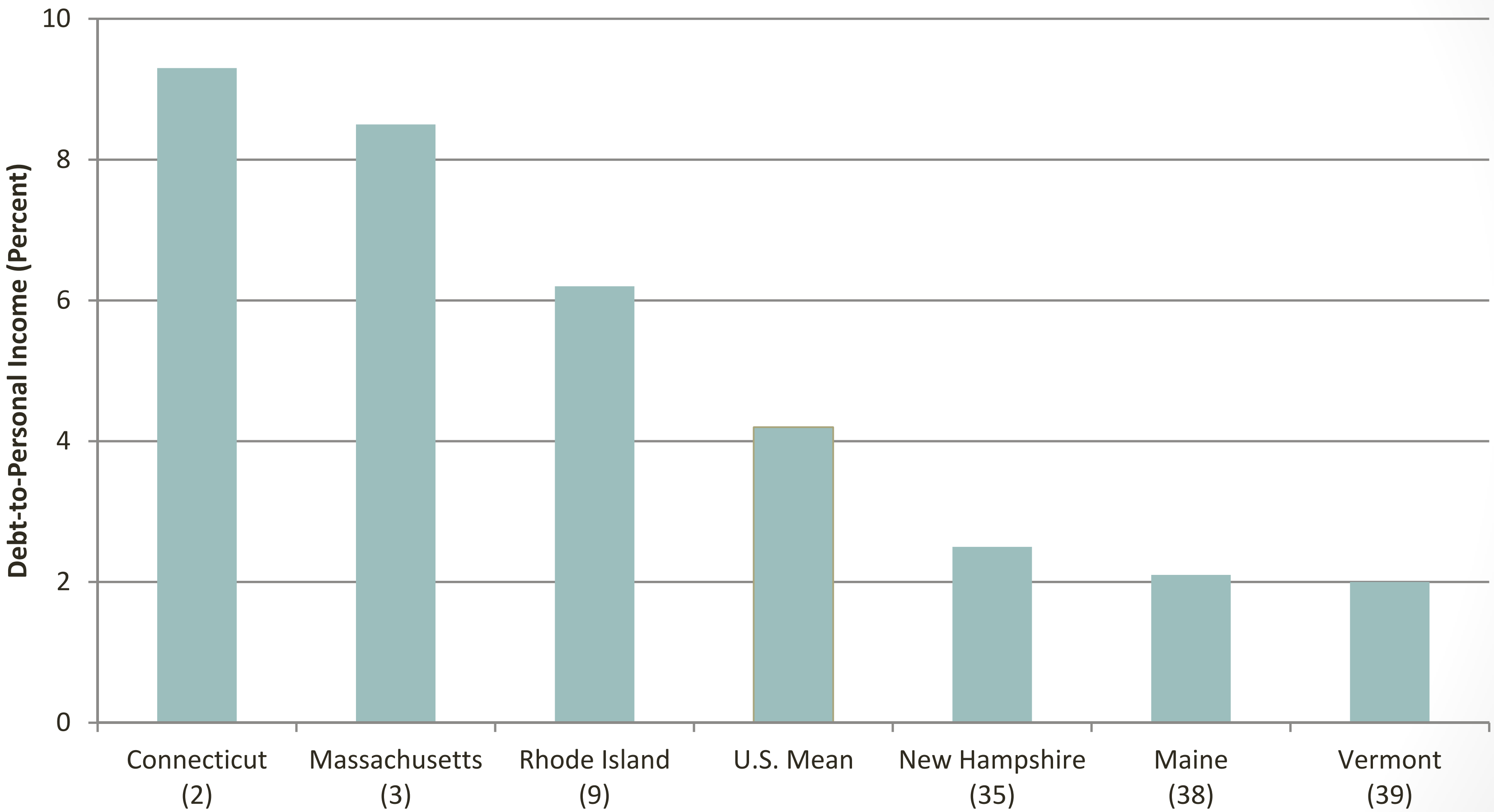
Approaches to assessing affordability using debt burden metrics

	Pros	Cons
Debt ceiling: Compare state's debt burden with specified numeric threshold	• Less data intensive	• Choice of threshold may be arbitrary
Benchmarking: Compare state's debt burden with those of other states	• Less arbitrary • Aligns with "competitiveness" view of affordability	• Requires standardized data • Does not always account for key differences across states

Debt ceilings in New England

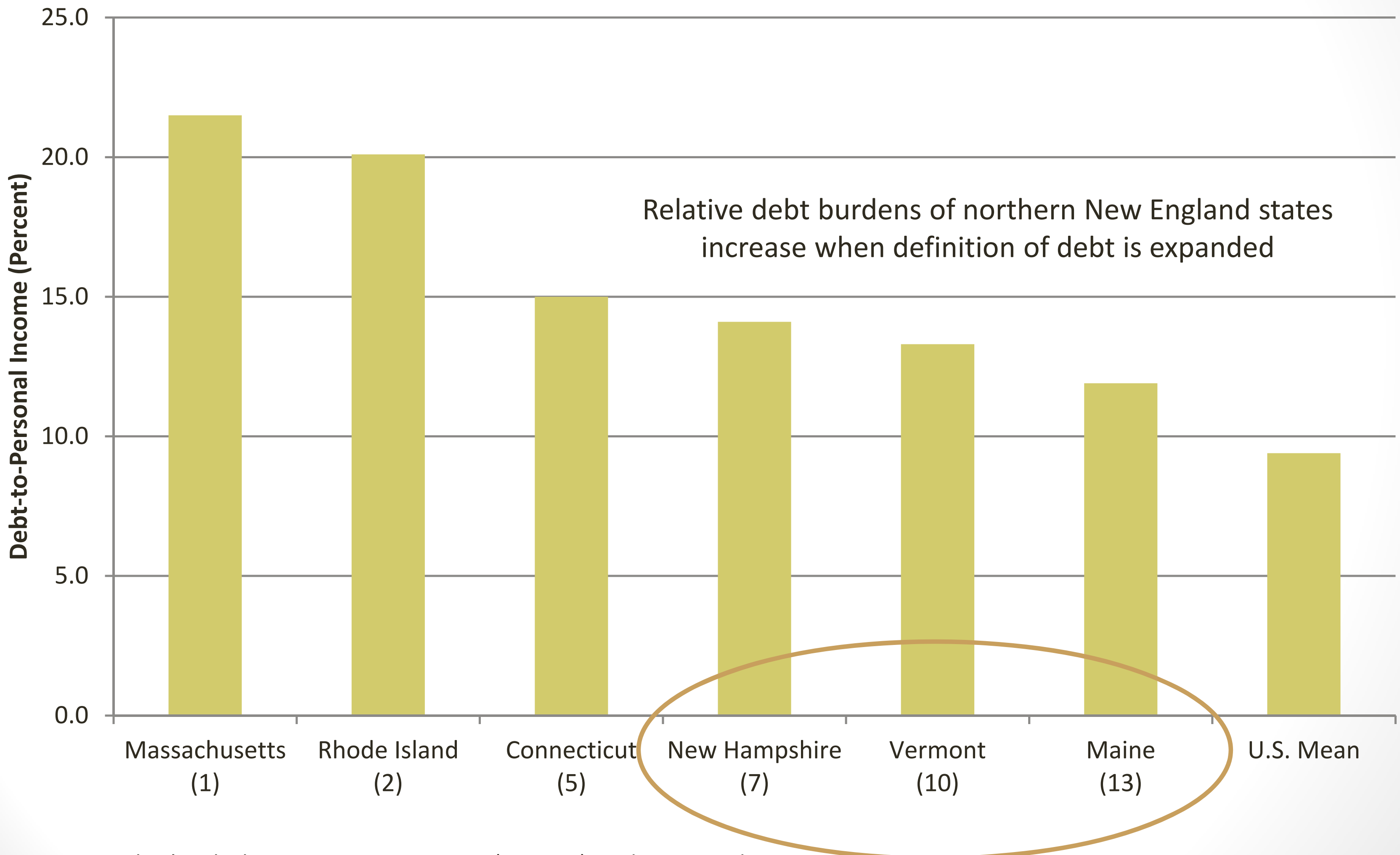
Metric	State	Ceiling	Source
Debt-per-Capita	Vermont	Mean/median of AAA-rated states	Guideline
Debt-to-Personal Income	Rhode Island	5.0 to 6.0%	Guideline
	Vermont	Mean/median of AAA-rated states	Guideline
Debt-to-Revenues	Connecticut	160.0%	Statute
Debt Service-to-Revenues	Maine	5.0%	Guideline
	Massachusetts	8.0%	Guideline
	New Hampshire	10.0%	Statute
	Rhode Island	7.5%	Guideline
	Vermont	6.0%	Guideline
Debt Service-to-Expenditures	Massachusetts	10.0% (pre-2013)	Statute

How New England states rank:
Primary state government debt-to-personal income



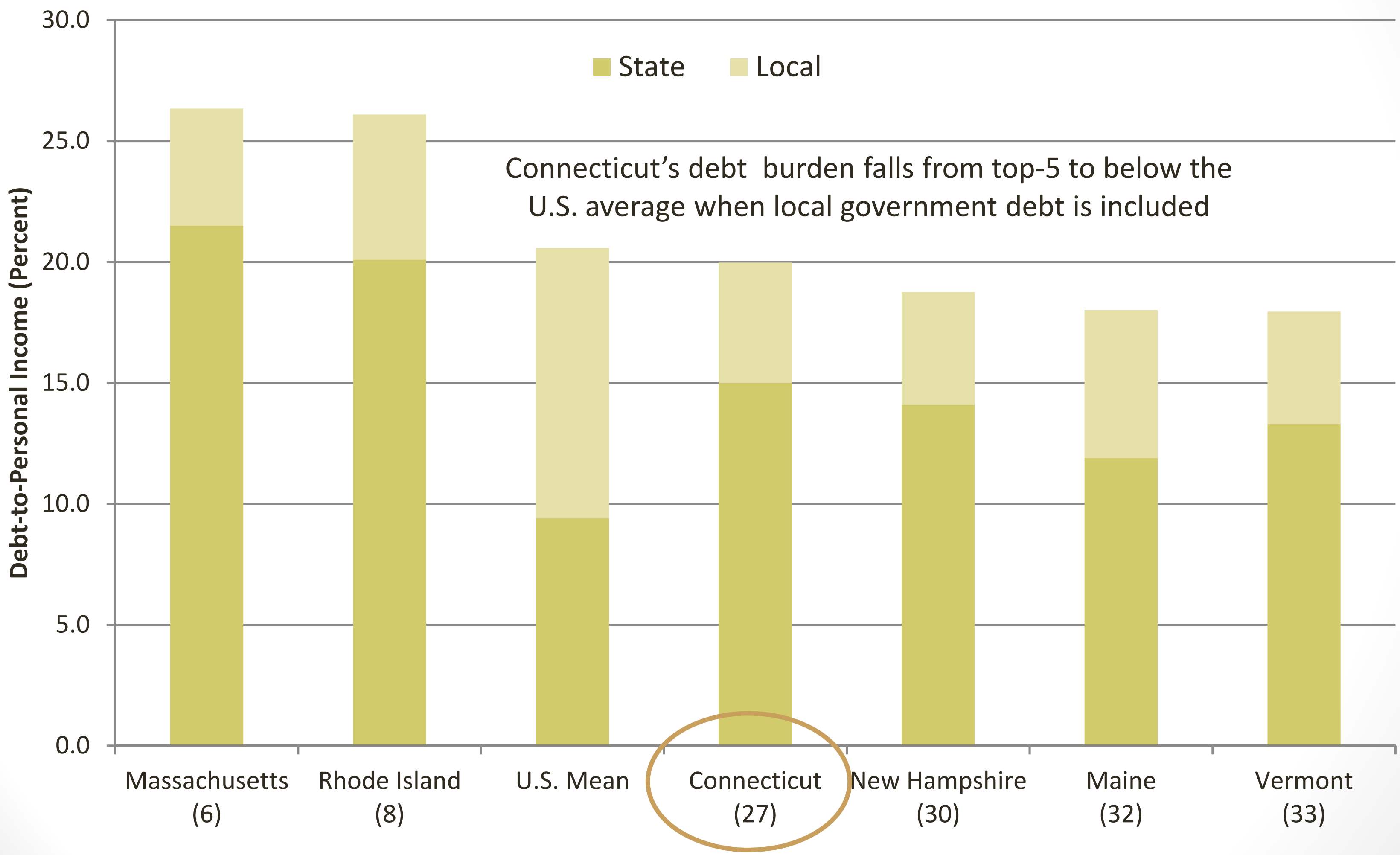
Source: Author's calculations using state CAFR (FY 2012) and U.S. BEA data.
Note: Does not include local government debt.

How New England states rank:
Total state long-term debt-to-personal income



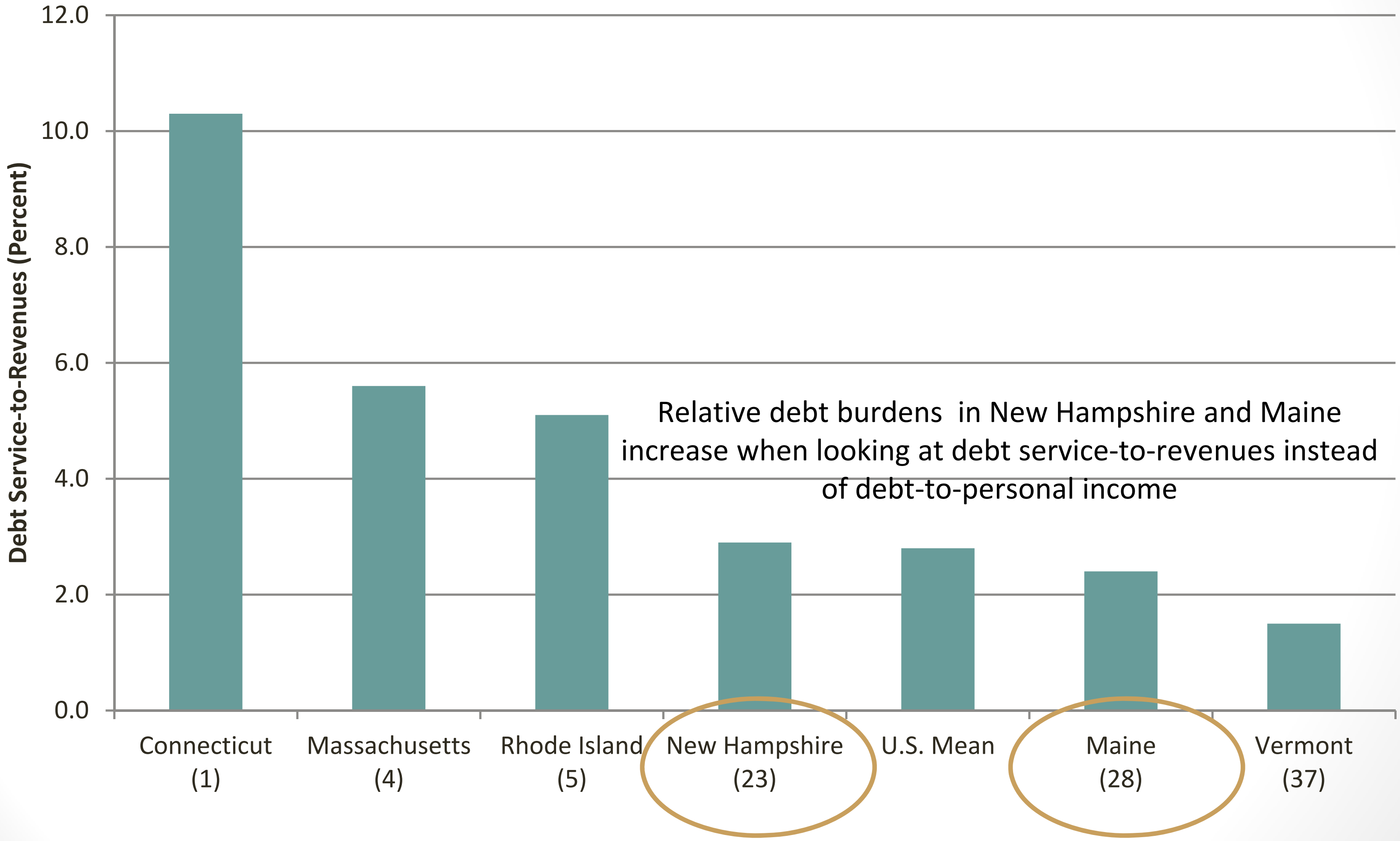
Source: Author's calculations using U.S. Census (FY 2011) and U.S. BEA data.
Note: Does not include local government debt.

How New England states rank:
Total state & local long-term debt-to-personal income



Source: Author's calculations using U.S. Census (FY 2011) and U.S. BEA data.

How New England states rank: Primary state government debt service-to-revenues



Source: Calculations by author using state CAFR (FY 2012) data.
Note: Includes revenue from all primary government funds. Does not include local government debt.

Main take-aways

- No single way to define state debt
  - Choice of which obligations to include depends on perspective (and can lead to different conclusions)
- No single way to assess affordability
  - Commonly-used metrics and approaches each have strengths and weaknesses

What can states do?

- Report recommends that states:
  - Improve transparency surrounding state debt
  - Consider both narrow and broad definitions of debt and multiple debt burden metrics
  - Re-examine existing debt limits
  - Exercise care with benchmarking
  - View debt affordability as complement to capital planning
- An annual formal debt affordability analysis provides a venue for addressing these recommendations

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