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Should We Worry About American Debt?: Part V

Debt of State & Local Governments is Low, But...

Executive Summary

The outstanding debt of state and local governments (SLGs) has been flat in recent years, and the sector has a very low debt-to-GDP ratio. However, unfunded pension liabilities, which are currently being accrued, are not included in conventional measures of SLG debt. The pensions of some, but not all, SLGs are seriously unfunded.

We are generally not worried about a full-blown nationwide municipal debt crisis. But, some SLGs have coped with their rising pension liabilities by cutting back on spending in other areas, especially in capital investment. Failure to invest adequately (e.g., replace aging infrastructure) could act as yet another hurdle to faster potential GDP growth in the United States in the years ahead.

Debt-to-GDP Ratio of SLGs Is Only 15% Presently

In [Part I](#) of this series, we showed that the total amount of debt in the overall U.S. economy has risen more than \$15 trillion (nearly 30%) over the past ten years. We focused on consumer debt in [Part II](#) and determined that the financial health of the consumer sector has generally improved over the past decade. In [Part III](#), we analyzed the increase in debt in the business sector in recent years. We concluded that although the financial health of the business sector is not as strong as it was a few years ago, it is not so weak at present to make us unduly alarmed either. In [Part IV](#), we discussed the sizable growth in federal government debt and the factors that have held down Treasury yields, which have made this debt burden easier to finance. In this, our fifth report in the series, we focus on debt of SLGs.

At first glance, there does not appear to be much of a problem regarding SLG debt. Most SLGs have balanced budget requirements, or statutory debt limitations. Unlike the debt of the federal government, SLG debt is utilized in a more project-oriented, capital investment way rather than simply as a means to plug a structural gap between general revenues and outlays. The result is that SLGs generally do not run large budget deficits that lead to persistently rising debt. As shown in Figure 1, the outstanding amount of SLG debt, the vast majority of which is financed via municipal bonds, stood at \$2.5 trillion in 2005. It subsequently trended up to more than \$3 trillion as SLGs, which reined in investment spending in the early 2000s, started to spend again on investment.

But the absolute amount of SLG debt has been flat in recent years because SLGs have reined in investment spending again, a subject to which we will subsequently return. Indeed, inflation-adjusted capital spending by SLGs has contracted at an average annual rate of 1% since 2010. Moreover, the economy has been expanding for ten years, so the debt-to-GDP ratio of the SLG sector has receded to less than 15% today from 21% in 2010. When compared to the federal government sector, where the debt-to-GDP ratio is 78%, and the business sector (74%), this ratio for the SLG sector appears to be miniscule.

However, this low amount of SLG debt does not fully capture the overall financial picture of the sector. That is, the \$3 trillion of outstanding debt has been largely used to finance capital spending

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projects of the SLGs, but it does not take account of future promises that are reflected in pension liabilities. In 2005, the accrued pension liabilities of the SLGs totaled \$4.2 trillion (Figure 2). Roughly \$2.7 trillion of those pension liabilities in 2005 were funded while the remaining \$1.5 trillion of the total were unfunded. Since 2005, the pension obligations of the SLG sector have more than doubled to \$8.7 trillion, and nearly half of those liabilities are currently unfunded. At present, the unfunded liabilities of SLGs are equivalent to 20% of U.S. GDP, up from 12% a decade ago. Is the SLG sector holding a ticking time bomb in the form of unfunded pension liabilities?

Figure 1

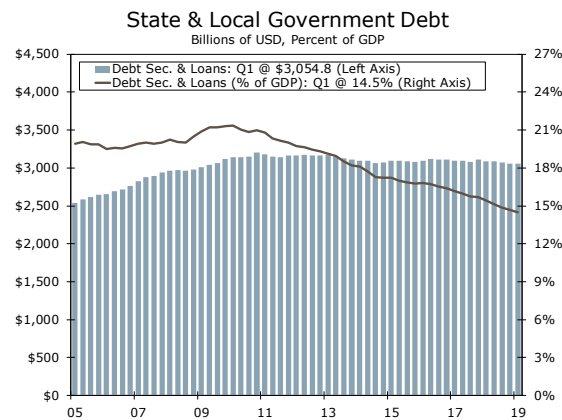
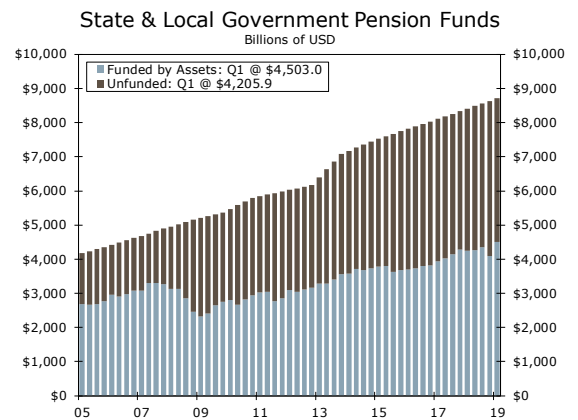


Figure 2



Source: Federal Reserve Board, US Department of Commerce and Wells Fargo Securities

But Unfunded Pension Liabilities Could Be a Problem for Some SLGs

In a sense, the pension challenge facing state and local governments is a bit different than the traditional leverage challenges we have addressed in previous reports. Traditional debt instruments, such as Treasury securities or corporate bonds, are more straightforward than future pension obligations because there is some uncertainty around pension liabilities and the extent to which they are (or are not) funded. One common way to assess the solvency of a pension plan is to, at a given point in time, compare the level of a plan’s assets to its accrued liabilities. While this is a useful measure of a plan’s solvency at a fixed point in time, it is also inherently backward-looking. On a forward-looking basis, the outlook can be a bit murkier: what is the assumed rate of return on those pension plan assets? What assumptions are made about life expectancy or retirement rates? Have policies been put in place to increase future contributions to make up past shortfalls?

In the aggregate, pension funding ratios have clearly deteriorated, though there are significant differences on a state-by-state basis. According to analysis by the Pew Charitable Trusts, 69% of the nationwide pension liabilities were funded in 2017, down from 86% before the recession.¹ However, as the map below illustrates, this average masks significant differences among the states. Some states, such as North Carolina, New York and Wisconsin, have funding ratios close to or at 100%, while others, such as Connecticut, Illinois and Kentucky, have funding ratios below 50%.

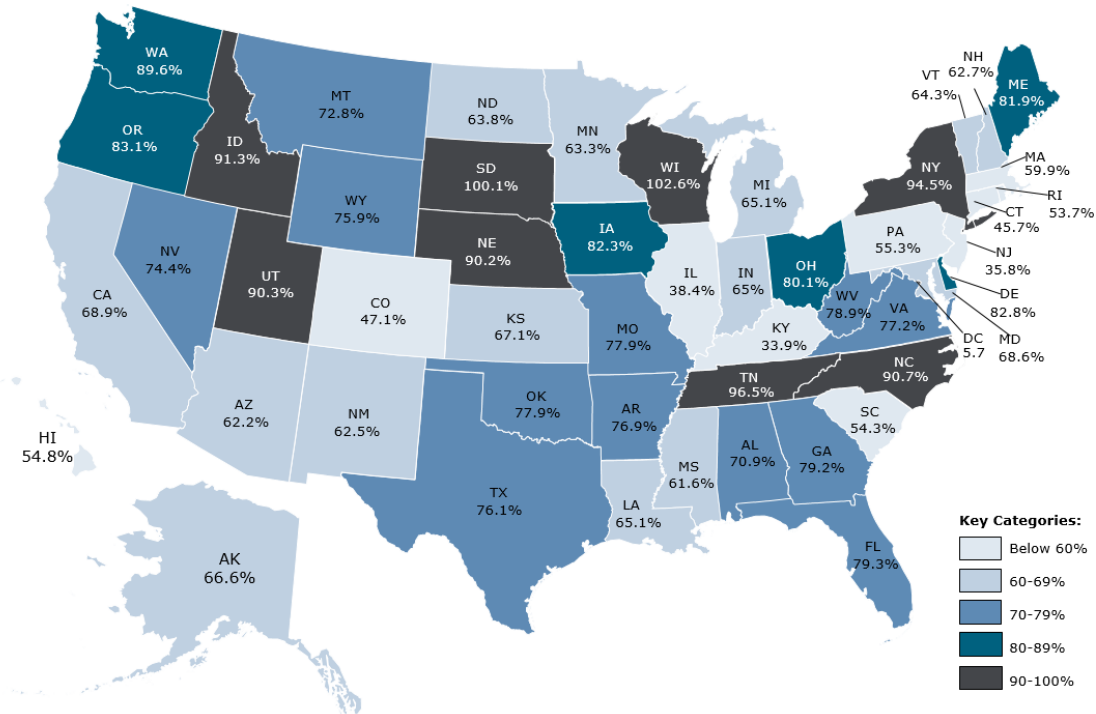
Against this backdrop, policymakers have a few choices given their balanced budget requirements. In order to meet their future pension obligations, they could raise taxes, reduce non-pension spending, make retirement benefits less robust or go with some combination of the three. Making retirement benefits less generous may seem to be the most obvious of the three, but not only can this be a politically thorny issue it can also be a legally challenging one, particularly as it relates to those in or nearing retirement. The Illinois Constitution, for instance, states that “membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.” This makes retroactive benefit changes especially

¹ [“The State Pension Funding Gap: 2017”](#), The Pew Charitable Trusts, Washington, DC (2019).

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difficult, and likely means that states like Illinois will need to make up the bulk of past pension funding shortfalls with higher taxes and/or lower non-pension spending.

Figure 3: State Pension Funding in 2017



Source: The Pew Charitable Trusts and Wells Fargo Securities

Note: Numbers reflect the Governmental Accounting Standards Board reporting standards as of 2017.

There are signs that a grim pension outlook (as well as other structural state budget pressures, such as rising health care costs) have weighed on non-pension spending in some states. As discussed previously, the level of state and local government investment spending has been stagnant during this expansion. And as a share of GDP, it has trended lower over the past ten years (Figure 4). State and local government employment growth has also lagged in this cycle, and as a share of total employment is at its lowest point in decades (Figure 5).

State and local government employment as a share of total employment is at its lowest point in decades.

Figure 4

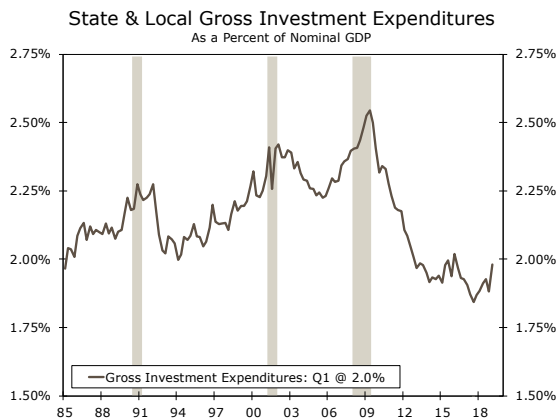
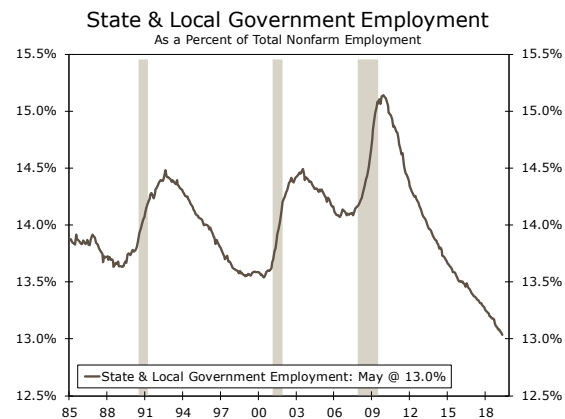


Figure 5



Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

While Others May Be Missing Opportunities for Capital Investment

In our view, the crowding-out effect that pension obligations can potentially have on public investment spending, especially on public infrastructure, should not be idly dismissed. SLGs are responsible for two-thirds of infrastructure investment.² Not only can public infrastructure spending serve as a useful macroeconomic stabilization tool during economic downturns, but it could also boost productivity growth, which has generally been anemic during the current expansion. In our view, the relative fiscal austerity by SLGs, illustrated in Figure 6, represents a missed opportunity to address needed capital investment in U.S. infrastructure, especially in an environment of historically low borrowing costs for SLGs that, taken in aggregate, generally have a low debt-to-GDP ratio.

Should we worry about the pension outlook of the SLGs? On one hand, the unfunded pension situation of the SLGs is not very worrisome because it is not universal. Although some SLGs face significant challenges, others are in good shape. In the aggregate, the combination of traditional municipal debt and unfunded pension liabilities totals about 35% of GDP, which is rather low when compared to some other sectors we have examined in this series. State tax revenue as a share of GDP has been fairly steady over the past couple decades, while federal government revenue relative to the economy is currently about one percentage point below its long-run average. This suggests there could be some scope to raise taxes at the SLG level without “overtaxing” households and businesses.

On the other hand, however, the aggregate numbers mask the fact that some of the states with especially large pension problems are already relatively high tax states (e.g. Illinois or New Jersey). States with large unfunded pension liabilities could hope that asset prices continue to rise. But the stock market has trended higher for ten consecutive years, and bond prices are high already. How much higher can asset prices realistically rise? A recession, should one occur in the near term, would likely weigh on asset prices and, thereby, pension funding levels. Pension liabilities are long term, which still gives states time to address very real fiscal and political realities. But ultimately, many states will likely face some difficult decisions in order to meet pension funding requirements.

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Figure 6

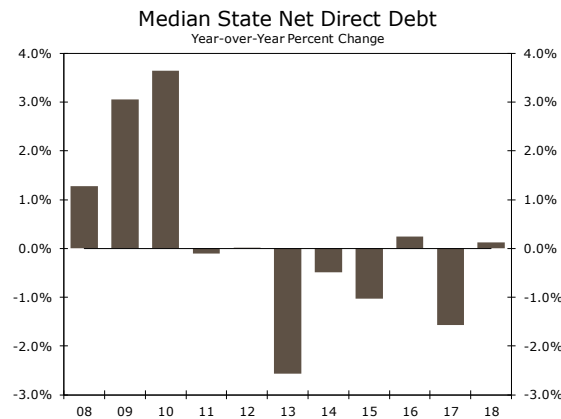
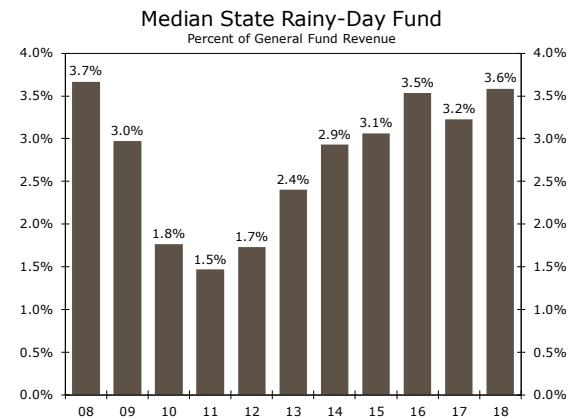


Figure 7



Source: Merritt Research Services/CreditScope and Wells Fargo Securities

State and local governments already have and likely will continue to look for new revenues sources (e.g., marijuana and gaming). We also believe that states will try to shift some cost burdens to local governments, but local governments in higher tax states will probably have the least amount of revenue-raising flexibility to meet obligations. That said, most states have utilized the expansion to rebuild rainy-day funds (Figure 7) to pre-recession levels in preparation for an economic downturn.

Most states have utilized the expansion to rebuild rainy-day funds.

² See [“Public Spending on Transportation and Water Infrastructure”](#), Congressional Budget Office, October 15, 2018.

These reserves will probably give SLGs the ability to manage operations and debt service during the downturn, but at the expense of pension funding and capital investment.

Conclusion

The outstanding amount of traditional municipal debt has been relatively flat in recent years, and as a share of GDP it is less than 15% at present. However, the gap between pension plan assets and accrued pension liabilities has grown significantly since the pre-recession period, creating a future obligation that to some extent mimics a more traditional debt burden. With pensions eating up more SLGs resources, states have not, in the aggregate, ramped up traditional debt issuance to maintain current tax and spending levels due, at least in part, to balanced-budget requirements. Rather, pension challenges have been felt more through crowding-out channels as SLG hiring and investment have grown at a tepid pace over the past decade.

The pension outlook varies considerably at the state level, with some states in quite healthy shape and others facing a grim outlook. These facts suggest to us that the biggest economic challenge may not be a full-blown nationwide municipal debt crisis along the lines of the housing bubble. Instead, some states may endure an ongoing squeeze on their budgets as they try to close the pension funding gap. Although this outcome would not likely lead to a debt crisis in the traditional sense, continued stagnation of investment spending at the SLG level could act as yet another hurdle to faster potential GDP growth in the United States in the years ahead.

Some states may endure an ongoing squeeze on their budgets as they try to close the pension funding gap.

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