

State Debt Affordability Studies: Common Elements & Best Practices



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Views expressed are the author's and are not necessarily those of the
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Motivation

- State governments issue debt in the form of notes and bonds primarily to fund capital projects
- 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 generate questions about states' ability to meet financial obligations
- How can states gauge what is an **affordable** level of debt?
- What role can debt affordability studies play?

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

A tool for assessing affordability: Debt affordability studies

- Analyses that describe and/or evaluate a state's debt burden and provide other relevant information
- Routinely performed by at least 21 states, including:

Alaska (S)	Minnesota (S)	South Carolina
California (S)	Nevada	Tennessee
Florida (S)	New Jersey (S)	Texas (S)
Georgia	New Mexico	Vermont (S)
Louisiana	North Carolina (S)	Virginia (S)
Maryland (S)	Oregon (S)	Washington
Massachusetts (S)	Rhode Island	West Virginia (S)

Note: (S) indicates that study is required by statute. Additional detail and links to state studies available in online appendix.

Why do states conduct debt affordability studies?

- To inform and guide policymakers making decisions about state borrowing
 - Some studies largely informative in nature
 - Others provide specific recommendation for new debt issuance
- To protect or enhance state credit rating
 - Signal of prudent debt management
 - Platform for dialogue with ratings agencies
- To provide the general public with a transparent view of state debt burden

What entity is responsible?

- Capital debt affordability committee:
 - Exist in 6 states (MD, MA, NC, OR, VT, VA)
 - Typically comprised of state officials and appointed public members
- State treasurer's office
- State bond commission
- Other state government finance agency

Common elements of debt affordability studies

- State debt profile
- State debt policies
- State credit ratings
- Debt capacity calculation
- Benchmark comparisons
- Other relevant issues

Common elements: State debt profile

- Obligations may be classified in different ways, including:
 - By issuer:
 - By security/pledge
 - By program area
- May highlight current levels, historical trends, and/or future projections
- Also may address: amortization speed, variable rate debt exposure, and use of refunding bonds

Common elements: State debt policies

- Description of debt limits
 - Fixed
 - Flexible
- Other restrictions
 - Voter or legislative supermajority requirements
 - Limits on bond terms
 - Constraints on use of debt
- Outline of the bonding process

Flexible debt limits 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

Common elements: State credit ratings

- Review any recent changes to credit ratings or outlooks
- Highlight credit strengths and weaknesses noted by ratings agencies

New England State	Fitch	Moody's	S&P
Connecticut	AA	Aa3	AA
Maine	AA	Aa2	AA
Massachusetts	AA+	Aa1	AA+
New Hampshire	AA+	Aa1	AA
Rhode Island	AA	Aa2	AA
Vermont	AAA	Aaa	AA+

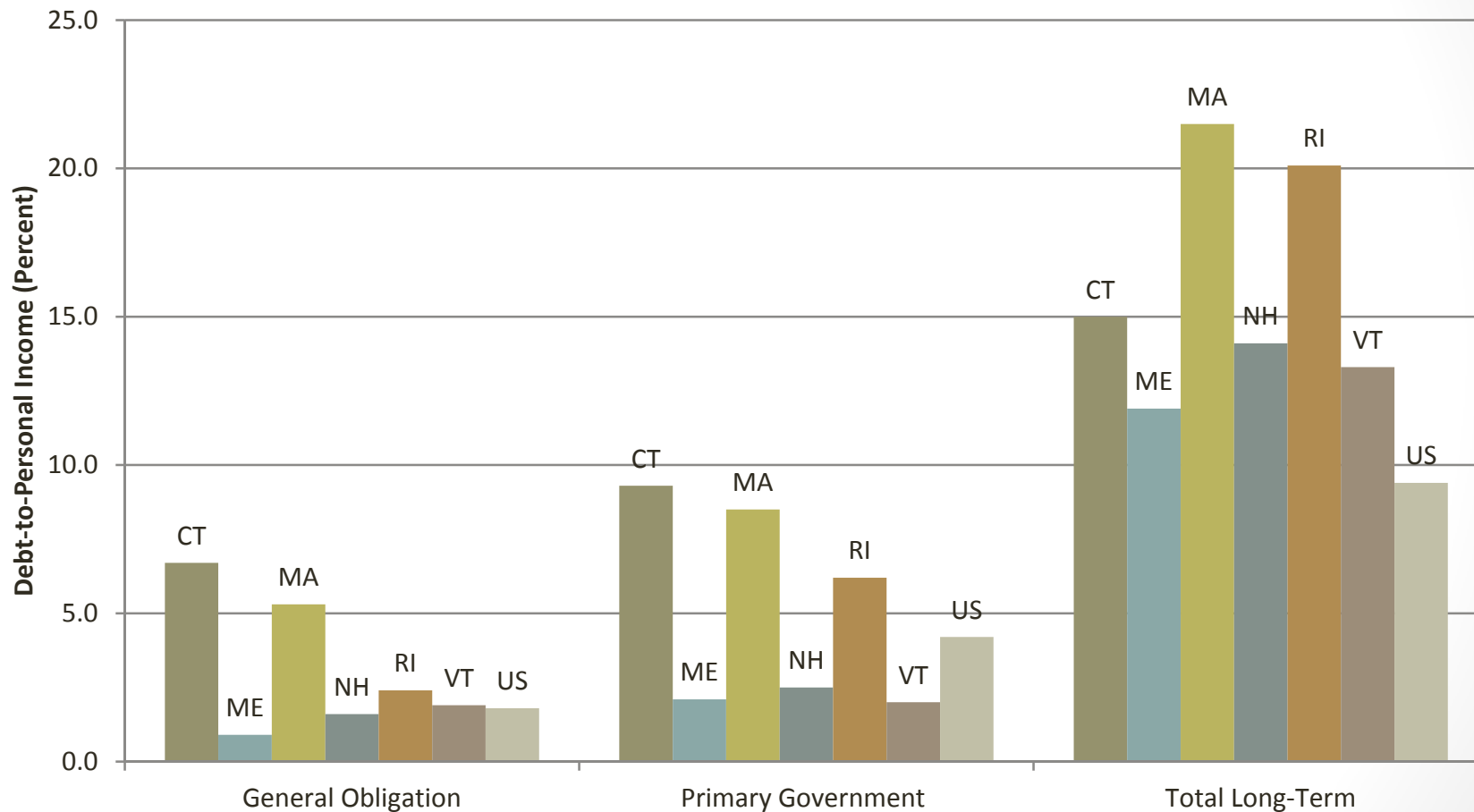
Common elements: Debt capacity calculation

- Centerpiece of many affordability studies
- Typically used to determine maximum amount of new debt that can be issued under existing limit(s)
- Details of calculation will vary based on:
 - Which debt burden ratio used as limit
 - What debt obligations are included
 - How resources (e.g. state revenues) are measured
 - Time horizon captured
 - Assumptions about interest rates and repayment

Common elements: Benchmark comparisons

- Compare selected debt burden ratios with peer group or national averages
- Peers may be based on geographic proximity, population size, infrastructure age, credit rating or other factors
- Requires consistent debt measures across states
- Evaluation of relative debt burden will depend on debt measure and debt burden metric used

Benchmark comparisons for NE states based on alternate measures of state debt



Source: Author's calculations using state CAFR, U.S. Census Bureau and U.S. BEA data.

Note: US refers to mean of 50 states. General obligation and primary government debt for FY 2012 year-end; Census data for FY 2011 year-end. Does not include local government debt.

Common elements: Other relevant issues

- Examples from recent studies include:
 - Downgrade to U.S. credit rating
 - Potential implications of sequestration or revision of tax-exemption for municipal bond interest
 - Unfunded pension and OPEB obligations
 - Other state-specific factors (e.g. demographic trends, natural disasters)

Best practices for debt affordability studies

- Time reports to inform capital planning process
- Be comprehensive when profiling state debt
- Calculate capacity under alternative scenarios
- Provide context for cross-state comparisons
- Reexamine existing limits and other debt practices
- Promote readability

Best practices: Time reports to inform capital planning process

- Studies should be performed on a regular basis and timed to inform capital planning
- Examples of states preparing affordability analysis as part of capital plan:
 - Massachusetts
 - New Jersey

Best practices: Be comprehensive when profiling state debt

- Limiting focus may paint misleading picture
- Ideal to present information on different categories of debt and explain how they differ
- **Example: Rhode Island**



Tax-Supported Debt

Debt payable from or secured by general taxes and revenues of the state or by specific state-collected taxes that are pledged to pay a particular debt.

State-Supported Revenue Debt

Debt payable from specified revenues which are not general taxes and revenues of the state. State pledges contingent credit support.

Agency Revenue Debt

Debt issued by state agencies or public corporations to finance self-supporting state-owned enterprises. State pledges no credit support.

Conduit Debt

Debt issued by state agencies or public corporations on behalf of private sector borrowers. State pledges no credit support.

Best practices: Calculate capacity under alternative scenarios

- Sensitivity analyses allows policymakers to see how capacity changes under alternate:
 - Debt issuance scenarios
 - Assumptions about interest rates, amortization, etc.
- Calculations and assumptions should be transparent
- Examples of states presenting multiple scenarios:
 - Louisiana
 - Texas
 - Virginia

Best practices: Provide context for cross-state comparisons

- Differences across states can contribute to valid differences in debt burden, including:
 - Division of responsibility between state & local
 - Infrastructure needs & preferences
 - Economic or demographic trends
- A discussion of state-specific factors and use of multiple debt burden metrics can provide context
- Example: **Washington's** study notes the state's high income levels, strong population growth, diverse economy, and centralized structure.

Best practices: Reexamine existing limits and other debt practices

- Regular debt affordability studies provide periodic opportunities to:
 - Reconsider appropriateness of debt limits
 - Examine other debt practices and offer recommendations for the future
- **Example: North Carolina's** study notes state's growing use of costlier non-GO debt which does not require voter approval and recommends greater use of GO debt going forward.

Best practices: Promote readability

- Most useful reports are accessible to broad audience
- Examples of features that can promote readability:
 - Executive summaries (e.g. Florida, Maryland)
 - Appendices (e.g. California, Virginia)
 - Graphics (e.g. Oregon)
 - Glossaries (e.g. New Jersey, Texas)

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Summary

- Debt affordability has implications for fiscal sustainability, economic competitiveness, and future borrowing costs
- Regular debt affordability studies are conducted by nearly half of all states
- Studies vary in scope and quality, but can promote transparency and provide guidance to policymakers weighing decisions about state debt

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