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 Federal Reserve Bank of Boston or the Federal Reserve System.
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:

<table>
<thead>
<tr>
<th>State</th>
<th>State</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alaska (S)</td>
<td>Minnesota (S)</td>
<td>South Carolina</td>
</tr>
<tr>
<td>California (S)</td>
<td>Nevada</td>
<td>Tennessee</td>
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<tr>
<td>Florida (S)</td>
<td>New Jersey (S)</td>
<td>Texas (S)</td>
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<tr>
<td>Georgia</td>
<td>New Mexico</td>
<td>Vermont (S)</td>
</tr>
<tr>
<td>Louisiana</td>
<td>North Carolina (S)</td>
<td>Virginia (S)</td>
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<tr>
<td>Maryland (S)</td>
<td>Oregon (S)</td>
<td>Washington</td>
</tr>
<tr>
<td>Massachusetts (S)</td>
<td>Rhode Island</td>
<td>West Virginia (S)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Metric</th>
<th>State</th>
<th>Ceiling</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt-per-Capita</td>
<td>Vermont</td>
<td>Mean/median of AAA-rated states</td>
<td>Guideline</td>
</tr>
<tr>
<td>Debt-to-Personal Income</td>
<td>Rhode Island</td>
<td>5.0 to 6.0%</td>
<td>Guideline</td>
</tr>
<tr>
<td></td>
<td>Vermont</td>
<td>Mean/median of AAA-rated states</td>
<td>Guideline</td>
</tr>
<tr>
<td>Debt-to-Revenues</td>
<td>Connecticut</td>
<td>160.0%</td>
<td>Statute</td>
</tr>
<tr>
<td>Debt Service-to-Revenues</td>
<td>Maine</td>
<td>5.0%</td>
<td>Guideline</td>
</tr>
<tr>
<td></td>
<td>Massachusetts</td>
<td>8.0%</td>
<td>Guideline</td>
</tr>
<tr>
<td></td>
<td>New Hampshire</td>
<td>10.0%</td>
<td>Statute</td>
</tr>
<tr>
<td></td>
<td>Rhode Island</td>
<td>7.5%</td>
<td>Guideline</td>
</tr>
<tr>
<td></td>
<td>Vermont</td>
<td>6.0%</td>
<td>Guideline</td>
</tr>
<tr>
<td>Debt Service-to-Expenditures</td>
<td>Massachusetts</td>
<td>10.0% (pre-2013)</td>
<td>Statute</td>
</tr>
</tbody>
</table>
Common elements: State credit ratings

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

<table>
<thead>
<tr>
<th>New England State</th>
<th>Fitch</th>
<th>Moody’s</th>
<th>S&amp;P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Connecticut</td>
<td>AA</td>
<td>Aa3</td>
<td>AA</td>
</tr>
<tr>
<td>Maine</td>
<td>AA</td>
<td>Aa2</td>
<td>AA</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>AA+</td>
<td>Aa1</td>
<td>AA+</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>AA+</td>
<td>Aa1</td>
<td>AA</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>AA</td>
<td>Aa2</td>
<td>AA</td>
</tr>
<tr>
<td>Vermont</td>
<td>AAA</td>
<td>Aaa</td>
<td>AA+</td>
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</tbody>
</table>
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**

<table>
<thead>
<tr>
<th>More Important to State’s General Credit</th>
<th>Less Important to State’s General Credit</th>
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<tr>
<td><strong>Tax-Supported Debt</strong></td>
<td><strong>Conduit Debt</strong></td>
</tr>
<tr>
<td>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.</td>
<td>Debt issued by state agencies or public corporations on behalf of private sector borrowers. State pledges no credit support.</td>
</tr>
<tr>
<td><strong>State-Supported Revenue Debt</strong></td>
<td><strong>Agency Revenue Debt</strong></td>
</tr>
<tr>
<td>Debt payable from specified revenues which are not general taxes and revenues of the state. State pledges contingent credit support.</td>
<td>Debt issued by state agencies or public corporations to finance self-supporting state-owned enterprises. State pledges no credit support.</td>
</tr>
</tbody>
</table>
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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