Retirement News Highlights

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States at Risk Under All Debt-Ceiling Scenarios

A DEBT-CEILING BREACH WOULD COST STATES IN TERMS OF REVENUE, PENSION INVESTMENT LOSSES AND INCREASED BORROWING COSTS. EVEN A FIX AT THIS POINT WILL LIKELY LEAD TO CUTS IN FEDERAL GRANTS.

By Alan Greenblatt
GOVERNING
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Like the rest of the world, state and local policymakers are nervously awaiting the outcome of debt-ceiling negotiations in Washington. Unlike most entities, however, states and localities recognize they might end up bearing a good deal of the pain, even assuming there is ultimately a solution.

House Republicans are demanding spending cuts as their price for agreeing to raise the debt ceiling, which allows the Treasury Department to borrow funds to cover costs that have already been approved. They don't want to see any cuts to entitlements such as Social Security and Medicare, nor do they want any cuts to the military or health care for veterans.

That leaves domestic discretionary spending. It's a relatively small slice of the federal budget — not quite 15 percent — but it accounts for all the money that flows into state and local programs in areas including transportation, housing, law enforcement and education.

In fiscal 2022, states alone received $204.3 billion worth of discretionary grants from Washington, according to Federal Funds Information for States. In all, including mandatory Medicaid spending, states rely on the feds for roughly a third of their revenues.

The size and scope of any cuts are still very much matters of contention. Perhaps President Biden in the end will convince House Speaker Kevin McCarthy and his caucus to extend the debt ceiling without making any substantial cuts. That, of course, is unlikely.

But even if states, cities and counties were somehow able to come out of the debt-ceiling debate unharmed, this may just be a warm-up for the arguments about domestic spending sure to come as Congress considers its regular annual spending bills over the summer and into the fall.

Cuts to current programs are still not necessarily the worst possible scenario for states, cities and counties. If the debt limit is in fact breached, they'll suffer serious fallout. Aside from federal payments being delayed, failure to raise the debt ceiling will have deep economic effects, including driving up interest rates for all borrowers.

"A default by the federal government would likely cause … rates to skyrocket temporarily, making it unfeasible for local governments to utilize short-term borrowing facilities," Clarence Anthony, the executive director of the National League of Cities, said in a statement. "In turn, cities, towns and villages would have to delay or cancel many projects, such as bridges and sewer system upgrades, until interest rates return to normal."

Known Unknowns

Treasury Secretary Janet Yellen says the borrowing limit will be reached as early as next week, but certainly at some point in June. Edging ever closer to that deadline, Biden and McCarthy and their intermediaries have been playing Let's Make a Deal, without notable success. Once they hammer out an agreement, assuming they can, they'll then have to sell it to majorities in both chambers of Congress.

The main reason for optimism at this point is that neither side wants to risk a default. "No party has any incentive to go over the Rubicon and have some kind of a default scenario," says Jonathan Williams, chief economist at the conservative American Legislative Exchange Council. "That's something we all want to avoid."

But what if it were to happen? Economists, who generally can't reach consensus on anything, agree it would be terrible for both the national and global economies, practically guaranteeing a recession. The potential fallout for state and local governments is real, but unclear. "We've obviously dealt with federal government shutdowns in the past," says Brian Sigritz, director of state fiscal studies at the National Association of State Budget Officers. "This type of situation would be more unpredictable."

There are some things that would be bound to happen. Treasury bonds are generally considered the world's safest loans, so other loans are often pegged to their price. In the event of a default, or perhaps even a close call, borrowing costs would go up for the feds and thus, in turn, for everybody else, including state and municipal borrowers. "I would anticipate a very large jump in interest rates," says Ronald Fisher, an economist at Michigan State University.

States and localities are also huge investors in financial markets, thanks to pension funds. The stock market, which has started to get a bit wobbly, would take a nosedive in the wake of a federal default. The last time the feds flirted so openly with default, back in 2011, the S&P 500 lost nearly 20 percent of its value before beginning to recover toward the end of that year. "Suddenly, those pension funds would be even less funded than they are today," Fisher says.

Good News and Bad News

Then there is the matter of direct payments to states. If the government goes into default, it won't completely run out of money, but it won't have enough money to pay everyone. States would have to get in line with, or perhaps behind, Social Security recipients, federal contractors, bondholders and the like.

That probably wouldn't be so terrible. Any spending already approved by Congress would be reimbursable. States might run into a cash flow problem, but they could expect to be made whole once the debt ceiling is raised. Given the likely market reaction — a major downturn — that would presumably happen quickly. The biggest federal payment to states, by far, is Medicaid, but the feds send that money out quarterly, with the next tranche due on July 1. Congress and the administration will almost certainly be putting the pieces back together by then.

Still, no one knows how difficult that will be, or how much damage might be done by a default lasting just a day or two. "In all that uncertainty, the full impact of breaching the debt ceiling is unknown, but it's expected to be more severe than a federal shutdown," says Justin Theal, a state fiscal policy program officer at the Pew Charitable Trusts.

The good news for states is that they're sitting on a mountain of cash, with rainy-day funds at all-time highs in a majority of states. The bad news is that a recession could suddenly throw a lot of state budgets out of whack. And the reality of the situation is that, in contrast to the pandemic and earlier

recessions, further help from Washington would not be as generous. (One of the points of contention in the debt-ceiling debate is whether to claw back COVID-19 relief funds.)

“States would have limited options for scaling back spending,” Theal says. “In recessions, states often cut back on hiring or keep vacancies open. Many states took this approach early in the pandemic but have yet to backfill those positions.”

Best-Case Scenario

Again, none of this may come to pass. The debt-ceiling drama may be resolved any day now. In that case, the potential direct or indirect costs to states and localities won’t occur (although there could still be an increase in borrowing costs, which happened after the feds flirted with disaster back in 2011, with federal credit downgraded by one rating agency).

As noted earlier, however, states and localities wouldn’t be out of the woods. The outlines of the debt-ceiling demands made by House Republicans have made it clear that cutting nondefense discretionary (NDD) spending will be a priority during the regular budget session.

If the debt-ceiling bill passed by the House last month became law, nondefense discretionary spending would be cut by $208 billion. Over time, caps on future spending would result in cuts of 58 percent to NDD programs over the next decade, after inflation, according to an analysis by the liberal Center for American Progress.

Caps on future spending are generally a political fiction. Congress imposed spending caps during the debt-ceiling debate in 2011, then mostly ignored them as the years went on.

Nonetheless, NDD has already fallen as a share of GDP from more than 5 percent in the early 1970s to roughly 3 percent today. With neither party interested in cutting Social Security or Medicare, Republicans refusing any cuts to military spending and interest payments on the existing federal debt approaching $400 billion annually, there’s essentially nowhere else to cut.

That’s bad news for states, who receive nearly a third of NDD funding.

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