BBVA Research

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Economic Watch

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State and Local Government Debt

Fears of massive municipal debt defaults seem overblown

- **State and local governments have the requisite flexibility to avoid bankruptcy**
- **We expect a spike in municipal bond defaults topping $20bn; an amount easily manageable**
- **Systemic risk is limited due to the complexity and fragmentation of tax-supported debt**

Introduction

In recent weeks, yields on municipal bonds have increased to their highest levels in four months. These trends could reflect a sharp increase in supply, an upward revision to inflation expectations and heightened fears of massive defaults. While it is difficult to isolate the individual impact of each factor, in our baseline scenario, 7% of these bonds amounting to approximately $20bn could enter default over the next two years. The probability of a systemic crisis due to these defaults, however, is limited.

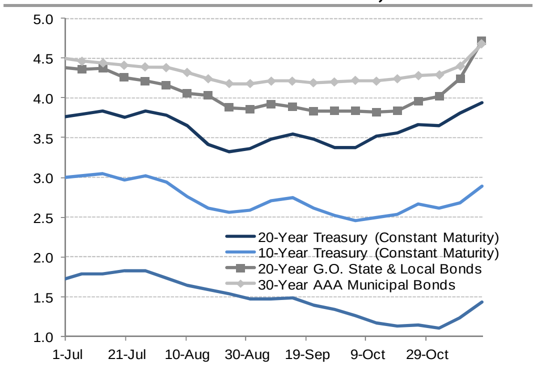
Increasing supply, falling prices and rising yields

In order to deal with large projected fiscal gaps, states and municipalities continue to issue significant amounts of conventional bonds. If supply suddenly rises in tight market conditions (as we have experienced over the past few months), investors have to be indulged with higher yields to purchase these bonds, so that the market can rapidly digest the new issuance.

Traditionally, these federal tax-exempt bonds are attractive to high-income individuals. Retail investors account for around 70% of total holdings and 80% of trading volume. Thus, a sharp increase in issuance could have a large effect on yields if investors are reluctant to absorb the excess supply. However, despite the sharp upturn in issuance, the increase in yields has been relatively moderate as the Build America Bonds (BAB) program eased pressures by broadening the investor base to corporations, foreigners and pensions. This program was created by the American Recovery and Reinvestment Act and provides a 35% interest-cost subsidy from the federal government to help state and local governments finance new capital projects at low costs. Between April 2009 and October 2010 there have been more than $150bn of bond issuances that constitute around 21% of the municipal bonds market. This program is set to expire at year-end 2010. As a result, states and municipalities have been rushing before year-end to tap this market thus inflating supply. The expiration of the program will shift municipal debt issuance back to the conventional market and traditional investors, and thus over-supply problems could intensify. This risk partly explains why the administration wants to extend this program and expand its eligible uses.

Graph 1

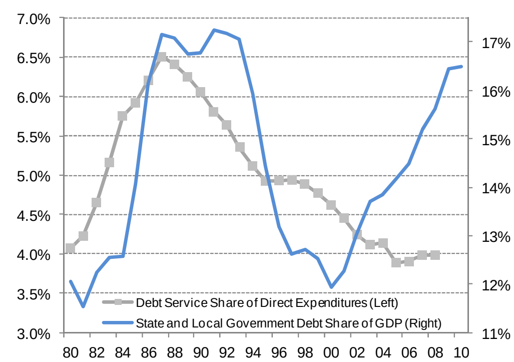
Yields on Government Bonds, 2010 %



Source: Wall Street Journal, Federal Reserve / Haver Analytics

Graph 2

State and Local Government Debt



Source: Federal Reserve, BEA, Census / Haver Analytics

Effects of QE2

Another possible driver of the recent spike in yields could be sharp revisions to both growth and inflation expectations. After the Fed announced the second round of the Large-Scale Asset Purchase program, higher uncertainty probably drove investors to move away from longer-dated securities into shorter term notes. This shift may reflect an upward revision to economic growth and inflation expectations. In fact, the increase in yields not only happened in municipal bonds but also in longer dated Treasuries and inflation-indexed bonds. This pattern suggests that investors' lower appetite for municipal debt is no different from similar securities and that the origins of higher risk perception reflect ongoing adjustments to macroeconomic perspectives. According to our estimates, higher inflation and growth expectations could account for 16 to 50% of the recent increase in yields.

Default Fears

The third element behind rising yields relates to weak conditions of state and local government finances. This fiscal stress has raised the possibility of a massive wave of debt defaults. According to our analysis, risks remain limited and a systemic crisis is unlikely.

State and local government finances remain under considerable pressure and these conditions are likely to worsen as federal aid diminishes and economic growth remains slow. The American Recovery and Reinvestment Act included around $280bn to flow to states and municipalities. Between 2009 and 2010, these dollars have helped to close approximately 50% of the budget shortfalls but these resources will soon dry up and the budget gaps will remain elevated at more than $120bn for 2011-12. Moreover, mid- and long-term challenges related to unfunded liabilities are escalating.[1]

However, overall, debt levels and service payments are currently manageable as Graph 2 illustrates. The ratio of state and local government debt to GDP is 16% of which less than 1% has a maturity of 13 months or less. In addition, the ratio of interest payments on general debt to total revenue from own sources averages 5%, and only 3 states and 6 local governments have a ratio above 8%. As a share of expenditures, interest on general debt is at an historic low. Thus, while it is unlikely that a state government will default, the outlook for local governments is highly uncertain.

Both state and municipal governments can secure their debt with a "general obligation" (GO) pledge that allows them to use their revenue-producing power, including levying taxes, to service the debt. However, some municipal bonds that finance industrial development, private universities, hospitals, housing projects and land development are not backed by a GO pledge, and thus are more risky and have higher default rates. As general obligation municipal debt is issued to fund long-term capital projects, the risk of default is low, and the recovery rate relatively high.

To illustrate the relatively low risk of municipal debt, Moody's reports only 54 defaults between 1970 and 2009 among their rated municipal securities, and only 3 of these defaults were backed by general obligation pledges. As there are many municipal debt issuers and the industry is fragmented, a full risk assessment should consider non-rated municipal securities. For example, Standard and Poor's recorded 137 defaults of rated securities and 780 defaults of non-rated securities during the 1990s.

We expect the total number of municipal defaults to increase to unprecedented levels in spite of historically low default rates. In our baseline macroeconomic scenario, over the next 2 years, the default rate could jump more than seven times to 0.74% from a 10-year average of 0.10%. This jump, in addition to a wave of downgrades, implies default on approximately $20bn of principal amount, equivalent to 0.13% of GDP.

For comparison, Standard and Poor's reports 917 municipal defaults during the 1990s amounting to $9.8 billion of principal value. Our simulated outcome does not consider any form of a federal bailout. However, when we consider the historical recovery rate of almost 70%, the net loss would not surpass $7bn. Even if we assume a lower recovery rate, the net loss would remain manageable. Moreover, commercial banks' hold less than 10% of total municipal debt and loans. Thus, expected defaults will not cause a systemic crisis.

[1] For more detail information please consult US Regional Outlook 4Q10

Graph 3

Municipal Debt Accumulated Default Rates (%)

	Investment Grade		Speculative Grade		All Rated	
Year	Non-GO	GO	Non-GO	GO	Non-GO	GO
1	0.00	0.00	1.55	0.01	0.02	0.00
2	0.01	0.00	2.77	0.01	0.04	0.00
3	0.03	0.00	3.75	0.01	0.07	0.00
4	0.04	0.00	4.57	0.01	0.09	0.00
5	0.05	0.00	5.29	0.01	0.11	0.00
6	0.07	0.01	5.93	0.01	0.12	0.01
7	0.08	0.01	6.48	0.01	0.14	0.01
8	0.09	0.01	6.90	0.01	0.16	0.01
9	0.11	0.01	7.20	0.01	0.18	0.01
10	0.13	0.01	7.37	0.01	0.19	0.01

Source: Moody's

Graph 4

Defaulted Bonds in S&P/Investortools Municipal Bond Index, Aug. 31 2010

Index Constituents as of:	12/31/2009	8/31/2010
Total Number of Bond Deals In Default:	156	173
Total Par Value:	$5.14 Bn	$5.93 Bn
% of Market Value of Index:	0.42	0.47
Highlighted Sectors (Number of Defaulted Bonds)		
Revenue Bonds (Industrial and Economic Development)	44	33
Health Care	20	19
Land Secured	54	73
Multifamily	16	19
Indian Tribal	1	2

Source: Standard and Poor's

Legal Considerations for State and Municipal Defaults

The 11th Amendment to the U.S. Constitution prevents citizens from using the federal courts to compel states to honor their contracts. Unlike corporations or individuals that file for bankruptcy in courts, this amendment has afforded flexibility to states to negotiate directly with bondholders. Only state constitutions and laws can establish the legal framework for debt recovery in the event of state government default, and many states delineate the rights of creditors in their constitutions. A large amount of case law can be dusted off from the 16 varying degrees of state defaults between 1840 and 1890. However, much has changed since Edison's invention of the phonograph.

The only recorded state government default in the 20th century happened after the Great Depression in 1933. Arkansas absorbed an exorbitant amount of infrastructure debt that state revenues were not sufficient to service. Thus, the state defaulted on payments, and was rescued by a Hoover Administration federal program. In the end, however, creditors were paid in full. The lessons were painful and states view default with caution, as it has some immediate benefits, but high long-term economic and political costs. Furthermore, whenever conditions deteriorate, the federal government has the option to provide discretionary assistance to state governments.

Balanced budget requirements are a key element to prevent state defaults. According to state law, all states but one (Vermont) are required to balance their budgets. These rules imply that either the legislatures or the Governor under the auspices of special powers will have to implement spending cuts or tax increases if needed.

Although we foresee a significant increase in municipal defaults, state and local governments have ample access to financial markets and they can complement their debt issuance with loans from the financial sector. Because state and local governments have the authority to collect and raise taxes from businesses and individuals, future tax revenues can serve as collateral to issue short-term debt. Given that the share of debt service payments to own-revenue is currently low, many states and municipalities have sufficient flexibility to avoid bankruptcy: they can refinance debt, increase their leverage, and issue debt obligations to cover off-balance sheet liabilities (such as pension payments).

While there is no consistent legal framework in place for state government defaults, municipal governments can choose to file for bankruptcy under Chapter 9 of the U.S. bankruptcy code. This common set of rules is available exclusively to municipalities and guarantees an orderly debt-restructuring process that prioritizes bondholders and elevates the probability of investment recovery. Chapter 9 affords municipal governments a temporary protection from creditors until all parties mutually agree to a re-payment plan. Negotiations may include debt reduction or refinancing to lower the interest rate or extend the maturity of the loan. Indeed, Vallejo, California filed for Chapter 9 protection in 2008, and Harrisburg, Pennsylvania is considering this option.

The Road Ahead

Therefore, the biggest default risk stems not from economic conditions or the legal framework but from the legislative process. This implies that the states which are closer to the edge of the cliff are not necessarily the ones with the largest budget gap, but those in which political interests obstruct the adoption of painful and unpopular but much needed measures of fiscal responsibility.

State and local finances will continue under stress as the fiscal stimulus vanishes and the economy recovers at a gradual pace. Budget cuts will help to prevent default in the majority of states; however, states that increase taxes precipitously instead of cutting spending risk sending their tax base fleeing for low-tax states. As budget cuts may reduce payments to municipalities, these reductions combined with lower sales tax revenues and forthcoming re-assessments to home values (and thus lower property taxes) will prompt a significant number of municipal bond defaults over the next two years.

However, much of these defaults will be confined to bloated capital spending projects and neighborhood construction bonds (special taxing districts) in the wake of the housing bust. The ability to resolve these issues is manageable and in our baseline scenario, these defaults are unlikely to cause an economic maelstrom. Thus, comparisons of current conditions in the U.S. to global sovereign crises must take everything into consideration. First, although states cannot enter bankruptcy proceedings, many of them have established legal guidelines to pay bondholders in the event of default. Second, even in the event of a massive wave of municipal defaults, the clear, consistent legal framework for bankruptcy differentiates this crisis from a typical sovereign debt crisis in which countries exercise unilateral discretion to negotiate with creditors. Nonetheless, the warning signals have to be taken seriously and state and local governments must tread parsimoniously to support the private-led recovery.

The crisis, however, presents opportunities for improvement. State officials must carefully consider costs and analyze the services that states can and should provide. In particular, legislators must target specific inefficient and wasteful programs rather than make across-the-board cuts or force worker furloughs. These measures may temporarily shave expenses; however, they do nothing for long-term fiscal sustainability. Increasing the efficiency of public spending on healthcare, education and social assistance is a good starting point. Changes to criminal sentencing laws could also alleviate the rising cost of maintaining prisons. From a long-term perspective, state and local governments must refine their public pension systems to ensure fiscal sustainability. Clearly, the time is now for leaders to put aside partisan bickering, break the gridlock and provide solutions.

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