PARAMETRIC

January 2021

State Budgets and Crises: Notes for the Municipal Bond Investor

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Municipal bond investors may be concerned that periods of economic stress could result in states defaulting on their debt. This fear can be exacerbated by political rhetoric, by inflammatory reporting, or even by inherent suspicion of the efficacy of governments. Yet states have successfully managed through multiple economic contractions in the postwar era, and we believe almost all will do so again. This paper will explain how states set budgets, how they react during contractions, and why we believe the current recession will prove to be no exception.

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How states set budgets

All US states except Vermont are required by state law to balance their operating budgets. This balanced-budget provision is written in different ways in different states. However, the net result is that states are required to limit operating expenses to operating revenue. The balanced-budget requirement generally doesn't apply to capital budgets for long-term expenditures, such as infrastructure spending.[1]

State governments engage in a practice known as *fund accounting*, in which revenues are deposited and expenditures come from particular funds. The general fund in almost every state receives almost all tax and fee revenue. The legislature then makes most of its appropriations from this fund. When talking about a balanced budget, we're most often discussing the general fund budget specifically.

Fund accounting
An accounting system used by governments and nonprofit entities, focused on accountability and intended for recording resources whose use has been limited by law or another restricting authority such as a charitable donor.

States will try to carry reserves from one fiscal year to the next, often through a formal budget stabilization fund. States maintain these reserves because borrowing restrictions largely constrain their ability to manage revenue fluctuations any other way. Some states do allow short-term (less than one year) borrowing without the approval of the legislature, but few can borrow for longer without getting approval from voters.

States have some riskier methods of deriving flexibility, such as extending deficits into the next fiscal year. This can become problematic if repeated, which can happen during an extended downturn. Some states also delay making actuarially required pension contributions—a tactic that can become destabilizing over the long term, which New Jersey and Illinois illustrate today.

Why state bankruptcy isn't an option

State revenue and expenses are procyclical: When a recession hits, receipts drop and expenses may increase as laid-off workers stop being taxpayers and start looking to draw down benefits. The crunch is immediate, and it can be painful. Since states can't initiate stimulus, investors often worry that stressed states may elect to fail to meet their obligations to bondholders, preferring instead to aid their voting populace. Political rhetoric often exacerbates these concerns rather than assuaging them, such as when Senate majority leader Mitch McConnell said in April 2020 that he "would be in favor of allowing states to use the bankruptcy route."

What McConnell forgot was that because states are semisovereign entities with full taxing and franchise powers, there's no legal bankruptcy route available to them. They could instead default on their obligation like a sovereign nation might, and indeed as Argentina has done nine times. However, unlike holders of sovereign debt, holders of state debt could seek recourse from federal courts and receive enforceable judgments. Furthermore, only one state default has occurred in the US since the beginning of the 20th century, when Arkansas defaulted on its highway bond debt at the height of the Great Depression in 1933.[2] Defaults in the modern era have been rare for three reasons:

Minimal benefits: Annual debt service costs are less than 5% of annual revenue for 46 out of 50 states. Based on our assessment, the median percentage that debt, pension, and other postemployment benefit costs represent relative to state revenues is 6.7%. Attempting to restructure debt would provide limited budget relief, and that relief would come at a high cost.

[1] National Conference of State Legislatures, NSCL Fiscal Brief: State Balanced Budget Provisions, October 2010, https://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf.

[2] Emre Ergungor, "Sovereign Default in the US" (working paper, Federal Reserve Bank of Cleveland, 2016).

Uncertain paths to resolution: Resolving general obligation defaults can be a long and expensive process. The Commonwealth of Puerto Rico, which isn't a state, defaulted on its debt in 2016 in the largest municipal default ever. While some of the circumstances surrounding that default are shared by other stressed municipal issuers, its unique territorial status is likely to have been a key contributor to the conditions that led to the default. There's still no resolution four years after the default: Puerto Rico has struggled with the absence of legal precedents for its restructuring and expects legal costs to reach $1 billion by 2023. Even the much smaller 2013 Detroit debt restructuring, which was covered by defined law (the Chapter 9 bankruptcy code), still cost the city $178 million in legal fees.

Potentially long-lasting repercussions: Defaulting on debt locks issuers out of the market for years. In the case of Arkansas, despite resolving the default in 1934 with a restructuring,

> *The state suffered under the stigma for many years to come. Arkansas bonds remained "speculative grade" until 1939, which prevented banks in the nation from investing in them. Even Arkansas' own banks were not allowed to invest in the state's bonds until 1937. Large financial centers remained closed to the state for a decade or more. State banks and trusts in New York and Pennsylvania could not invest in Arkansas bonds until 1944, and not until 1954 in Massachusetts and Connecticut.*[3]

Similarly there's been no Puerto Rico issuance since 2016, with the exception this year of one $250 million current refunding package for the Puerto Rico Housing Finance Authority, secured by an annual allocation from US Department of Housing and Urban Development. Persistent demand for high-yield municipals also allowed Detroit to return to the market just four years after exiting bankruptcy. Perhaps modern times are more forgiving.

How states deal with adverse economic conditions

When finances are out of balance, borrowing is out of the question, and restructuring is a generally unacceptable option, issuers balance their budgets the same way households do: looking to earn more and spend less. Earning more can mean raising taxes or finding new sources of revenue. Arizona, Montana, New Jersey, and South Dakota legalized marijuana—which they're set to tax—in the 2020 election, while voters in Louisiana raised *ad valorem* (according to value) property assessments for oil and gas producers.

On the other hand, the ability of state and local issuers to raise taxes is constrained by the need for voter approval. In 2020 alone, voters in Arizona approved an income tax increase for individuals, voters in Illinois rejected a proposed graduated income tax, and voters in Colorado passed a measure to reduce corporate and individual income taxes. Economic conditions create a second constraint on revenue raising: Severe downturns can create conditions where raising taxes to balance budgets is no longer a viable solution. To quote former Supreme Court chief justice John Marshall, "An unlimited power to tax involves a power to destroy, because there is a limit beyond which no institution and no property can bear taxation."

An alternative or complement to raising taxes is cutting expenses. State and local issuers may do this by paring back services, furloughing or laying off staff, or reducing aid sent to localities. Under sufficient pressure they may engage in one-time budget measures such as asset sales or reallocating funds set aside for specific purposes.

3 Ibid.

Case study: California during the Great Recession

Revenue sources for the State of California are very procyclical. The table below, comparing 2017 tax revenue by source, illustrates how much of an outlier California is when compared to the other 49 states. We removed intergovernmental transfers so that all state percentages reflect the adjusted percentage of tax, fee, and charge revenue.

Source	All states	California
Sales taxes, fees, and charges	62.8%	18.4%
Individual income taxes	26.7%	69.4%
Other taxes	7.0%	3.3%
Corporate income taxes	3.4%	8.9%

Source: California Department of Finance, 12/31/2019. For illustrative purposes only.

California has the highest state individual income tax in the country, with a 13.30% top bracket. Raising it further is politically challenging. Since such a significant share of revenue comes from individual income taxes, no state feels the impact more than California when recessions occur and the unemployment rate climbs. Revenues can drop precipitously, and budget gaps widen dramatically. This is exactly what happened during the Great Recession.

Like most states, California's fiscal year runs from July to June. The state's fiscal year (FY) 2008–2009 budget estimated general fund revenue to be $102 billion, with expenses expected to range between $98 billion per the state treasurer and $104 billion per the Legislative Analyst's Office. But this was before the recession hit. As the state's Legislative Analyst's Office has written:

> *On December 31, 2008, Governor [Arnold] Schwarzenegger's proposed budget projected a $42 billion deficit. This shortfall was stunning, but, in fact, it turned out to be optimistic. A few months later, the Governor's deficit projection was $15 billion larger.*[4]

As the state unemployment rate hit 10%, the legislature passed a FY 2009–2010 budget in February 2009 that included $14.5 billion in spending cuts, $12.5 billion in temporary tax increases, $8.5 billion in federal stimulus funds, and $300 million in borrowing. In July 2009, as the estimated shortfall grew to $60 billion, the legislature passed an additional $18 billion in spending cuts, $3.5 billion in one-time measures and transfers, and $2.2 billion in short-term borrowing. In January 2010, Schwarzenegger identified a $19 billion shortfall for FY 2010–2011, setting the stage for a particularly contentious budget battle. The legislature took until October 2010 to produce the most delayed budget in state history, which included $19.3 billion in budget actions, $7.8 billion of which related to expenditure cuts.

Business Insider published an article in May of that year that described California as "the next Greece."[5] But while the process was no doubt painful, the reality was that California wasn't the next Greece. By FY 2011–2012, the governor's proposed expenditures were $84.6 billion—14% lower than the proposed precrisis FY 2008–2009 expenditures. Expenses went down, and taxes went up. Proposition 30, a temporary increase in sales and income taxes, passed in November 2012. The legislature extended the income tax portion for another 12 years with Proposition 55 in 2016, but the sales tax portion has expired.

In the midst of the most severe recession since the Great Depression, the state whose budget was most heavily impacted did what was necessary to balance its budget. That's what well-managed municipal issuers do.

[4] Mac Taylor, *The Great Recession and California's Recovery* (Sacramento: California Legislative Analyst's Office, 2018).

[5] Gus Lubin, "16 Reasons Why California Is the Next Greece," *Business Insider*, May 11, 2010, https://www.businessinsider.com/why-california-is-the-next-greece-2010-05.

COVID-19, economic suppression, and state finances

The COVID-19 pandemic has been unprecedented in the modern era. Lockdowns initiated around the globe in order to slow the spread of the virus threw the global economy into recession. In the face of uncertainty, the financial community has taken various tactics to assess risk.

In April 2020, relatively early in the shutdown, Moody's reported, "If we were to expand out to fiscal 2022, our estimate of total needs would increase to more than $450 billion versus realistic resources of only $181 billion, which leaves a 27-month forecast shortfall of close to $300 billion."[6] With so many unknowns, this seemed to be a reasonable estimate of what the consequences of an extended shutdown would be for states. However, Moody's released an updated forecast in September, with the revenue shortfall now expected to be $240 billion through 2022 and FY 2021 state tax revenue to be down 11.2% versus FY 2019. The Moody's forecast may still overestimate the contraction: Their call for the FY2021 unemployment rate was 8.7%, and the actual rate stands at 6.9% as of October.

The economy has surpassed many of the direst predictions, and so have state revenues. The Tax Foundation and Tax Policy Center estimated a $75 billion decline in state revenue for FY 2020, while the Center on Budget and Policy Priorities estimated a $110 billion decline.[7] FY 2020 ended in June with states reporting a $59.3 billion or 5.5% decline in revenue. The actual decline in revenue is likely to be significantly lower after accounting for the shifting of income tax collections into the current fiscal year due to delayed tax filing deadlines.

Some data is available that includes elevated July receipts, since Tax Day was pushed from April 15 to July 15. From January to July 2020 and with 47 states reporting, overall average YTD tax revenue collections declined only $328 billion or 2.9% from the same period in 2019. As the economy has opened up, preliminary August and September data show year-over-year growth in tax collections. Tremendous uncertainty remains as much of the country posts record-high case counts. However, it appear that revenue declines won't reach the levels suggested in earlier worst-case scenarios. A FY 2021 decline of 5% to 6% in revenues would be roughly equivalent to what states experienced in the Great Recession.

Conclusion

Many states were in strong fiscal positions before the pandemic hit.[8] These reserves have helped states manage through the current crisis. Absent further aid from the federal government, the next few years will likely require states to implement austerity measures and reduce expenditures. But as they've demonstrated in the past, most states will manage through this current recession using the tools available, making necessary if painful cuts in expenditures and continuing to honor their obligations to their bondholders.

[6] Moody's Analytics, "Stress-Testing States: COVID-19", April 2020, https://www.economy.com/economicview/analysis/379097/StressTesting-States-COVID19.

[7] Jared Walczak, "State Forecasts Indicate $121 Billion 2-Year Tax Revenue Losses Compared to FY 2019," The Tax Foundation, July 15, 2020, https://taxfoundation.org/state-revenue-forecasts-state-tax-revenue-loss-2020.

[8] Barb Rosewicz, Justin Theal, and Joe Fleming, "States' Financial Reserves Hit Record Highs," Pew Charitable Trusts, March 18, 2010, https://www.pewtrusts.org/en/research-and-analysis/articles/2020/03/18/states-financial-reserves-hit-record-highs.

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