All Government Debt Is Not the Same: Different Problems Require Different Responses

Threats of defaults in Greece and Puerto Rico should raise questions and concerns about debt in the United States. Our own states court trouble—in some states, dire and imminent trouble—by failing to put aside enough money for their nonbonded debt. The federal government has a longer-term structural problem with debt because of its unwillingness to coordinate tax policy with spending policy. Citizens need to look hard at these different problems to arm themselves in order to press our political leadership to respond appropriately.

Total debt issued by state and local agencies is $4 trillion—total federal debt is $18 trillion. Each sells debt in a different manner, and the federal government issues debt for an entirely different reason than states.

State debt is the concern of an individual state and each state has its own problems and issues, albeit with many shared characteristics. Federal debt concerns all of us. Both levels of government require policy initiatives to maintain their viability.

State governments issue debt for three purposes: to finance capital improvements; to finance short-term cash flow imbalances during a fiscal year; and to plug budget gaps or finance deficits. The first two are legitimate—assuming the short notes are liquidated before the end of the fiscal year. The third purpose is a no-no in public finance and a violation of most state constitutions.

Several states like California and Illinois have borrowed to address annual budgetary deficits. New Jersey issued debt to address pension requirements.

Generally, long-term debt issued for capital purposes consists of two types: (1) general obligation (GO) debt and (2) appropriation debt—sometimes referred to as contract debt.

In most states, GO debt must be approved by the voters whereas appropriation debt is generally approved by the legislature and governor. GO debt has the full faith and credit of the state’s taxing power while appropriation debt is subject to annual appropriations. Wall Street views GO debt as more secure than appropriation debt as the legislature could decide not to appropriate funds for contract debt—whereas GO debt is a constitutional obligation.

An entire treatise could be written about the origin of appropriation debt, but suffice to say it is an expanding method to issue debt—and most folks would argue it originated to circumvent the voter requirement.

Debt issued by local governmental units is not debt of state governments. Furthermore, most states create authorities to finance capital projects with bonds secured by their revenue, such as a turnpike authority. Such debt is also not state debt.

Debt comparison across states is tricky because different states assign functions to different levels of government. For example, California finances most school construction at the state level while in Texas all of it is financed locally. In New Jersey it is a mixture.

In addition to bonded debt, states have “nonbonded” obligations—the two largest being for pension and retirement health benefits. Unlike bonded debt, which requires annual appropriations to meet annual obligations, these obligations are paid over the lifetime of a retiree, albeit pension commitments do require annual contributions to have sufficient funds for lifetime payments—but unfortunately many states have deliberately underfunded their commitments.

The federal government issues debt to fund both capital and operating costs in its single budget—no distinction is made. States have a separate capital budget generally funded only by debt. Federal debt, for example, supports Medicare, the purchase of aircraft carriers, the FBI—and all other functions.
For many years the federal government has funded its budget deficits by selling bonds and notes. There are various definitions of total federal debt. The “debt held by the public” (the accumulation of annual budget deficits) is one number—$13 trillion. In addition, the federal treasury has often borrowed from the Social Security Trust Fund, which must be repaid when the fund needs cash to make benefit payments.

Including these IOUs, the “total federal debt” is $18 trillion—and is projected to increase to $26 trillion by 2025. In addition, there is “hidden nonbonded debt”—specifically, the unfunded liability for future Social Security and Medicare obligations totaling $50 trillion.

As with most public policy issues, there are many views about debt. State debt has grown substantially in recent decades, but 98% has been for critical infrastructure rather than for inappropriate budgetary purposes. Most state debt remains highly creditworthy.

Unlike the federal government, states do not have the entire taxing power of the country to support an “infinite” amount of debt. More important, the capital market itself, if not state constitutions, automatically limits how much debt states can issue. So, we have appropriate forces at work to limit state bonded debt.

However, states must address their nonbonded debt problem, particularly unfunded pension liabilities ($1 trillion nationwide). A handful, such as Wisconsin and Oregon, fund their obligations. The majority of states, however, are underfunded—and some, like Illinois and Kentucky—are so underfunded that extensive reforms are necessary to maintain the viability of the systems. These actions must be taken immediately.

At the federal level, the policy discussion about debt is different because of its size and use. The budgetary trade-offs between defense and safety net programs and overall tax policy have an obvious impact on how much debt the federal government can afford in the future.

The answer, however, is much more complicated than a certain number. Those who say just balance the budget are just not realistic. It will not happen as the needs are just too expansive and growing—especially as the population ages. But a realistic compromise is necessary.

At least three actions are worth considering. First, fix the tax code to make it fairer and raise more revenue to include limiting special credits and deductions. Second, fund Social Security by requiring taxpayers to pay tax on one’s entire salary rather than only on the current $118,500. Third, revise the supply and demand structure of the Medicare payment model, including switching from a fee for services (FFS) system that rewards volume to systems that reward quality and value. These actions are necessary so federal debt is maintained at a reasonable level vis-à-vis the economic wealth of our nation.