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State Borrowing No Substitute for Additional Direct Aid to Help States Weather COVID Downturn

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Contrary to suggestions by Treasury Secretary Steven Mnuchin and others, borrowing is not a viable substitute for the substantial direct aid states need to offset their sharp revenue declines and cost increases stemming from COVID-19. Without more federal aid, states will have to lay off even more workers and make even deeper cuts in services, likely resulting in thousands of teacher layoffs, reductions in health care services, and other cuts that would worsen the recession and disproportionately hurt people of color and low-income people already particularly harmed by the pandemic. Arguments that states don't need direct federal aid because they can borrow more to cover their shortfalls have three key shortcomings:[1]

- Secretary Mnuchin, in explaining his resistance at this time to more federal aid, mischaracterized states' problem as primarily a short-term "cash flow" issue — a mismatch between when they receive tax revenues and when they must pay state expenses. States do face significant cash flow challenges at present because of the three-month postponement of their income tax filing deadlines, but the *fundamental* problem is that states will likely see their tax revenues fall far short of their necessary expenses for health care, education, and other critical services for several years — we estimate by $615 billion in just the current, 2020 fiscal year and the next two combined.

  If states borrowed enough to avoid the deep service cuts they'll have to make without substantially more direct aid, they would not be in good enough financial shape to repay it when the debt came due in a year or two, based on current economic and unemployment projections by the Congressional Budget Office (CBO), Goldman Sachs, and other forecasters. States may wish to borrow in the short term to manage cash flow or to buy time in hopes of additional direct federal aid or faster-than-expected economic growth. But without substantial, additional direct aid, this likely would only delay damaging layoffs and spending cuts, not avert them.

[1] This report focuses on state governments because policymakers who favor state borrowing over additional direct financial assistance to states and localities often argue that state financial mismanagement justifies their position. Nonetheless, the arguments offered here about the inadequacy of this alternative also apply to localities — as do, in many cases, constitutional limitations on local governments' ability to run deficits and borrow to finance them.

- Some analysts have proposed *longer-term* state borrowing as an alternative to more direct aid, but most state constitutions include balanced budget requirements and/or debt limitations barring them from building borrowing into their enacted budgets and borrowing to cover unanticipated revenue shortfalls for more than a very short period, often less than a year.
- Even for a state not constrained by its constitution, it would be risky to borrow for long periods to cover budget gaps, which could set the state up for even deeper financial problems down the road. No one knows how long the recovery from this recession will last or when a natural disaster might strike; states could find themselves in new fiscal straits before paying off the debt incurred during this recession. Moreover, every dollar used to pay off new debt would be a dollar unavailable for deposit in a "rainy-day fund" to prepare for the next recession. And even if states could take out substantial loans to mitigate the need for immediate service cuts, this would likely drive up interest rates on borrowing that states routinely — and appropriately — do to finance long-lived capital assets like highways and state university facilities, further squeezing their finances.

In short, significant borrowing (beyond short-term borrowing aimed at managing cash flow or buying a few weeks or months before imposing cuts) would not be a viable, legally permissible, or prudent strategy for closing states' deep budget gaps. States urgently need substantial, additional direct financial assistance in the form of grants.

Short-Term State Borrowing Would Only Postpone Deep Service Cuts

Asked in a May 11 interview about whether additional direct aid to states was warranted, Secretary Mnuchin mentioned several ways the federal government had already helped states cope with the effects of the COVID crisis:

> We're also very quickly opening up the lending facility that the Fed[eral Reserve], working with the Treasury, [is creating], so that states that have cash flow issues can borrow. . . . [W]ith interest rates very, very low, states can borrow this money. Some of them would have to make changes because they do have balanced budget [requirements]. . . .[2]

States are indeed facing severe cash flow issues due to their postponement into July of the normal April 15 income tax filing and remittance deadline. Many states have also delayed deadlines for other taxes, including sales and excise taxes. These delays are forcing states to minimize the expenses they will incur before collecting revenues — states laid off or furloughed 251,000 workers in April and May, for example — and to scramble for cash to pay expenses they can't avoid.

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[2] Squawk on the Street, "Treasury Secretary Mnuchin's Full Interview on Supporting Economy During Crisis," May 11, 2020, https://www.cnbc.com/video/2020/05/11/treasury-secretary-mnuchins-full-interview-on-supporting-economy-during-crisis.html, at 4:40.

New Federal Reserve Liquidity Fund Has Limited Ability to Help Most States

Secretary Mnuchin and many other advocates of additional state borrowing seem to envision it occurring through the Federal Reserve's new Municipal Liquidity Facility (MLF), which the CARES Act authorized to purchase up to $500 billion of new state and local government debt. But in reality, the MLF can do relatively little to help most states cope with their massive shortfalls, not only because of the constitutional limits on state borrowing discussed in this report but also because of the MLF's current structure.

As its name suggests, the MLF was intended to provide "liquidity" to state and local governments, that is, to make sure they had access to enough short-term working capital to manage the different timing of their revenue receipts and expenditures. This became especially critical after the IRS' March 21 announcement that it was delaying the April 15 income tax filing deadline by three months, which forced most states to follow suit since most people have to prepare their federal income tax returns before they can prepare their state returns. States' access to adequate working capital was very much in doubt even before the IRS announcement because state and local government capital markets had come close to freezing as it became clear that state shelter-in-place orders would cripple state finances.

The Fed's announcement of its willingness to buy substantial amounts of state and local debt for the first time in its history played a critical role in stabilizing those capital markets and ensuring that states and localities could continue to access them, experts agree. However, as the details of the MLF have emerged, these same experts also generally agree that the large majority of states and localities can borrow on more favorable terms in the financial markets than by borrowing directly from the MLF, given the MLF's current structure.[a] So far, only Illinois — which has the lowest credit rating of any state — has taken steps to borrow from the MLF.

More to the point, even though the Fed extended the maximum maturity date of MLF borrowing from its initial proposal of September 30, 2022 to December 31, 2023, as this report discusses:

- the constitutions of relatively few states would permit them to borrow for anywhere near that long a period to cover operating deficits; and
- even for the states that could, few seem likely to be in a good enough financial situation even by the end of 2023 to fully repay any substantial loans they might take out this year.

One final feature of the MLF as presently structured further limits its potential usefulness to states: December 31, 2020 is the last day that MLF loans may be taken out. This creates two problems. First, states that might be able to muddle through this fiscal year by tapping rainy-day funds, cutting spending, and/or increasing revenues but might need to borrow from the MLF *next* year will be unable to do so. Second, states that borrow from the MLF this year and might want to roll over the same debt in subsequent years will be unable to do so.

The MLF *could* be restructured to make it more beneficial for states with the constitutional authority to borrow for more than one or two years. For example, the lending window could be kept open past 2020, the maturity limit on its loans could be extended, and their interest rates could be reduced. Several organizations are lobbying the Fed to make such changes on its own authority, and the Heroes Act, which the House passed on May 15, would mandate such changes.

[a] See, for example: Karen Pierog, "U.S. states, cities may snub Fed lending program over high rates," Reuters, May 28, 2020, https://www.reuters.com/article/us-health-coronavirus-fed-states/u-s-states-cities-may-snub-fed-lending-program-over-high-rates-idUSKBN2341J3.

Nonetheless, the fundamental issue states now confront is the massive gap between the sales, income, and other revenues they will be able to collect, given the steep drop in employment and retail activity, and their spending needs — including new, COVID-driven spending needs. CBPP estimates that even after states use all their rainy-day funds and the federal aid provided to date that is flexible enough for use in covering revenue shortfalls, they face a combined budget gap of approximately $440 billion for the rest of this fiscal year and the next two years — not including the new costs states face to contain the virus. While the shortfalls almost certainly will peak during this period, states will continue to struggle with reduced revenues and higher costs for some time, given that unemployment will remain elevated according to credible forecasts.

If states borrowed substantial sums to get them through the next one to two years, very few would be in a position to begin repaying those loans when they came due, since revenues would still be depressed and service needs would still be high. Thus, borrowing would only postpone deep spending cuts, and those cuts would be a drag on whatever economic recovery was then underway.

The Great Recession demonstrated that state revenues take a long time to recover from economic shocks of this magnitude. State tax revenues overall did not return to pre-recession levels (after adjusting for inflation) for five years, and even ten years after the recession, revenues remained below pre-recession levels in 1 of every 5 states.[3] CBO projects that the monthly unemployment rate will average 7.3 percent in 2023 and 6.7 percent in 2024, versus just 3.7 percent in 2019.[4] Each percentage-point increase in the unemployment rate reduces aggregate annual state revenue by about $40 billion.[5] This suggests that if CBO's unemployment projections prove accurate, state revenues in both 2023 and 2024 will still be below those of 2019 by $140 billion and $120 billion, respectively.

State and local government employment patterns in the last decade also show the lasting effects of a deep recession. States and localities started laying off workers in summer 2008, the start of the first state budget cycle under the Great Recession, and they kept reducing employment for the next five years. By summer 2013 they had eliminated the jobs of nearly 750,000 people. State and local employment did not return to pre-recession levels until October 2019 — more than 11 years after the cuts started.

In addition, states struggle to restore cuts to education, health care, and other services after recessions, and they often defer addressing infrastructure needs for years. These cuts are particularly painful for low-income people and communities of color already struggling to overcome longstanding barriers to opportunity. Having to repay loans would make it even harder for states to restore services cut during the worst of the downturn. If states took out loans large enough to avoid

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[3] Barb Rosewicz *et al.,* "Lost Decade Casts a Post-Recession Shadow on State Finances," Pew Charitable Trusts, June 4, 2019, https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/06/lost-decade-casts-a-post-recession-shadow-on-state-finances.

[4] Congressional Budget Office, "Interim Economic Projections for 2020 and 2021," May 19, 2020, https://www.cbo.gov/publication/56351.

[5] Matthew Fiedler, Jason Furman, and Wilson Powell III, "Increasing Federal Support for State Medicaid and CHIP Programs in Response to Economic Downturns," Brookings Institution, May 2019, https://www.brookings.edu/wp-content/uploads/2019/05/ES_THP_FFP_web_20190506.pdf. Note: The pandemic-induced recession is different from previous recessions in several ways, including how swiftly and how far employment will drop. Thus, the actual relationship between unemployment and state revenues in this downturn may differ from the historical pattern.

significant cuts in the 2020-22 state fiscal years, the needed cuts in services to repay those loans would be even larger.

- **Medicaid.** States will likely face elevated Medicaid costs for many years due to the health crisis and the job losses from the resulting downturn. During an economic decline, Medicaid enrollment rises as many people lose their jobs and job-based health coverage and many people without job-based coverage experience an income decline that makes them and their families eligible for Medicaid. While the COVID-19 public health crisis seems likely to persist for some time, the economic crisis — and with it, higher eligibility for Medicaid — will likely last even longer, with forecasters projecting high unemployment through 2021 and beyond.[6]
- **K-12 Education.** K-12 schools in every state — especially those attended by low-income children, who are disproportionately children of color — rely heavily on state aid, which makes up a large share of state budgets. Most states cut this aid after the Great Recession, and state K-12 spending remained below pre-recession levels for years, making it difficult for states to hire high-quality teachers, extend learning time, and take other steps that could substantially boost test scores and high school graduation rates, especially for low-income children and children of color. At least 30 states provided less funding per pupil (after adjusting for inflation) for the 2014-15 school year — six years after the bottom of the recession — than they did before the recession hit.[7]
- **Higher education.** Public colleges and universities are one of the first places states cut when revenues fall and one of the *last* places to have funding restored. Overall state funding for public two- and four-year colleges in the school year ending in 2018 — ten years after the Great Recession hit — was more than $7 billion below its 2008 level, after adjusting for inflation. In the most difficult years following the recession, colleges responded to significant funding cuts by raising tuition, reducing faculty, limiting course offerings, and in some cases closing campuses — steps that often particularly harm students of color.[8] These would be the same years in which states would have to repay loans used to close budget shortfalls.
- **Infrastructure.** When state revenues fall in an economic downturn, states often postpone capital projects and put off maintenance of buildings, roads, water systems, and other infrastructure. For example, after the last recession, spending on public infrastructure dropped once the effects of the 2009 Recovery Act's borrowing incentives for infrastructure ended. Since 2009, state and local spending on infrastructure as a share of the economy has fallen in every year but two.[9] Partly as a result, the nation's infrastructure remains badly neglected, with communities of color and low-income areas often bearing the worst effects,

[6] Aviva Aron-Dine *et al.,* "Larger, Longer-Lasting Increases in Federal Medicaid Funding Needed to Protect Coverage," Center on Budget and Policy Priorities, May 5, 2020, https://www.cbpp.org/research/health/larger-longer-lasting-increases-in-federal-medicaid-funding-needed-to-protect.

[7] Michael Leachman and Chris Mai, "Most States Still Funding Schools Less Than Before the Recession," Center on Budget and Policy Priorities, October 16, 2014, https://www.cbpp.org/sites/default/files/atoms/files/10-16-14sfp.pdf.

[8] Michael Mitchell *et al.*, "State Higher Education Funding Cuts Have Pushed Costs to Students, Worsened Inequality," Center on Budget and Policy Priorities, October 24, 2019, https://www.cbpp.org/sites/default/files/atoms/files/10-24-19sfp.pdf.

[9] Elizabeth McNichol, "It's Time For States to Invest in Infrastructure," Center on Budget and Policy Priorities, updated March 19, 2019, https://www.cbpp.org/research/state-budget-and-tax/its-time-for-states-to-invest-in-infrastructure.

as the families of Flint, Michigan — where a neglected water system poisoned thousands of children — can attest.

- **Unemployment insurance.** The nation is facing historic numbers of unemployment claims, and forecasters expect unemployment rates to remain elevated for years. For example, CBO projects the unemployment rate will be over 9 percent in 2021 and remain over 6 percent in 2024.[10] States administer unemployment insurance separately from the general fund they use for state operating expenses, but meeting the needs of unemployed workers will strain state finances for years. Many states will take out large federal loans to enable their unemployment compensation programs to pay benefits to the millions of newly jobless workers; those loans will need to be repaid. (Indeed, just a few months into the downturn, 11 states have already either begun to borrow or informed Treasury that they intend to borrow because their unemployment trust funds will run out of money.[11]) The interest on those loans comes out of states' general funds.

Short-term borrowing will continue to play its traditional, important role in helping states manage cash flows within a budget year. This role may be even more important than usual in the near term, given the high degree of uncertainty around the economy's trajectory and the chances of additional federal aid coming later this summer. Indeed, states may wish to borrow in the short term to avoid layoffs and other harmful cuts, in hopes that more federal aid is forthcoming or that the economy improves more quickly than expected over the next few months. Such borrowing could buy states valuable time, but without substantial, additional direct federal grants, it likely would only delay dramatic cuts to meet balanced budget requirements.

Constitutions Restrict Most States' Ability to Borrow

Although Secretary Mnuchin appears to be pushing states to borrow on a short-term basis to manage cash flow, some analysts advocate instead that states borrow to finance their current and predicted revenue shortfalls, assuming that state finances will be much healthier when they need to repay the loans in several years.[12] For example:

- "Congress should offer to make up lost state-government revenue resulting from the economic shutdown through guaranteed loans on favorable terms. . . . Congress could have the Treasury build on the Municipal Liquidity Facility [MLF] it established with the Federal Reserve in April to buy state bonds and quickly provide financing. Or it could otherwise guarantee loans that could help states replace lost income. Swift support could allow the states to get through the coming economic hardship without needing to cut back education, welfare, or other core services. And providing such help not as grants but as generous loans

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[10] Congressional Budget Office, "Interim Economic Projections for 2020 and 2021," May 19, 2020, https://www.cbo.gov/publication/56351.

[11] See TreasuryDirect, Title XII Advance Activities Schedule, U.S. Department of the Treasury, as of June 18, 2020, https://www.treasurydirect.gov/govt/reports/tfmp/tfmp_advactivitiessched.htm.

[12] The Federal Reserve staff who created the MLF apparently also wanted to see a medium-term repayment timeline, since they increased the maximum maturity date for MLF loans from two years to three before finalizing the program. Since MLF loans can be taken out until the end of 2020, this would lead to repayment as late as December 31, 2023 — three and a half years from now.

that can be slowly repaid to the Treasury, as state revenues recover over time, can both protect federal finances and avoid favoring higher-tax states."[13]

- "States and municipalities facing budget crunches can borrow money today and pay it back with future tax revenue once their economies are up and running again."[14]

These proposals ignore the fact that the constitutions of the large majority of states would prevent them from taking out such loans. These constitutional restrictions have received virtually no attention in the extensive expert and media discussion of the MLF since the Fed announced the program on April 9.[15] Even when they are noted, as Secretary Mnuchin did in passing in his May 11 interview, they are treated as minor obstacles to be circumvented. They are anything but.

Two types of state constitutional provisions likely would severely constrain most states' ability to take out loans to cover deficits in their general operations budgets resulting from a combination of revenue shortfalls and higher-than-anticipated expenses (for example, more people qualifying for Medicaid).[16] The first governs the adoption of the state budget; the second governs carrying over a deficit from one year into the next.

Constitutional Provisions Requiring Enactment of a Balanced Budget

The constitutions of 31 states require the budget approved by the governor (that is, the budget for general operations, typically the budget for the "General Fund") to be balanced, according to a 2015 tally by the National Association of State Budget Officers (NASBO).[17] Since actual revenues and expenditures in the forthcoming fiscal year or two-year biennium cannot be known, such a provision requires a governor to sign the budget the legislature enacts only if the governor believes it is based on reasonable, good-faith forecasts of what those revenues and expenditures will likely be.

[13] Yuval Levin, "How Congress Can Help the States," American Enterprise Institute, May 6, 2020, https://www.aei.org/op-eds/how-congress-can-help-the-states/.

[14] Adam Millsap, "More Federal Money to States Isn't the Solution," *Forbes,* May 11, 2020, https://www.forbes.com/sites/adammillsap/2020/05/11/more-federal-money-to-states-isnt-the-solution/#6586098b677f. See also: John S. Baker Jr. and Robert T. Miller, "A Better Alternative to State Bankruptcy or Default," *Wall Street Journal,* May 7, 2020, https://www.wsj.com/articles/a-better-alternative-to-state-bankruptcy-or-default-11588869870; and Matthew D. Dickerson and Alison Waters, "Federal Budget Assistance for State & Local Governments," Americans for Prosperity, May 2020, https://americansforprosperity.org/wp-content/uploads/2020/05/AFP_Report_FedBudgetAssistance.pdf.

[15] One notable exception is Amanda Albright, "Fed's $500 Billion Muni-Lending Plan Faces Hurdles in State Laws," *Bloomberg Law,* April 21, 2020, https://news.bloomberglaw.com/securities-law/feds-500-billion-muni-lending-plan-faces-hurdles-in-state-laws.

[16] This discussion focuses on state constitutional rather than statutory provisions because, in theory at least, statutes could be changed relatively easily to permit borrowing to cover deficits if the legislature deemed it desirable, while amending a state constitution often involves a vote of the people (typically a supermajority vote) and a multi-year process. That said, potent and deeply ingrained historical and political factors could well render such statutory provisions quite difficult to undo as well.

[17] National Association of State Budget Officers, "Budget Processes in the States," Spring 2015, p. 52, https://www.nasbo.org/reports-data/budget-processes-in-the-states.

The next state fiscal year or biennium of 29 states begins on July 1, 2020, and Michigan's begins on October 1.[18] About a third of these states have not yet enacted their budgets for the coming period. For those states that have not yet enacted their budgets and have constitutional provisions requiring that the budget be balanced when enacted, the enacted budgets may not, *by definition,* provide for any borrowing to cover the difference between anticipated revenue and anticipated spending. Any gap between forecasted revenue and desired spending will have to be closed by some combination of drawing down any remaining reserves at the end of this year, spending cuts, and revenue-raising measures. The same will hold true when states proceed next spring to enact their 2022 budgets.

In reality, this balanced budget constraint is not ironclad. If a legislature and governor agreed to engage in some borrowing to close a budget shortfall that would otherwise occur, they could enact a budget based on what they knew to be an overly optimistic revenue forecast and/or an unrealistically conservative estimate of spending growth in programs that they cannot easily control on a day-to-day basis — for example, state employee overtime pay and Medicaid. Such steps would open up a gap between actual revenues and expenditures once the next fiscal year was underway, which the state could then close with borrowing (assuming that other constitutional provisions, discussed below, did not bar it).

Nonetheless, there are significant practical and political limits to such a strategy. Any blatant lowballing of spending estimates or adoption of wildly optimistic economic assumptions would likely draw objections by some legislators or the governor — especially if they were of opposite parties — and harsh scrutiny from the media and budget watchdog groups that could prove politically damaging.

In short, for the significant number of states whose constitutions require enactment of a balanced budget and have not yet adopted their budgets for the upcoming fiscal year or biennium, that requirement likely will significantly constrain their ability to borrow to compensate for deep revenue declines. If Congress does not provide substantial additional direct assistance, they will be forced to reduce services or increase revenues — both of which will slow the economic recovery.[19]

Constitutional Provisions Limiting Borrowing to Cover Year-End Deficits

A diverse set of provisions in many state constitutions govern when and for what period the state can issue debt to cover deficits that emerge after the budget's adoption. The 2015 NASBO study cited above reports that 39 states may not constitutionally "carry over a deficit" from one fiscal year to another, while a 2010 National Conference of State Legislature (NCSL) study says that 37 are so

[18] New Jersey's 2021 fiscal year normally would have begun July 1, but the 2020 fiscal "year" was extended by three months and the 2021 budget period was shortened by three.

[19] This would imply that Congress needs to approve additional aid by June 30 to prevent most states from having to adopt 2021 budgets containing deep spending cuts or tax increases. Such action is indeed urgent, but it is not uncommon for states to delay enacting budgets beyond the start of the fiscal year, and if Congress is seriously considering additional direct federal aid by July 1, some states likely would delay their final budgets in order to account for that aid. Others would hold special legislative sessions later in the year to revise their budgets to account for the aid.

restricted.[20] The two lists identify 18 states that can "carry over a deficit," but only six states appear on *both* lists, demonstrating that interpreting these provisions is not clear-cut.[21]

A close examination of the relevant state constitutional language reveals that even among the six states that both NASBO and NCSL agree may carry over a deficit from one year into the next, borrowing to finance that deficit is often sharply restricted if not prohibited altogether:

- The **Arizona** constitution acknowledges that an unanticipated and unavoidable deficit may arise but implies that it must be closed in the next fiscal year: "Whenever the expenses of any fiscal year shall exceed the income, the legislature may provide for levying a tax for the ensuing fiscal year sufficient, with other sources of income, to pay the deficiency, as well as the estimated expenses of the ensuing fiscal year." Further, the constitution all but prohibits the state from incurring debt to finance such a deficit: "The state may contract debts to supply the casual [unforeseen] deficits or failures in revenues, or to meet expenses not otherwise provided for; but the aggregate amount of such debts, direct and contingent, whether contracted by virtue of one or more laws, or at different periods of time, shall never exceed the sum of three hundred and fifty thousand dollars." If the constitution does not prohibit ending a fiscal year with a deficit but effectively prohibits new borrowing to finance the deficit by setting such a low limit on such borrowing, the state would have to cover the deficit by using reserves, delaying payments to local governments or vendors, or taking similar actions.
- The **Illinois** constitution provides that "State debt may be incurred . . . to meet deficits caused by emergencies or failures of revenue." However, it also states that "Such law shall provide that the debt be repaid within one year of the date it is incurred."[22]
- Several provisions of the **Michigan** constitution interact in such a way that the state, practically speaking, could not borrow for more than one year to cover any deficit that opens in the middle of a fiscal year. While language concerning the governor's budget submission notes that a "deficit incurred in any fund during the last preceding fiscal period shall be entered as an item in the [subsequent] budget," the same article states that "The governor . . . shall reduce expenditures authorized by appropriations whenever it appears that actual revenues for a fiscal period will fall below the revenue estimates on which appropriations for that period were based." And while the constitution authorizes borrowing *within* a fiscal year to meet budget needs (that is, taking out a loan to be repaid within the same fiscal year), longer-term borrowing for operations requires a two-thirds supermajority of both houses plus voter approval at a general election. Both could be difficult to obtain at present.

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20 National Conference of State Legislatures, "NCSL Fiscal Brief: State Balanced Budget Provisions," October 2010, p. 3, https://www.ncsl.org/documents/fiscal/statebalancedbudgetprovisions2010.pdf.

21 Both lists concur that 32 states cannot carry over a deficit, although, as discussed below, some of these may be able to do so for a short period.

22 Illinois is the first state to borrow from the MLF but, consistent with this constitutional requirement, will do so for only a one-year period. See Karen Pierog, "Illinois to Sell Debt in First Deal with Fed's Muni Liquidity Facility," Reuters, June 2, 2020, https://www.reuters.com/article/us-usa-illinois-fed/illinois-to-sell-debt-in-first-deal-with-feds-muni-liquidity-facility-idUSKBN239328. Illinois can borrow for longer periods with a three-fifths majority approval in both houses of its legislature, and Democrats hold the requisite majorities in both houses.

- The provisions of the **Wisconsin** constitution governing shortfalls are almost identical to Arizona's. It acknowledges that the state may experience an unanticipated shortfall but requires that "whenever the expenses of any year shall exceed the income, the legislature shall provide for levying a tax for the ensuing year, sufficient, with other sources of income, to pay the deficiency as well as the estimated expenses of such ensuing year." As in Arizona, it appears that, effectively, no borrowing is permitted to cover that shortfall: "For the purpose of defraying extraordinary expenditures the state may contract public debts (but such debts shall never in the aggregate exceed one hundred thousand dollars)."
- Among the six states common to both the NASBO and NCSL lists, only **Connecticut** and **Vermont** appear not to have constitutional provisions restricting borrowing to cover unanticipated shortfalls. Thus, both states apparently could engage in medium- or even long-term borrowing to finance mid-year budget gaps that open up in the next year or two due to the current downturn. That said, Connecticut has several stringent *statutory* restrictions on running deficits that the legislature has only recently implemented and would be politically difficult to reverse. And although Vermont is widely cited as the only state with no constitutional "balanced budget requirements" of any kind, historically the state has incurred deficits no more frequently than any other state.

Similarly, many of the states that NASBO *or* NCSL (but not both) classify as able to carry a deficit from one year to the next have constitutional prohibitions on medium- or long-term borrowing to finance such a deficit. For example:

- The **California** constitution provides that "the State may not obtain moneys to fund a year-end state budget deficit . . . [except for] funding obtained through a short-term obligation incurred in anticipation of the receipt of tax proceeds or other revenues that may be applied to the payment of that obligation, for the purposes and not exceeding the amounts of existing appropriations to which the resulting proceeds are to be applied." In other words, the constitution allows only "short term" borrowing to cover a revenue shortfall (but not overspending). Further, under state law California may authorize such "short-term obligations" (technically known as "tax and revenue anticipation notes") only if they have a maturity of 15 months or less.
- The relevant language of the **Nebraska** constitution is virtually identical to that of Arizona and Wisconsin. It acknowledges that unanticipated deficits may occur but essentially forbids borrowing to finance them, stating: "The state may, to meet casual deficits, or failures in the revenue, contract debts never to exceed in the aggregate one hundred thousand dollars."
- The **Louisiana** constitution acknowledges that unanticipated deficits may occur but requires that they be eliminated in the subsequent fiscal year: "If a deficit exists in any fund at the end of a fiscal year, that deficit shall be eliminated no later than the end of the next fiscal year." Moreover, "If within thirty days of the determination that appropriations will exceed the official forecast the necessary adjustments in appropriations are not made to eliminate the projected deficit, the governor shall call a special session of the legislature for this purpose unless the legislature is [already] in regular session." Finally, although the constitution allows the legislature to approve debt to "provide relief from natural catastrophes" (which presumably could encompass COVID-19), this requires a two-thirds supermajority in both houses.

- The **Rhode Island** constitution states that "the general assembly may provide by law for the state to borrow in any fiscal year, in anticipation of receipts from taxes, sums of money not exceeding twenty percent of the receipts from taxes during the next prior fiscal year." However, it also requires that "Any money so borrowed in anticipation of such receipts shall be repaid within the fiscal year of the state in which such borrowings take place."

Also, some states that both NASBO and NCSL classify as *unable* to carry a deficit over from one year to the next may actually be able to do so.[23] But, again, they appear to be limited to very short-term borrowing that must be repaid, at the latest, in the fiscal year after the one in which the debt is incurred. For example:

- The **Virginia** constitution provides that "The General Assembly may . . . contract debts, or may authorize the Governor to contract debts, to meet casual deficits in the revenue or in anticipation of the collection of revenues of the Commonwealth for the then current fiscal year within the amount of authorized appropriations, provided that . . . such debt shall mature within twelve months from the date such debt is incurred.[24] Thus, Virginia could borrow money to finance a deficit that emerged in the middle of one fiscal year, but it would have to repay by the middle of the subsequent year.
- Likewise, the **Washington** constitution says that "the state may issue certificates of indebtedness in such sum or sums as may be necessary to meet temporary deficiencies of the treasury. . . . [S]uch certificates must be retired and the debt discharged other than by refunding within twelve months after the date of incurrence."[25]

In sum, state constitutional provisions — both those requiring enactment of a balanced budget and those governing the issuing of new debt to finance an unanticipated mid-year deficit — significantly constrain states' ability to borrow to cope with their severe current shortfalls.

Long-Term Borrowing to Finance Operating Deficits Could Be Problematic

Even if states could legally borrow over a relatively long term (say, five to ten years) to finance deficits in fiscal years 2020-22, such borrowing could have significant drawbacks.[26]

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[23] Nearly all states can engage in borrowing *within* a fiscal year to manage cash flow. For example, the state treasurer is authorized to sell "tax anticipation notes of the state of Idaho, for fixed periods, not greater than twelve (12) months or the end of the current fiscal year, *whichever is shorter*." Section 63-3201 Idaho Statutes, https://legislature.idaho.gov/wp-content/uploads/statutesrules/idstat/Title63/T63CH32.pdf. [Emphasis added.]

[24] In adopting a budget for the 2021-22 biennium, the Virginia legislature authorized borrowing up to $500 million under this provision to handle the cash flow needs of the state with a maximum 12 month maturity. See: https://budget.lis.virginia.gov/item/2020/1/HB30/Reenrolled/4/4-14.00/.

[25] The reference to "other than by refunding" implies that, in theory, the state could continue rolling over that borrowing at one-year intervals, although in doing so, it would repeatedly incur significant debt issuance costs.

[26] Law professors Darien Shanske and David Gamage have proposed a different approach to relatively long-term borrowing to cover anticipated near-term revenue shortfalls that could make considerable sense for states should meaningful additional direct aid not be forthcoming. They propose that states increase taxes significantly, through significant structural reforms or enactment of a new tax, and then issue long-term bonds based on the expected revenue from those increases, which they would then repay with that new revenue. (The new revenue would be put into a dedicated fund to ensure that the money was available.) Through such a "securitization" mechanism, multiple years of

First, states would risk setting themselves up for deeper financial problems down the road. There is no way to know how long the recovery will last; the recovery from the Great Recession was the longest on record (almost 11 years), but the previous recovery lasted only six years. If states borrow heavily to finance revenue shortfalls during the current recession, they could find themselves in new fiscal straits before paying off this debt. In addition, a costly natural disaster like Hurricane Katrina, Superstorm Sandy, or last year's widespread California wildfires can occur at any time; taking on substantial new debt now might constrain states' ability to assume further debt to finance infrastructure reconstruction or offset revenue shortfalls if such a crisis occurs.

Second, repaying loans used to address state general fund shortfalls would interfere with restocking state rainy-day funds — a critical tool for preparing for future downturns. Every dollar used to pay off new debt would be a dollar unavailable for such a deposit. State rainy-day balances sank to their lowest point on record in 2010 due to the Great Recession, and it took states until 2015 to restore them to their pre-recession peak.[27] In addition, states often use one-time measures to get through the worst years of a downturn, such as shifting large payments to the next fiscal year and borrowing from special-purpose funds (such as highway construction funds). To be available for future downturns, these measures must be undone once revenues recover, but states would find that difficult if they have to pay off new debt.

Finally, borrowing heavily to finance near-term operating deficits could drive up the interest rates on other state borrowing, especially for states that already have relatively low credit ratings. States routinely and appropriately borrow to finance the cost of long-lived assets like highways, office buildings, and state university facilities; paying higher interest rates on this borrowing would further squeeze their finances.

In sum, if states were to engage in substantial short-term borrowing to finance the enormous operating deficits they will run over at least the next couple of fiscal years, they would not be in a position to pay off that debt when it came due and would only have postponed harmful cuts in vital services. Borrowing for a longer period would not be allowed under most states' constitutions and would be problematic even if it were. Since additional state debt is not a viable solution to the current state fiscal crisis, federal policymakers must act promptly to provide substantial additional direct aid on the scale of what is included in the House-passed HEROES Act.

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future revenue could made available upfront to address budget shortfalls. See: Darien Shanske and David Gamage, "States Should Borrow Rather than Make Brutal Cuts During a Recession and Pandemic," Medium, May 22, 2020, https://medium.com/whatever-source-derived/states-should-borrow-rather-than-make-brutal-cuts-during-a-recession-and-pandemic-710d2175ccf8. Because this strategy would rely on dedicated new revenues for repayment of debt, it would not compete with other essential uses of existing revenue sources, such as replenishing rainy-day funds and financing infrastructure. However, as Shanske and Gamage acknowledge, state constitutional debt limitations might well also constrain the ability of many, and potentially most, states to borrow in this way.

[27] National Association of State Budget Officers, "The Fiscal Survey of the States," Fall 2019, https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/Fiscal%20Survey/NASBO_Fall_2019_Fiscal_Survey_of_States_S.pdf.