

# SPECIAL REPORT

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## Federal, State, and Local Debt Piles Up *Government Debt Stands at \$16,835 Per Person*

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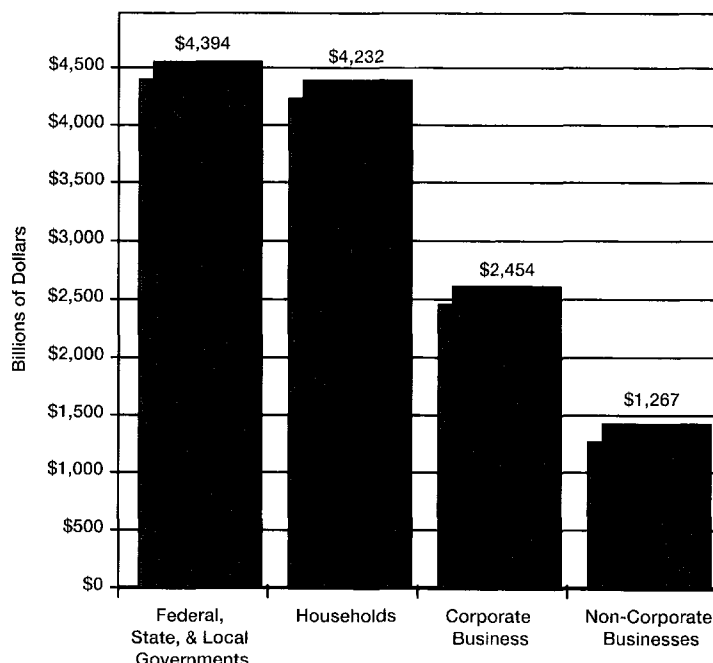
By the end of 1993, federal, state, and local governments in the United States owed \$4.4 trillion in credit market debt, an average of \$16,835 for each American. This total means that governments are the largest borrowers in the country—ahead of households, which borrow for home mortgages and other uses, and ahead of corporate and noncorporate businesses, which borrow to finance investments in buildings, machines, and other items (see *Figure 1*). Of the total, the federal government owes \$3.3 trillion while

state and local governments owe \$1.1 trillion.

At the federal level, debt has been rising quickly as each annual deficit adds to the total accumulated national debt. Any notion of ever paying off the debt seems distant as the federal budget has not been balanced since 1969—an unprecedented 26-year string of budget shortfalls. The second worst string of unbalanced budgets in U.S. history occurred during the Great Depression and World War II when 16 budgets in a row went unbalanced.

While overshadowed by concern about the national debt, state and local government debt has been piling up quickly since the early 1980s as well. Factors contributing to rising state and local debt levels are discussed starting on page 4.

*Figure 1*  
*Credit Market Debt Outstanding by Borrower, End of 1993*



Source: Federal Reserve Board.

### Trends in Federal Debt

The July Mid-Session Review from the Office of Management and Budget (OMB) projects that gross federal debt will rise to \$6.26 trillion by fiscal 1999—an addition to the national debt of \$1.59 trillion in just the next five years (see *Table 1*). Even when measured in constant dollars, federal debt rises 16 percent by fiscal 1999, as shown in *Figure 2*.

As the federal debt rises, so do budget outlays required for interest payments. Interest outlays totalled \$204 billion in fiscal 1994 and represented 13.8 percent of all federal outlays. Interest outlays will increase to \$282 billion, or 15.2 percent of all outlays, by fiscal 1999, according to OMB projections.

The federal debt has become large enough that interest payments are expected to continue moving upwards even as the deficit is somewhat lower in the next few fiscal years (see *Figure 3*). Since outlays for interest have

become larger than the annual deficit, it can be argued that all new federal borrowing goes simply to pay past federal creditors. In effect, the federal government operates a \$200 billion Wall Street "transfer program" which simply passes money from new bondholders to old ones.

Another indication of the size of the accumulated federal debt is the dramatic effect that interest rate changes have on federal interest payments. *Figure 3* indicates that federal interest outlays stabilized during fiscal years 1991 to 1994. This result was achieved by the refinancing of large amounts of maturing federal debt at then-lower interest rates.

But the president's February 1994 budget optimistically assumed that these lower rates would continue indefinitely. Long-term interest rates were projected to level out at 5.8 percent over the next five years. Unfortunately, the president's latest July budget figures project that long-term rates will instead level out at 7.0 percent through to fiscal 1999. The result: federal interest payments will be \$104.8 billion higher, in total, from fiscal 1995 through 1999.

#### *Measurement of the Federal Debt*

*Table 2* presents various measures of the federal government's debt load for fiscal

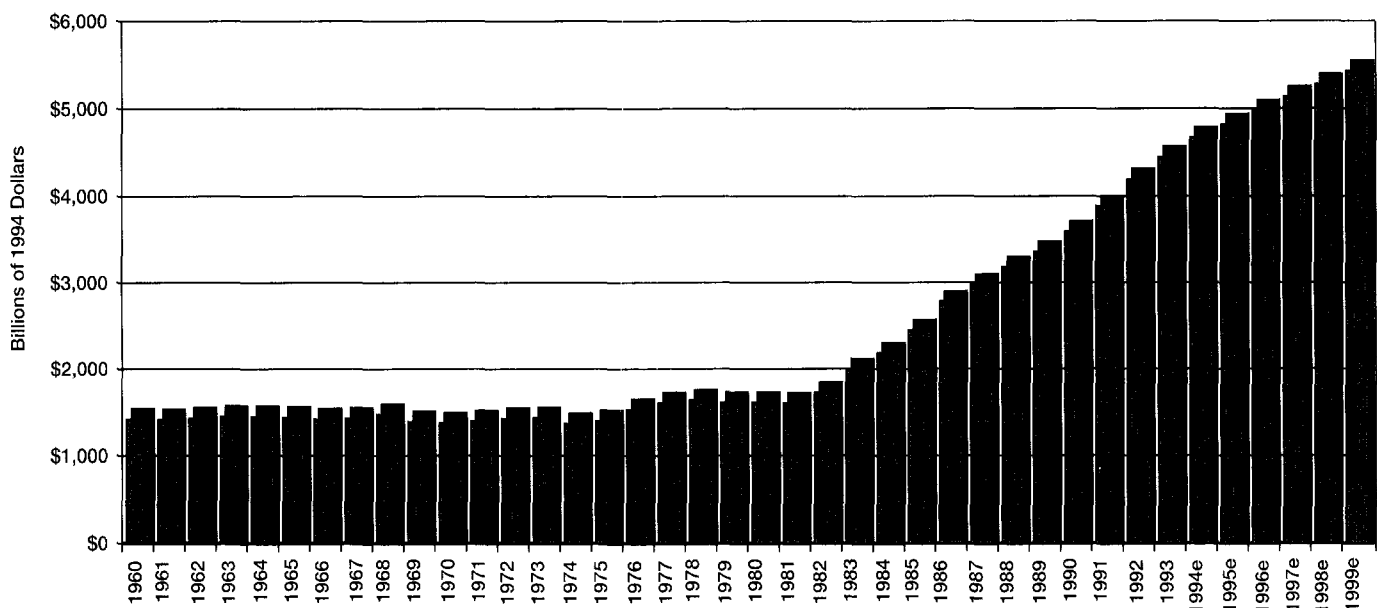
1994. Federal gross debt of \$4.67 trillion in fiscal 1994 includes \$1.21 trillion of debt held by various federal trust funds, in particular, the Social Security Trust Fund. This portion of debt is, in effect, a liability owed by the federal government to itself and does not represent current borrowings from the private sector. However, if the Social Security Administration were to redeem this debt in the future, the Treasury Department would have to issue more public debt, or Congress would have to raise taxes or cut spending.

Excluding this portion of debt yields "debt held by the public" which totalled \$3.46 trillion by the end of fiscal 1994. Public debt is a good measure of the federal government's debt load that taxpayer's would face if the federal government were to pay back all its borrowings. If each resident of the United States were billed tomorrow for his/her share of the federal public debt, they would have to pay \$13,249 each.

#### *Is There Any Good News About the Federal Debt?*

A common way to judge the size of the government's debt is to compare it to the size of the economy that supports it. *Figure 4* shows that federal debt as a percentage of the nation's gross domestic product steadily fell

*Figure 2*  
*Gross Federal Debt in 1994 Dollars, Fiscal Years 1960-1999*



**Table 1**  
*OMB Federal Budget Projections, Fiscal 1994 to 1999 (\$Billions)*

	Deficit	Net Interest Outlays	Gross Federal Debt	Debt Held By the Public
1994	\$220	\$204	\$4,667	\$3,458
1995	167	224	4,953	3,634
1996	179	242	5,262	3,826
1997	190	256	5,587	4,031
1998	192	269	5,918	4,239
1999	207	282	6,264	4,465

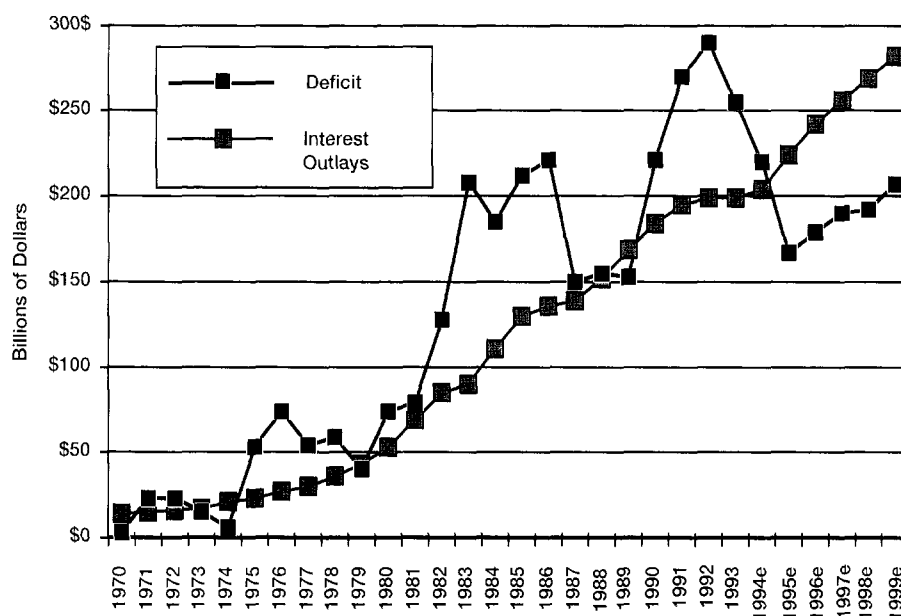
Source: Office of Management and Budget, Mid-Session Review, July 1994.

**Table 2**  
*Federal Government Debt, Fiscal Year 1994*

	Federal Debt (\$billions)	As a Percent of GDP	Per Capita
Gross Debt	\$4,667	70.0%	\$17,881
Less Debt Held by Government Accounts	1,210	-	-
Debt Held by the Public	3,458	51.8	13,249

Source: Office of Management and Budget, Mid-Session Review, July 1994.

**Figure 3**  
*Federal Deficit and Net Interest Outlays, Fiscal Years 1970-1999*



Source: Office of Management and Budget, July 94.

for three decades following the massive World War II debt buildup. But the trend was reversed in the 1980s and 1990s, and by fiscal 1994 the gross federal debt was back up to 70 percent of the nation's GDP.

The good news is that the administration currently projects that this debt-to-GDP ratio will not rise much further throughout the 1990s. But in the longer term, this trend is not certain. The Congressional Budget Office, which projects budget trends out 10 years, currently estimates that the debt-to-GDP ratio will steadily rise all the way to fiscal 2004. Of course, if Congress balanced the federal budget, the federal debt would steadily diminish with respect to the size of a growing economy.

### State and Local Government Debt

The 1980s represented a sharp break from the past for state and local debt levels, as it did for federal debt levels, as shown in Figure 5. After hovering between \$500 and \$600 million (in 1993\$) every year from 1965 to 1984, state and local debt outstanding soared in the 1980s and early 1990s, and now totals over \$1 trillion. (Note: there are some measurement differences between Federal Reserve credit market debt shown in Figure 1, and Bureau of Census state and local debt shown in Figure 5.)

### Benefits and Costs of State and Local Debt

While state and local debt growth during the past decade mirrored the growth in federal government debt, the dynamics of the two trends differ somewhat. Federal debt is issued because federal politicians simply fail to balance the annual federal budget. In contrast, debt financing at the state and local level is traditionally considered to be a sensible way to finance capital-intensive government projects. Local structures such as roads and schools provide benefits over many future years; debt financing provides a method for project costs to be spread over future years as well, to match these benefits.

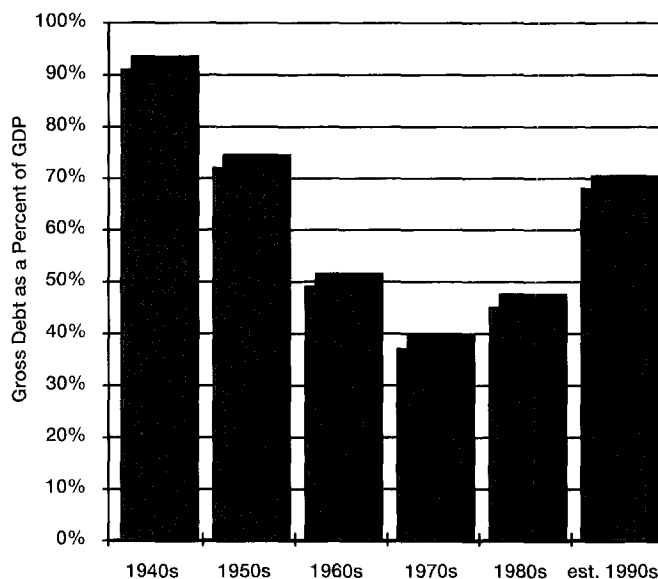
Of course, the benefit of using debt financing is gained at the expense of higher total government costs since interest payments must be made on borrowings. State and local governments in the United States spent \$65 billion on interest in 1992—more than state and local governments spent on police and fire protection combined (\$49 billion in 1992).

Despite the cost, debt financing is an attractive alternative to tax increases for governments. One factor contributing to debt's popularity is the tax-exempt status of state and local bonds (together called "municipal" or "muni" bonds). Since the introduction of the federal income tax in 1913, interest on muni bonds has been exempt from the federal income tax. In contrast, investors in U.S. Treasury or corporate bonds do pay income tax on interest earnings. Investors in muni bonds of their own state typically don't pay state or local income taxes either. These advantages for muni bond investors allow state and local governments to issue debt more cheaply than would otherwise be the case, since governments can sell muni bonds at lower (pre-tax) interest rates.

### Hurdles to Debt Issuance

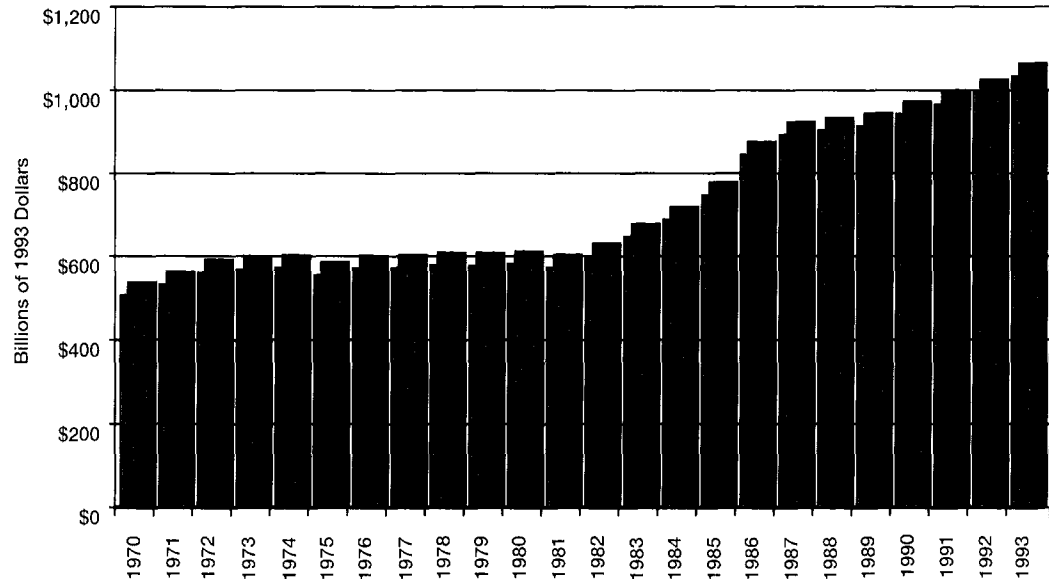
While state and local governments have a debt financing advantage over federal debt, they face greater restrictions on debt issuance than the federal government. For example, while the federal government has a legal debt limit, the U.S. Congress routinely votes to raise it whenever required, thus allowing continual deficit spending. In contrast, state governments are typically bound by either constitutional or statutory debt-issuing limits and by voting requirements including general referendums or leg-

Figure 4  
Federal Gross Debt as a % of GDP, Averages by Decade



Source: Tax Foundation based on OMB's Mid-Session Review, July 1994.

Figure 5  
State and Local Debt Outstanding in 1993 Dollars, End of Fiscal Years 1970-1993



Sources: Bureau of the Census; 1993 estimated by the Tax Foundation.

islative supermajorities. At the local level, cities and counties have their debt-issuing powers limited by state governments as well as by referendum requirements. Currently, 48 states place debt limits (usually based on local property values) on cities and 40 states place limits on county debt issuance.

Voter approval of local bond issues is required in 39 states. *Figure 6* shows that approval is generally given in a majority of bond votes, but that approval is no sure thing. Voters would seem to be the most skeptical of debt issuance when the economy is in poor or unstable condition, such as in the 1930s and 1970s. In the early 1990s, voters rejected bonds at a greater rate than during the boom years of the 1980s. In 1993, voters in the United States cast ballots on 747 separate bond issues and approved 64 percent of them, a figure which is down from approval rates of over 80 percent during the mid-1980s.

Of course, bond-voter sentiment is subject to regional patterns within these national totals. For example, in California, which has been hard-hit by recession, voters on June 7 rejected each of four separate bond issues totalling \$5.9 billion for earthquake repairs, schools, and other projects. The state already pays over \$2 billion annually in interest on debt, and the

new issues would have added about \$425 million to the annual repayment burden. One financial analyst noted that "total skepticism about the state's finances" caused this overwhelming rejection. Since a government debt burden is more easily repaid when a local economy is growing, it makes sense that voters reject bond issues when they are uncertain about the future.

#### *Growth in Debt Bypasses Restrictions*

Nonetheless, neither voting requirements nor legal restrictions halted a rapid expansion of state and local debt issuance during the past decade. This is largely explained by the fact that typically only "general obligation" (or "full faith and credit") bonds are subject to limits and voter approvals. "Non-guaranteed" debt is usually not so limited, but was traditionally used only by governments for self-financing projects. Over the years politicians have sought to avoid voter resistance and bond limits and have expanded the use of non-guaranteed debt for a wider range of purposes.

One type of fast-growing non-guaranteed debt, used to circumvent restrictions, is "lease-backed" debt or "certificates of participation." Annual issues have grown from about \$5 billion in 1987 to over \$15

**Table 3**  
**State and Local Per-Capita Debt in 1992 Dollars**

	Per-Capita Debt in 1992 Dollars		1992 Rank	% Change 1982-1992	% Change Rank
	1982	1992			
U.S. Average	\$2,556	\$3,812		49%	
Alabama	1,966	2,689	40	37	31
Alaska	24,404	15,307	1	-37	50
Arizona	3,528	4,941	9	40	29
Arkansas	1,557	2,093	47	34	34
California	1,765	3,698	24	110	1
Colorado	2,588	4,567	13	76	6
Connecticut	3,081	4,767	12	55	16
Delaware	4,914	6,612	2	35	33
Florida	1,955	4,053	19	107	2
Georgia	2,004	3,067	35	53	18
Hawaii	3,677	5,214	8	42	28
Idaho	1,433	1,799	50	26	38
Illinois	2,142	3,489	27	63	11
Indiana	1,085	2,205	46	103	3
Iowa	2,047	1,915	49	-6	44
Kansas	3,129	2,838	38	-9	45
Kentucky	3,297	4,186	18	27	37
Louisiana	3,351	4,405	16	31	36
Maine	1,926	3,296	31	71	8
Maryland	3,218	3,882	22	21	40
Massachusetts	2,797	5,492	6	96	4
Michigan	1,927	2,534	41	31	35
Minnesota	3,705	4,329	17	17	42
Mississippi	1,335	1,927	48	44	24
Missouri	1,480	2,277	45	54	17
Montana	2,416	3,566	25	48	22
Nebraska	4,811	4,029	20	-16	48
Nevada	2,887	4,907	10	70	9
New Hampshire	2,685	4,839	11	80	5
New Jersey	3,119	4,435	14	42	26
New Mexico	3,367	2,883	37	-14	46
New York	4,083	6,405	3	57	15
North Carolina	1,440	2,520	42	75	7
North Dakota	2,108	3,071	34	46	23
Ohio	1,631	2,338	44	43	25
Oklahoma	1,814	2,774	39	53	19
Oregon	4,856	3,480	28	-28	49
Pennsylvania	2,474	3,948	21	60	14
Rhode Island	3,911	5,901	4	51	21
South Carolina	2,226	3,160	33	42	27
South Dakota	2,453	3,383	30	38	30
Tennessee	2,105	2,464	43	17	41
Texas	2,481	3,786	23	53	20
Utah	3,521	5,721	5	63	12
Vermont	2,594	3,532	26	36	32
Virginia	1,892	3,176	32	68	10
Washington	5,680	5,461	7	-4	43
West Virginia	2,812	3,479	29	24	39
Wisconsin	1,857	2,990	36	61	13
Wyoming	5,206	4,421	15	-15	47
District of Columbia	6,303	8,385		33	

Note: Figures includes all state and local, long and short-term debt.  
Source: Tax Foundation calculations based on Bureau of Census data.

billion by 1993. This form of debt basically involves a government contracting with a private entity (such as a bank) to issue bonds to fund a government facility. The government then makes "lease" payments to the bond issuer to cover interest expenses. Lease-backed bonds have been used to finance everything from prisons to new school facilities.

In addition to growth in such nontraditional debt to fund government facilities, governments have expanded issuance of non-guaranteed debt for private purposes. "Industrial development bonds" (IDB's) are issued with the advantage of a muni bond's tax-exempt status but the proceeds fund private industry expansion. But IDB's have become so popular that the federal government has restricted the quantity of such bonds receiving the federal tax exemption. Nonetheless, this form of debt explains a significant portion of the growth in state and local debt, particularly during the mid-1980s, as shown in *Figure 5*.

*Figure 7* highlights the sea change that has occurred in state and local debt issuance over the past two decades. At the state level, general obligation debt fell from 50 percent of long-term debt in 1972 to just 26 percent by 1992. At the local level, general obligation debt fell from 65 percent of the total in 1972

to just 34 percent by 1992, as non-guaranteed local debt soared from \$117 billion in 1972 to \$382 billion by 1992, in constant dollars.

### *Consequences of High Debt*

There are limits to how much of any type of debt a state or local government can issue. As debt increases, a government's fiscal maneuvering room gets increasingly restricted. Higher debt loads lead to increased borrowing costs as bond rating agencies downgrade debt and push up interest costs. In addition, local governments have to answer to state governments for high and rising debt levels and may find themselves audited and further restricted by the state.

A heavy local government debt load can have a positive result, however. Just as a heavily-indebted corporation may be forced to keep a tighter rein on costs and be subjected to extra scrutiny, so may a local government. Local governments that have gone deeply into debt can be pushed into needed reforms they otherwise may not have made.

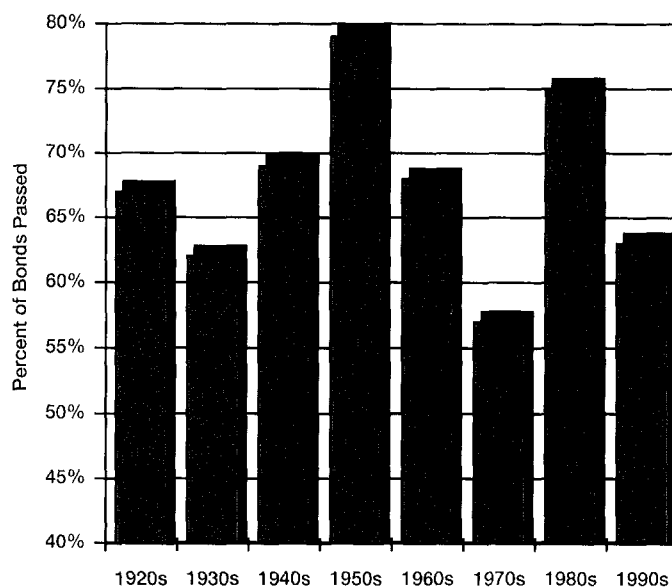
The city of Philadelphia is a good recent case in point. In late 1990, the city was virtually bankrupt and its bonds downgraded to junk status. In response, the state legislature moved in and set up an independent fiscal authority, "PICA," to monitor the city's finances. PICA acts as a watchman to see that the city's books are balanced legitimately and not by accounting tricks, such as delayed pension fund payments, that are popular with local governments during budget shortfalls.

Perhaps more importantly, Philadelphia's debt crisis and the authority of PICA made it politically feasible for a new mayor to set about overdue reforms. Mayor Edward Rendell used the crisis to cut city costs and make other reforms in city services that might not have been possible without the discipline of a high debt load.

### *Government Debt by State*

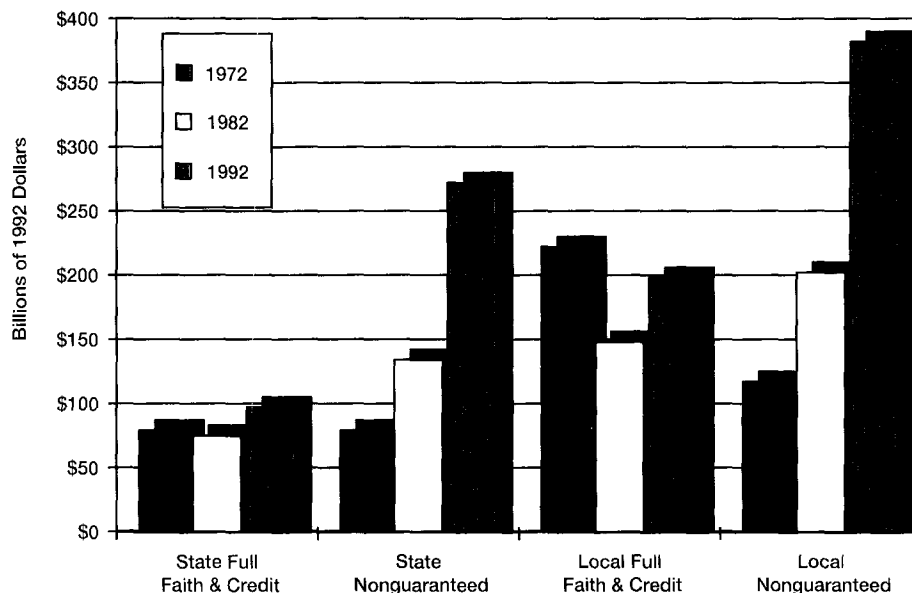
Government debt levels vary widely by state as documented in *Table 3*. On a per-resident basis, Alaska is in a league of its own in with state and local indebtedness of \$15,307 per capita in 1992. After Alaska, highly indebted states include Delaware, New York, Rhode Island, Utah, Massachusetts, Washington, and Hawaii—each with government debt of over \$5,000 per resident. The District of Columbia would rank second after Alaska if it were a state with a per-resident debt of \$8,385. The least indebted state and local governments can be found in Idaho, Iowa, Mississippi, and Arkansas.

*Figure 6*  
*State and Local Bond Election Results—Average Passed by Decade*



Note: 1920s includes 1926-1929; 1990s includes 1990-1993.  
Source: The Bond Buyer; Tax Foundation calculations.

**Figure 7**  
*State and Local Debt by Type (in Billions of 1992 Dollars)*



Source: Bureau of Census.

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For the country as a whole, state and local debt rose 49 percent per resident between 1982 and 1992. Eight states were successful in reducing their level of government indebtedness—Alaska, Oregon, Nebraska, Wyoming, New Mexico, Kansas, Iowa, and Washington. Five of these eight states had been among the most indebted back in 1982. Oregon, for example, had a state and local debt load 90 percent above the national average back in 1982, but by 1992 debt had been trimmed dramatically enough to fall 9 percent below the U.S. average.

But the level of indebtedness dramatically increased in some states over the past decade. In three states, California, Florida, and Indiana, per-resident debt more than doubled between 1982 and 1992. Of course, particular state circumstances must be considered in comparisons. For example, California and Florida experienced explosive population growth during the past decade and therefore required greater infrastructure investment than, for example, Indiana, whose population stagnated during this time period.

#### *In the Public Interest?*

Any discussion of the advantages and disadvantages of state and local debt wouldn't be complete without consideration of the political

environment in which debt is issued. Unfortunately, with over \$1 trillion of debt to oversee, local officials have ample opportunity to act in ways contrary to the public interest. And in fact, the municipal bond industry has been shaken by scandal.

Securities and Exchange Commission Chairman Arthur Levitt has spurred a probe into the "pay-to-play" system which has developed in the muni bond industry whereby securities firms that donate to politicians are alleged to get the favor returned by receiving muni bond business. For example, last year congressional and SEC probes looked into whether a \$2.9 billion debt issue by the New Jersey Turnpike Authority was influenced by political contributions from securities issuing firms. More recently, the SEC opened a similar investigation into the bond financing of the new \$3.2 billion Denver airport.

Recently there have been steps taken to increase public disclosure and curb conflicts of interest both by the SEC and the securities industry itself. But there may be more changes and restrictions to come in the state and local debt industry if the anti-tax movement spills over into a newer anti-bond movement, which the Wall Street Journal reports is a rising "national trend."