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A Digest of Political Ideas
and Issues for Teachers

Teaching About Impacts of the Federal Debt on State and Local Government Finances

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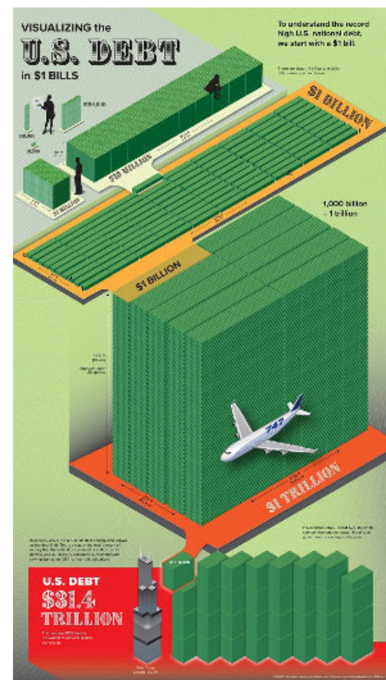
Good citizenship requires an understanding of the impacts of the federal debt across America's federal system. The $36.2 trillion federal debt, which is the total amount of money the federal government has borrowed over recent decades to pay its expenses, plays a critical role in how Americans govern themselves. The manner in which the debt is issued and managed also has important implications for state and local governments, such as their ability to undertake infrastructure projects. This digest explores the interconnectedness of federal debt and state and local governments and how teachers may approach these issues with students.

The digest has three parts. The first explains why the taxing and spending responsibilities and arrangements in state and local budget processes are both similar to, and different from, those of the federal government. This is important for understanding the federal debt/state-local relationship. The second part discusses three key aspects of federal debt/state-local interconnectedness. The digest concludes that because of this interconnectedness, state and local officials must play a role in how the Congress addresses both the level and the composition of federal budget policy.

Structure of Government Budgeting

There are two types of general-purpose government budgets: state and local and federal. They have three common features. First, there are two sides to a budget: income (receipts) and spending (expenditures). Second, there are two types of spending: one for paying current period expenses (operating expenditures) and the other for longer-term asset building and accumulation (capital investment expenditures). Third, the flow of benefits from capital spending, such as building a bridge, occurs over time and, thus, over different types of users and generations. Consequently, to satisfy goals of equity and efficiency, capital investment spending should be debt financed. This allows payments to be spread out over years to the changing sets of users who benefit from that flow, such as students who attend a school in 2024 and students who will attend the same school in 2044.

However, there is a fundamental difference between the structure of state and local budgets and that of the federal budget.



State and local governments have two budgets: an *operating budget* to address current public services (e.g., teacher salaries, day-to-day administrative spending on public safety, and road and bridge maintenance) and a *capital budget*, which is a financial plan that takes on debt in order to spend on long-term investments in infrastructure and other durable goods (e.g., building a school or a bridge). Although distinct, at the "end of the day"—the budget accounting period ("budget cycle")--spending outflow must "match" revenue inflow. But to say there must be a "match" is just the first part of the budget story.

- For the operating budget, current revenues must equal current spending over the current budget cycle. Thus, one often hears that state and local government budgets "must be balanced." To accomplish this operat-

Kansas State Capitol Building, Topeka, KS

Hawaii State Capitol Building, Honolulu, Hawaii

ing budget balance—think of it as a "pay-as-you-go" process--state and local governments adopt either an annual or a biennial budgeting process.

- The capital budget involves a different process whereby the borrowing government, such as a school district, and its lenders agree that the government borrowing will be paid off over the life of the infrastructure financed by the debt. The technical term is that the "debt is serviced" (a line item in the operating budget) whereby the government pays out interest plus part of the principal loan over the life of the infrastructure being financed. So, in both the operating and capital budgets, there is a spending and payment match, or "balance," but the timing of the match differs. In short, both budgets meet the matching test, but the operating budget is done annually or biannually while the capital budget is done over a long time. A capital budget always carries debt.

Now another nuance of fiscal federalism arises. Unlike for the state and local sector, this budget-balance rule does not apply to the federal government's budget debt.

Why? For three reasons.

First, the federal government does not have separate operating and capital budgets. The federal government has a *unified* budget that combines operating and capital expenses in a single "pay-as-you-go" process (the merits and demerits of which need another essay). This is a fundamental difference for policy practice; different fiscal management rules apply to the federal government and state and local governments.

Second, in the U.S. system of fiscal federalism, state and local governments are the primary providers of domestic public services that largely benefit citizens. However, because state and local governments cannot effectively control the flow of people, resources, and products across their borders, they have limited access to revenues to pay for all the domestic public services for which they are responsible.

The federal government, which can better control the flow of people, goods, and services across the country's borders, has access to wider revenue sources. This means that the federal government is, in effect, responsible for partnering with the less revenue-rich state and local government sector on its capital investment spending (the state/local sector owns and maintains more than 90% of the nation's infrastructure) and also for taking on the role of taxing, spending, and, as necessary, borrowing money to effect a macroeconomic stabilization policy that is intended to ensure full employment along with low inflation.

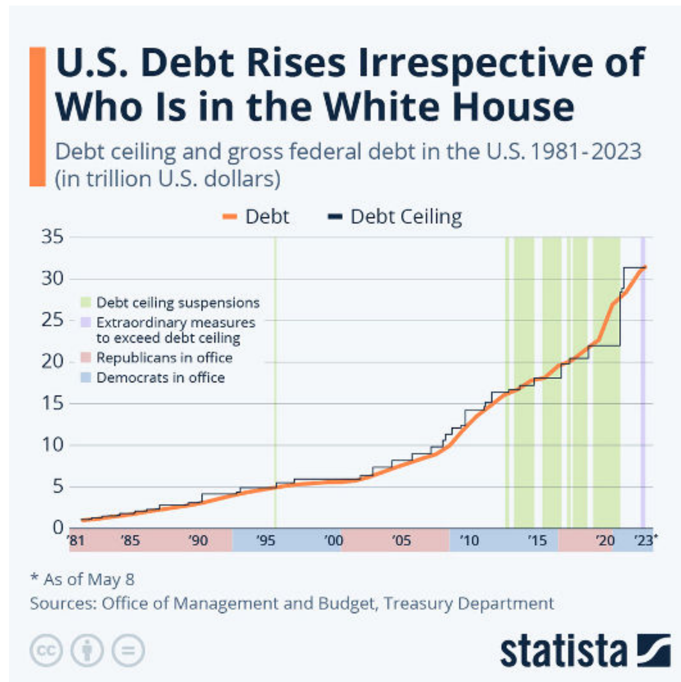
Third, and this is key, to give the federal government the ability and flexibility to carry out its roles, a national financial system has been established that allows the federal government to borrow funds as needed from not only the open credit markets but also directly from the independently managed Federal Reserve (FED) system–a system whereby the FED can electronically create or destroy money when it buys or sells back U.S. Treasury bonds. What makes this all work is the people's trust in financial arrangements that are tightly and transparently regulated.

A Closer Look at Federal Debt in U.S. Federalism

Given these arrangements, three key aspects illustrate the interconnectedness of federal debt and state and local governments.

Interest Rates and State/Local Borrowing Costs. A main way the federal debt affects state and local governments is through interest rates and borrowing costs. When the

federal government borrows heavily (or lightly), it drives up (or down) interest rates that a state or local government or school district must pay for issuing its own debt (i.e., bonds) in the credit market. As the federal debt interest rate changes, the cost of borrowing to finance state and local capital projects changes too. High interest rates delay state and local infrastructure projects; low rates facilitate them.



Pension Funds and Investments. State and local governments are significant institutional investors with substantial holdings of U.S. Treasury securities. Accordingly, as the debt-induced interest rates change, so does the value of U.S. Treasury-issued bonds held in a pension fund. A rising (or falling) federal debt can cause budget strain (or reduced stress) for the pension fund. In a worst-case scenario, a high level of federal debt can reduce bond values significantly and thus lead to pension underfunding whereby the pension system has insufficient money to cover future pension payments.

Federal Grants-in-Aid. Closely related to the interest rate effect on borrowing and the bond market is the flow of federal aid to state and local governments. Federal money now accounts for about a quarter of state and local government budgets, and federal aid is partly financed by the federal government taking on debt. The "catch" is that the amount of federal aid is becoming uncertain as grants-in-aid dollars compete with the growing amount of congressionally mandated "mandatory spending," which is now 67% of the total federal budget. Under current law, mandatory spending is largely driven by the rising costs of entitlement programs such as Social Security, Medicare, and the federal-and-state funded Medicaid program. Because entitlement spending is increasing faster than the rest of the federal budget (several programs are indexed to inflation), it might "crowd out" other types of federal assistance (e.g., infrastructure finance and Title 1 funds for education and teacher hiring), thereby forcing states and localities to raise additional revenues to keep pace with capital planning and/or delay or even abandon investment projects such as new schools, modes of public transportation, and health service.

Plus, there is the additional matter that the annual net interest due on the federal debt, which though not categorized as "mandatory," is nevertheless a contractual agreement that must be paid annually. Now, the "must-be-spent" part of the federal budget jumps from 67% to 77 % of total outlays.

The rest of the budget goes for "discretionary" spending, all of which is part of Congress's annual appropriations process. The largest part of discretionary spending is the Defense Appropriations Act. Though not "mandatory," much of defense can be seen as a "must-be spent" federal responsibility. Now, that 77% mandatory figure jumps to 90% of total federal expenditures.

Crowding out? It largely depends on whether the federal government will continue borrowing to try to maintain grants-in-aid and its own programs.

Concluding Comment

The federal debt is a persistent political issue and a frequent topic in social studies classrooms. However, many citizens do not fully appreciate the impact of the federal debt across their governments. The relationship between federal debt and state and local governments highlights the interconnectedness—and partnership—feature of the United States system of federalism. Citizens, school officials, and state and local leaders all benefit from a deeper understanding of, and greater voice in, how the federal government manages its finances.

About the Author

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