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Helping State and Local Governments Stay Liquid

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Update (5:45 p.m.): An earlier version of this post misstated the ending date of New York's fiscal year. It is March 31, not April 30.

This post is part of an ongoing series on the credit and liquidity facilities established by the Federal Reserve to support households and businesses during the COVID-19 outbreak.

On April 9, the Federal Reserve announced up to $2.3 trillion in new support for the economy in response to the coronavirus pandemic. Among the initiatives is the Municipal Liquidity Facility (MLF), intended to support state and local governments. The details of the facility are described in the term sheet. The state and local sector is a unique but very important part of the economy. This post lays out some of the economics of the sector and the needs that the facility intends to satisfy.

Most first year economics students know that gross output is comprised of consumption, investment, government purchases, and net exports. What fewer people recognize is that the state and local sector is the dominant form of government spending in the output accounts: in 2019 the state and local sector contributed 8.5 percent of GDP, while the federal sector contributed just 3.8 percent. Although the federal government is very large and active in the economy, much of its activity appears in the economic accounts in the form of transfer income. State and local governments, on the other hand, are in the service delivery business. They employ over 20 million workers, from governors to firefighters. The services delivered by these governments are central to the quality of life in every part of the country and their substantial role in public health is especially relevant (and costly) right now.

In addition to being large, the state and local sector is unusual in its financing. State and local governments are generally required to balance their operating budgets, and can usually only borrow long term in order to finance infrastructure investments. While most people know that there is a market for municipal bonds—indeed that market is sizable, at more than $3.5 trillion in outstanding debt—many do not realize that those bonds are almost exclusively sold to finance capital projects like bridges and schools. State and local governments typically can, however, also use short-term notes to smooth cash flows during a fiscal year.

The Short-Term Market

Here's how this short-term market works: States and localities depend on revenues (tax receipts, federal grants, the proceeds of bond issues and other revenues) that are received at specific intervals. They frequently want to smooth spending in anticipation of such receipts, and can do so by issuing TANs, RANs and BANs – tax anticipation notes, revenue anticipation notes, and bond anticipation notes. These notes are typically secured by the revenues expected to be received later in the fiscal year, and are paid off when said revenues arrive.

A classic example would be the proceeds from final settlements of state income tax returns due April 15. For a state like New York, these are substantial (New Yorkers in aggregate earn a substantial amount of taxable unearned income and capital gains) and many of these proceeds are received right before the end of the state's fiscal year—March 31. So, New York could issue a TAN in January, with a maturity of April 30, to enable it to start spending part of the expected settlement amount in the interim.

This example, with its reference to the IRS's April 15 filing deadline, makes it easy to see a fundamental issue this year: the federal tax filing deadline (and with it, the deadlines of states) has moved from April 15 to July 15. That means that the states (and a small number of cities) that rely on income taxes will likely have an unexpected delay in their tax receipts. In addition, they generally won't get estimated income tax payments for the quarter either. This blows a large hole in the states' budgets right now, but it's almost certain to be largely made up in July. (The receipts that are due with final settlements are based on activity that took place in 2019.) So we might expect a spike in the demand for short-term financing—TANs—to fund the cash flow needs of these states and localities (most localities don't tax incomes but instead rely on property taxes, so for most this change doesn't have a direct impact).

Addressing Liquidity Needs

Just as all of this was becoming clear, however, interest rates on municipal borrowing moved up sharply in March, as investors worried that these governments would face difficulties raising the cash required to finance the delay in settlements—especially in light of the reduction in economic activity taking place in response to the coronavirus pandemic. For these reasons, the Fed established a facility to support the liquidity needs of state and local governments. The U.S. Treasury, under the CARES Act, will make a $35 billion initial equity investment in the special purpose vehicle that will operate the facility, thus sharing the risk with the Fed.

The MLF will provide as much as $500 billion in total lending to states, the District of Columbia, cities with populations of more than one million and counties with populations over two million. The limits of individual governments are determined by their size as measured by their pre-crisis revenues. States may request that the limits be expanded to allow borrowing on behalf of their instrumentalities that are not eligible for the facility.

The overall size of the facility—$500 billion—is well above the sector's previous public note issuance, which was considerably less than $100 billion in 2019. In order to provide borrowers the ability—while remaining within the bounds of the issuer's legal constraints—to repay over a longer-than-normal time horizon, the loans will have terms of up to twenty-four months. The substantial size and relatively long note maturities are intended to provide these governments with the flexibility they need to weather the current crisis.

As noted, the MLF is geared toward supporting the short-term cash flow needs of these governments. For all the reasons we discussed here, those are likely to be substantial in the next few months and, as a consequence, one-year note yields declined after the announcement. Nonetheless, in the words of the press release announcing the facility, " …the Federal Reserve will continue to closely monitor conditions in the primary and secondary markets for municipal securities and will evaluate whether additional measures are needed to support the flow of credit and liquidity to state and local governments."

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