

Subject: Economic consequences of default on state and local governments

The U.S. reached the debt limit at the end of July. Since then, the U.S. Treasury has been taking extraordinary measures to prevent the U.S. from defaulting on its obligations. In her 3rd letter to Congress, sent on September 8th, Secretary Yellen made clear that while it remains difficult to forecast how long extraordinary measures will last, it is Treasury's prediction that the most likely outcome is that these measures and cash will run out during the month of October. If Congress does not act before cash runs out, the U.S. will default for the first time in its history.

Raising or suspending the debt limit does not authorize new spending commitments. It simply enables the government to pay for obligations that Congresses and presidents of both parties have already approved. We expect Congress to act promptly to raise or suspend the debt limit and protect the full faith and credit of the United States -- just as it did in a bipartisan fashion three times during the prior Administration and about 80 times since 1960.

The U.S. economy has just begun to recover from the pandemic and a manufactured debt ceiling crisis would threaten the gains we've made and the future recovery. If the U.S. defaults on its obligations, the ripple effects will hurt cities and states across the country:

If the U.S. defaults and can no longer pay its obligations, **billions of dollars in state aid and state-run but federal funded programs could be halted.**

- *Disaster relief efforts* – the federal government responds to disasters both by providing direct assistance and by providing grants to states and locales. The Federal Emergency Management Agency (FEMA), the Small Business Administration, the Department of Housing and Urban Development, and the Department of Transportation all spend tens of billions of dollars, and much more during years with especially damaging catastrophes, helping states deal with disasters such as hurricanes, earthquakes, and wildfires.
- *Medicaid and the Children's Health Insurance Program (CHIP)* – the federal government covers 2/3rds of the cost of Medicaid and the entire cost of CHIP, which provide health insurance for 1 out of every 5 Americans and give more than half of a trillion dollars to states each year.
- *Infrastructure funding* – through grants for transit, highways, and airports, the federal government provides roughly \$100 billion to states and locales.
- *Education* – across Title I education funding, special education funding such as Individuals with Disabilities Education Act (IDEA), Head Start, and School Improvement Programs, the federal government provides more than \$50 billion annually to states and local governments for schools.
- *Public Health* – with the Community Health Centers and the rest of the Health Resources and Services Administration, as well as with the Centers and Diseases Control and Prevention and the Substance Abuse and Mental Health Services Administration, the federal governments provides more than \$10 billion to states for public health.
- *Child Nutrition* – the federal government provides the funding to states and local governments to carry out the National School Lunch and National School Breakfast programs, which serve 30 million children. In addition, the federal government provides funding for the Women's Infants and Children Program (WIC), which gives to pregnant mothers, infants, and children for nutrition. Together, these, and the federal government's

portion of the administration costs of the Supplemental Nutrition Assistance Program (SNAP), give more than \$30 billion to states and local governments for nutrition for children and pregnant mothers.

Hitting the debt ceiling could cause a recession. Economic growth would falter, unemployment would rise, and the labor market could lose millions of jobs. City and state revenues often decline during a recession, as revenues fall due to declining incomes and spending. But, the federal government's ability to deficit spend, as was the case during the pandemic with the American Rescue Plan, can mitigate the negative consequences of a recession on state and municipal budgets. However, if the U.S. defaults on its debt – cities and states could experience a double-whammy: falling revenues and no federal aid as long as Congress refuses to raise or suspend the debt limit. This means critical state services will be at risk for budget cuts, from education to healthcare to pensions.

A federal debt limit crisis could make it harder for states and localities to borrow and raise borrowing costs: If city revenues also decline due to a default-induced recession, investors may also begin to doubt cities' ability to service their debts and pull out of the municipal bond market. Cities will then have trouble borrowing to cover their own critical operations. This could affect both long-term borrowing—which often funds capital & infrastructure projects—and, perhaps even more alarmingly, short-term bridge funding like revenue anticipation notes that many localities use to smooth through normal seasonal ups and downs in tax receipts.

Capital market volatility could affect state assets: When the U.S. was in a prior debt limit standoff, the S&P 500 fell by 17 percent in the months near the debt limit. Under a scenario where the debt limit is actually breached, the market could fall even further and the value of state pension fund assets would fall as a result, hampering states ability to pay their pension obligations.