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State and Local Government Series (SLGS) Treasury Debt: A Description

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October 29, 2015

Congressional Research Service
7-....
www.crs.gov
R41811

Introduction

As part of the Continuing Appropriations Act, 2014 (P.L. 113-46), the United States' statutory debt limit was temporarily suspended through February 7, 2014. On February 8, 2014, the debt limit was reinstated at a level that accommodated the borrowing incurred during the suspension period. As a result, on February 7, 2014, Treasury Secretary Jacob Lew sent a letter to Congress indicating that the Treasury would engage in "extraordinary measures" to allow for financing of government activities to continue until February 27, 2014.[1] As part of these measures, the U.S. Department of the Treasury's Bureau of the Fiscal Service announced on February 4, 2014, that it would suspend the sales of State and Local Government Series (SLGS) as of February 7, 2014.[2] On February 15, 2014, the debt limit was suspended again through March 15, 2015, as part of the Temporary Debt Limit Suspension Act (P.L. 113-83). Sales of SLGS resumed on February 18, 2014.[3]

As of September 30, 2015, SLGS represented 0.4% ($78.1 billion) of total debt outstanding. (Approximately 0.2% of outstanding debt is not subject to the debt limit.)[4] Suspending SLGSs does not change the debt limit but rather just delays the date when it is reached. Some have expressed concern that a suspension may have a negative impact on state and local government finances. In the near term, a suspension is not expected to cause significant disruptions for state and local government issuers. This report explains SLGS—a nonmarketable, custom-tailored security—and how suspension may impact state and local government issuers.

SLGS Purpose

SLGSs are an administrative tool state and local governments use to comply with Internal Revenue Service rules on how the proceeds of tax-exempt bonds can be invested. Generally, state and local government issuers cannot invest tax-exempt bond proceeds "to acquire higher yielding instruments."[5] SLGSs are nonmarketable securities offered by the U.S. Treasury to state and local government bond issuers that, by design, comply with IRS rules.

SLGSs help state and local governments manage debt and capital spending. The timing of spending on capital projects and the required coordination with state and local budget appropriation cycles typically results in a mismatch between when bonds are issued and when spending needs arise. SLGSs provide a "safe harbor" investment option for state and local governments to "park" the proceeds until needed to pay vendors.

Issuers also use SLGSs to reduce interest cost. Issuers often sell a second tranche of tax-exempt bonds to replace outstanding bonds to take advantage of falling interest rates or to establish a

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[1] Letter from Jacob J. Lew, Secretary of the Treasury, to John A. Boehner, Speaker, February 7, 2014, http://www.treasury.gov/initiatives/Documents/Debt%20Limit%20Letter%20020714.pdf.

[2] Treasury Direct, "Treasury Suspends Sales of State and Local Government Series Securities," press release, February 4, 2014, http://treasurydirect.gov/news/pressroom/pressroom_1401slgsoff.htm.

[3] Treasury Direct, "State and Local Government Securities Sales Resume," press release, February 18, 2014, http://www.treasurydirect.gov/news/pressroom/pressroom_slgsresumerelease0214.htm.

[4] U.S. Treasury, Debt Position and Activity Report, various fiscal years, available at http://www.treasurydirect.gov/govt/reports/pd/pd_debtposactrpt.htm.

[5] Generally, when proceeds of tax-exempt bonds are invested in higher-yielding instruments, they are considered "arbitrage bonds." These arbitrage bonds are not permitted under IRS rules and are taxable, see 26 U.S.C. 148(a)(1).

reserve fund (or escrow account) to help repay or service outstanding bonds.[6] The IRS identifies two general types of refunding: "current" and "advanced." If the old bonds are redeemed within six months, the proceeds from the new bonds are in compliance with IRS regulations. This is considered a "current refunding."

In contrast, if the proceeds of the new issue are outstanding for more than six months, the new bonds would likely violate IRS rules and lose their tax-exempt status. This is considered "advanced refunding," and the proceeds from the bonds are most often used to purchase SLGSs.

Advance refunding is necessary as many outstanding bonds cannot be bought from the holder or "called" back before a given number of years, typically 10 years. Thus, the SLGS maturity must roughly match the time to the term of the old bond to be refunded. For example, if a refunding bond were issued today for a bond that can be called one year from today, a SLGS with a term of one year would be purchased. Today, the interest rate paid by the U.S. Treasury on the security would be 0.11%.[7]

SLGS Volume

SLGS volume has declined as state and local governments have not been refunding existing debt and the need for SLGSs has waned. As noted earlier, as of September 30, 2014, $105.7 billion of SLGSs were outstanding—down from $193.2 billion four years earlier. **Table 1** reports SLGSs outstanding in September for the last five fiscal years. The slow decline will likely continue as market participants seem to have a limited appetite for the SLGS instruments.[8] The declining volume likely reflects strained state and local budgets generally and the relatively low interest rate paid by the U.S. Treasury. The lower rate reduces the opportunity cost of unspent bond proceeds. In FY2014, SLGS redemptions ($95.0 billion) have exceeded SLGS issues ($79.1 billion) by $15.9 billion.[9]

[6] Generally, the size of the reserve fund cannot exceed 10% of the original bond issuance.

[7] U.S. Treasury, "SLGS Daily Rate Table," available at https://www.treasurydirect.gov/GA-SL/SLGS/selectSLGSDate.htm, visited November 7, 2014.

[8] Temple-West, Patrick, "Treasury Schedules SLGS Closure for Friday," *The Bond Buyer*, May 2, 2011.

[9] Treasury Direct, "SLGS and Savings Bond Data," available at http://www.treasurydirect.gov/instit/annceresult/annceresult_slgssb.htm, visited November 11.

Table 1. Total SLGS Outstanding and Percentage of Total Debt Outstanding

(On September 30 of year listed)

Year	September SLGS Outstanding (in millions)	Change from Previous September	Percent of Total U.S. Treasury Debt Outstanding[a]
2010	$193,208		1.4%
2011	$151,831	-21.4%	1.0%
2012	$158,514	4.4%	1.0%
2013	$124,079	-21.7%	0.7%
2014	$105,668	-14.8%	0.6%
2015	$78,115	-26.1%	0.4%

Source: U.S. Treasury, Debt Position and Activity Report, various fiscal years, available at http://www.treasurydirect.gov/govt/reports/pd/pd_debtposactrpt.htm.

a. Roughly 0.2% of total debt outstanding is not subject to the debt limit.

SLGS Suspension

A suspension of the SLGS program will likely create some disruptions for tax-exempt bond issuers that had anticipated using SLGSs for debt management in the near term. As stated by the U.S. Treasury, the suspension "might increase cost and cause inconvenience" for state and local governments.[10] Without SLGSs, issuers will find other assets to invest in and will be required to monitor the investments to ensure they do not violate IRS rules. The IRS rules apply to the yield on the asset investment, not necessarily the type of asset. A likely alternative would be other U.S. Treasury securities purchased on the secondary market. As noted above, the impact of the suspension is mitigated by the apparent decline in demand for the instruments. An extended suspension, however, may generate significantly more disruptions as compliance costs would increase for potentially more issuers.

A long-term suspension coupled with rising interest rates, however, could lead to a more significant strain on state and local debt management.

According to the U.S. Treasury, the SLGS program has been suspended 10 times in the previous 20 years. The periods of suspension lasted an average of 69 days and are detailed in **Table 2**. The most recent suspension was for seven days. In past suspensions, little market response was noted, though some used the opportunity to suggest changes to the SLGS program to improve its operation.[11]

[10] U.S. Treasury, "State and Local Government Series: Frequently Asked Questions," released February 4, 2014, available at http://www.treasury.gov/initiatives/Documents/SLGS%20FAQ%20020414.pdf.

[11] *The Bond Buyer*, "Market Participants Ask Treasury to Make Changes in Slugs," January 19, 1996.

Table 2. Suspension of the SLGS Program over the Last 20 Years

Begin	End	Days
October 18, 1995	March 29, 1996	163
May 15, 2002	July 7, 2002	53
February 19, 2003	May 26, 2003	96
October 14, 2004	November 21, 2004	38
February 16, 2006	March 16, 2006	28
September 27, 2007	September 28, 2007	1
May 6, 2011	August 1, 2011	87
December 28, 2012	February 4, 2013	62
May 17, 2013	October 16, 2013	152
February 7, 2014	February 14, 2014	7
	Average	69

Source: U.S. Treasury, "State and Local Government Series: Frequently Asked Questions," released February 4, 2014, available at http://www.treasury.gov/initiatives/Documents/SLGS%20FAQ%20020414.pdf.

Notes: CRS Calculations based on U.S. Treasury data.

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