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The Federal Reserve Public Education Emergency Finance Facility (PEEFF): A Proposal

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I. Introduction

Public education — K-12 and public higher education — has been hit hard financially by the COVID-19 crisis. This punch has partly come from general financial problems afflicting state and local governments, including the fall off in tax revenues and increased health and public safety expenses associated with dealing with the pandemic. And a significant part has also resulted from specific increases in costs and declines in revenues directly impacting the public education sector itself. State and local governments are in deep financial trouble. With most states having balanced budget provisions, and in the face of declining revenue and increased expenses, state and local governments, including public education, need massive financial help from the federal government in order to provide basic services to its residents. Estimates of the shortfall facing state and local governments vary, but range from $500 billion to $1 trillion dollars.

In principle, there are multiple mechanisms that could raise and channel these needed funds to state and local governments generally and public education in particular. The US Congress, with the signature of the president, has committed almost $3 trillion to provide grants and to underwrite loans to businesses and individuals. Moving forward, the federal government has the financial and technical capacity to allocate hundreds of billions of dollars more to the state and local governments to fund these needs. While some policy makers have raised concerns about looming federal budget deficits, the vast majority of economists — even those who traditionally have been "deficit hawks" — agree that with the US economy in free fall in the midst of an unprecedented global health emergency, and with interest rates on public debt at rock bottom lows, there need be no concerns about more federal government borrowing for the foreseeable future (Epstein, 2020).

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In particular, grants from the federal government would be, far and away, the best solution to the fiscal problems states and locales face. Republican lawmakers, led by Senate Majority Leader Mitch McConnell, are dragging their feet in providing critically needed federal government aid, but the Democrats are pushing hard, and one hopes that major federal grants will be provided. Even in the best likely scenario, however, it is unlikely that sufficient funds will be forthcoming.

Fortunately, there are additional available financial channels, namely through the Federal Reserve System. The central bank of the US, the Federal Reserve (Fed), has already committed to provide an "unlimited" amount of liquidity to the US financial system to prevent a financial meltdown and to provide credit (liquidity) to some sectors of the US economy, primarily, but not exclusively, financial markets and businesses. Most of these funds are being created through a declaration of the equivalent of a financial emergency, with the Fed using special authority given to it by section 13(3) of the Federal Reserve Act. Through multiple 13(3)-sanctioned financial facilities (many of them revived from the Fed's tool kit created during the Great Financial Crisis of 2007-2009), so far the Fed has made available to the financial markets up to $6 trillion, while many knowledgeable observers believe this sum could get much higher (Timaros and Hilsenrath, *Wall Street Journal*, 2020). In fact, as the crisis has worsened, the Fed has been expanding almost weekly the kinds of financial institutions and markets it has been willing to support. These have included money market funds, commercial paper markets, and corporate bond markets. The Fed has even recently expanded its liquidity support measures to "junk bonds" and private equity firms (Rennison, Wigglesworth and Smith, *Financial Times*, 2020).

In principle, if the Federal Reserve can support "junk bond" issuers and private equity firms, it can certainly support state and local governments and public education. There is no economic barrier preventing the Fed from supporting these activities, and under Section 13(3), few, if any, legal barriers. If anything, there are only political barriers. (See Sections II and III below.)

In fact, among the new facilities that the Fed has created is a *Municipal Liquidity Facility (MLF)* which currently has the capacity to buy up to $500 billion of state and municipal debt. This facility was created in order to calm the massive municipal debt markets which had been experiencing low liquidity, large spikes in interest rates, and financial instability at the onset of the crisis. In principle, this facility could serve as a mechanism to channel needed funds to public education. With $500 billion in lending capacity, this would be an easy way for the Federal Reserve to begin to support the needs of public education. In Section III, I describe the MLF and describe how it could be used to support public education. For example, the MLF could be immediately used to help state governments refinance outstanding debt at much lower costs, given that one of the goals of recent Federal Reserve policy has been to drive interest rates lower. This could free up millions of dollars of state funds for covering other COVID-19 costs.

Still, there could be several obstacles in the way of public education accessing sufficient, useable funds through this mechanism. One is that education will be competing with many other institutions and interests to access funds from this facility, including those financing infrastructure projects, economic development projects, and many others. Public education would simply be one of many interests vying for these funds and might lose out in this competition. A second potential problem is that the dominant way in which borrowers can access these funds is by identifying a clear revenue stream to finance interest payments and repayment of the loans from the Fed. But in the context of this public emergency, school districts and higher public education may find it difficult to identify a viable revenue source and to do so in a relatively short-term time frame. (The MLF loans have a three-year maximum duration.) Finally, as mentioned earlier, most states have balanced budget requirements for current expenditures,

and regular operating expenses for education are considered current expenditures. Thus, borrowing to finance current expenditures for public education is likely to crowd out expenditures for other publicly useful activities or require governments to raise tax revenues, which is not likely to happen during the crisis.

As a result of these possible obstacles, a complementary or alternative approach may be needed. One approach would be to create a new facility at the Fed that would be specifically tailored to the needs of public education during this emergency. For want of a better name, I call this the **Federal Reserve Public Education Emergency Finance Facility (PEEFF)**. This facility would provide both short and longer-term support to public education in order to help these institutions survive the pandemic and continue to provide needed education for our children and young adults. Section IV describes how the PEEFF could work.

One potential drawback of all these Federal Reserve facilities is that they provide credit, but not grants. This is a potential problem because, as mentioned earlier, most states have balanced budget requirements. As a result, without adjustments, states could not participate in these borrowing programs without squeezing out other needed current expenditures. To address this problem, I explore several alternatives.

The first exploits the fact that most states' balanced budget requirements only apply to the budgets for current spending. These states have separate capital budgets for longer-term investments, such as in new schools, new buildings on college campuses, new roads, etc., that are designed for borrowing. So, one way around the balanced budget problem is to identify this emergency education spending as a type of capital spending and put it under the capital budget. This would entail denoting these borrowing instruments as investments in **human capital** using parlance long established in the economics profession. The bonds could be called, for example, **human capital bonds** and they could be issued under states' capital budgets. These bonds could be issued for longer than the current limit in the MLF of three years. (I will address below other constraints that might limit capital issues from the state level).

A second innovation, that has even broader implications, is to allow the Fed to buy human capital bonds issued by a regional authority that would issue bonds for education funding. In fact, in the latest version of the MLF, provisions have been made to allow the Fed to buy bonds issued by multi-state issuers (for example the Port Authority in New York and New Jersey). For example, a *Federal Reserve District Education Finance Facility* could be created that would issue the human capital bonds, and the states could subscribe to the portion of these that they wanted to buy. If the Federal Reserve District issued these subscriptions as long term, zero-interest paper, then states and locales could avoid many of the limitations they would face with state issued bonds. In addition, as with the Paycheck Protection Program, the Fed could offer principle repayment forgiveness, if the school districts spend the funds as intended: to educate children and young adults and pay appropriate wages to teachers and other school personnel. I will explore some of these ideas in Section IV.

One thing should be clear, however. These financing facilities, no matter how cleverly constructed, cannot create a political panacea in the current environment. Under changes made in the Dodd-Frank financial reform act implemented after the Great Financial Crisis of 2007-2008 (GFC), the 13(3) authority has to be agreed to by the secretary of the Treasury. More importantly, the Federal Reserve is a creature of Congress. If Congress chooses to block the Federal Reserve from undertaking these policies, it can do so. And in fact, it could be risky for the Fed to undertake a policy that is seen as an "end run" around Congress. On the other hand, it is often the case that Congress prefers to let the Fed do things that Congress thinks should be done but can't or won't take responsibility for doing itself. Which of these categories this initiative would fall under is currently unclear.

II. Section 13(3) and Federal Reserve Actions

Since most of these new Federal Reserve Actions are taken under the authority of Section 13(3) of the Federal Reserve Act, it is worth briefly recounting the history and meaning of 13(3).

Section 13(3) was signed into law by President Herbert Hoover on July 21, 1932 in the throes of the Great Depression. Section 13(3) allowed the Federal Reserve Board "in unusual and exigent circumstances" to advance credit more widely than it could under normal circumstances. A study of the history of the "section" by an economist at the New York Federal Reserve concludes that "the framers of the section intended to authorize credit extensions to individuals and nonfinancial businesses unable to get private-sector loans. In other words, Section 13(3) sanctioned direct Federal Reserve lending *to the real economy* (emphasis added) rather than simply to a weakened financial sector, in emergency circumstances." (Sastry, 2018, p. 2; see also D'Arista; 1984; Eccles, 1951) This intention to allow the Federal Reserve to aid "the real economy" is certainly of relevance to the problems facing public education today.

The Act was initially little used, even during the Great Depression. But it was amended and loosened up significantly in the decades that followed. During the GFC, Section 13(3) was extensively used, many say "abused," to finance (i.e., "bail-out") numerous mega-financial institutions, including AIG, Goldman Sachs, JP Morgan, and others. As a result of this perceived over-reach by the Fed, the Dodd-Frank financial reform law passed in 2010 modified Section 13(3) in at least two key ways: First, narrowing that authority, the Dodd-Frank Act stated that such lending must now be made in connection with a "program or facility with broad-based eligibility," and cannot "aid a failing financial company" or "borrowers that are insolvent," and cannot have "a purpose of assisting a single and specific company avoid bankruptcy" or similar resolution. In addition, the Federal Reserve cannot establish a Section 13(3) program without the prior approval of the secretary of the Treasury (Long, 2019). This latter requirement may be particularly relevant to the political calculations of Federal Reserve facilities established under Section 13(3) to aid public education.

III. The Federal Reserve Municipal Liquidity Facility (MLF)

On April 9, the Federal Reserve announced the creation of the Municipal Liquidity Facility (MLF) to channel up to $500 billion to state and local securities markets. In response to comments and criticisms, the Fed announced a broadened program on April 27th, which included more cities and counties, multi-state borrowers, such as the Port Authority, and extended the maximum term from two years to three years. The total potential credit available remained at $500 billion (Board of Governors, 2020a).

The rationale for creating the MLF, according to the Fed, is as follows:

> "The municipal securities market is an important part of the financial system, which helps provide states, cities, and counties (and their political subdivisions and other governmental entities) with the funding needed to provide essential public services to their citizens. … (Since the onset of the COVID-19 crisis) there are many issuers that have not been able to meet their financing needs through the capital markets. At the same time, states, cities, and counties are facing severe liquidity constraints resulting from the increase in state and local government expenditures related to the COVID-19 pandemic and the delay and decrease of certain tax and other revenues. By ensuring the smooth functioning of the municipal securities market, particularly in times of strain, the Federal Reserve is providing credit that will support families, businesses, and jobs in communities, large and small, across the nation." (Board of Governors, 2020d)

The MLF was established under section 13(3) with an equity investment of $35 billion from the US

Treasury, upon which the Fed is allowed to buy up to $500 billion of securities issued by state and local governments, with a maturity of up to three years. (The fund was set up as a special purpose vehicle (SPV) that would hold the securities.)

In principle, the MLF could buy bonds issued by state governments that would then allocate funds to school districts or public higher education.

> "States, Cities, and Counties may use the proceeds of Eligible Notes sold to the SPV under the MLF to purchase the notes of, or otherwise assist, any of their political subdivisions or other governmental entities as described above. For purposes of the "Eligible Use of Proceeds" section, a "political subdivision or other governmental entity" is broadly defined as any county, city, municipality, township, village, school district, special district, utility, authority, agency or other unit of government, as determined by the Eligible Issuer." (Board of Governors, 2020d)

More generally, the needs of public education clearly fall within the purview of the MLF. According to the Board of Governors of the Fed:

> "An *Eligible Issuer* may use the proceeds of the Eligible Notes purchased by the SPV for the following purposes: (1) to help manage the cash flow effects of income tax deferrals resulting from an extension of an income tax filing deadline; deferrals or reductions of tax and other revenues or increases in expenses related to or resulting from the COVID-19 pandemic; and requirements for the payment of principal and interest on obligations of the Eligible Issuer or its political subdivisions or other governmental entities; (2) to purchase similar notes issued by, or otherwise to assist, its political subdivisions and other governmental entities for the purposes enumerated in clause (1)." (Board of Governors, 2020d)

While potentially useful to support public education, the MLF has a number of restrictions that might limit its usefulness to some extent.

The first issue concerns who is eligible to borrow from the facility. This is restricted to states or cities of towns of a minimum size and multi-state entities.

In addition, "Each eligible State, City, and County may only access the Facility through one issuer; provided that the Federal Reserve may approve one or more additional issuers per State, City, or County to facilitate the provision of assistance to political subdivisions and other governmental entities of the relevant State, City, or County." (ibid)

So, it is clear that education in most instances, will have to share access with many other institutions that also will need funding. The second restriction is that states and municipalities can only issue three kinds of securities to this facility: the first two of these, Tax Anticipation Notes (TANs) and Tax and Revenue Anticipation Notes (TRANs) are intended to address timing mismatch between the receipt of taxes or other revenues and ongoing expenditures. These are generally backed by and rated based on the anticipated receipt of tax and other revenues over the course of a fiscal year or longer, in amounts sufficient to pay off the notes by maturity (Board of Governors, 2020d). These seem ill-suited to the current crisis facing public education where the shortfalls are so significant and the future so uncertain in depth and duration. The third type is Bond Anticipation Notes (BANs). These appear to be better suited for the problems faced by public education: "BANs are issued in anticipation of future bond issuance and are typically not secured by a pledged revenue stream, but are rated based on the long-term credit rating of the issuer and its assumed future market access for refinancing (either as new BANs or long-term bonds)." (ibid) These appear to give more flexibility in the current environment.

Finally, most states have balanced budget provisions that severely limit the borrowing they can engage in. In particular, "Regardless of the use of proceeds, the Facility (and any other holder of the Eligible Notes) faces only the credit of the Eligible

Issuer. The Eligible Issuer would bear the credit risk associated with any notes it purchased from its political subdivision or other governmental entity." (ibid) In other words, the state would ultimately be responsible for servicing the debt and so the debt would fall under the state's debt budget. Relatedly, as states borrow more, they risk a downgrading of their ratings by the ratings agencies, which increases costs of borrowing.

To overcome these constraints, a new Federal Reserve facility could be created that would be devoted specifically to funding for public education and could operate in the following way.

IV. Public Education Emergency Finance Facility (PEEFF)

The Federal Reserve could establish, under section 13(3), with the approval of the secretary of the Treasury, a facility that would be designed specifically to provide emergency funding for public education. The terms of this fund could be tailored specifically to the needs of public education. These terms could include lower interest rates and fees, and longer terms (beyond the three years), and they could accept paper that is not tied to immediate revenue generation but to revenue that could be generated over a longer term period (or forgiven entirely). The PEEFF could be created in a form similar to the MLF, with the creation of a special purpose vehicle (SPV) with capital put up by the Treasury department (which has been allocated under the CARES act), or it could be a stand-alone facility such as some of the other emergency facilities created by the Fed in the recent pandemic. There is no law requiring it be created through a SPV structure with Treasury backing. (It should be noted, however, that as of this writing, not all of the initial $450 billion allocated by the CAREs act to back up facilities at the Fed have been allocated as of yet.)

As long as the state is borrowing through its current spending authority, these loans might be subject to the balanced budget constraint. However, the loans could be added to the capital budgets of states, potentially giving the states more flexibility.

State and Local Human Capital Bonds

PEEFF could accept state and local human capital bonds, in keeping with the traditional economics understanding of education as building human capital. These bonds reflect the long term pay-off to both the individual student and to society as a whole of investments in public education. These human capital bonds would not only potentially qualify as part of the capital budgets of these states, but would not need to be tied to clear short-term revenue sources in order to be eligible paper for the PEEFF. The Federal Reserve's financial support for these bonds would enhance their safety and help preserve their bond ratings.

Regional Human Capital Bonds

A further innovation that could allow an enhanced emergency borrowing mechanism enabling states to fund public goods such as public education would be to create a regional consortium to issue these human capital bonds. Regional groupings are emerging as important innovations in the way our society is handling the fall-out from the Coronavirus. Regional differences in economics, politics, and even culture are leading to these regional consortia and allowing for a more flexible type of federalism to overcome acute adversity. An example could be a PEEFF organized at the Federal Reserve District level. For example, the Federal Reserve Bank of Boston or the Federal Reserve Bank of San Francisco could host a PEEFF that could issue regional human capital bonds and allocate the proceeds to states within the regions which, in turn, would take responsibility for allocating these funds for public education and for ultimately servicing their share of the bond issue (see Pollin, 1983, for an early presentation of a related plan). The District Fed could provide some risk sharing funds to reduce the risks to participating states, something that is necessary in light of the great uncertainty characterizing this pandemic.

The advantage of the regional approach is that it could help states overcome state-level debt issuing restrictions and ratings problems, while being able to take advantage of regional risk-sharing facilities through the District Federal Reserve.

Finally, as with the CARES Act that gives funding to "small" businesses, the Federal Reserve could forgive the debts of school districts that used the funds appropriately and cannot pay them back because of the severity of the crisis. Such debt forgiveness could be justified in numerous ways including the public value of education for our children and young adults, and the exogenous nature of the crisis. In addition, it could be justified as a matter of fairness. Most of the Federal Reserve's emergency activities have guaranteed the debt or bought the assets of extremely big and wealthy financial asset holders and institutions. This was the case with the Fed's Quantitative Easing following the GFC, where wealthy financial asset holders were the major beneficiaries of the Fed's actions (Epstein, 2019).

It seems only fair that students and teachers — and the public at large — should also benefit from the Federal Reserve's largess.

V. Conclusion

In addition to the huge direct human toll, the COVID-19 crisis is derailing many crucial social and public functions, including the education of the next generation. While federal government revenue sharing to the states would be a first best option of confronting this problem, the Federal Reserve can also contribute by creating additional needed resources and allocate them to state and local governments, as they have created many billions of dollars for corporations and financial institutions. In this memo, I have indicated how the current Municipal Liquidity Facility might be utilized for this purpose, and how a new, specially targeted educational facility, the Public Education Emergency Financing Facility, could even better serve the purpose of keeping public education afloat during these trying times.

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