Money in the Time of Coronavirus

G. Epstein, Human Capital Bonds and Federal Reserve Support for Public Education: The Public Education Emergency Finance Facility (PEEFF)

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Introduction

Public education – K-12 and public higher education – have been hit hard financially by the Covid-19 Crisis. General financial problems afflicting state and local governments – the fall off in tax revenues and increased health and public safety expenses associated with dealing with the pandemic – contribute to the shortfall. Specific increases in costs and declines in revenues afflicting the public education sector itself add to the impact. Given that most states have balanced budget provisions, states and local governments need massive financial help from the Federal Government in order to provide basic services to its residents, including public education. Estimates of the shortfall facing state and local governments suggest an amount approaching $1 trillion dollars through 2021.

In principle, there are multiple mechanisms that could raise and channel these needed funds to state and local governments including public education. In particular, grants from the Federal government would be, far and away, the best solution to the fiscal problems of states and locales. However, even in the best likely scenario, it is unlikely that sufficient funds will be forthcoming through this route.

Fortunately, there are additional available financial channels, namely via the Federal Reserve System (Fed). The Fed has already committed itself to providing an “unlimited” amount of liquidity to the US financial system to prevent a meltdown and to provide credit to some sectors of the economy. Characteristically, this support has been primarily, if not exclusively, for financial markets and businesses. The Fed has created most of these funds through declaring the equivalent of a financial emergency under the authority given to it by section 13(3) of the Federal Reserve Act.

The Federal Reserve has so far made available up to $6 trillion to the financial markets through multiple 13(3)-sanctioned financial facilities, including a number revived from the group it used in the Great Financial Crisis of 2007-2009. Many knowledgeable observers believe this sum could get much higher. In fact, as the crisis has worsened, the Federal Reserve 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. If the Federal Reserve can support “junk bond” issuers and private equity firms, it can certainly support state and local governments and public education.

Indeed, 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. For example, the MLF could be used immediately to help state governments refinance outstanding debt at much lower levels, 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.

Several obstacles stand 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 for funds from the MLF facility, including those financing infrastructure projects and economic-development projects. 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 do so in a relatively short 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 during the crisis.

To address these problems, I explore several remedies. For one thing, many of these restrictions could be loosened or eliminated. The Federal Reserve has already loosened the rules governing the MLF once and they could do so again. Alternatively, a new facility might be needed that could best address these obstacles.

Public Education Emergency Finance Facility (PEEFF)

With the approval of the Secretary of the Treasury, the Federal Reserve could establish, under section 13(3), a facility that would be designed specifically to provide emergency funding for public education for our children and young adults. 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 public education survive the pandemic and continue to provide needed education. Like the MLF, this facility could accept paper issued by state and local governments for the purpose of supporting 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, longer terms (beyond the three years), and the ability to accept paper that it is not tied to immediate revenue generation but to revenue that could be generated over a longer terms 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). Alternatively, 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 long as the state is borrowing through its current spending authority, these borrowings might be subject to the balanced budget constraint.

State and Local Human Capital Bonds

However, if the borrowings could be put on the capital budgets of states, this could give the states more flexibility. States could innovate by creating *Human Capital Bonds* that the Federal Reserve could purchase.

Most states' balanced budget requirements apply only to the budgets for current spending. These states have separate capital budgets for longer term investments including new schools, new buildings on college campuses, new roads, etc. that are designed for borrowing. 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. These **human capital bonds** could be issued under states' capital budgets. An additional innovation would be to allow these bonds to be issued for longer than the current limit in the MLF of 3 years.

The MLF and/or the PEEFF could in turn buy the bonds. That purchase would be in keeping with the traditional economics understanding of education as building human capital. By putting its stamp of approval on these bonds, making a market in them and providing liquidity for this market, the Federal Reserve could be essential in creating a new financing tool for a critical social and public good for our country. In addition, the Federal Reserve's financial support for these bonds would enhance their safety and help preserve the state's bond ratings.

Federal Reserve District Regional Human Capital Bonds

A further innovation would be to create a regional consortium to issue 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 allow for a more flexible type of federalism to overcome acute adversity.

PEEFFs could be 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 facility which issued regional Human Capital Bonds, and allocated the proceeds to states within the regions. State governments would take responsibility for allocating these funds for public education and for ultimately servicing their share of the bond issue. This regional plan builds on Federal Reserve practices developed during the Great Depression and enhanced during World War II.[2]

The Regional Federal Reserve approach has several advantages. First, it could help states overcome state-level debt issuing restrictions and ratings problems while being able to take advantage of regional risk-sharing facilities, lines of credit, and discount facilities through the District Federal Reserve. The District Fed would thus be able to reduce the risks to participating states. In addition, a Federal Reserve District Facility could help develop mechanisms for a more accountable and democratic Federal Reserve through effective elements of a more decentralized Federal Reserve System (see Epstein, "Reforming the Federal Reserve for the 21st Century", in Epstein, *The Political Economy of Central Banking: Contested Control and the Power of Finance.* Elgar Press, 2019, chapter 23.) Building a more democratic Federal Reserve starting at the Regional level would build on a founding idea of the US central bank, but would help transform it into more accountability to the people, rather than to the bankers.

Conclusion

In addition to the huge direct human toll, the Covid-19 crisis is de-railing many crucial social and public functions, including the education of the next generation. While federal government revenue-sharing would be the best way to confront this problem, the Federal Reserve can also contribute by creating additional needed resources and allocating them to state and local governments, as they have created many billions of dollars for corporations and financial institutions. 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 serve the purpose of keeping public education afloat during this trying time. In either event, the Federal Reserve's support of a new public financial instrument, Human Capital Bonds, might help funding of this crucial social good, especially in the context of an economic and social emergency.

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[2] Pollin, Robert. 1993. "Public Credit Allocation through the Federal Reserve: Why it's Necessary; How it Should Be Done," in R. Pollin, G. Dymski and G. Epstein, eds., *Transforming the U.S. Financial System: Equity and Efficiency for the 21st Century*, M.E. Sharpe Publishers, pp. 321-354. Lilia Costabile & Gerald Epstein, 2017. "An activist revival in central banking? Lessons from the history of economic thought and central bank practice," The European Journal of the History of Economic Thought, Taylor & Francis Journals, vol. 24(6), pages 1416-1439, November.