Rated for Default, Not Delivery:

Credit Rating Criteria as De Facto Fiscal Rules for American Local Government

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ABSTRACT

Local governments finance service delivery in a capital market that scores them against published, quantitative criteria — fund balance ratios, liquidity, leverage — with no factor for whether services are actually delivered. This paper argues that rating criteria have become the operative fiscal rules of American local government: unlegislated, privately authored, and enforced through borrowing costs. Because the criteria price distance to default rather than service adequacy, they score fiscal adjustment asymmetrically: a government that closes facilities and accumulates reserves is rewarded, while one that draws reserves to sustain services is penalized for "structural imbalance" — despite nearly identical near-term default risk. I propose three empirical studies: (1) bunching estimates of reserve management around published rating thresholds in a multi-state panel of audited fund balances; (2) difference-in-differences around four mechanical criteria changes between 2010 and 2024, tracing effects on the composition of fiscal adjustment; and (3) text-as-data measurement of which official actions rating rationales reward. Texas school districts confronting post-pandemic enrollment and attendance decline supply the sharpest laboratory: an explicit choice between closing schools and drawing reserves, made under scorecard scrutiny, with complete public data.

1. Motivation

Two facts sit uneasily together. State and local reserves reached historic highs in the years after 2021, with rainy-day funds and general-fund balances at or near record shares of spending in many jurisdictions. Over the same period, service retrenchment proceeded: major districts closed schools, transit agencies debated deep service cuts, and library and public-safety hours contracted in shrinking cities. The standard explanations are demand-side (population decline), cost-side (the labor intensity of public services), or fiscal-federalism stories about expiring federal aid. This paper proposes a complementary institutional explanation: the capital-market institutions through which local governments finance themselves systematically reward the balance sheet and place no weight on the service. If thousands of governments manage to these criteria — the proposition the designs below test directly — then a measurable share of local retrenchment is financed-in rather than demanded.

The framing takes the rating agencies at their word. Ratings are, by the agencies' own definitions, opinions about default risk and expected loss — nothing more. The question is what happens when default-focused scores become the operative performance metric for institutions whose purpose is service delivery, in an asset class where cumulative ten-year default rates on investment-grade credits are on the order of one-tenth of one percent. Enormous variation in ratings maps onto nearly zero variation in default; meanwhile the variation that matters to residents — whether the water system is maintained, whether the school stays open — is vast and unpriced. "Service insolvency," a condition well documented in the Chapter 9 literature, carries no rating consequence until it matures into payment risk.

2. Rating criteria as fiscal rules

A substantial literature shows that fiscal institutions — balanced-budget rules, tax and expenditure limits — shape state and local fiscal behavior and are priced in bond markets (Poterba 1994; Poterba and Rueben

1999). The claim here is that the most binding fiscal rules in contemporary local government are privately authored. Three features support the analogy. First, the criteria are published and quantitative: S&P's 2013 local government criteria scored budgetary flexibility against explicit available-fund-balance bands (reserves above 15 percent of expenditures scored "very strong," 8 to 15 percent "strong," with descending bands below); Moody's current sector scorecards place their heaviest weights on financial performance and leverage; and the GFOA's two-months-of-spending norm (16.7 percent) supplies a third focal threshold that finance officers cite in adopted reserve policies. Second, the criteria are enforced by price: a causal literature exploiting Moody's 2010 recalibration shows that exogenous rating changes move borrowing costs, expenditures, and local employment (Adelino, Cunha, and Ferreira 2017; Cornaggia, Cornaggia, and Israelsen 2018). Third, no factor in any major scorecard measures the adequacy or continuity of service delivery.

The result is an asymmetric objective function. For a jurisdiction facing structural revenue decline, the two canonical adjustment paths — cut services while preserving reserves, or draw reserves while preserving services — carry approximately identical near-term default risk but opposite scorecard treatment. The prediction is that the composition of local fiscal adjustment tilts toward retrenchment relative to the counterfactual without rating-mediated financing.

3. Empirical design

Study 1: Bunching at published thresholds. I assemble a multi-state panel of audited general-fund balances from state compilations of local financial reports (New York's Office of the State Comptroller, California's State Controller, the Texas Education Agency's financial actuals, and counterparts in Ohio, Michigan, and Washington), yielding on the order of twenty thousand government-years without proprietary data. If governments manage reserves to public cutoffs, the cross-sectional distribution of fund-balance ratios should display excess mass just above the S&P bands and the GFOA norm, testable with standard notch and kink estimators (Saez 2010; Chetty et al. 2011). Kisgen (2006) documents precisely this behavior for corporations at the investment-grade boundary; no study has tested it for governments, whose thresholds — unlike corporate rating criteria — are explicitly published. Cross-agency differences in band placement and comparisons of rated versus unrated governments separate agency thresholds from professional norms. The welfare question is what funds the bunching: which expenditure categories are compressed by governments holding position just above a cutoff.

Study 2: Criteria changes as natural experiments. Four methodology events moved implied scores mechanically, with no change in underlying fundamentals: Moody's 2010 global-scale recalibration; S&P's 2013 local government criteria implementation; Moody's 2021 school-district and 2022 cities-and-counties scorecard revisions; and S&P's 2024 consolidated U.S. governments criteria. The existing literature uses the first to identify effects on fiscal capacity. I use all four to identify effects on the composition of adjustment: capital outlay, staffing, facility closures, and reserve accumulation. The deep-dive laboratory is Texas school districts, where attendance-based funding converted post-pandemic attendance declines into revenue losses even at flat enrollment, and where the 2022–23 expiration of hold-harmless funding forced the close-or-draw choice under active scorecard scrutiny. PEIMS and TEA financial data provide complete public panels of enrollment, attendance, staffing, fund balances, and campus closures.

Study 3: The incentive content of rating actions. I construct a corpus of rating reports and press releases from EMMA filings and the machine-readable ratings-history disclosures that NRSROs file under SEC rules, and code the valence rating rationales assign to official actions. The hypothesis is asymmetry: expenditure cuts are coded as credit strengths ("difficult decisions," "proactive expenditure management") while service-preserving reserve draws are coded as weaknesses ("structural imbalance," "reliance on one-time

measures”). The output is the first quantitative measure of what the market’s scorekeepers reward — the incentive content of the rules examined in Study 1.

4. Contribution

The paper extends the fiscal-institutions literature to privately authored rules; complements the causal ratings literature by identifying the composition margin of fiscal response rather than the level of fiscal capacity; introduces two new measurement objects (bunching in government balance sheets and a coded corpus of rating rationales); and speaks to policy questions that are live now — the design of reserve norms, the consequences of the Financial Data Transparency Act’s coming machine-readable disclosure regime, and whether federal countercyclical aid is partly absorbed into reserve targets rather than service maintenance.

5. Feasibility and timeline

All data are public. The author maintains existing scraping and parsing infrastructure for EMMA disclosures and state financial compilations. August–September 2026: panel assembly and ratings histories. October: preliminary bunching and event-study estimates. November: text corpus and classification. Complete draft by the January 2027 conference.

Author note. This research is independent, undertaken in a personal capacity, and uses exclusively public data; the views expressed are the author’s own. Contact: matt@takhara.com.

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