

UNDERSTANDING STATE CREDIT RISK IN THE GREAT RECESSION

The Great Recession has left states grappling with one of the most difficult fiscal environments in the past 100 years. The situation has induced concern that some states may impair debt, as occurred after the Panics of 1837 and 1873 and during the Great Depression.

Breckinridge strongly believes a state default is an extremely unlikely event. States are in better fiscal condition than is commonly realized, and modern laws make default onerous. Today's policymakers recognize the fiscal consequences of default, and in the current environment, federal intervention may ensue for a state in dire need.

Fiscal and Political Conditions in the States

The prevalence of fiscal stress among the states is unparalleled in the modern era. Since January 2009, states have received \$150 billion in federal subsidies, made \$87 billion in budget cuts, and raised \$32 billion in new revenue, yet budget directors still expect \$15 billion in additional budget gaps this year (FY 2010) and \$21.9 billion next year (FY 2011).¹ Deficits are projected beyond FY 2011, as unemployment remains elevated, federal stimulus runs-out, and Medicaid liabilities increase under healthcare reform legislation.² These fiscal conditions exist against the backdrop of \$2.2 trillion in infrastructure needs³ and diminished state capacity to finance additional projects over the next decade. Current debt burdens, while manageable, jumped 67% between 2001 and 2008 compared to U.S. GDP growth of only 40%.⁴

The recession has left lasting fiscal scars in almost every state. Economists forecast that auto-industry-reliant Michigan will not return to pre-recession productivity over the next 30 years.⁵ In Connecticut and Illinois, where large unfunded liabilities existed *before* the stock market collapse, pension obligations are now more burdensome. In Oregon and Rhode Island, volatile and ineffectual tax systems need reform.

Politicians of both parties are sounding fiscal alarms. New York's Governor has warned of cash-flow problems. In Illinois, the Governor and Controller have engaged in a public spat over the prudence of issuing additional debt, and California officials may ask the federal government for a "backdoor" bailout by requesting a compliance-waiver from certain federal mandates.

Voters are tax-averse and skeptical that state government can effectively navigate the current crisis. In New Jersey, 68% of voters prefer state budget cuts to tax increases to

solve the state's budget problems; even a majority of union households support layoffs for state workers.⁶ In California, 69% of residents support existing property tax caps, while 51% favor holding a constitutional convention.⁷ Nationwide, only 48% of voters support federal stimulus for state and local governments, but 2-to-1 majorities support subsidies for private sector job creation, infrastructure spending, and job retraining.⁸

Superficial Similarities to Prior Debt Crises

On the surface, prior state debt crises were characterized by similar fiscal and political conditions, including costly infrastructure projects, public aversion to taxes, and financial panics that precipitated a loosening of "financial morals."

In 1841 and 1842, nine states defaulted on their debt obligations following the Panic of 1837. The states borrowed or guaranteed debt on behalf of private companies to finance the construction of canals and to capitalize banks. Lawmakers believed the investments would promote economic activity without requiring tax increases.⁹

In the 1860s and 1870s, another nine states defaulted, with the Panic of 1873 increasing the indebtedness of a number of states. Defaults in this era were concentrated in the South, where there was a need to rebuild infrastructure after the Civil War. Without slave taxes, unpopular Reconstruction-era lawmakers chose to borrow, rather than tax, to finance railroads, levees, and other improvements.¹⁰

In 1933, Arkansas defaulted on state highway bonds. Here again, voter preference for borrowing to taxing caused a run-up in debt.¹¹ The borrowing binge was a decades-long affair precipitated by the need to construct roads during Reconstruction.

In each of these debt crises, fiscal reality overwhelmed Americans' traditional desire to meet debt obligations. As one observer noted in 1838: "Universal indebtedness created throughout [America] a loose sense of morality that gave rise to an apathetic and indifferent attitude on the subject of state debts."¹²

State Default Remains Highly Unlikely

Today's fiscal and political challenges compare only superficially to those in the 19th century and Great Depression. State debt burdens are very manageable, and modern legal protections insulate bondholders from debt impairment. State leaders understand a default's repercussions, and the federal government would likely act on behalf of a seriously overburdened state.

Manageable State Debt Burdens

Modern state indebtedness is a tiny fraction of that in the 19th century and Great Depression. Today, debt service expense is less than 7% of general fund revenues in California¹³ and less than 5% of all revenues in New York.¹⁴ By contrast, 1841 interest expense in Louisiana, Florida, Maryland, Alabama, and Mississippi exceeded annual state revenues.¹⁵ In 1876, interest payments were 22% of revenues in South Carolina, and 32% in Florida.¹⁶ In 1933 Arkansas, debt service payments comprised \$13 million of the state's \$14 million budget.¹⁷

Even when pension liabilities are included, state indebtedness is relatively modest. Annual payments for unfunded pension obligations amount to less than 3% of annual state spending,¹⁸ and on average, state and local pension funds are 85% funded.¹⁹ In Illinois, where unfunded obligations are a serious problem, 2008 bonded debt and unfunded pension and retiree healthcare liabilities were only 138% of annual revenues.²⁰ This compares to Illinois' outstanding debt of 10,000% of revenues in 1841.²¹

Collectively, state debt burdens are very much within historical norms. Outstanding municipal debt as a percentage of GDP is 18.6%, less than it was throughout the early 1990s (its peak over the last 20 years was 21.2% in 1991).²²

States have ample capacity to meet current debt obligations with tax increases, if necessary. State tax codes contain billions worth of exemptions, credits, and deductions.²³ Moreover, many states exclude entire measures of wealth from their tax systems. For example, Florida, Nevada, and Texas have no state personal income tax, and Alaska, Oregon, and Delaware have no sales tax. New Hampshire has neither a sales tax nor a tax on earned income.²⁴ Even in states where large increases in revenue are circumscribed by tax or revenue caps, "cap overrides" are generally permitted in times of fiscal duress.²⁵

State budget administrators and lawmakers have managed through crises of similar size, duration, and political turmoil. Connecticut faced large budget deficits from 1988 through 1992, with a 1991 budget gap of -43%.²⁶ Texas lawmakers closed deficits from 2002 through 2004, with a 2004 budget gap of -22%. In each case, rhetoric was intense. Fifty-thousand residents marched on Connecticut's capitol to protest the 1991 budget. In Texas, the Governor implored lawmakers to "re-examine the core responsibilities of government and state spending."²⁷ In neither case was debt impaired.

Legal Protections Insulate Bondholders

Modern state constitutions and statutes contain a variety of provisions that benefit bondholders during times of fiscal crisis. These include clauses that prioritize debt repayment, constrain revenue or spending increases, require balanced budgets, limit borrowing, or mandate voter-approval for bond issuance. When a state runs a deficit, these provisions impede lawmakers' ability to impair debt, foisting budget cuts onto creditors *other than bondholders*. Furloughs, IOUs, and cuts to popular programs, such as those for K-12 education and the environment, evidence these legal protections. Most of these provisions were nonexistent in prior debt crises.²⁸

Today's legal protections for general obligation bondholders are also particularly strong. General obligation bonds require states to raise taxes to repay investors.²⁹ Usually, such bond issues are approved by a majority vote of state residents, strengthening the states promise regarding taxes. In the 19th century, investors did not require a state's pledge to raise taxes before lending, often assuming that the federal government's sterling credit record was applicable to the states.

Financial disclosure is another form of legal protection now available to bond investors that was previously lacking. Most states make available monthly tax collections and expenditures on their websites, and states' annual financial reports are today subject to a uniform method of accounting that permits state-to-state comparisons. Unfunded pension and post-employment benefit obligations are part of these required disclosures. As late as the 1990s, important expenditures, including long-term liabilities, went unreported in state financial reports.

Policymakers Want to Avoid Default Because They Need Access to Credit

After lawmakers advocated for, and then repudiated, state debts in the 19th century, the market responded by refusing to lend to the states for years, and then only at high rates of interest.³⁰ Lack of market access retarded states' infrastructure and economic development.³¹

Elected officials today are taking steps to avoid the mistakes of 19th century politicians. California's treasurer recently announced that only nuclear war would prevent California from paying debt service.³² Together with the state's finance director and controller, he penned an article in the *Sacramento Bee* educating voters about the negative tax consequences of default.³³

Lawmakers' fear of a modern-day default is justified. A default would only exacerbate, rather than ameliorate a state's poor fiscal condition. It would eliminate a state's

access to credit, forcing it to keep more cash-on-hand and requiring larger budget cuts than currently planned. It would damage a state's long-term infrastructure-financing capacity, and it would harm the state's municipal governments, higher education authorities, affordable housing corporations, and other quasi-public entities (which often gain market access only through state guarantees, implicit state backing, or the state's covenant to appropriate annual debt service payments).

Federal Government Intervention is a Strong Possibility

The federal government has a strong incentive to act on behalf of a struggling state, as a state default would negatively impact important policy initiatives. For example, New York and California comprise roughly 25% of the \$2.7 trillion municipal bond market. Default by either issuer would immediately increase interest rates and could exert deflationary pressure on the economy, counteracting Fed and Treasury policies designed to promote economic growth. The "Ford-to-New-York-Drop-Dead" policy framework of the 1970s is less applicable in today's economic climate.

The federal government's ambitious infrastructure program outlined in the American Recovery and Reinvestment Act of 2009 would also be threatened by a state default. The federal government requires state cooperation to undertake large infrastructure projects in the U.S.'s federal system. If states have difficulty borrowing, Recovery Act subsidies for clean energy projects, high speed rail, and highway reinvestment will be less effective. New state-local financing vehicles, such as the popular Build America Bonds program, would also be harmed.

America's public finance architecture now provides the federal government with the tools to act if faced with a state debt crisis. Before the New Deal, voters were deeply skeptical of federal interference in state affairs (federal spending comprised only one-sixth of public sector expenditures pre-1933 compared to 59% today),³⁴ and the Federal Reserve was weak and passive. Today, Congress can act to increase states' Medicaid, special education, or transportation reimbursements; the Federal Reserve can act to inflate-away debts, in general.

Conclusion

The next few years will challenge state lawmakers, voters, and budget directors with unpleasant policy choices. It would not be surprising if states enacted new laws or constitutional provisions to enforce fiscal prudence or enable more fiscal flexibility for lawmakers. Despite the fiscal and political environment, Breckinridge remains very confident that no state will impair its debt in 2010 or

beyond. The sizes of states' debts are manageable. Legal protections for bondholders are strong, and state policymakers' want to repay state debts. Even in the worst case scenario, modern fiscal federalism affords the federal government the ability to act promptly.

- ¹ “Fiscal Survey of the States,” National Association of State Budget Officers, p. vii. (December 2009).
- ² “Fiscal Survey of the States,” National Association of State Budget Officers, p. 11. (December 2009)
- ³ “2009 Report Card for America’s Future,” American Society of Civil Engineers, p. 2. (March 25, 2009).
- ⁴ See Federal Reserve Flow of Funds Accounts of the United States December 7, 2006 and December 10, 2009 releases, Table L. 211, and national GDP figures from Bureau of Economic Analysis, available at: <http://www.bea.gov/national/index.htm#gdp>.
- ⁵ “Beyond California: States in Fiscal Peril,” Pew Center for the States, p. 23 (November 2009), and Steve Cochran, “U.S. Regional Economies: The Pattern of Recovery,” web briefing with Moody’s Economy.com (September 24, 2009).
- ⁶ Quinnipiac University Poll (November 24, 2009).
- ⁷ Field Polls, Releases #2318 and 2316 (October 14/16, 2009).
- ⁸ CNN/Opinion Research Corporation Poll (Dec. 16-20, 2009). Available at: <http://www.pollingreport.com/budget.htm>.
- ⁹ Richard Sylla and Joseph Wallis, “The Anatomy of Sovereign Debt Crises: Lessons from the American State Defaults of the 1840s,” *Japan and the World Economy* 10, 267-293, p. 280. (1998).
- ¹⁰ Christopher Shortell, *Rights, Remedies, and the Impact of State Sovereign Immunity*, State University of New York Press, p. 85. (2008).
- ¹¹ In the early 20th century, Arkansas lawmakers passed and increased motor vehicle and motor fuel taxes to pay for the costs of road construction, but the construction was far more costly than the taxes designated to pay for them.
- ¹² Reginald McGrane, as quoted in the *London Times* (December 15, 1838).
- ¹³ FY 2009-10 debt service payments are \$6 billion against \$89.5 billion in general fund revenues. See California State Treasurer’s 2009 Debt Affordability Report, p. 17.
- ¹⁴ New York’s state-funded debt (the state controller’s most comprehensive debt measure) was \$5.3 billion in 2009 compared to total state spending of \$119.7 billion. See Financial Condition Report 2009, State of New York, pp. 7 and Appendix 3 (2009).
- ¹⁵ Sylla and Wallis, Table 1, p. 280. (1998).
- ¹⁶ Shortell, p. 86. (2008).
- ¹⁷ Daniel Vock, “Nightmare Scenario Haunts States,” Stateline.org (December 14, 2009).
- ¹⁸ “Market Decline and Public Pensions,” *NASRA/NCTR Issue Brief*, p. 4 (December 2008).
- ¹⁹ “Public Fund Survey,” National Association of State Retirement Administrators, p. 6 (October 2009).
- ²⁰ In 2008, outstanding bonded and unfunded pension and post-employment healthcare liabilities were 43.9 billion compared to annual revenues of \$31.7 billion. See Statement of Activities, p. 20 and Note 8 to Illinois’ Comprehensive Annual Financial Report, p. 88 (2008).
- ²¹ In 1841, Illinois had annual revenues of \$98,000 but public debt of \$10.6 million and annual interest expense of \$800,000. See Shortell, p.61.
- ²² Federal Reserve Flow of Funds Accounts and U.S. Bureau of Economic Analysis.
- ²³ These carve outs, known as “tax expenditures,” cost Ohio \$4.8 billion in annual sales and use taxes in 2009. In Pennsylvania, “tax expenditures” related solely to personal income taxes for retirees cost the state \$2 billion in 2009. See: State of Ohio Executive Budget, FY 2010 and 2011, Book Two, p. 6. (February 2009) and 2008-09 Proposed Governor’s Executive Budget (Pennsylvania), FY 06-07 through FY 12-13, Governor’s Office of the Budget, annual release, p. D16 (Feb. 2008).
- ²⁴ Table D16, “Facts & Figures on Government Finance,” 38th Edition, *Tax Foundation* (March 1, 2005).
- ²⁵ For example, in Michigan, the state’s constitutionally prescribed revenue limit may be ignored if the Governor declares an “emergency” and two-thirds of each house of the legislature concurs. See Mich. Const. Art. IX, Sec. 27.
- ²⁶ Adam Stern, “The Connecticut Income Tax Wars,” *Connecticut History*, Vol 48, No. 2, p. 147.
- ²⁷ “State Responses to Budget Crises in 2004: An Overview of Ten States, Case Study – Texas,” *Kaiser Commission on Medicaid and the Uninsured* (January 2004).
- ²⁸ See Richard Briffault, “The Fiscal Provisions of American State Constitutions,” Rutgers University Center for State Constitutional Studies, pp. 2, 4. Available at: <http://www.camlaw.rutgers.edu/statecon/subpapers/richard.pdf>
- ²⁹ The state can avoid payment if it can show that it was “reasonable and necessary” to do so, but this is a near impossible standard to meet. See *United States Trust v. New Jersey*, 431 U.S. 1 (1977)
- ³⁰ Shortell, pp. 61, 79, 109-110.
- ³¹ Shortell, p. 110.
- ³² Vock (December 14, 2009).
- ³³ Vock (December 14, 2009).
- ³⁴ Briffault, Richard, “The Central Place of State and Local Governments in American Federalism,” Chapter 1, *The Handbook of Municipal Bonds* (2008) and Facts and Figures on Government Finance, 38th Edition, Tax Foundation, Table B1 (March 1, 2005).