

# Strapped States Seek a Lifeline

Governments — from the largest states to the smallest cities — are caught up in the tightening web of the financial crisis and looking to Washington for help

BY CLEA BENSON  
AND ALAN GREENBLATT

**C**ALIFORNIA HAS the world's eighth largest economy and the state's government has paid back, with interest, every penny it has ever borrowed. But in recent weeks, the credit crisis has gotten so bad that the state has been unable to find investors willing to finance its short-term debt for much longer than 24 hours at a time.

Almost every weekday since financial markets seized up, California has been forced to roll over hundreds of millions of dollars in "commercial paper," which is similar to a line of credit and is used to cover day-to-day expenses on construction projects.

This kind of borrowing has in the past been a relatively cheap way to ensure that work on roads, schools and bridges isn't held up while the state goes through the process of issuing long-term bonds at lower interest rates to pay for them. Typically, the debt matures every 90 days, and the state pays about 1.5 percent interest on it. But suddenly buyers in this market aren't willing to bet for even three months that the state won't default, so California is left with no option other than to borrow a day at a time at rates approaching 10 percent.

"We have been harmed just as much as financial institutions and businesses by the economic meltdown and the credit crunch," said Tom Dresslar, a spokesman for the California Treasurer's office. "We provide funding that keeps our communities safe, that cleans up pollution and educates our kids. There's a lot at stake here."

On the other side of the country, tiny East Haven, Conn., borrowed \$7.5 million last month to help with its annual budget of about \$37 million. Officials in the town of 30,000 estimate they are paying about \$70,000 more in interest than they would have just a couple of months ago — a sum, one local official told a newspaper, that East Haven could have used to hire a new teacher or firefighter or to buy a few police cars.

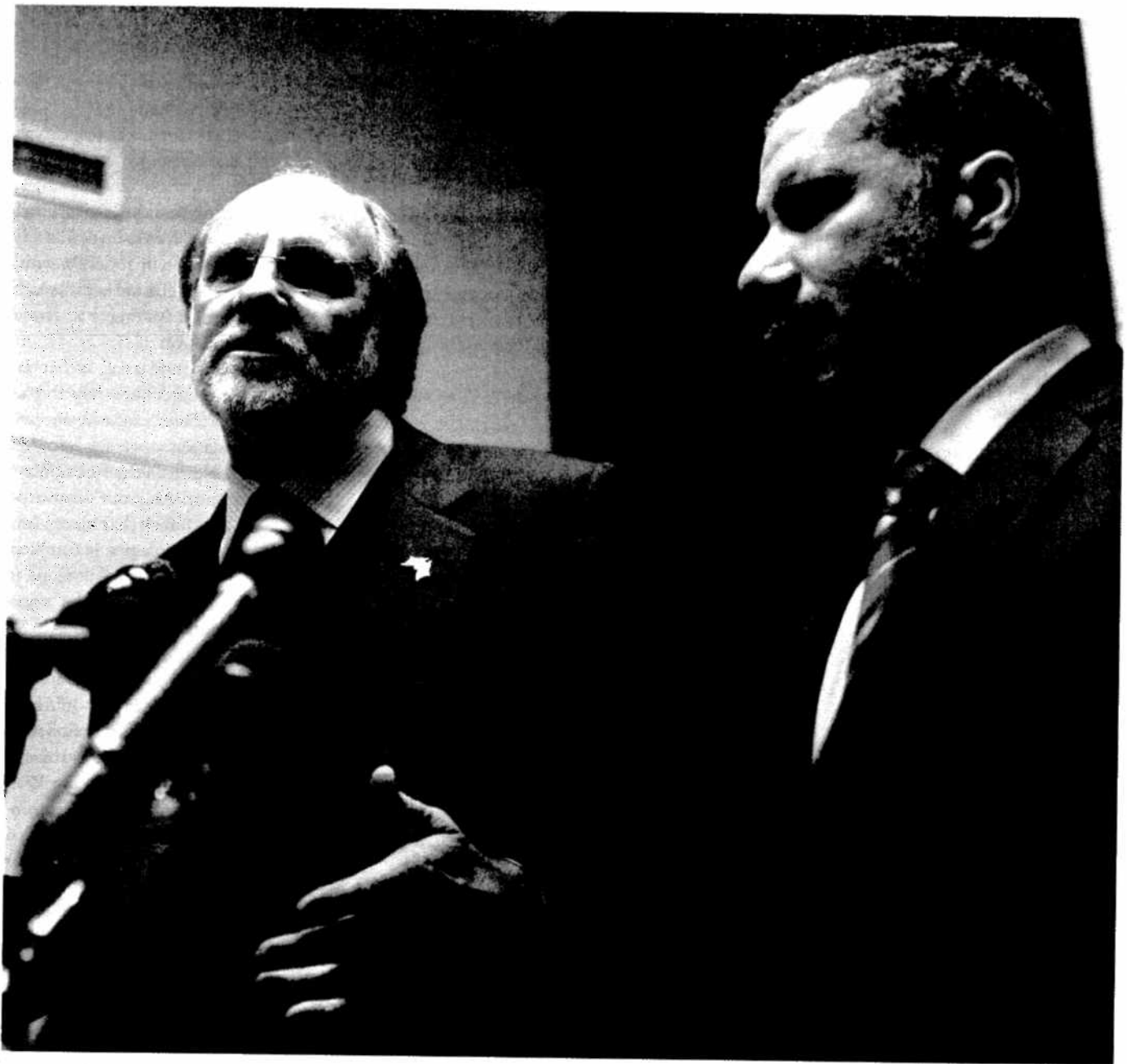


**BUILDING A CASE:** Louisville, Ky., Mayor Jerry E. Abramson, left, and Gary L. Gallegos of the San Diego Association of Governments were among the local leaders on Capitol Hill last week seeking budget assistance.

This is the new reality for states and local governments, whose costs to borrow are ballooning, if they can borrow at all. Governments from the largest states to the smallest cities are caught in the tightening web of the economic crisis.

And Congress may have little choice but to help, especially if shrinking state spending might result in deeper economic pain. While insurers and automakers are lining up for federal relief, state and local governments say they — and the people who depend on them — are the ones most in need.

"Unless states receive fiscal relief, I believe the goal of stabilizing the economy cannot be achieved," New York Gov. David A. Paterson, a Democrat, told the House Ways and Means Committee last week, as lawmakers began asking how to bring the economy out of its tailspin. Paterson noted that New York faces a \$12.5 billion budget shortfall next year, an amount equal to a quarter of the state's general fund.



**GOVERNORS APPEAL:** Corzine and Paterson, above, appeared before separate congressional committees last week to plead for extra help. Sanford, left, was among the few officials to say Congress doesn't need to pass an economic stimulus bill with state aid.



He and other governors have been saying that states deserve — and need — help at least as much as do the private enterprises the federal government has already rescued.

“Many areas of our economy need the same direct aid that Congress provided to the banking and mortgage industry,” Illinois Gov. Rod R. Blagojevich, a Democrat, wrote to congressional leaders Oct. 10. Deepening cash flow difficulties have put his state \$1.8 billion behind in its payments to vendors.

When Congress returns to Washington after the election, lawmakers are almost certain to consider a comprehensive measure to shore up the faltering economy. Its specifics have yet to be clarified, but many congressional supporters of additional stimulus are talking about money for public works projects and Medicaid, the federal-state health care program for the poor and disabled.

Even though Congress is in recess, several governors and other state and local officials traveled to Capitol Hill last week to make their case for help from Washington. At the same time, bipartisan leaders from state and local groups, including the National Governors Association and the National League of Cities, sent a written appeal to Congress.

The focus of their efforts is the stimulus plan that Democratic leaders in the

# Local Services Feel the Squeeze

LOCAL GOVERNMENTS are used to being victimized by a certain form of trickle-down economics. As much as states are fond of complaining about being saddled with mandates and program costs from Washington, they regularly turn around and hand similar marching orders to cities and counties. So, even as states petition Congress for help with their weakening budgets, localities are worried they may be hit the hardest.

Four years ago, voters in California gave some local revenue sources protections from state actions, said Michael Coleman, principal fiscal policy adviser to the League of California Cities. "But there are other ways they can get at us, by shifting revenues or mandates to us," he said.

The kind of revenue sharing that went out of style in Washington during the Reagan administration is still practiced in many states. And states finance a large share of K-12 education. That means a big chunk of local government finances is tied directly to state budget decisions. And because cities

and counties can raise their own tax money, aid to local governments — along with higher education — is typically among the first line items cash-strapped states will look to cut.

During the last big budget crunch, 24 states cut aid to cities for fiscal years 2003 and 2004, while 13 other states increased it only marginally, according to the National League of Cities. The overall cut in fiscal 2004 was \$2.3 billion, or 9 percent of total aid. "For cities, we're probably only in Year One of a three- to four-year downturn, so it's only going to get worse," says Christopher Hoene, policy and research director for the national group.

Cities and counties are made especially nervous this time around by the threat of states passing down costs. They are more vulnerable than five years ago, largely because property tax collections were still growing then. That's why city and county associations have joined with state lobbyists to press for a federal stimulus package that will devote extra dollars for Medicaid, infrastructure and other programs. Counties benefited from the recent financial bailout law, which included more than \$3 billion over four years for rural schools and primarily Western counties that include large tracts of federal land.

Any new money would probably go to states, but some would ultimately be passed down. Local officials also recognize that if Washington bolsters state budgets, local cuts might not be as severe.

Fiscal pain for cities and counties is already acute. Their primary sources of money — sales and property taxes — are slowing. As a result, Chicago and Los Angeles are each facing shortfalls that might top \$400 million. In light of his city's \$40 million shortfall, Hartford, Conn., Mayor Eddie A. Perez announced the elimination of 132 city jobs Oct. 23. And Maricopa County, Ariz., which includes Phoenix, is experiencing its first decline in sales tax revenue in at least 40 years, according to County Manager David R. Smith, leading to a second round of spending cuts for the current fiscal year.

"What I hear from my members, both large and small, is that the fiscal condition is very serious, and they really don't know how they're going to balance their budgets," says Jeffrey L. Esser, executive director of the Government Finance Officers Association.

Douglas H. Palmer, mayor of Trenton, N.J., told the House Ways

and Means Committee last week that his city has already seen a \$4.6 million cut this year in the aid it receives from the state, which is facing its own \$4 billion deficit next year. Palmer, a Democrat, said relief for states would help cities. "Now that Congress has enacted a \$700 billion package to bail out Wall Street, we strongly recommend the enactment of a Main Street stimulus package," he said.

Local officials complain that they are being buffeted by economic trends beyond their control. Ken Guy, finance di-

rector for King County (Seattle), Wash., says that \$58 million out of the county's current \$93 million shortfall can be attributed to the general economic slowdown.

But many localities are guilty of having spent money as fast as it's come in during recent good times, raising expenditures and expectations rather than preparing for an inevitable downturn. The most prominent case in point is Vallejo, a city of 117,000 residents just northeast of San Francisco, which filed for bankruptcy in May.

The nominal cause was the housing slump, but the root problem was excessively generous salaries and pension contributions for city employees. Police and fire personnel costs make up almost 75 percent of the city budget. Other cities are watching carefully to see whether a bankruptcy judge will rewrite Vallejo's contracts on terms more favorable to the city.

Most local leaders, however, will try to make do by making cuts on their own. These will be felt more directly by the public than those made by states, because local governments provide basic services such as fire protection, libraries and garbage pickup.

"All of the signs are pointing to a pretty severe downturn for state and local governments," says Hoene. "The things that both states and locals normally try to protect are going to be on the table."

— ALAN GREENBLATT



**TROUBLE BELOW:** Trenton Mayor Palmer appeals to lawmakers last week to boost spending to states. Cities complain that they often bear the brunt of state budget cuts.

House and Senate have said they want to take up in a post-election, lame-duck session. In addition to infrastructure spending and Medicaid relief, state and local officials want extended unemployment benefits and federal policy changes that will relax the conditions on which they borrow money, both short- and long-term.

They say their financial well-being is important to an overall national recovery. And as the economy has slowed, their costs are soaring with the rising demand for the benefits they provide. At the same time, government revenue from sales, property and income taxes is falling as taxpayers lose their jobs, spend less and see the values of their houses plummet. Slumping stock prices carry a two-fold threat: Tax revenue from the sales of stock and other capital gains is sure to decline and public employee pension funds are losing so much value that they will need infusions of cash from workers or governments to stay healthy.

As a result, states face a combined \$60 billion deficit in fiscal 2009, the current year, some budget experts project. And that gap could widen in 2010. Because states generally have to keep their operating budgets in balance, the immediate consequence of a revenue loss for most of them is to cut spending, which could threaten needed services.

State requests for federal aid aren't new, of course, and opponents of passing along federal assistance contend that ballooning state budgets in recent boom years contributed to the current problem. Indeed, one fiscally conservative governor, Republican Mark Sanford of South Carolina, told lawmakers last week not to approve a stimulus bill. "I think this stimulus would exacerbate the clearly unsustainable spending trends of states," Sanford, a former House member, testified before Ways and Means.

It's true that state spending and borrowing have surged. Combined state general fund spending jumped to an estimated \$693 billion for the current fiscal year, a 36 percent increase over 2003, according to the National Association of State Budget Officers. Over roughly the same period, state borrowing surged to \$2.23 trillion, a 42 percent rise, Federal Reserve figures show.

But the question of whether states are deserving may be beside the point. Wash-



OUR TURN: Steps to ease the credit crisis provoked protests.

ington has pitched in during economically stressful times in the past, as state and local officials reminded lawmakers repeatedly last week. Congress gave \$10 billion to states with no strings attached during the last recession, in 2001, and spent an additional \$10 billion to help with rising Medicaid costs.

To state officials, it's doubly important that Congress help. States, they say, can assist in restoring the economy to health. But if they

falter, state and local governments can also add to the problem, said Jeffrey L. Esser, executive director of the Government Finance Officers Association.

"What we know from previous recessions, especially severe recessions, is that when the federal government tries to provide stimulus to the economy, and states and local governments are cutting back, it negates what the federal government is trying to do," Esser said.

#### FINANCING TIGHT

State and local governments would have been hurting anyway in a shrinking economy, but the meltdown in credit markets is magnifying their problems. One of the most urgent needs, they say, is for Washington to step in and help repair the market for municipal securities — debt issued by states and cities.

A few weeks ago, states were worried that they simply would be unable to find buyers for their short-term debt at all, raising the possibility that ordinary government operations would come screeching to a halt. California Republican Gov. Arnold Schwarzenegger wrote to Treasury Secretary Henry M. Paulson Jr. on Oct. 2 telling him the state might need a \$7 billion federal loan if it was unable to conduct its usual practice of issuing revenue anticipation notes — a form of short-term debt the state uses in addition to commercial paper that is akin to an advance on a paycheck. States use RANs, as they're called, to meet operating costs for schools and other big-ticket expenses that fall due before they take in most of their tax revenue for the year. The same week, Massachusetts raised a similar concern about borrowing.

That turned out to be something of a false alarm. Both California and Massachusetts went into the market and were able to sell their notes, although at higher interest rates than in years past.

Default rates on municipal securities are typically much lower than those on securities issued by private companies, and the investors who purchased almost \$5 billion of California's revenue anticipation notes apparently realized that. But the 4.25 percent interest rate was still about four times what the federal government is paying on comparable Treasury securities, indicating that investors are still wary of state solvency.

What's happening now is a kind of

## Infrastructure Costs

Generally, state and local governments are permitted to borrow to finance capital construction projects, such as roads and schools, but not to pay operating costs. States with larger populations and older infrastructure tend to have more debt.

### Top 10 state borrowers

At end of fiscal 2007, ranked by government debt per capita

Rank	State	Debt per capita	Principal and interest costs*
1	Massachusetts	\$4,248	5.6%
2	Connecticut	3,736	12.6
3	Hawaii	3,584	6.4
4	New Jersey	3,166	7.4
5	New York	2,311	6.5
6	Delaware	2,137	4.2
7	Washington	1,901	4.3
8	Illinois	1,778	4.3
9	Wisconsin	1,696	4.2
10	California	1,571	4.2

\*As a percentage of general government spending  
SOURCE: Standard & Poor's

# States Feel Pain of Medicaid Burden

BY REBECCA ADAMS

JUST A YEAR AGO, before the mortgage crisis blew up into an economy-wide catastrophe, the nation's governors were feeling confident about their ability to handle the steadily growing expenses of Medicaid, which provides health coverage for the poor and disabled. Most states took at least one step that added to the cost of this joint federal-state program — boosting payments to providers, expanding long-term care or offering coverage to more people.

Things are quite different now.

Governors are warning Congress that they need tens of billions of dollars in additional revenue from Washington to maintain Medicaid coverage at current levels. Without the extra money, they say, they may have to cut back on provider payments, impose limits on services or limit who's eligible. Any of those actions would strain the already overburdened health care system by shifting costs onto other payers and would hamper federal efforts to shore up the weak economy.

While lawmakers may rush to provide assistance to the states soon after the election, the debate over what to do about Medicaid won't be finished there, even if states do get the \$20 billion or more they say they need from a stimulus bill. With critics of the program complaining that its costs are out of control, the fundamental structure of the program is under fire. And because the government is such a large consumer of health care, decisions on Medicaid are likely to influence other debates, including children's insurance or even the structure of the entire health care system.

"Any discussion of financial changes is controversial," said Matt Salo, director of the Health and Human Services Committee of the National Governors Association. "Medicaid can become a referendum on the role of government in providing health care, a not-insignificant political debate in itself."

## ROLLER COASTER RELATIONSHIP

The federal government and the states have an uneasy partnership over Medicaid, which serves about 50 million people and cost federal and state governments combined roughly \$6,120 per beneficiary in 2007 — or \$316 billion total, not counting administrative expenses.

States depend on the federal government to pay much of the cost, even though they run the program. Congress provides a generous matching rate for every penny that states put up for Medicaid. Under a formula that varies by state, the federal government pays an average of 57 cents of every dollar.

At the same time, Washington has always been somewhat conflicted about the program. In years when the economy is strong, budget hawks search for ways to trim its costs. But in years like this, when states are desperate, the federal government typically steps in with a bigger payout. Five years ago, Congress gave states a \$10 billion across-the-board temporary rate boost as part of a larger package of assistance.

Lawmakers are inclined to heed governors' calls for help because of the multiple ways in which pressure builds on Medicaid when the economy sours: Many people who lose their jobs and their health insurance coverage are poor enough to qualify for Medicaid, so there is a rise in demand for services just as states face declining revenue.

Nationally, the jobless rate has increased more than a percentage point so far this year, and it stood at 6.1 percent in September. Some analysts say that for every 1 percentage point rise in unemployment, about a million people become eligible for Medicaid or a related program, the State Children's Health Insurance Program, which provides coverage for low-income children who aren't poor enough to be eligible for Medicaid. On top of those who qualify for Medicaid, that same increase in joblessness is estimated to cause an additional 1.1 million people to lose their health insurance. And they have no publicly financed health care options.

Before the economic crisis deepened this fall, 30 states already were facing significant Medicaid problems, said Ann Kohler, director of the National Association of State Medicaid Directors. This is the case, she said, even though states "have not expanded inappropriately." In fact, she said, many had significant rainy day reserves set aside, and even those reserves are being swamped by increased demands for service.

Governors are now seeking an increase in the matching rate for the next two years, not only because the weak economy has crimped their budgets, but because the current match

is based on spending from 2004-06, when the economy and state budgets were much stronger. Still, it's unclear how generous Congress might be.

This year's growing Medicaid troubles are also being exacerbated by other health care cost issues. State officials are particularly frustrated by a lingering aftereffect from the 2003 prescription drug law, which requires states to pay billions of dollars to the federal government each year to help cover the drug costs of about 7.5 million people who are eligible for both Medicaid and Medicare, the federal program for the elderly and disabled. Previously, drugs for these people were the states' responsibility, but they had the power to cut costs if needed. Now states have no ability to control expenses, yet they pay a high percentage of the costs.

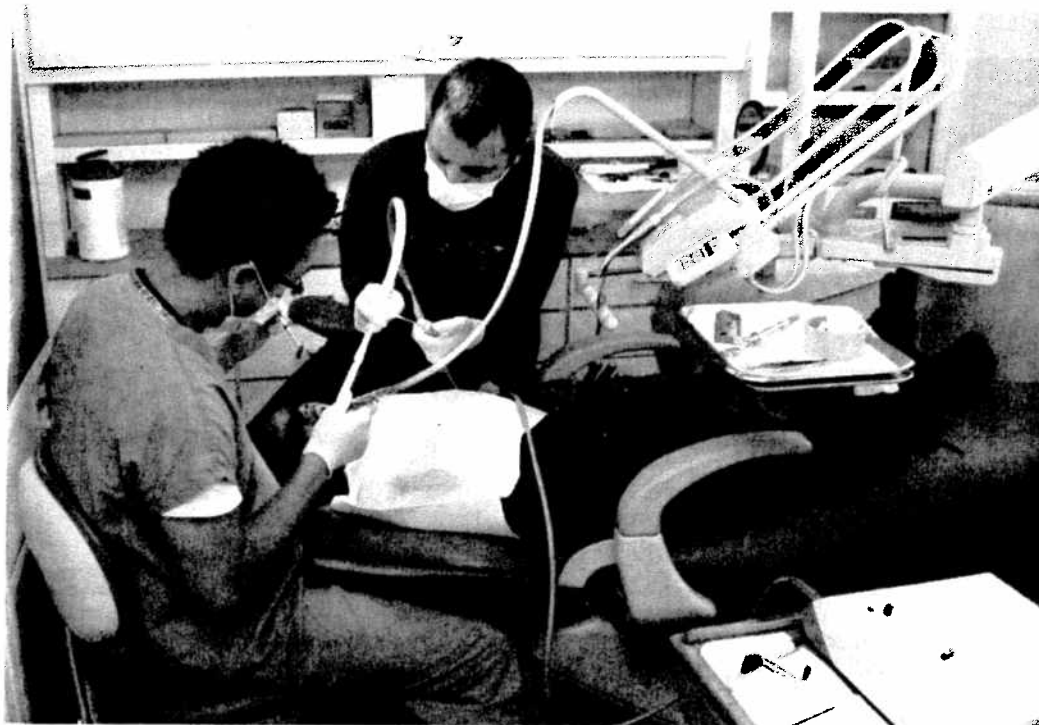
"There's a very high level of frustration for state Medicaid directors because states are being forced to pay for a program over which they have no control — no say over who's covered or which drugs are covered," said Kohler.

## HELPING THE ECONOMY

State officials say additional federal aid will prevent unwarranted Medicaid cuts and at the same time limit fallout in other parts of their budgets, which might further strain the economy. And they say the extra money will actually produce a beneficial ripple effect throughout the economy and the health care system.

“There’s a very high level of frustration . . . because states are being forced to pay for a program over which they have no control.”

— Ann Kohler, National Association of State Medicaid Directors



**COSTS RISING:** Medicaid services, like this mobile dental facility for children in Georgia, are threatened by rising costs and demand.

In an Oct. 27 letter to House leaders of both parties, the National Governors Association said increasing the federal Medicaid payment for two years would be “particularly effective” as a tool to counter the economy’s slowdown. An increase “immediately allows governors to eliminate planned budget cuts required to meet balanced-budget requirements and continue services for those with the greatest need,” the governors wrote.

During the 2001 recession and its aftermath, about 6 million additional poor people became eligible for Medicaid, according to Iris Lav, deputy director of the liberal Center for Budget and Policy Priorities. She expects a much larger number during this downturn.

“This is about one of the best forms of stimulus you can do,” said Lav. “That can be used right away.”

And although some economists disagree that federal Medicaid assistance is a good way to help the economy recover, many state health policy analysts said it fills a vital need. “We’d say that people who aren’t healthy won’t be good workers ready to rejoin the workforce,” said Joy Johnson Wilson, health policy director of the National Conference of State Legislatures. “To some, it may not be stimulus in a green-eyeshade way, but it’s a critical component, just as we’d provide food stamps or energy assistance for the low-income.”

#### NOT SO FAST

Most Republicans, however, take the opposite view. They say states would probably spend the money anyway, regardless of how much Congress provides. House Minority Leader John A. Boehner,

R-Ohio, said his caucus prefers “pro-growth policies that create new jobs, lower energy costs and protect taxpayers — not hundreds of billions in new government spending masquerading as economic stimulus.”

Republicans also argue that it’s unfair to give blanket relief to all states because some of them, such as those in oil- and gas-producing areas, haven’t faced the level of budgetary problems that others have. What’s more, they argue, some states expanded Medicaid eligibility or benefits imprudently, and Washington should not have to pick up the tab. “The Democrats’ approach would give a handout to states and give incentives to those that overspend and don’t budget properly,” said Boehner spokesman Kevin Smith.

And many fiscal conservatives are simply opposed in principle to spending more on Medicaid.

“The current path of Medicaid spending is unsustainable for both federal and state governments,” said Health and Human Services Secretary Michael O. Leavitt on Oct. 17, when he released a report on Medicaid finances. “If nothing is done to rein in these costs, access to health care for the nation’s most vulnerable citizens could be threatened.”

The report found that, if left unchecked, Medicaid spending would expand to 8.4 percent of the federal budget by 2013 from 7 percent in 2007, a growth rate much higher than that projected for the overall economy.

State officials say a broader discussion on health care should include a way to prevent repeated fights over temporary Medicaid financing increases. The governors want certainty that they will get additional money in tough economic times, and they are frustrated

with what they say are Washington’s mixed messages. Even though Congress gave extra money to the states in 2003, less than three years later the Bush administration won enactment of program cuts that will total more than \$26 billion over a decade. The governors say such an up-and-down approach makes it hard to know what to expect.

“We’d like a trigger so that if a natural or economic disaster occurs, we wouldn’t be in the position of putting the hat out and trolling for sympathy,” said Wilson of NCSL.

But she acknowledged that major changes that would give states long-term Medicaid predictability will be hard to enact. “I don’t know that we have a consensus on how to make it happen,” she said.

## Medical Bills

Spending by states and by the federal government for Medicaid services continues to grow faster than the broad economy. As overall costs surge, Washington pays 57 cents of every dollar on health care for the poor.

	State share	Total
1999	\$78.3	\$189.5
2000	84.6	195.7
2001	93.9	217.1
2002	106.2	246.3
2003	109.2	262.6
2004	114.8	281.8
2005	128.7	300.7
2006	128.5	299.0
2007	135.8	315.8
2008	146.4	339.0*

Note: Data do not include administrative costs and the Vaccines for Children program.

SOURCE: Department of Health and Human Services

# State Budget Woes Have a Broad Reach

The economic crisis has limited borrowing and curtailed tax receipts, posing threats to services.



New York is only one place where crumbling infrastructure demands additional spending.



... while home prices fall nationwide, reducing property tax revenue and straining budgets.



Along with tight credit, that has cut borrowing for such projects as the Huey P. Long Bridge.

standoff. Many governments are delaying borrowing in the hope that as credit markets return to normal, interest costs will also come down. The question is how soon.

"I suspect that the access will settle down a little bit, but once it settles down, with the exception of U.S. Treasuries, bonds are going to end up at significantly higher rates," said Ray Scheppach, executive director of the National Governors Association.

Bond financing is currently on hold for projects ranging from the widening of the Huey P. Long Bridge outside New Orleans to the construction of a high school in Fluvanna County, Va. So far, governments are awaiting a better market for about \$18 billion of municipal debt. That backlog, alone, could create its own problems.

"The gates are still not open wide enough for issuers to access capital," said W. Bartley Hildreth, a professor of public finance at Wichita State University.

In some cases, states are forced into paying higher costs whether or not they issue bonds because they are unable to conduct routine refinancing to convert higher-cost short-term debt into longer-term bond issues that carry a lower rate.

Meanwhile, some governments are biting the bullet and moving forward, but with serious consequences.

Omaha, Neb., issued \$18 million worth of bonds two weeks ago, far less than the \$68 million it had originally intended. And the interest rate was 5.42 percent, 1.6 percentage points higher than the rate the city paid on similar bonds it sold in July. The additional interest cost will be

\$200,000 annually for 20 years.

Carol Ebdon, the city's finance director, said the higher cost was mitigated somewhat by the fact that rates have been so low in the recent past. But she frets about the future. "So far, we are holding our own, but I am worried about the next year," she said. "Typically, we are on the lag in economic downturns, so we don't usually see things right at the beginning."

## SEEKING HELP WITH MARKETS

State and municipal officials say there are steps the federal government can take to help. At the top of their list, they want their governments to be able to take advantage of a new

program by the Federal Reserve to purchase commercial paper with a maturity of up to three months in an effort to buoy the short-term borrowing market.

"What we need is for the federal government to guarantee some short-term borrowing," said Jacqueline Byers, research director for the National Association of Counties. "They haven't addressed it, and we are asking them to address it."

The Fed is stepping into the \$1.6 trillion commercial paper market because the usual purchasers of those securities — money market mutual funds and institutional investors — aren't buying. But so far, the Fed program is only open to banks and some other private corporate issuers.

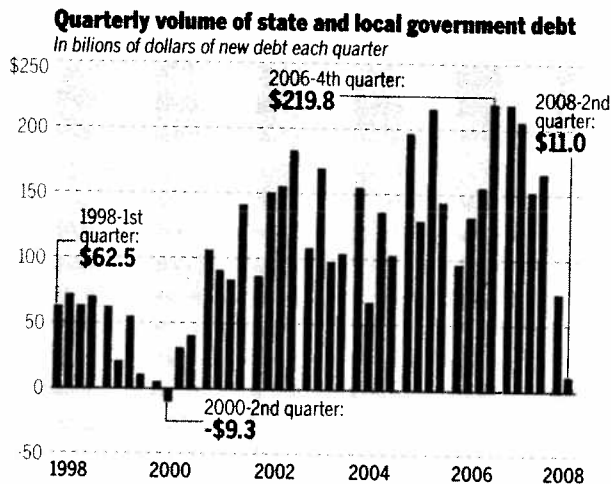
State and local governments are relatively small players, having sold only about \$26 billion in commercial paper in the past nine years, according to Thomson Reuters. Yet, as the California example shows, the freeze in that market does raise serious concerns. If state and local governments could sell to the Fed, which is currently paying about 1.1 percentage points less than average market costs, California could stop rolling over its short-term debt every day at interest rates near 10 percent.

"While local governments have not contributed to the problems of the credit crisis and continue to serve as first-responders between citizens and government, we are not receiving help," Timothy Firestine, chief administrative officer for Montgomery County, Md., complained to Ways and Means last week.

Fed chairman Ben S. Bernanke has heard from varied officials on this

## Borrowing Drops Off

The rise of state and local borrowing seen in recent years reversed abruptly in the first half of this year. While that's partly due to the slowing economy, local officials say tight credit markets are hurting them.



SOURCE: Federal Reserve



The credit crisis has been particularly hard on California, where local services from



garbage collection to hospital emergency rooms to schools could be threatened with cuts



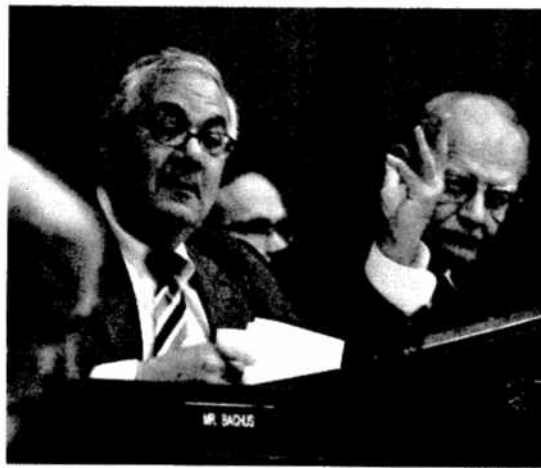
and the state government continues to pay high rates of interest on short-term borrowing

subject: Florida officials, Democratic Rep. Paul E. Kanjorski of Pennsylvania and a coalition of five organizations representing local governments have all pressed for the Fed to buy municipal commercial paper.

"Without such action, states and municipalities will be saddled with ever-increasing costs to manage their current short-term debt portfolios. These increased costs are ultimately borne by taxpayers, and could inhibit the vital services provided to our citizens," the coalition said in an Oct. 15 letter.

In the face of all these requests, the Fed has said it is weighing the matter but has given no sign that it will change its mind. Finance experts say it would probably take a complete freeze of the municipal credit markets to cause the federal government to intervene.

"If we got back to the point where states really felt that the credit markets weren't working for them, I suspect that Treasury and the Fed could act pretty quickly to solve the problem," said Nicholas Johnson, director of the



**REGULATORY FIX:** Frank wants to change the way municipal bonds are rated to reduce costs to states and localities.

state fiscal project at the Center on Budget and Policy Priorities, a liberal-leaning think tank.

Beyond seeking relief from problems in the short-term debt market, state and local officials also want the federal government to assist in improving the market for long-term bonds, which has been troubled since earlier this year.

Before this spring, municipalities kept

borrowing costs down by purchasing insurance on the bonds they issued. Essentially a repayment guarantee, the insurance boosted the credit rating on the securities, which allowed the issuers to pay lower interest rates.

But many municipal bond insurance companies were caught in the collapsing market for securities backed by defaulted subprime mortgages. Their own credit ratings fell, calling into question the value of the insurance policies they wrote on municipal bonds, and the downward cascade hampered the ability of local governments to borrow cheaply. Today, about 10 percent of municipal bond issues carry insurance; previously, the figure was about 50 percent. At the same time, governments' own credit ratings are declining as their tax bases shrink, their pension funds lose value and their budget deficits widen.

New York's insurance superintendent has called on the Treasury Department to aid bond insurance companies with money from the \$700 billion financial institution bailout

## Learning the Lingo: A Lexicon of State and Local Leverage

State and local government borrowing takes many different forms, some of which are regarded by investors as more risky than others.

### General Obligation Bonds

Typically the least risky, and least expensive municipal debt, government obligation bonds are secured by the issuers' "full faith and credit" — pledging repayment through general tax collections. These bonds are commonly used for projects that don't generate revenue, such as schools and parks, and in some states require voter approval.

### Assessment Bonds

Used for public improvement projects, assessment bonds are repaid by fees or taxes collected from beneficiaries. A common type of assessment bond for sidewalks is repaid through taxes on a neighborhood's residents.

### Revenue Bonds:

These long-term bonds are typically repaid with collections from the projects they finance. These

bonds are designed to be self-supporting and generally don't require extra taxes. A bond to build a parking garage might be repaid through parking fees.

### Revenue Anticipation Notes

Governments sometimes borrow using revenue anticipation notes when revenue won't be available for some time, hampering cash flow. They are commonly issued at the start of the fiscal year and

mature at year's end, when the anticipated revenue is collected.

### Commercial Paper

Short-term debt called commercial paper matures between one and 270 days. Commercial paper is mostly used by corporations for short-term cash-flow needs, but states and municipalities also use it. New York City, for example, uses this type of debt for water and sewer projects.

package enacted last month.

Massachusetts Democrat Barney Frank, chairman of the House Financial Services Committee, thinks the problem lies with the bond rating system, and he has written a bill that would change the way municipal bonds are rated to reflect that they have much lower default rates than corporate debt. Frank, who has said he intends to pursue the matter soon, says he believes the change would lower costs.

Another House Democrat from Massachusetts, Richard E. Neal, has proposed restoring the tax deduction that banks and financial companies can take for carrying and buying tax-exempt bonds. That deduction was eliminated in 1986.

Currently, banks can only get a deduction on tax-exempt securities issued by small governments that don't borrow more than \$10 million per year. Neal says giving banks and financial companies an incentive to buy municipal securities would broaden the market and lower borrowing costs.

In a mid-October appearance before the House Budget Committee, Bernanke urged lawmakers to consider policies that would help municipal bond issuers, though he didn't specify how. "This might be an area where the federal government could assist the state and local governments at lower cost by simply helping them obtain credit at more normal rates," Bernanke said.

#### FILLING BUDGET HOLES

Bernanke also told the Budget panel that he supported enactment of an economic stimulus bill soon that would aid cash-starved states, provided the money was targeted so it would be spent quickly. States, meanwhile, say the money is increasingly essential.

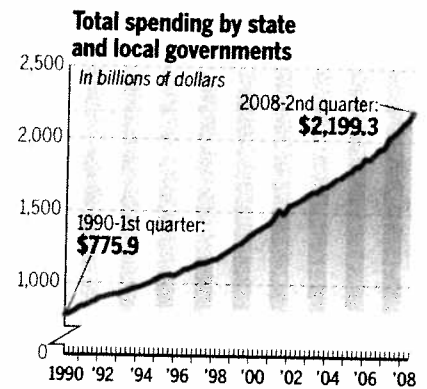
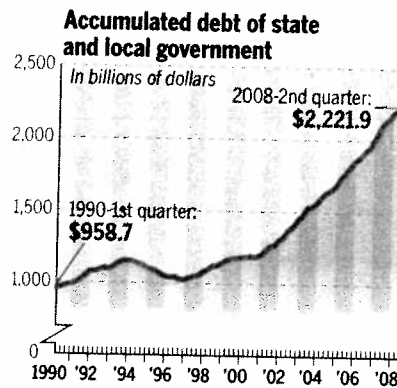
Fifteen states surveyed by the Center on Budget and Policy Priorities reported a median drop of 5.9 percent in tax revenue in inflation-adjusted terms for the third quarter compared with a year ago.

About half of the states cut their budgets this year, reducing support for everything from schools to public health, and 18 states trimmed their work forces. California and New York are among the states that have called their legislatures into emergency sessions this month to work on closing the gap.

Scheppach, of the governors' association, projected the shortfall between the amount states have budgeted and their actual revenue could reach \$50 billion to \$60 billion this year. And he said it could grow to \$80 billion

## Debtor Nation: Borrowing on the Rise

Accumulated borrowing by state and local governments has more than doubled in the past two decades, although most of the surge has occurred in recent years. Meantime, taxpayer-financed operations have grown steadily over the period, partially to cover payments on increasing amounts of debt.



SOURCES: Federal Reserve, Bureau of Economic Analysis

“So far, we are holding our own, but I am worried about the next year.”

— Carol Ebdon, Omaha, Neb.,  
finance director

for fiscal 2010. There's a lag, he pointed out, between the beginning of an economic slump and the time when families that are out of work make peak demands on such state programs as unemployment benefits and health care. Any stimulus plan should take that into account, he said.

"My own sense is that it would be good to get around \$20 billion a year for two years," he said — roughly the amount given to states during the last recession. That would cover a third of the states' budget shortfall this year, but also kick in some aid next year when it may be needed even more.

And while states are pleading for help, they are doing so with the recognition that their problems will also affect local schools and other services provided by municipalities.

New Jersey Gov. Jon Corzine, a Democrat and former senator, told reporters on Capitol Hill last week that cuts at the state level would trickle down to cities and towns, forcing government officials at all levels to curtail spending. "It's a very difficult set of choices each of these units of government are going to have to make, and they're very large

numbers," Corzine said.

State officials are increasingly optimistic that they are being heard in Washington.

"While it's certainly not a done deal that they're actually going to address this in a lame-duck session, I think the prospects have improved," said Michael Bird, federal affairs counsel for the National Conference of State Legislatures. If not, Bird said, the prospects of enactment of a stimulus measure in January or February appear even more promising.

Even states that have already cut spending and raised taxes say they are going to have problems if they don't get federal help — and soon.

In Maryland, for example, lawmakers hashed out a plan in special session to get the budget under control, including spending cuts, tax increases and revenue from slot machines that is subject to voter approval this week. Even with all that, Neil Bergsman, director of the Maryland Budget and Tax Policy Institute, said his state projects a deficit next year of more than \$1 billion.

Even with anticipated assistance from Washington, states are girding themselves for what may be their worst budget crisis in a quarter century, Scheppach said. "I use one term — ugly." ■

**FOR FURTHER READING:** *Nation's demand for improved infrastructure*, CQ Weekly, p. 1248; *economic needs vary state to state*, p. 242; *Frank bill on municipal bond ratings is HR 6308*, p. 2134; *Neal bill on bank holdings of municipal bonds is HR 6333*.