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INVESTORS SERVICE

SPECIAL COMMENT

Roadmap 2010: U.S. State Governments

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Summary Opinion

This is the third of three roadmap special reports pertaining to specific conditions now being faced by U.S. public finance markets and how we assess their credit impact. The two prior roadmaps examined key ratings drivers for housing and local government credits. This roadmap outlines those credit factors we expect to be most prominent as we review U.S. State Government credits over the next year.

The U.S. State Government sector has carried a negative outlook since February 2008 reflecting weak economic conditions that have resulted in three years of reduced revenue for state governments. States have responded to this serious challenge by taking decisive actions. These actions have included reducing expenditures, spending reserves, and in some cases, increasing taxes and other revenues. However, certain states have continued to spend more than their current revenues causing reserves for operations to be virtually depleted, thereby reducing future financial flexibility. In addition, the federal fiscal stimulus dollars made available by the American Recovery & Reinvestment Act are set to expire during the current fiscal year, adding future downward pressure on revenue.

Despite the narrowing options that states have available to deal with declining revenues, we expect the sector overall to remain resilient, barring a return to severe recessionary conditions. States possess many tools to maintain their credit position and will continue to need to deploy them as they face continued high unemployment and weak revenue growth. Further adjustments to lower spending, with some instances of tax increases, are likely to continue for the next year or more.

Moody's ratings are forward looking and assigned and maintained in accordance with our published methodology evaluating economy, finance, governance and debt. However, as the financial and economic landscape changes each year, we can identify several factors that we expect to impact our rating analysis.

The factors we expect to have the most significant impact on state credit ratings this year include:

1. Reliability of budgets and revenue forecasts
2. Risk of double dip recession
3. Magnitude of structural imbalance
4. Phase-out of federal stimulus funding
5. Financial flexibility and availability of reserves
6. Available liquidity
7. Extent of long-term liabilities (debt, pension and OPEB funding) and near-term impact on budgets
8. Exposure to variable rate debt and rollover risk
9. Political consensus related to spending and benefit levels

For more information on our outlook for U.S. State Governments, please see Annual Sector Outlook for U.S. State Governments, February 2010 (123172).

Background

Early in 2009, more than a year into the recession that began in December 2007, as we waited to see how the American Recovery & Reinvestment Act (ARRA) would take shape, we defined six characteristics that would drive rating changes in 2009[1]. At that time, the potential pressures included revenue declines, liquidity, recession induced spending pressures, and deficit financing. Offsetting these potential negative pressures were two important potential positive mitigants: the extent to which federal fiscal stimulus would be available to support state operations and the extent to which management responded to revenue weakness.

As it turned out, the federal fiscal stimulus was extremely beneficial for states, making $135 billion available primarily to pay for education and health care. This allowed states to use their diminished revenues to support public safety and other essential public services and to avoid politically unpopular tax increases. As a result, only five states were downgraded during 2009. Many school districts, universities and hospitals were also spared severe budget cuts and credit deterioration.

Now, most economists believe that the recession has ended. The seemingly endless downward spiral in revenue receipts experienced over the last two years appears to have stabilized, although it may have bottomed out at an uncomfortably low level. The economic news continues to be mixed. This spring, encouraging news indicated that private sector jobs were being created, existing homes were being sold, and consumer confidence, albeit low, was rising. Further, withholding taxes and corporate income taxes, both leading indicators, exceeded projections in many states. Even as this good news surfaced, sales tax receipts were still disappointing and refund requests from corporations exceeded

[1] *Outlook Remains Negative for U.S. States: Federal Fiscal Stimulus May Moderate Recession's Effects on U.,S. States; Impact from Recession Will Not be Equal*, February 2009 (114526)

expectations. Now, mid-year reports indicate that, while the unemployment rate has modestly declined, so has the number of nonfarm jobs, suggesting that labor force participants are, once again, discouraged and dropping out of the job market. Federal fiscal stimulus is scheduled to wind down at a time when the size of state budgets has been cut to resemble those not seen in five years.

Reliability of Budgets and Revenue Projections

Revenues have proven extremely difficult to project accurately since the middle of fiscal year 2008 when the recession began. Since then, even states using pessimistic economic projections to forecast revenues have fallen short on virtually every line item. Accurate projections of income taxes and sales taxes – which account for approximately three-quarters of all state revenue -- have proven to be elusive, and it was only this spring when it appeared that revenue estimates had finally captured the full impact of the recession. However, even as it appears that some revenues have hit bottom, uncertainty continues. Personal income taxes and sales taxes are highly dependent on employment trends, but the labor markets continue to waiver; growth in manufacturing employment (9.1% of the U.S. total) has slowed and other sectors including construction (4.6% of the U.S. total) continue to suffer. In June, with the release of 225,000 temporary census workers, nonfarm payroll employment actually declined.

A unique aspect of personal income relates to non-wage income; capital gains and other unearned income. After the rally during the week of July 4, the stock market is off a little more than 2% for the year, as measured by the Dow Jones Industrial Average, which does not provide much incentive to sell stocks. However, investors sitting on investment gains from prior years may chose to sell securities in calendar year 2010, as the 15% tax rate on capital gains is set to expire and a higher capital gains tax rate is anticipated beginning in 2011.

If employment is unsteady, the stock market continues to lose ground and home prices don't improve, consumer confidence is likely to stay low and sales tax revenues may continue to be depressed as well.

Over the past year, we have seen the use of an increasing number of aggressive assumptions. As fiscal year 2011 begins for most states, we see reliance on yet-to-be-approved federal funding emerging as a theme in roughly half of state budgets. Other budget balancing actions, which may not be realized or may yield less than budgeted amounts include the sale of public buildings, increased cigarette taxes, tax amnesty, and sale of various licenses including those for state parks, casinos and other forms of gambling. Since, by definition, revenues that have not been implemented are uncertain, we view budgets that are dependent on these types of assumptions to be less conservative than those where spending is constrained to existing revenue streams. Budgets based on unreliable funding will be viewed more negatively than those that are more conservatively constructed.

Similarly, many budgets include expenditure savings that may not be fully achievable. Several states have budgeted savings related to the consolidation of functions that are in various stages of planning. Others anticipate budgetary savings by assuming cuts to certain Medicaid services and other programs. Others have, once again, budgeted savings from so-called "scoop and toss" debt refundings whereby states refinance current year debt service to produce current year budgetary relief. A state's inability to achieve planned savings without offsetting incremental revenues will likely lead to mid-year budgetary adjustments. A state's unwillingness to adjust its budget in the face of unrealized savings will lead to higher structural imbalances and could lead to a change in outlook or downgrade.

Risk of Double Dip Recession

The consensus of economists as per the July Blue Chip Economic survey is that there is a 20% probability of a another quarterly contraction of real GDP before the end of 2011. In testimony given before the House Budget Committee on July 1st, Moody's Economy.com assigned a 25% probability to the likelihood of a double-dip recession if Congress enacts additional federal fiscal stimulus this summer. Without additional stimulus in the form of additional unemployment insurance, an extension to federal Medicaid matching funds, and funding for small business lending, Moody's Economy.com's projection for a double-dip recession increased to 33%. While a return to negative growth in gross domestic product is not a majority view, significant reductions in government spending as well as liquidation of the real estate still held by the world's banks could cause adverse economic condition.

No state has built a budget on an assumption of a double-dip recession as fiscal year 2011 begins. In fact, across the board, states are expecting reasonably modest growth from a low base over the next year. Without growth in the economy or, if the GNP turns negative, states will again be faced with making difficult choices between reducing services and raising revenues. The longer unfavorable economic conditions prevail, the harder and harder these choices become. Although not the likeliest scenario, a double-dip recession would force states to take prompt actions to reduce spending further or to raise revenues to address the new gaps that are likely to occur with that scenario.

Magnitude of Structural Imbalance

Due to the receipt and use of federal fiscal stimulus funds, most states' budgets are currently not structurally balanced (recurring revenues meeting or exceeding recurring expenditures). While we expect these ranges to narrow as the recovery takes hold, the current structural imbalances generally are less than 10% for Aaa-rated states, between 10% and 15% for Aa1-rated states, up to 25% for Aa2-rated states, and as high as 35% for lower rated states. The lack of structural balance has been exacerbated by the use of nonrecurring budget solutions such as sale of assets, temporary increases in various revenues, delay of state aid and vendor payments, and the use of deficit financing. These approaches have been successfully implemented in past recessions, serving as a bridge to V-shaped recoveries. However, recovery from the most recent recession is expected to be very slow. The economy is not expected to heat up fast enough to generate revenues to fill the large structural imbalances that have materialized in some states. Furthermore, with budgets already $52 billion below fiscal 2008 levels according to the National Association of State Budget Officers, reducing expenditures will likely be very difficult. Those states with large structural imbalances will have less remaining financial flexibility than other states and may find it difficult to find recurring solutions to support operations in the future. As a result, this year we expect to flag the magnitude of structural imbalance as an important potential rating trigger. Structural imbalance of a magnitude larger than other states in a particular rating category could result in a negative outlook or downgrade.

Financial Flexibility and Availability of Reserves

As expected during a severe recession to address unforeseen expenditures or unexpected revenue loss, most states have now used a portion of their financial reserves. Some states, including Kentucky, Ohio, Nevada, and Pennsylvania have now exhausted their financial reserves. Despite this use of reserves, some higher rated states including Virginia have begun to replenish these reserves to guard against the next unforeseen financial pressure or have mandated formulas in place that will help rebuild reserve funds going forward. Those states that are replenishing reserves or reasonably budgeting for ending surpluses will be viewed more positively than those that have exhausted their

reserves and have no plans for replenishment. Despite drawdowns, Aaa-rated states generally still have modest balances in their reserve accounts while reserves for many lower rated states are projected to be zero when fiscal year 2010 finances are closed out. As such, focus on reserves in the next year will focus not only on the amount of reserves on hand, but on plans to replenish reserves that have already been drawn down. Aaa-rated states are expected to implement plans to restore reserves even as they use existing reserves to cushion current operations. Aa1-rated states should at least have plans to replenish reserves when the economy improves. Lack of plans to replenish reserves is more characteristic of Aa2 and lower rated states.

Available Liquidity

With the reduction in revenues experienced by states during the last two years, liquidity has narrowed. Thirteen states, including Pennsylvania, which is not a regular cash-flow note issuer, addressed this situation by issuing cash-flow notes in fiscal 2010 or acquiring lines of credit. In addition to or in lieu of cash-flow borrowing, states including Arizona, California, Illinois, Kansas, and New York delayed vendor payments or state aid. Moody's will continue to assess a state's ability to pay its obligations by keeping a close watch on its liquidity options. States with available cash or programs in place to obtain it will fare better than those that have no contingency plans in the event of a cash short-fall. States with available internal liquidity or those that have established a line of credit to address possible cash-flow needs as well as those states authorized to temporarily defer certain payments without major operational disruption will be viewed more positively than those that are reliant on access to the capital markets for such cash-flow and will likely be rated in the Aaa to Aa2 range. States without authorization to modify the timing of large expenditures or those that have exhausted their ability to defer payments on a temporary basis will likely be rated lower than Aa2. Regardless, we expect liquidity to remain tight in fiscal year 2011 and therefore expect to see increased volume of cash flow notes issued and possibly more states accessing the capital markets for cash. California has projected the need for a $10 billion cash flow borrowing, 14% more than the state borrowed for cash flow in fiscal year 2010.

Extent of Long-Term Liabilities (Debt, Pension and OPEB Funding) and Near-Term Impact on Budgets

A state's fiscal position cannot be thoroughly assessed without taking long-term liabilities into consideration. Chief among these long-term liabilities for most states are those for debt, pensions, and other post-employment benefits (OPEB). The median net tax-supported debt as a percentage of personal income for U.S. states is 2.6% based on our 2010 state debt medians report. However, this measure for individual states ranges from virtually nothing for Nebraska to 9.4% for Hawaii which issues debt on behalf of its political subdivisions. While the absolute burden that this debt places on state budgets is considered in a credit assessment, the rate of increase is also an important indicator of future stress. A state such as New Jersey that has lowered its debt burden as a percentage of personal income from a high of 7.9% as of our 2006 report to 7.2% as of our 2010 report is viewed more favorably on this measurement than a state whose debt burden has steadily grown such as Rhode Island whose net tax-supported debt as a percent of total state personal income has increased from 4.1% to 5.2% during the same four-year period.

The stock market decline in 2008 left states with significantly higher unfunded pension liabilities. According to the U.S. Bureau of the Census, public pension funds lost an average of over 25% in 2008. This reduction in pension funded ratios resulted in higher actuarially-calculated annual required contributions, bringing more budgetary pressure to states that strive to meet that level of funding. The more recent recovery of stock market values could ease some pressure on funding levels

for most states, but that easing is not likely to be felt until an update in the actuarial accounting, which varies among states in frequency and timeliness and may not occur in fiscal 2011.

Similarly, states are more acutely aware of their responsibility to fund growing post-retirement benefits. States like California and New York have continued to pay into their pension trusts even as their revenues have declined, either because they are required to or because they believe it is a basic financial discipline. As a practical matter, most states have chosen to pay only current costs for OPEB during this recessionary period. Many states including New York, New Jersey, and Illinois have adopted pension reforms, primarily reducing benefits for new employees, and many other states are studying similar benefit reductions. Other reforms include requiring higher employee contributions to pension plans, increasing the age at which a retiree could collect his pension and basing the pension payment on the average of more years of service, thereby lowering the benefit. Alaska has adopted a mandatory defined-contribution plan for all new workers while Utah and Michigan have introduced so-called "hybrid" plans whereby a portion of the benefit is fashioned like a 401(k) plan and the balance is guaranteed by the state.

The burden of post-retirement health care costs for those states that offer such a benefit, has grown as the cost of health care has increased significantly over the recent past. While few states have explicitly changed these benefits as they have for pensions, it is widely held that these benefits are not protected by state constitution and therefore can be modified at any time. Recently, for instance, West Virginia completely eliminated its state-paid post retirement health care benefit.

Based on these varying practices, a potential rating trigger for 2010 will be an assessment of various factors related to long-term liabilities and the near term budget pressures associated with providing these benefits. We will examine unfunded actuarial values, contribution trends, the affordability, as well as policy modifications that will impact liabilities over time.

While, in most states, contributions to pension and OPEB trusts can be modified from year to year, debt service is, of course, fixed. However, if support for pensions and retiree health care is not fully funded for a significant amount of time, the pressures on a state's annual budget, without regard to investment profits or losses or plan changes, will grow. At this point, debt service constitutes less than 10% of most state's budgets and is therefore manageable. The median combined pension and OPEB actuarially-determined annual required contribution is another 11%. Therefore, all other things being equal, we would expect average states – those rated Aa1-- to have up to approximately 20% of their budgets dedicated to a combination of debt service, pension and OPEB while higher rated states would have less exposure and lower rated states could have greater exposure.

Exposure to Variable Rate Debt and Rollover Risk

The amount of variable rate exposure as well as rollover risk, including the risk that bank liquidity facilities may be expensive or hard to obtain, are an important part of our credit analysis. The sheer size of U.S. state budgets and the relatively insignificant amount of variable rate debt they generally have outstanding as compared to their total outstanding debt, however, minimizes the impact of this exposure. Also, most states with outstanding variable rate debt have matched that debt with some form of swap. These swaps typically limit a state's exposure to interest rate volatility.

One area that could result in a negative credit impact is one where a state has unhedged swaps (those that are not matched with outstanding variable rate debt), particularly when those swaps have collateral posting requirements or automatic termination provisions. We will examine a variety of

interest rate scenarios to evaluate the potential impact of swaps and variable rate debt on budget pressure.

Political Consensus Related to Spending and Benefit Levels

As revenues have declined, states across the country have held the line on or lowered spending for various programs. Since early 2009, however, federal fiscal stimulus funds have been available to buoy support for education and Medicaid, which together comprise about two-thirds of state budgets. Now, as the federal fiscal stimulus funds are about to run dry and most states have depleted their rainy day funds, governors and state legislatures are debating whether to fund current programs and services and, if so, how. Despite the continued strong anti-tax sentiment, these debates focus on whether or not to lay off public employees or reduce their salaries and/or benefits; whether or not to cut social services or to increase class sizes. While Moody's does not take a position on public policy, there is an emerging consensus around the need to reduce public sector salaries and benefits. In some states, the debate surrounds whether programs and services have been cut to the bone or whether they need to be paid for through increased revenues. Raising taxes is an untenable option for others, especially given the pressures on constituents brought on by the recession.

If federal stimulus funds are not extended beyond December 2010, we expect 18 states will need to address midyear budget gaps, given these states currently do not have a backup plan to fund the portion of Medicaid costs that the federal government paid as a result of the American Recovery and Reinvestment Act. States that cannot reach agreement about how to address emerging budget gaps for the current fiscal year and those for which the adoption of fiscal year 2011 budgets are delayed by political discord are likely to be viewed more negatively by Moody's than states for which the budgetary process is constructive and timely.

Moody's Related Research

Special Comments:

- » Roadmap 2010: Local Governments, July 2010 (125375)
- » Roadmap 2010: State Housing Finance Agencies, July 2010 (126017)
- » U.S. State and Local Governments Remain Inherently Resilient, Despite Growing Pressures, February 2010 (123154)
- » U.S. States' Note Issuance Rises as Fiscal Weakness Contributes to Cash Flow Stress, February 2010 (120179)
- » Are U.S. Municipal Issuers on the Road to Recovery?, August 2009 (119381)
- » Impact of the Credit Crisis and Weaker Economy on States Governments, October 2008 (112042)

Outlook:

- » Annual Sector Outlook for U.S. State Governments, February 2010 (123172)

Rating Methodology:

- » Moody's State Rating Methodology, November 2004 (89335)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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