



Inferential Focus

eFOCUS

eF 304

March 18, 2008

### **Seeing Beyond Muni Insurance: The Municipal Government Squeeze**

Austerity will be the name of the game for municipal governments as tax receipts decline and debt financing costs rise. Unfortunately, such cutbacks would be another “ripple” from the housing crisis that would further undercut the overall economy. In our last eFocus (see **eF 303**, 3/11/08), we noted that weakness in commercial real estate could have a pronounced effect on the economy’s overall health, because commercial construction now represents a record high proportion of the total economy. Similarly, municipal government spending now represents 12.5 percent of U.S. GDP, a level not seen since 1975. Therefore, state and local government cutbacks would have a pronounced economic effect, compared with previous business cycles.

Ongoing speculation about the health of municipal bond (muni) insurers has tended to ignore this larger context of a squeeze on state and local governments. Muni rating downgrades and even the possibility of rating downgrades increase the costs of issuing debt. For instance, early this year, muni interest rates spiked anywhere from one-quarter to nearly one-half percentage point, when investors started worrying such bonds would be downgraded due to the insolvency of insurers. The effects of this uncertainty swiftly reached the debt markets. The volume of municipal bond issuance declined roughly 80 percent in the first 5 weeks of this year. Increased costs could affect the budgets of hospitals and school districts, as well halt plans for capital improvements to infrastructure. (*Financial Times*, 1/31/08; *Christian Science Monitor*, 2/8/08; *The New York Times*, 2/2/08)

Meanwhile, as we wrote in a past eFocus, (see **eF 104**, 8/1/06), municipal governments are now in the process of estimating their unfunded liabilities, such as pension and retiree health benefits. A new accounting rule forces such a disclosure and could lead to lower credit ratings for states with enormous liabilities, further increasing borrowing costs and limiting capital improvements.

Fears over the muni market have hiked borrowing costs for states and cities at a time when they face broader budgetary challenges from their traditional revenue streams. With a heavy reliance on real-estate and sales taxes, weakness in the housing market and in consumer spending could create dual nightmares for municipalities. Meanwhile, voters, feeling a financial squeeze from a variety of price increases, just as home values fall, are showing signs of rebellion against tax hikes. Last November, voters in Florida amended their constitution to slash property taxes while voters in Texas passed four tax-relief initiatives. In Washington, a ballot initiative passed that would require a two-thirds legislative majority to increase taxes. Utah, Arizona and Nevada voters are debating their own tax-limiting initiatives. New Jersey commuters have expressed outrage at Governor Corzine’s plans to increase rates on the state’s toll roads. (*Education Week*, 2/6/08; *New York Times*, 2/27/08; *Investor’s Business Daily*, 11/9/07; *Seattle Times*, 11/8/07)

At least 15 states are running deficits this year, and at least 25 states are now projecting shortfalls for fiscal 2009, forcing governors in several high population states, including California, New Jersey, New York, and Arizona to propose steep budget cuts. Facing a budget gap equal to 16 percent of its general fund – the largest deficit by percentage in the nation – Arizona’s governor announced a hiring freeze. New Jersey’s governor announced up to 3,000 job cuts. Rhode Island’s governor has proposed an overall 8.7 percent spending cut, which would cut welfare and healthcare spending, hundreds of state jobs, and aid to local governments. New Jersey is also proposing cuts in aid it gives to local governments, with Governor Corzine suggesting that fiscal responsibility may require smaller municipalities, school districts, and safety districts to merge, and then cut costs – a traditional corporate M&A rubric. (*Education Week*, 2/6/08; *Chronicle of Philanthropy*, 2/21/08; *The New York Times*, 3/17/08; *AP*, 2/1/08; *New York Times*, 2/27/08)

While that proposal may reflect Corzine’s investment banking mindset, it also demonstrates the enormity of the budget crisis some states are facing. California’s government cut \$2 billion in spending in recent weeks, primarily in healthcare and education, although they have a long way to go to balance a budget with a \$14.5 billion deficit. Governor Schwarzenegger has even proposed freeing as many as 22,000 prisoners to counter the rapidly rising costs of the state’s penal system. Meanwhile, nine states are reducing their Medicaid spending. (*Christian Science Monitor*, 2/25/08; *LA Times*, 2/16/08; *San Francisco Chronicle*, 12/21/07)

Increased pressures to raise capital, in light of rising debt costs and falling revenues, have led at least one state to question the current paradigm for issuing municipal bonds. California’s treasurer is soliciting the support of other states to lobby the credit-rating agencies to grade municipal bonds with the corporate bond ratings rubric, rather than maintaining two separate scales. That change would put most municipal bonds automatically into the Triple A or Double A categories, since municipal governments rarely default. Right now, more than half of municipal bonds are rated A or lower, which makes them ineligible for investment by money-market funds and which elevates the cost of issuing the bonds. While this battle plays out to secure cheaper debt financing, many municipal projects may go on hold. California has decided to save on borrowing costs by forgoing muni insurance altogether. While the state spent \$102 million insuring bonds between 2003 and 2007, it did not purchase any insurance for its two most recent issuances of over \$1 billion. In January of this year, municipalities nationwide borrowed just \$8.6 billion through new bonds guaranteed by insurers, compared with \$31 billion in January of 2007. (*New York Times*, 3/3/08; *MarketWatch*, 3/1/08; *Financial Times*, 1/21/08)

In sum, the state and local government sector – a large contribution to the U.S. economy – is just starting to grapple with lower revenues, higher borrowing costs and rising social-services expenses. Citizens are in no mood to pay higher taxes, and demand for government services in an economic slowdown is likely to rise even further. Meanwhile, a spending slowdown in this sector will aggravate slowdowns in other areas. For example, the construction and materials sectors could face a triple whammy in the coming months, with a slowdown in municipal government spending, the ongoing housing crisis, and a potential pullback in commercial real estate. This squeeze on state and local governments should continue well into 2009, which means contraction from this sector will drag down the overall economy for just as long.