# State of the States / April 2010

## CHALLENGES AHEAD – WHAT'S THE PROGNOSIS?

We are now in the second year of an economic recovery – however, fiscal challenges for states and local governments are not yet abating. State revenue growth has historically lagged the end of a recession between 18 months and 2 years. This time, the recovery pattern for states may be longer due to the slow recovery in home prices – an important driver of state revenues.

State tax collections were down 8.6% in 2009 from 2008 per the U.S. Census Bureau. All states experienced year-over-year revenue declines, net of tax increases. Tax revenue for the fourth quarter of 2009 vs. the same period last year showed a very small increase, indicating that state revenue growth may be resuming. Many of the most populous states have huge budget gaps to close over the next few months before the start of the next fiscal year starting July 1, including California, Illinois, New York and New Jersey. As bad as it is for states, we are even more cautious about local governments, as states reduce tax support, pushing their problems down to local governments and school districts, entities that have fewer options than states to develop solutions.

States face an especially difficult process in crafting balanced budgets for FY 2011 (starting July 1 for most states). After several difficult budget cycles, most of the fiscal one-time measures and reserve funds have been exhausted. Funds provided from the American Recovery and Reinvestment Act of 2009 (ARRA) were used to close FY 2009 and FY 2010 budget gaps and will be used again in 2011. The ARRA stimulus monies phase out in 2011, potentially creating a new revenue gap for FY 2012. The ARRA provides the states with much needed increases in their share of Medicaid expenses paid by the federal government and money for education.

While states deal with current fiscal issues, the seeds of the next credit issue have already been sewn – unfunded retirement costs. According to the Pew Foundation, states face an aggregate one trillion dollar unfunded bill for pensions and other post retirement benefits – namely health care. Annual required contributions for retirement plans are consuming an ever-increasing share of scarce state resources. There is a wide variance among states in both the size of their unfunded liabilities and their proposed solutions, contributing to a growing dispersion in credit quality among the states.

Our outlook for state credit quality remains negative. Although political risks are rising, we expect states to take the necessary actions to balance their budgets as required by their constitutions. Increased retirement costs, expiration of ARRA stimulus monies and increasing healthcare costs pose credit challenges beyond the current year.

## KEY FINDINGS

- Conning maintains a negative outlook on bonds backed by State General Fund revenues;
- All states are experiencing varying degrees of fiscal stress – not just California and Illinois;
- However, state revenues finally may have begun to stabilize;
- Local tax-backed credits are under increasing credit stress as states push down problems to local level;

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- Increased headline and political risk lie ahead as states need to make painful choices to raise revenues and cut expenditures to balance FY 2011 budgets;
- Unfunded retirement costs pose a long term threat to state credit quality;
- The American Recovery and Reinvestment Act of 2009 (ARRA) has assisted states in addressing current budget issues, but alone cannot solve longer term budget deficits and will be going away;
- Current Rating Agency ratings are catching up to states' weakened credit quality;
- State credit quality is a lagging economic indicator – weak state fundamentals will continue into 2011;
- The likelihood of a state GO payment default remains remote;

## STATES HAVE INHERENT CREDIT STRENGTHS

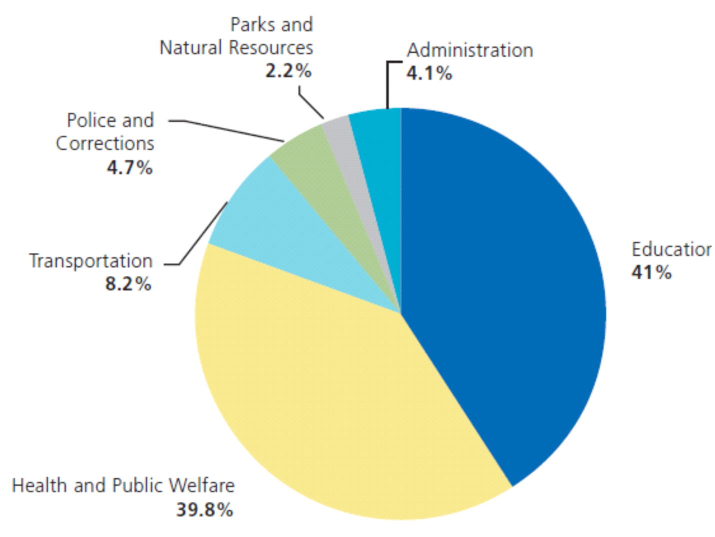
States are the largest issuers of debt in the municipal marketplace. State GO bonds are widely considered the lowest risk type within the municipal credit universe with an average rating quality of "AA." Credit strengths are based upon their full faith and credit pledge, sovereign powers with substantial control over spending and revenue raising, broad economic and tax bases and the ability to access credit markets on short notice. States cannot declare bankruptcy and all are required by their constitutions (except for Vermont) to balance their budgets. Credit problems generally arise because of an inverse correlation between revenues and expenditure needs during economic cycles.

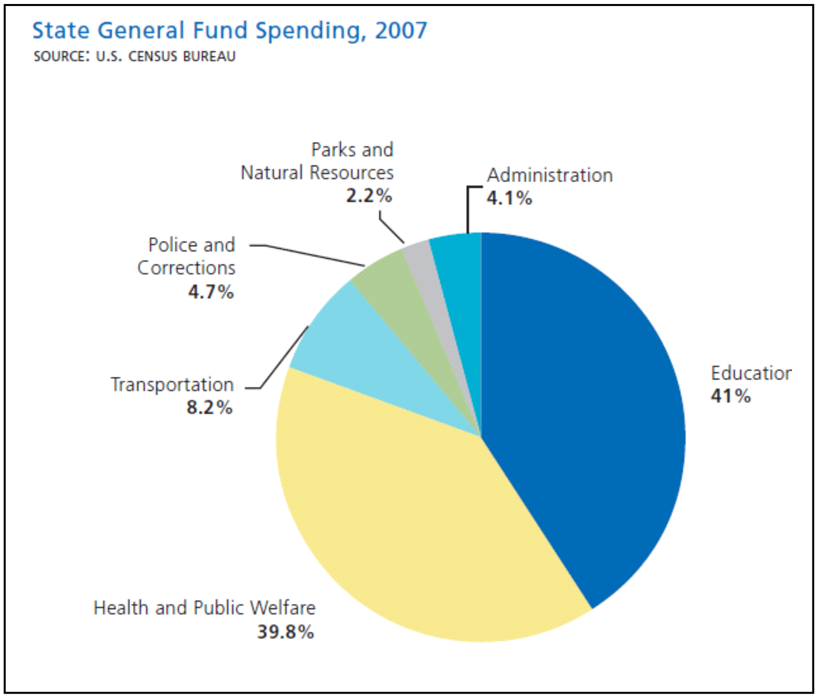
## STATE REVENUES AND EXPENDITURES

State budgets are very vulnerable to changes in economic conditions due to their revenue and expenditure mix. Unlike local governments, which rely more on historically stable property tax revenues, states on average depend on personal and corporate income taxes and sales taxes for almost 90% of their General Fund revenues.

State General Fund Spending, 2007

SOURCE: U.S. CENSUS BUREAU






As illustrated at right, state spending is concentrated in education and healthcare, needs that increase during recessions. Any material cost-cutting needs to include reductions to education and health care, which are politically difficult to reduce.

## STATE OF THE STATES METHODOLOGY

The major purpose of our study is to differentiate credit quality by state. Conning's proprietary model ranks the states and provides outlooks based on quantitative factors that we believe are predictive of credit quality. We have selected ten indicators that measure what we believe matters most and also have calculated individual state credit outlooks based on a different set of five indicators that measure change over a shorter period of time. Developing our unique analysis of state credit quality helps us determine relative value between states. This report provides us with a disciplined approach to manage state exposures for both State GO debt and other credit types within the state.

The willingness and ability of states to take corrective budget action is a critical strength common to all states, but in our opinion it obscures less controllable, but real credit differences among states. Our goal is to rank the states by objectively using the credit indicators that provide a less subjective and truer indication of the economic and fiscal health of the states.

## CREDIT INDICATORS

The selected indicators measure a state's business climate, economic activity, changes in housing prices, wealth, debt loads, income and economic factors as well as traditional state financial condition credit measures. Over the years, we have changed some of the credit indicators to reflect new priorities. This year we added economic debt per capita, replacing stimulus funds per state. Economic debt per capita includes direct plus unfunded pension and other post-employment benefits (OPEB) liabilities (namely health care) as debt. This captures a truer measure of a state's debt load. This has resulted movement in the rankings. Connecticut, which has the highest economic debt per capita, fell to 35th from 30th in our rankings.

We also added Medicaid enrollment as a percentage of the population as an indicator replacing median family income. Medicaid expenditures are a high percentage of state expenditures and are difficult to cut. California, which has the highest percentage of its population on Medicaid, saw its rank fall to 48th from 44th.

The tables on the following page set forth the indicators and the weightings assigned to arrive at overall credit and outlook rankings.

| Credit Indicator | Measurement | Weighting |
|---|---|---|
| Laffer State Economic Competitiveness Ranking | State business climate | 10% |
| FY 2009 General Fund Balance as a % of General Fund Revenues | Financial Condition | 10% |
| Debt per capita | Financial Condition | 10% |
| Economic Debt per capita | Financial Condition | 10% |
| Debt service as a % of GF expenditures | Financial Condition | 10% |
| Real State GDP 3 year average growth | Economic activity | 10% |
| Year over year employment growth | Economic activity | 10% |
| One year home price changes | Housing Price Movement | 10% |
| Per capita income | Income level | 10% |
| Medicaid enrollment as a % of population | Income level | 10% |

## THE RESULTS

| State | April 2010 Rank | October 2009 Rank | Improvement / Decline |
|---|---|---|---|
| North Dakota | 1 | 2 | 1 |
| South Dakota | 2 | 3 | 1 |
| Nebraska | 3 | 5 | 2 |
| Texas | 4 | 9 | 5 |
| Iowa | 5 | 6 | 1 |
| Wyoming | 6 | 1 | -5 |
| Virginia | 7 | 7 | 0 |
| Colorado | 8 | 10 | 2 |
| Oklahoma | 9 | 3 | -6 |
| Montana | 10 | 12 | 2 |
| Kansas | 11 | 18 | 7 |
| Utah | 12 | 23 | 11 |
| Minnesota | 13 | 8 | -5 |
| New Hampshire | 14 | 16 | 2 |
| Idaho | 15 | 36 | 21 |
| Tennessee | 16 | 26 | 10 |
| Alaska | 17 | 13 | -4 |
| Indiana | 18 | 29 | 11 |
| Arkansas | 19 | 31 | 12 |
| Missouri | 20 | 17 | -3 |
| Louisiana | 21 | 20 | -1 |
| Nevada | 22 | 40 | 18 |
| North Carolina | 23 | 43 | 20 |
| Arizona | 24 | 35 | 11 |
| Pennsylvania | 25 | 25 | 0 |

*continued on the following page*

| State | April 2010 Rank | October 2009 Rank | Improvement / Decline |
|---|---|---|---|
| Maryland | 26 | 14 | -12 |
| Vermont | 27 | 11 | -16 |
| Washington | 28 | 19 | -9 |
| Florida | 29 | 38 | 9 |
| Massachusetts | 30 | 15 | -15 |
| Georgia | 31 | 41 | 10 |
| Maine | 32 | 28 | -4 |
| Alabama | 33 | 45 | 12 |
| Oregon | 34 | 37 | 3 |
| Connecticut | 35 | 30 | -5 |
| Wisconsin | 36 | 34 | -2 |
| New York | 37 | 22 | -15 |
| South Carolina | 38 | 47 | 9 |
| Mississippi | 39 | 27 | -12 |
| Michigan | 40 | 48 | 8 |
| Ohio | 41 | 49 | 8 |
| New Jersey | 42 | 42 | 0 |
| Rhode Island | 43 | 39 | -4 |
| West Virginia | 44 | 32 | -12 |
| New Mexico | 45 | 21 | -24 |
| Kentucky | 46 | 50 | 4 |
| Hawaii | 47 | 33 | -14 |
| California | 48 | 44 | -4 |
| Illinois | 49 | 46 | -3 |
| Delaware | 50 | 24 | -26 |

## IMPROVING STATES

The following states had double digit improvements in their state rankings. The most common ingredients of the improved states were low debt levels and a strong business climate; these characteristics were found in several southeastern and western states.

| State | Rank Apr '10 | Rank Oct '09 | Improvement in Rank | Reasons for Rank improvement |
|---|---|---|---|---|
| Idaho | **15** | 36 | 21 | Improved business environment, low Medicaid levels and lower debt levels |
| North Carolina | **23** | 43 | 20 | Improved business environment, steady home prices and low debt levels |
| Nevada | **22** | 40 | 18 | Low Medicaid population, strong business environment and modest debt levels |
| Alabama | **33** | 45 | 12 | Low debt levels, steady home prices and good business position |
| Arkansas | **19** | 31 | 12 | Very low debt levels and steady home prices |

*continued on the following page*

| State | Rank Apr '10 | Rank Oct '09 | Improvement in Rank | Reasons for Rank improvement |
|---|---|---|---|---|
| Arizona | **24** | 35 | 11 | Very low debt levels and a strong business climate |
| Indiana | **18** | 29 | 11 | Low debt levels and improved general fund operations |
| Utah | **12** | 23 | 11 | Strong business climate, low debt levels and small Medicaid population |
| Georgia | **31** | 41 | 10 | Low debt levels and strong business climate |
| Tennessee | **16** | 26 | 10 | Very low economic debt, strong business climate, improved general fund operations |

## DECLINING STATES

The following states experienced the double digit declines in their ranking. Common factors included high debt levels and high Medicaid populations – this list includes many eastern and mid-Atlantic states.

| State | Rank Apr-10 | Rank Oct-09 | Decline in Rank | Reasons for Rank Decline |
|---|---|---|---|---|
| Delaware | **50** | 24 | -26 | Lower GDP and employment growth, higher debt levels and weaker home prices |
| New Mexico | **45** | 21 | -24 | Weaker competitive climate, high debt levels and large Medicaid population |
| Vermont | **27** | 11 | -16 | Poor business climate, high Medicaid population and weak home prices |
| Massachusetts | **30** | 15 | -15 | Weaker business climate, high debt levels and large Medicaid population |
| New York | **37** | 22 | -15 | Weaker business climate, high debt levels and large Medicaid population |
| Hawaii | **47** | 33 | -14 | Very high economic debt levels, poor business climate and falling home prices |
| Maryland | **26** | 14 | -12 | Very high debt levels, low employment growth and falling home prices |
| Mississippi | **39** | 27 | -12 | Low wealth levels and high Medicaid population |
| West Virginia | **32** | 44 | -12 | Weak GDP and employment growth with a large Medicaid population |

## WHAT'S UP WITH DELAWARE?

Delaware's ranking decline to 50th surprised us. Factors contributing to the rating decline include high debt per capita and economic debt per capita of $2,128 (45th) and $9,119 (44th), respectively. Additional factors include a 3 year State GDP compound annual growth rate of negative 0.45% (49th) and year-over-year (YoY) employment growth of negative 4.86% (46th). The state's high direct debt burden reflects its role in directly financing local facilities such as prisons and schools, which in other states would be financed at the local level. Its high economic debt incorporates a large unfunded OPEB liability. Employment figures are more negative for the state than the nation as a whole, in large part due to the closure of auto manufacturing plants in the state.

| Delaware Rank Indicator | Data | Rank |
|---|---|---|
| Laffer Econ. Competitiveness | -- | **37** |
| FY09 GF Balance % of Exp | 11.50% | **10** |
| Debt Service % of Exp | 5.20% | **37** |
| Debt per Capita | $2,128 | **45** |
| Economic Debt per Capita | $9,119 | **44** |
| State GDP Growth (3yr CAGR) | -0.45% | **49** |
| YoY Employment Growth | -4.86% | **46** |
| Per Capita Income | $40,457 | **17** |
| % of population on Medicaid | 22% | **38** |
| 1-yr House Price Change | -3.80% | **38** |

Delaware's GO debt is rated Aaa/AAA by Moody's and S&P. Both rating agencies note that Delaware's high rating is primarily based on the strong legal and constitutional protections offered to Delaware GO bondholders as well as the states strong financial management characteristics. The legal and constitutional protections include limitations on debt issuance (although Moody's cites the states "large debt burden relative to population and income" as a credit negative), and a constitutionally required Rainy Day Fund. Conning recognizes and incorporates these structural strengths into our mid AA target rating on Delaware GOs.

This is a striking example of a mismatch between the current ratings and our assessment of credit quality and indicates that future Rating Agency downgrades may be likely.

## OUTLOOK INDICATORS

To determine a credit outlook for each of the states, we selected five leading credit quality indicators. We wanted to differentiate state outlooks based on a balance of recent economic, housing and credit factors.

| Outlook Indicator | Measurement | Weighting |
|---|---|---|
| Tax Revenue Growth – most recent quarter | Credit | 20% |
| Mid-year FY 2010 budget gap as a % of GF Expenditures | Credit | 20% |
| Population Mitigation – one year change in population | Economic | 20% |
| Unemployment Rate | Economic | 20% |
| Foreclosure Rate | Housing | 20% |

## STATE CREDIT OUTOOKS

We have divided the state outlooks into five roughly equal categories based on the aggregate score in the Outlook Indicators above.

| Among the Best | Improving | Stable | Declining | Among the Worst |
|---|---|---|---|---|
| SOUTH DAKOTA | NEW HAMPSHIRE | KENTUCKY | NEW MEXICO | OHIO |
| WYOMING | LOUISIANA | MONTANA | MASSACHUSETTS | GEORGIA |
| VERMONT | VIRGINIA | COLORADO | CONNECTICUT | CALIFORNIA |
| NEBRASKA | WEST VIRGINIA | IDAHO | ARIZONA | ALASKA |
| ARKANSAS | IOWA | TEXAS | MARYLAND | NEW JERSEY |
| TENNESSEE | PENNSYLVANIA | OKLAHOMA | MISSISSIPPI | WISCONSIN |
| KANSAS | WASHINGTON | HAWAII | DELAWARE | RHODE ISLAND |
| MAINE | UTAH | NORTH DAKOTA | ALABAMA | OREGON |
| NORTH CAROLINA | SOUTH CAROLINA | MISSOURI | NEVADA | ILLINOIS |
| MINNESOTA | NEW YORK | FLORIDA | INDIANA | MICHIGAN |

## THE BEST AND THE WORST STATES

The top ten states and their outlooks are shown below.

| | | |
|---|---|---|
| North Dakota | **1** | Stable |
| South Dakota | **2** | Among the best |
| Nebraska | **3** | Among the best |
| Texas | **4** | Stable |
| Iowa | **5** | Improving |
| Wyoming | **6** | Among the best |
| Virginia | **7** | Improving |
| Colorado | **8** | Stable |
| Oklahoma | **9** | Stable |
| Montana | **10** | Stable |

States with a low rank **AND** negative outlooks are:

| | | |
|---|---|---|
| Delaware | **50** | Declining |
| Illinois | **49** | Among the Worst |
| California | **48** | Among the Worst |
| Hawaii | **47** | Stable |
| Kentucky | **46** | Stable |
| New Mexico | **45** | Among the Worst |
| West Virginia | **44** | Improving |
| Rhode Island | **43** | Among the Worst |
| New Jersey | **42** | Among the Worst |
| Ohio | **41** | Among the Worst |
| Michigan | **40** | Among the Worst |

## RECENT RATING AGENCY ACTIONS

Recent rating actions since our last report have largely been in line with our previous rankings and outlooks. In addition to our State of the States ranking, Conning assigns ratings to GO debt issued by the states. Our State of the States ranking and outlook are major factors in our assigned state ratings. Individual state ratings also reflect specific security features, unique credit factors and recent developments.

| Credit | Agency | Action | Date | 2010 Conning State Rank / Outlook |
|---|---|---|---|---|
| CONNECTICUT | Moody's | Outlook Change to Negative from Stable | 10/26/2009 | 35/Declining |
| NEVADA | Fitch | Downgraded to AA from AA+ | 10/29/2009 | 22/Declining |
| ILLINOIS | Moody's | Downgraded to A2 from A1 | 12/8/2009 | 49/Among the Worst |
| ILLINOIS | S&P | Downgraded to A+ from AA- | 12/10/2009 | 49/Among the Worst |
| ARIZONA | Moody's | Downgraded to A1 from Aa3 | 12/23/2009 | 24/Declining |
| ARIZONA | S&P | Downgraded to AA- from AA | 12/23/2009 | 24/Declining |
| WASHINGTON | Moody's | Outlook Change to Negative from Stable | 12/31/2009 | 28/Improving |
| CALIFORNIA | S&P | Downgraded to A- from A | 1/13/2010 | 48/Among the Worst |
| HAWAII | Moody's | Outlook Change to Negative from Stable | 2/4/2010 | 47/Stable |
| KANSAS | Moody's | Outlook Change to Negative from Stable | 2/8/2010 | 11/Among the Best |
| MINNESOTA | Moody's | Outlook Change to Negative from Stable | 2/9/2010 | 13/Among the Best |
| MAINE | S&P | Outlook Change to Negative from Stable | 3/10/2010 | 32/Among the Best |
| ILLINOIS | S&P | Rating placed on CreditWatch Negative | 3/26/2010 | 49/Among the Worst |
| ILLINOIS | Fitch | Downgraded to A- from A | 3/29/2010 | 49/Among the Worst |

## OBSERVATIONS

Since our last report, fundamental credit quality differences among the states have widened. This update placed an increased emphasis on debt – both direct and economic and included an indicator for a state's Medicaid population. We added these indicators because we feel that debt and health care expenses have become even more critical to a state's fiscal outlook. The result was that most Eastern and mid-Atlantic saw their overall ranking fall while many states in the Southeast and West saw improvements in their ranking.

States are approaching the FY 2011 budget season (beginning July 1) in their weakest position in memory. States enacted FY 2010 budgets using a combination of tax increases (14 states raised taxes), one-time budget actions (such as borrowing from other state funds – most notably CA, deferring expenses, and selling assets), stimulus money and budget cuts. Many of these options are not available for FY 2011.

At the same time that fundamental credit is deteriorating, both Moody's and Fitch have announced that they will implement global scale ratings for municipal bonds based on historically low municipal bond default rates starting in April 2010. This will result in one to two notch rating upgrades for all state general obligation bonds. These rating agency recalibrations obscure what is really happening in this sector and are not indicative of current credit fundamentals.

As the states current budget process proceeds, we expect headlines and the associated political risk of inaction to increase. In a worst case, we would expect the federal government to provide some form of assistance to prevent a state payment default. Although the chance of a state payment default remains very remote, other credit sectors in the municipal market (in particular, revenue bonds), currently offer better relative performance. Conning's investment approach for this sector is to have patience – wait for the credit bottom to be reached.

Paul Mansour
Gary Karvelis
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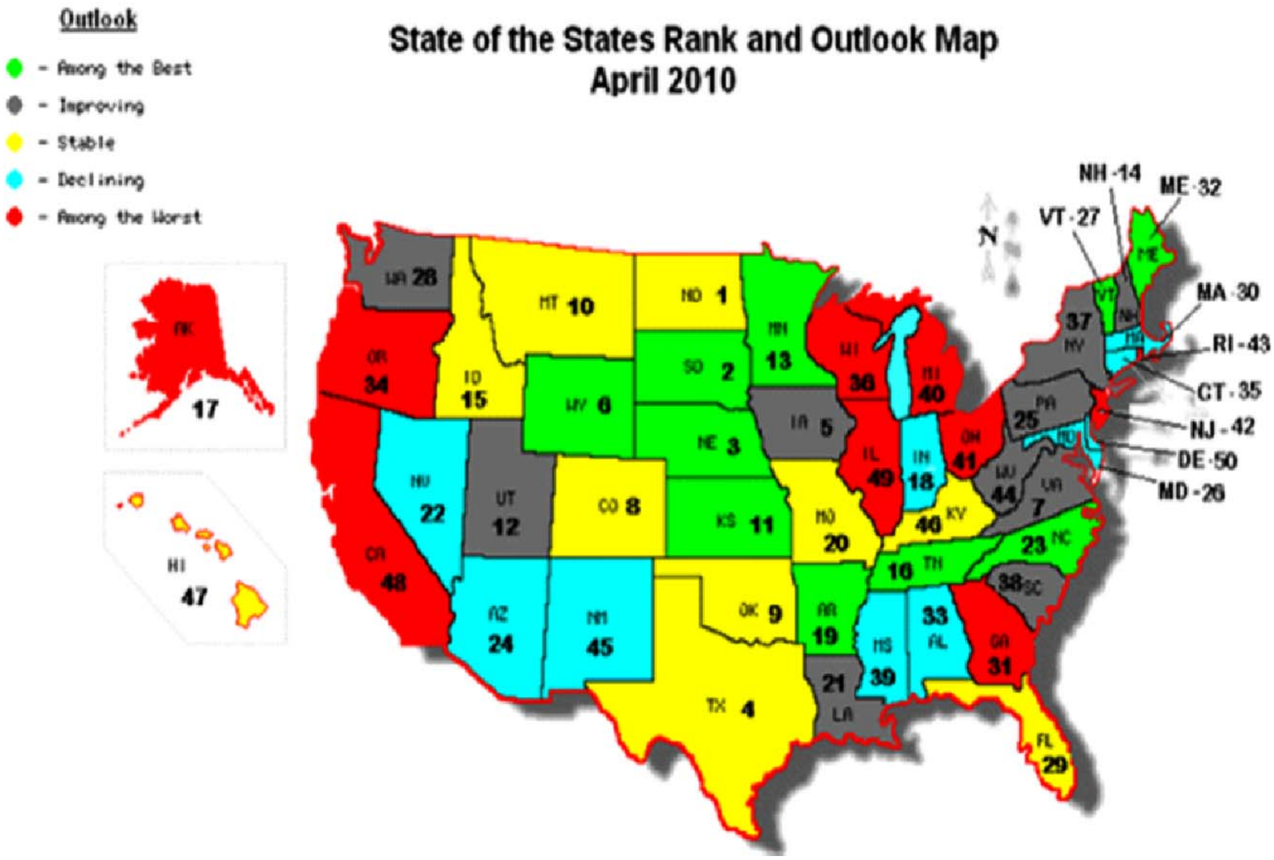
## Appendix A – STATE OF THE STATES RANKING AND OUTLOOK MAP, APRIL 2010



# Appendix B - DESCRIPTION OF INDICATORS

## RANK INDICATORS

### Laffer State Competitive Environment (10% weight)

Arthur Laffer, a supply-side economist, developed the Laffer State Economic Competitive Index. His most recent analysis of the states was released in March 2009 and prepared for the American Legislative Exchange Council (ALEC). The report assigns an Economic Outlook Rank based on a state's current standing in 16 state policy variables including top marginal personal and corporate income tax rates, property and sales tax burdens, and state minimum wage.

### General Fund Balance (10% weight)

This indicator ranks the states according to their General Fund balance as a percent of expenditures for their most recent FY, 2009. Each state's ending balance and budget stabilization fund are added together to equal their total funds. Each state's total fund is then divided by that state's expenditures. This data was taken from The Fiscal Survey of States, dated December 2009.

### Debt per Capita (10% weight)

This represents total state related debt divided by population. It was obtained from a Moody's special report published in July 2009.

### Economic Debt per Capita (10% weight)

This indicator ranks the states according to their "economic debt." Economic debt is defined as net tax supported debt + unemployment trust fund balances + FY10 mid year budget gap + unfunded pensions + OPEB liability. The 'economic debt' for each state was then divided by the most recent population estimate. The data was obtained through various sources including Moody's, Loop Analytical Services and the PEW Center on the States.

### Debt Service as a Percent of General Fund Expenditures (10% weight)

This indicator ranks the states based on their General Fund Debt Service as a percentage of General Fund expenditures. The data was obtained through each state's Comprehensive Annual Financial Report (CAFR).

### Real GDP Growth by State (10% weight)

This indicator ranks the states according to their 3-year compound annual growth rate in State GDP. This information was taken from a U.S Bureau of Economic Analysis.

### Year-over-Year Employment Growth (10% weight)

This indicator ranks the states based on their YoY employment growth (January 2010 vs January 2009). This data was obtained through the Bureau of Labor Statistics.

### One-Year change in Home Prices (10% weight)

This indicator ranks the states base on their one-year change in home prices. The data was obtained through the Federal Housing Finance Agency's Monthly HPI Data dated February 25, 2010.

**Per Capita Income (10% weight)**

This indicator ranks the states according to their third quarter 2008 per capita income statistics. This information was taken from the U.S Bureau of Economics and the U.S Census Bureau. Per capita income is the mean income computed for every individual in a particular group. This is calculated by dividing the total income of a group by the total population in that group. In our chart, each state's per capital income is compared to the U.S per capita income.

**Medicaid Enrollment as a Percentage of Population (10% weight)**

This indicator ranks the states based on the percentage of the population enrolled in Medicaid. This data was obtained from the Kaiser State Health Facts website.

## OUTLOOK INDICATORS

**Percent Change in State Tax Revenues (20% weight)**

This indicator ranks the States in order of their percent change in tax revenues from 3Q09 over 3Q08. The data was obtained from the U.S Census Bureau.

**Mid-Year FY10 Budget Gap as a Percentage of GF Expenditures (20% weight)**

This indicator ranks the states based on their mid-year FY10 budget gap as a percentage of their GF expenditures. The data was obtained through the Center on Budget and Policy Priorities website.

**Year-over-Year Population Growth (20% weight)**

This outlook indicator ranks the states according to their population change from July 1, 2007 to July 1, 2008. This data was obtained from the U.S Census Bureau's Population Division.

**Unemployment Rate (20% weight)**

This indicator ranks the states by their January 2010 unemployment rate. The unemployment rate is the percentage of the labor force that is unemployed but is actively seeking employment and is willing and able to work. Our data was obtained from the Bureau of Labor Statistics.

**Foreclosure Rates (20% weight)**

This indicator ranks the states based on the percentage of homes foreclosed on. This data was obtained through RealtyTrac.

## ADDITIONAL SOURCES

**Wilshire Consulting:** 2009 Wilshire Report on State Retirement Systems March 3, 2009

**Moody's Investors Service:** various reports

**S&P Ratings Direct:** various publications

**Center on Budget and Policy Priorities**: American Recovery and Reinvestment Act of 2009 February 13, 2009

**Center for American Progress**

**Nelson Rockefeller Institute of Government**