

Chicago Fed Letter

Assessing the State and Local Sector—Where Will the Money Come from?: A conference summary

by Richard H. Mattoon, senior economist and economic advisor

On May 12, 2009, the Federal Reserve Bank of Chicago, the National Association of State Budget Officers, and the National Tax Association co-sponsored a conference to examine key issues facing state and local governments, with a focus on factors that may affect their current and future revenues.

Materials presented at the conference are available at www.chicagofed.org/news_and_conferences/conferences_and_events/2009_state_local_government.cfm.

Governors and mayors across the country have been reporting bleak fiscal conditions. With all major tax sources declining and expenditure demands for health care and education rising, state and local government leaders are being confronted with very hard choices. The conference brought together over 100 leaders from government, business, and academia to discuss key issues for the state and local sector, including structural and cyclical trends affecting revenues, the role of federal government assistance, and access to capital.

Tax revenue performance over the business cycle

Leslie McGranahan, Federal Reserve Bank of Chicago, presented joint work with Richard H. Mattoon¹ on the changing composition of state tax revenues—and its possible implications for how states should manage their fiscal circumstances over the business cycle.² McGranahan said that the 2001 recession was a watershed event for state governments as a relatively shallow recession was unexpectedly accompanied by a severe decline in state tax revenues. In analyzing quarterly state tax revenues over two periods, 1980–97 and 1998–2008, McGranahan and Mattoon found that tax revenue shares had shifted and that the personal

income tax had emerged as the largest tax source by the late 1990s.

When this change in tax revenue composition is related to an individual state-specific business cycle,³ McGranahan noted, it is clear that revenues became more cyclically sensitive in 1998–2008. Specifically, in 1980–97, a 1% change in the state business cycle produced a 0.7% change in total per capita tax revenues. But in 1998–2008, the same 1% change in the state business cycle generated a 1.1% change in total per capita tax revenues. McGranahan said that this difference was accounted for by a tripling of the change in per capita personal income tax revenues relative to the state business cycle. The increase in personal income tax revenue sensitivity, she said, may be attributed to three factors: who we are taxing, how we are taxing, and what we are taxing. McGranahan concluded with some policy options for states in dealing with tax revenue performance over the business cycle. These included the following:

- Improve the stability of the state revenue structure, e.g., by increasing reliance on more stable taxes such as sales taxes;
- “Smooth” revenues (i.e., balance them over time) more aggressively by establishing larger rainy day funds and

selling or leasing out state assets (e.g., toll roads);

- Change state laws to allow state governments to run deficits;
- Accept that expenditures will need to be procyclical (i.e., they should grow as the economy expands), and better match expenditures to revenue behavior; and
- Ask the federal government for help when times are bad.

consider more closely aligning the fees they charge for a service with those who receive the greatest benefit from that service.

Asset sales and leases

States and localities have been increasingly interested in either the sale or long-term lease of their assets in an effort to manage their finances. Providing a review of the City of Chicago's use of asset sales and leases was Gene Saffold, the city's

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Michael Pagano, University of Illinois at Chicago, extended the discussion to the revenue performance of local governments. Pagano noted that revenue structures of municipalities are considerably more varied than those of states. While more than half of U.S. cities have some form of a sales tax, only one in ten has the ability to tap into personal income tax revenues. Further, while attention is often paid to the local property tax, it actually only accounts for 30% of own-source municipal revenues, with user fees (including utility taxes) accounting for 40%.

Pagano said that current conditions for municipalities are poor. Both revenues and general fund expenditures are under pressure, and conditions will worsen as declines in property values are reflected in future property tax bills. While municipalities as a group have fairly high ending balances as a percentage of expenditures, Pagano expected them to be drawn down in the near future. In the face of these difficult circumstances, Pagano argued that cities must rethink how they conduct their fiscal operations. First, they should renegotiate their tax authority with the state: Metropolitan regions are the economic engines of their state economies, and they need to have the fiscal tools and authority to maintain viability in an economic downturn. Cities also need to consider smoothing their fiscal behavior by creating reserve funds. Finally, cities should

chief financial officer. In the past five years, Chicago has completed three major long-term lease transactions (for the Chicago Skyway, the downtown parking system, and the parking meter system). In all, these leasing arrangements have raised \$3.6 billion.

As well as ensuring that such transactions further the city's public policy, managerial, and financial goals, it is crucial that the proceeds from the sale or lease are used responsibly. Saffold asserted that the use of the transactions' proceeds to meet short-term budget gaps is not responsible public policy. The goal should be to protect taxpayers over both the short and long term and improve the quality of life for citizens. For example, the proceeds from Chicago's three major leasing arrangements were used to create a perpetual long-term reserve fund, retire debt, invest in neighborhoods, and reduce future risk.

Scott Pattison, National Association of State Budget Officers, explained that asset sales and leases are an additional tool that states can use to raise revenue; such transactions can often lead to improved infrastructure and reduced repair and construction costs. The risks to the strategy include the possibility that the private market might sour and the public sector might lose control over the future use of the asset. Given these factors, the general public tends to distrust these types of transactions. Pattison argued

that some of this skepticism by the general public can be dispelled once successful projects are in place. For example, the lease of the Indiana Toll Road was initially criticized but is now largely accepted.

Pattison concluded that successful asset sales and leases take into consideration the following: the state's or municipality's statutory and political environment, the ability of the public sector to monitor contract compliance by the private sector company, the revenue stream that is guaranteed (and its duration), and the expertise of the private partner firm.

Laurence Msall, The Civic Federation, contended that appropriate asset sales and leases tend to focus on selling and leasing noncore assets, ensure that a competitive marketplace exists for bidders, guarantee appropriate management oversight, and reduce existing obligations of government. They should not be used to fill short-term budget gaps. Msall stressed that the use of the proceeds should be transparent and that officials should not make unrealistic future claims on the money. For example, part of the money from the leasing arrangement for the Chicago Skyway was used to create a five-year annuity; Msall emphasized that the expiration of the annuity should not create a new budget gap.

Impact of federal stimulus plan

Donald Boyd, Rockefeller Institute of Government, outlined the structure of the American Recovery and Reinvestment Act of 2009 (ARRA). The act provides \$787 billion in total aid, with \$250 billion going to state and local governments by specific category. By design, \$130 billion will provide immediate fiscal relief, especially for Medicaid and education. Current estimates from the Congressional Budget Office show that the bulk of the stimulus money will be spent in the first three federal fiscal years (FYs) of the program—\$47.4 billion in 2009, \$96.9 billion in 2010, and \$50.6 billion in 2011.

According to Boyd, while the stimulus money is certainly welcomed, the longer-term picture for state (and local) governments looks challenging. Under differing scenarios based on the behavior of state tax revenues in previous recessions, Boyd

argued that it may take more than five years for these revenues to fully recover. In one scenario, states as a group would still face potential budget gaps of greater than \$100 billion (6%) when the stimulus money is exhausted.

An Illinois perspective was provided by Ginger Ostro, director of the Governor's Office of Management and Budget. Ostro noted that with no policy changes Illinois is facing an \$11.6 billion deficit in FY2010. Revenues are expected to fall \$2.5 billion in FY2009 and continue falling in FY2010. Receipt of the ARRA money will certainly help, but it is not sufficient to preclude a combination of spending cuts and tax increases to close the budget gap.

Specifically, ARRA will provide Illinois with \$2 billion for education in FY2009 and FY2010, which will help prevent spending cuts. However, Ostro noted that the money does come with strings attached. Illinois will need to spend money on measuring how educational reform goals are met. With respect to Medicaid, Ostro noted that federal assistance raises the Federal Medical Assistance Percentage (FMAP) from 50% to 60%. Illinois has already drawn \$454 million in ARRA funds for Medicaid. The increased revenue also requires the state to reduce its payment cycle to 30 days for all health care providers; this has been challenging for Illinois because it has a large backlog of bills.

Finally, Illinois will receive \$2.2 billion for transportation and infrastructure projects, said Ostro. To date, Illinois has received approval for 249 projects worth \$606 million. A goal is to integrate this federal infrastructure money with the Illinois Jobs Now! plan—a new state capital plan. Ostro concluded that transparency and accountability standards are being met. The state has created a public website for tracking projects (www.recovery.illinois.gov), and the U.S. Government Accountability Office will audit the state's compliance.

Randy Blankenhorn, Chicago Metropolitan Agency for Planning (CMAP), evaluated ARRA's impact from the perspective of a regional planning agency. In anticipating the ARRA funds, the CMAP board adopted some principles

such as using the money to make a clear economic impact and using it in such a way that recognizes metropolitan areas are the primary drivers of economic growth.

Blankenhorn emphasized that ARRA should be seen primarily as a job creation vehicle and not as a longer-term investment program. ARRA's goal is to get the money to the states and localities quickly, so it must be channeled through existing programs and structures. That said, Blankenhorn argued that the ARRA funds could also present an opportunity to begin a national discussion on the value, creation, and maintenance of infrastructure.

J. Fred Giertz, National Tax Association and the University of Illinois, said that revisiting old concepts of government's roles will help us understand what the state and local sector is currently experiencing. Traditionally, government was seen as having three functions—allocation, redistribution, and stability.⁴ The use of the ARRA money represents a clear tension between allocation and stability. One of ARRA's goals is to have the stimulus money spent as fast as possible, but achieving this goal may undercut another goal—that of maximizing the productivity with which the money is spent. In the short run, a tax increase may be avoided by using the ARRA funds, but it is less clear whether this promotes the long-run stability of a state government. In the best case, stimulus funding can help smooth a transition to a more sustainable structure, but it can also be used simply to enable current practices that are inefficient.

Access to capital—What does the debt landscape look like?

Carl Tannenbaum, Federal Reserve Bank of Chicago, focused on how the financial crisis has affected the ability of state and local governments to access capital. The current recession has had an impact on all major tax sources for states and localities; it has also added special fiscal pressures, such as having to make up for pension funding shortfalls. As with other types of assets, government bonds have witnessed a flight to quality by investors. The spread between triple-A and single-A municipal bond yields has increased from 0.35% in early 2008 to

1% in 2009. Still, this yield spread is less than those experienced among other asset classes.

According to Tannenbaum, the reasons for the declining performance of municipal bonds include a poor fiscal outlook; a trend toward risk aversion for investing across all assets; stress on the collateral value and the ability to liquidate bonds; concern over the integrity of bond ratings; and instability of municipal bond insurers.

Conditions have been much worse for a variety of short-term structured products that were introduced by municipalities and states. While these offered issuers lower costs and greater liquidity and investors tax preferences, when these products started to fail, issuers were faced with skyrocketing costs and investors found themselves locked into poor deals.

Tannenbaum also addressed why municipal bonds were not seen as a good fit for the Term Asset-Backed Securities Loan Facility (TALF) program. First, states and localities are receiving direct aid through the fiscal stimulus plan. Second, the structure of these government bonds makes resolution procedures and exit strategies hard to identify, and the heterogeneous nature of the underlying assets makes the

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securities harder to value than other assets included in the TALF.

Geoffrey Cooper, Wisconsin Housing and Economic Development Authority, discussed the impact of current debt market conditions on a state government agency. The program directed by Cooper is designed to use tax-exempt bond proceeds to offer below-market-rate mortgage loans to low- and moderate-income borrowers. While the agency has recently averaged \$500 million in annual lending, current conditions have effectively closed it out of the mortgage market. In the current environment, the agency would have to go to the bond market at a rate of 5-3/8%. At this rate, the agency could only provide a 7% mortgage rate on a 30-year fixed-rate loan, which effectively makes the loan too expensive for its potential applicants.

Cooper said that many in the industry are hopeful that the federal government will consider backstopping variable-rate debt through the government-sponsored enterprises Freddie Mac and Fannie Mae; this move might start the refunding and reissuing of existing debt. The depth of the problem, he noted, is demonstrated by the fact that 20 state housing finance authorities are not currently lending. The remaining option is for the market to self-correct, but Cooper saw little evidence of this occurring soon.

John Miller, Nuveen Asset Management, provided an overview of municipal bond markets from an investor's perspective. Miller said that the municipal bond market has changed dramatically over the past two years. While triple-A bonds that are not bundled with credit enhancements have performed relatively well, other parts of the market have become highly fragmented. Although retail investors have stayed in the market, particularly for short-term high-quality bonds, institutional investors have put pressure on the market through heavy selling.

The key question facing investors is whether the market's reaction is correctly forecasting future problems that issuers might face. There have been several technical issues hurting bonds, including downgrades of the major companies that insure municipal bonds (monolines) and the unwinding of positions by hedge funds. Some of these factors have run their course, so conditions may begin to reflect better the underlying fundamentals related to the specific issuers' future health. For example, state-backed general obligation debt can recover, since states place servicing debt high on their list of priorities and have broad taxing powers to raise revenues. In contrast, health care sector debt tends to be over-supplied, and current conditions are squeezing hospital margins, making issuing this type of debt less favorable.

Miller concluded that federal support for the municipal bond market has helped. ARRA provides direct offsets to portions of municipal budgets, and permits issuers to take advantage of the taxable "Build America Bonds." The 2009 debt market has seen some restoration of liquidity and signs of improving investor confidence, but relatively lower levels of supply.

Conclusion

State and local governments are facing historic challenges. While money from the federal stimulus plan will help relieve some of the fiscal stress, it is not clear that current revenue structures can promote long-term fiscal health without greater ability to adapt to changing economic conditions.

¹ See www.chicagofed.org/publications/workingpapers/wp2008_15.pdf.

² The business cycle refers to the periodic but irregular up-and-down movements in economic activity, measured by fluctuations in real gross domestic product and other macroeconomic variables.

³ State-specific business cycles were modeled using the Federal Reserve Bank of Philadelphia's state coincident indexes: www.phil.frb.org/research-and-data/regional-economy/indexes/coincident/.

⁴ See Richard A. Musgrave and Peggy B. Musgrave, 1984, *Public Finance in Theory and Practice*, 4th ed., New York: McGraw-Hill.