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EVALUATING STATES' CREDIT WITH BOND YIELDS

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States continue to struggle through their worst budget crises in recent memory. Most states have seen red ink for the last three years, with total state budget gaps estimated at $96 billion for Fiscal Year 2011 (which started in July) and $72 billion for Fiscal Year 2012. With no end in sight to state budget woes, some bond investors are reasonably starting to worry about default. How likely is it that states will default on their bond obligations? And which states should be of greatest concern?

Information from the municipal-bond markets shows that while some states are still able to borrow at low rates, spreads for California and Illinois indicate that they are considered to be at far greater risk of default.

Just as credit card companies offer the lowest rates to individuals with the best credit histories, investors in the bond market offer the most favorable financing terms to states that are the most creditworthy. We can use the interest rates that investors demand as a way to determine which states are most likely to keep paying the interest on their bonds and ultimately repay the principal.

Below is a table of yields on long-term, general-obligation Build America Bonds ("BABs") issued by fourteen mostly large states.[1] The yield on the most recent bond purchase is compared to the same day's estimated yield on a Treasury bond with the same maturity. This "spread" represents the risk premium that investors in effect charge for lending to a particular state instead of to the federal government.

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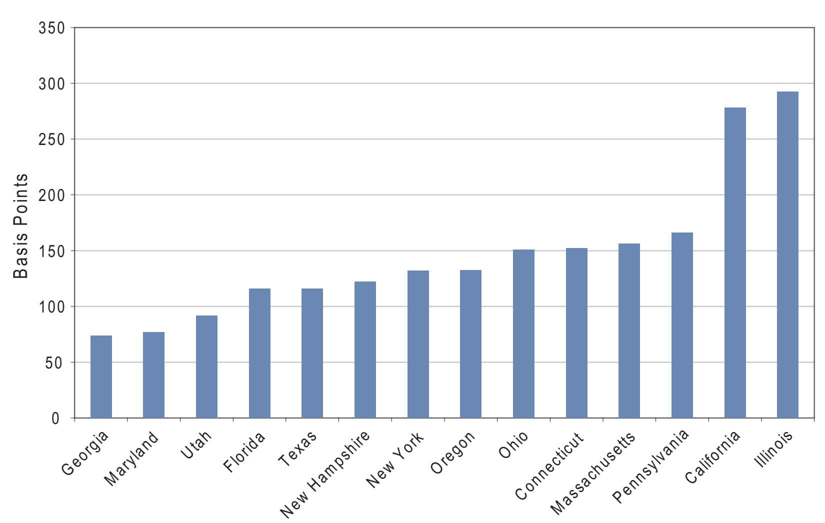
State	Trade date	Spread	Moody's Rating	Pew Fiscal Grade[2]
Georgia	9/21/2010	0.74%	Aaa	B+
Maryland	9/22/2010	0.77%	Aaa	B+
Utah	9/15/2010	0.92%	Aaa	A
Florida	9/10/2010	1.16%	Aa1	B-
Texas	9/23/2010	1.16%	Aaa	B
New Hampshire	8/30/2010	1.22%	Aa1	C-
New York	9/13/2010	1.32%	Aa2	C+
Oregon	9/8/2010	1.33%	Aa1	C+
Ohio	8/16/2010	1.51%	Aa1	B
Connecticut	8/13/2010	1.52%	Aa2	B-
Massachusetts	9/21/2010	1.56%	Aa1	C+
Pennsylvania	9/7/2010	1.66%	Aa1	B
California	9/14/2010	2.78%	A1	D+
Illinois	9/23/2010	2.93%	A1	C-

For example, an Illinois general obligation BAB due July 1, 2035, traded at a yield of 6.5 percent on Thursday, September 23. The approximate yield for a Treasury bond due that day was 3.57 percent, indicating a risk premium of 2.93 percent.

These results establish that California and Illinois are in a class by themselves, at least among large states. Their well-documented records of fiscal mismanagement have made bondholders particularly nervous that they will fail to pay their debts. Yields on California and Illinois BABs have spiked accordingly.

What in the fiscal situations of Illinois and California sets them apart from the other states in our sample? Both have extremely large structural budget gaps—that is, differences between expected revenues and planned expenditures beyond those created by the recession. California has strong institutional barriers to both tax increases and spending cuts, which can make it hard for it to meet its obligations. Illinois has some of the largest unfunded pension obligations in the country. With regard to fiscal realities, both states suffer from a culture of denial.

Yield Gap Between Build America G.O. Bonds and U.S. Treasuries



The costs to taxpayers of this bad behavior are real. Earlier this month, the Civic Federation of Illinois estimated that the state's deteriorating creditworthiness required it to pay an extra $551 million in interest on the $9.6 billion in bonds it has issued over the last year. Bad fiscal practices aren't a concern of just policy wonks and investors. In the long run, unsound finances mean higher taxes and fewer services for the public, as increasing amounts of government cash are spent on interest payments.

Georgia, Maryland, and Utah, by contrast, can be found at the top of our sample. Both states are generally perceived as employing sound fiscal practices: the Pew Center on the States rates Georgia and Maryland a "B+" for fiscal management and Utah an "A." Maryland's economy is relatively stable in part because so many of its residents work directly or indirectly for the federal government.

Surprisingly, investors do not demand an especially high yield for New York State's BABs. Despite significant weakness in its core industry (finance) and a budget gap that is among the country's widest, New York has managed to keep its public employee pensions relatively well-funded, by GASB standards. And unlike Illinois and New Jersey, which are permitted to balance their budgets by diverting to general revenues what would be their pension contributions, New York must obey a series of court decisions requiring pension contributions of actuarially recommended size.

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[1] Unfortunately, it is not possible to provide this sort of information for all fifty states. Eleven states have no general-obligation bonds outstanding. Others issue only tax-free long-term debt (which cannot be directly compared to taxable Build America Bonds); or their outstanding taxable debt has not been traded recently, and its yield is therefore unknown. Municipal-bond trading data are available from the Municipal Securities Rulemaking Board. We use taxable bonds because they are easier to compare on a like-for-like basis with Treasury bonds.

[2] The Government Performance Project at the Pew Center on the States publishes the Grading the States report, an assessment of the quality of management in the fifty states. View the 2008 report here: http://www.pewcenteronthestates.org/uploadedFiles/Grading-the-States-2008.pdf