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Mounting Debts by States Stoke Fears of Crisis

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The State of Illinois is still paying off billions in bills that it got from schools and social service providers last year. Arizona recently stopped paying for certain organ transplants for people in its Medicaid program. States are releasing prisoners early, more to cut expenses than to reward good behavior. And in Newark, the city laid off 13 percent of its police officers last week.

While next year could be even worse, there are bigger, longer-term risks, financial analysts say. Their fear is that even when the economy recovers, the shortfalls will not disappear, because many state and local governments have so much debt — several trillion dollars' worth, with much of it off the books and largely hidden from view — that it could overwhelm them in the next few years.

"It seems to me that crying wolf is probably a good thing to do at this point," said Felix Rohatyn, the financier who helped save New York City from bankruptcy in the 1970s.

Some of the same people who warned of the looming subprime crisis two years ago are ringing alarm bells again. Their message: Not just small towns or dying Rust Belt cities, but also large states like Illinois and California are increasingly at risk.

Municipal bankruptcies or defaults have been extremely rare — no state has defaulted since the Great Depression, and only a handful of cities have declared bankruptcy or are considering doing so.

But the finances of some state and local governments are so distressed that some analysts say they are reminded of the run-up to the subprime mortgage meltdown or of the debt crisis hitting nations in Europe.

Analysts fear that at some point — no one knows when — investors could balk at lending to the weakest states, setting off a crisis that could spread to the stronger ones, much as the turmoil in Europe has spread from country to country.

Mr. Rohatyn warned that while municipal bankruptcies were rare, they appeared increasingly possible. And the imbalances are so large in some places that the federal government will probably have to step in at some point, he said, even if that seems unlikely in the current political climate.

"I don't like to play the scared rabbit, but I just don't see where the end of this is," he added.

Resorting to Fiscal Tricks

As the downturn has ground on, some of the worst-hit cities and states have resorted to fiscal sleight of hand to stay afloat, helping them close yawning budget gaps each year, but often at great future cost.

Few workers with neglected 401(k) retirement accounts would risk taking out second mortgages to invest in stocks, gambling that the investment gains would be enough to build bigger nest eggs and repay the loans.

But that is just what Illinois, which has been failing to make the required annual payments to its pension funds for years, is doing. It borrowed $10 billion in 2003 and used the money to invest in its pension funds. The recession sent their investment returns below their target, but the state must repay the bonds, with interest. The solution? Illinois sold an additional $3.5 billion worth of pension bonds this year and is planning to borrow $3.7 billion more for its pension funds.

It is the long-term problems of a handful of states, including California, Illinois, New Jersey and New York, that financial analysts worry about most, fearing that their problems might precipitate a crisis that could hurt other states by driving up their borrowing costs.

But it is the short-term budget woes that nearly all states are facing that are preoccupying elected officials.

Illinois is not the only state behind on its bills. Many states, including New York, have delayed payments to vendors and local governments because they had too little cash on hand to make them. California paid vendors with i.o.u.'s last year. A handful of other states, worried about their cash flow, delayed paying tax refunds last spring.

Now, just as the downturn has driven up demand for state assistance, many states are cutting back.

The demand for food stamps has been rising significantly in Idaho, but tight budgets led the state to close nearly a third of the field offices of the state's Department of Health and Welfare, which take applications for them. As states have cut aid to cities, many have resorted to previously unthinkable cuts, laying off police officers and closing firehouses.

Those cuts in aid to cities and counties, which are expected to continue, are one reason some analysts say cities are at greater risk of bankruptcy or are being placed under outside oversight.

Next year is unlikely to bring better news. States and cities typically face their biggest deficits after recessions officially end, as rainy-day funds are depleted and easy measures are exhausted.

This time is expected to be no different. The federal stimulus money increased the federal share of state budgets to over a third last year, from just over a quarter in 2008, according to a report issued last week by the National Governors Association and the National Association of State Budget Officers. That money is set to run out next summer. Tax collections, meanwhile, are not expected to return to their pre-recession levels for another year or two, given that the housing market and broader economy remain weak and that unemployment remains high.

Scott D. Pattison, the budget association's director, said that for states, next year could be "the worst year of this four- or five-year downturn period."

And few expect the federal government to offer more direct aid to states, at least in the short term. Many members of the new Republican majority in the House campaigned against the stimulus, and Washington is debating the recommendations of a debt-reduction commission.

So some states are essentially borrowing to pay their operating costs, adding new debts that are not always clearly disclosed.

Arizona, hobbled by the bursting housing bubble, turned to a real estate deal for relief, essentially selling off several state buildings — including the tower where the governor has her office — for a $735 million upfront payment. But leasing back the buildings over the next 20 years will ultimately cost taxpayers an extra $400 million in interest.

Many governments are delaying payments to their pension funds, which will eventually need to be made, along with the high interest — usually around 8 percent — that the funds are expected to earn each year.

New York balanced its budget this year by shortchanging its pension fund. And in New Jersey, Gov. Chris Christie deferred paying the $3.1 billion that was due to the pension funds this year.

It is these growing hidden debts that make many analysts nervous. States and municipalities currently have around $2.8 trillion worth of outstanding bonds, but that number is dwarfed by the debts that many are carrying off their books.

State and local pensions — another form of promised debt, guaranteed in some states by their constitutions — face hidden shortfalls of as much as $3.5 trillion by some calculations. And the health benefits that state and large local governments have promised their retirees going forward could cost more than $530 billion, according to the Government Accountability Office.

"Most financial crises happen in unpredictable ways, and they hit you when you're not looking," said Jerome H. Powell, a visiting scholar at the Bipartisan Policy Center who was an under secretary of the Treasury for finance during the bailout of the savings and loan industry in the early 1990s. "This one isn't like that. You can see it coming. It would be sinful not to do something about this while there's a chance."

So far, investors have bought states' bonds eagerly, on the widespread understanding that states and cities almost never default. But in recent weeks the demand has diminished sharply. Last month, mutual funds that invest in municipal bonds reported a big sell-off — a bigger one-week sell-off, in fact, than they had when the financial markets melted down in 2008. And hedge funds are already seeking out ways to place bets against the debts of some states, with the help of their investment banks.

Of course, not all states are in as dire straits as Illinois or California. And the credit-rating agencies say that the risk of default is small. States and cities typically make a priority of repaying their bond holders, even before paying for essential services. Standard & Poor's issued a report this month saying that the crises that states and municipalities were facing were "more about tough decisions than potential defaults."

Change in Ratings

The credit ratings of a number of local governments have improved this year, not because their finances have strengthened somewhat, but because the ratings agencies have changed the way they analyze governments.

The new higher ratings, which lower the cost of borrowing, emphasize the fact that municipal defaults have been much rarer than corporate defaults.

This October, Moody's issued a report explaining why it now rates all 50 states, even Illinois, as better credit risks than a vast majority of American non-financial companies.

One reason: the belief that the federal government is more likely to bail out a teetering state than a bankrupt company.

"The federal government has broadly channeled cash to all state governments during recent recessions and provided support to individual states following natural disasters," Moody's explained, adding that there was no way of being sure how Washington would respond to a bond default by a state, since it had not happened since the 1930s.

But some analysts fear the ratings are too sanguine, recalling that the ratings agencies also dismissed the possibility that a subprime crisis was brewing. While most agree that defaults are unlikely, they fear that as states struggle with their growing debts, investors could decide not to buy the debt of the weakest state or local governments.

That would force a crisis, since states cannot operate if they cannot borrow. Such a crisis could then spread to healthier states, making it more expensive for them to borrow, if Europe is an example.

Meredith Whitney, a bank analyst who was among the first to warn of the impact the subprime mortgage meltdown would have on banks, is warning that she sees similar problems with state and local government finances.

“The state situation reminded me so much of the banks, pre-crisis,” she said this fall on CNBC.

There are eerie similarities between the subprime debt crisis and the looming municipal debt woes. Among them:

¶Just as housing was once considered a sure bet — prices would never fall all across the country at the same time, conventional wisdom suggested — municipal bonds have long been considered an investment safe enough for grandmothers, because states could always raise taxes to pay their bondholders. Now that proposition is being tested. Harrisburg, the capital of Pennsylvania, considered bankruptcy this year because it faced $68 million in debt payments related to a failed incinerator, which is more than the city’s entire annual budget. But officials there have resisted raising taxes.

¶Much of the debt of states and cities is hidden, since it is off the books, just as the amount of mortgage-related debt turned out to be underestimated. States and municipalities often understate their pension liabilities, in part by using accounting methods that would not be allowed in the private sector. Joshua D. Rauh, an associate professor of finance at Northwestern University, and Robert Novy-Marx, an assistant professor of finance at the University of Rochester, calculated that the true unfunded liability for state and local pension plans is roughly $3.5 trillion.

¶The states and many cities still carry good ratings, and those issuing warnings are dismissed as alarmists, reminding some analysts of the lead up to the subprime crisis.

Now states are bracing for more painful cuts, more layoffs, more tax increases, more battles with public employee unions, more requests to bail out cities. And in the long term, as cities and states try to keep up on their debts, the very nature of government could change as they have less money left over to pay for the services they have long provided.

Richard Ravitch, the lieutenant governor of New York, is among those warning that states are on an unsustainable path, and that their disclosures of pension and health care obligations are often misleading. And he worries how long it can last.

“They didn’t do it with bad motives,” he said. “Ninety-five percent of them didn’t understand what they were doing. They did it because it was easier than taxing people or cutting benefits. We’re getting closer and closer to the point where we can’t do that anymore. I don’t know where that is, but I know we’re close.”