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## States and the Debt Crisis

Over the past two years, political leaders in the United States have been engaged in an intensifying public debate about government deficits, particularly at the federal level. With the country’s total federal debt about \$14 trillion and climbing, most Democrats and Republicans now seem to agree that strong measures should be taken to bring public spending into closer alignment with revenues. But they remain sharply divided as to what those measures should look like – cuts in programs, increases in taxes or some combination of the two.

While federal deficits get most of the attention, state governments across the country are facing a severe fiscal crunch of their own. The American Recovery and Reinvestment Act of 2009, better known as the federal stimulus plan, pumped \$430 billion into state government budgets for infrastructure projects and to make up for budget shortfalls in such keys areas as Medicaid and higher education. But given the federal government’s debt load, and political winds in Washington that are forcing leaders to consider deep spending cuts, another round of stimulus is off the table, and that is forcing states to confront their budget issues without future help from above.

OUTLOOK recently asked two experts for their perspective on the state government budget crisis and its impact on the broader economy. Arturo Pérez is director of the Fiscal Affairs Program at the National Conference of State Legislatures and specializes in state tax and expenditure policy. Tucker Hart Adams is a senior partner with Summit Economics in Colorado Springs, Colorado. She has more than 30 years of experience in economic research, analysis and forecasting.

***OUTLOOK: We know the federal government faces a grim situation with its budget, but give us an overview of what’s happening with states.***

**Arturo Pérez:** States have had to deal with some sizeable budget shortfalls – the worst since the Great Depression. We’re talking about collectively over a half trillion dollars in shortfalls from 2008 through what’s projected for 2013.

States have actually had a stretch of revenue growth over the past year where revenue has met or exceeded projections. But they are still down.

[Stimulus dollars] were designed to bridge states to recovery, but the recovery clearly hasn't been sufficient to offset the budget shortfall. Many states don't see a return to their peak revenue years for several more years.

#### About this article



Arturo Pérez is director of the Fiscal Affairs Program at the National Conference of State Legislatures (NCSL). He specializes in state tax and expenditure policy. Arturo also serves as the liaison to an affiliate of NCSL, the National Association of Legislative Fiscal Offices. In addition to his research responsibilities, Arturo is also the NCSL liaison to the Puerto Rico and U.S. Virgin Islands legislatures. An NCSL staff member since 1990, Arturo has bachelor's degrees in history and political science from Texas A&M University. He also received a master's degree from the LBJ School of Public Affairs at the University of Texas at Austin.



Tucker Hart Adams is a senior partner with Summit Economics in Colorado Springs, Colorado. She has more than 30 years of experience in economic research, analysis and forecasting. She served 10 years as vice president and chief economist for United Banks of Colorado (now Wells Fargo) then ran her own firm, The Adams Group, for 22 years. She has an undergraduate degree from Wellesley College and a doctorate in economics from the University of Colorado at Boulder.

The latest Rockefeller Institute of Government report showed they are 13 percent below their peak revenues from 2008. So the growth is not sufficient enough to bring them back to their peak revenue levels.

Another reason for the budget shortfalls is the exhaustion of federal stimulus dollars. They were designed to bridge states to recovery, but the recovery clearly hasn't been sufficient to offset the budget shortfall. Many states don't see a return to their peak revenue years for several more years.

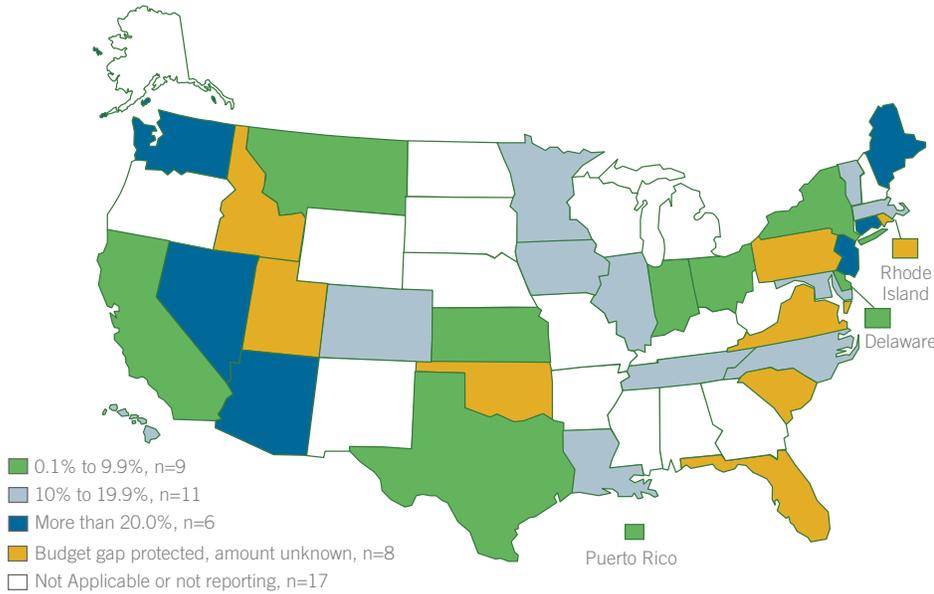
#### ***OUTLOOK: Do states have less flexibility than the federal government from a budgeting standpoint?***

**Tucker Hart Adams:** Forty-nine of the 50 states, by law, have to balance their budget every year. Vermont is the only one that can run a deficit. So nearly every state has to cut the budget or raise taxes to balance it. And even if they decide to raise taxes, it takes awhile for the revenues to come in. So states have had to say, 'What are we going to do without?' For some, they're letting a certain number of prisoners out because it's too expensive to keep them in prison. Or school teachers or firemen and police, on a local level, are being let go. One problem you run into is that the public sector is heavily unionized. If you try to cut things, you run up against employee unions and that leaves a very limited number of areas where you can cut. So programs that are valuable end up getting chopped. The other impact is that people lose their jobs. This is already a time of high unemployment for the U.S., so it just adds to the unemployment problem.

#### ***OUTLOOK: Why did state revenues tank?***

**AP:** There are three tax bases that account for well over two out of every three state tax dollars – personal income tax, sales tax and corporate income. In this recession, all three were impacted. About 36 percent of all states' general revenues are derived from personal income tax; about 32 percent are derived from general sales taxes; and 6 or 7 percent are derived from corporate income taxes. The corporate income tax is a very volatile revenue source to begin with. The private sector has begun reporting significant profits lately and states are actually realizing strong gains in corporate income tax collections, but we're still talking about only 6 to 7 percent of state revenue collections. So even a very good year for corporate income tax collection won't help balance the state budget alone, and as a result states have been primarily balancing budgets through budget cuts.

**FY 2011 BUDGET GAPS**  
AS A PERCENTAGE OF GENERAL FUND BUDGET



Source: NCSL survey of state legislative fiscal offices, various years.

**OUTLOOK: Have many states sought tax hikes to make up shortfalls?**

**AP:** There are states that have imposed temporary tax increases. Arizona has a temporary general sales tax that will expire in 2013. And Illinois, on the last day of its legislative session, passed a large revenue-raising package that's a temporary, multi-year tax. But the predominant approach to balancing budgets is to rely on program cuts.

**OUTLOOK: What are the key drivers of state government deficits on the spending side?**

**THA:** The pension issue is a big one. State employee pensions tend to be fairly rich. I'm not saying they're unreasonable, but they're nice employment benefits

and they're expensive. Pension money is saved and invested in stocks, bonds and securities. It's not like Social Security; it's not a pay-as-you-go plan. So, like your 401(k) plan, the stock and bond portfolios behind state pension funds probably aren't worth what they were three years ago. The value of everything went down, yet the obligation to employees and retirees remains the same.

**OUTLOOK: That's part of the battle we've witnessed across the country, most notably in Wisconsin where Gov. Scott Walker recently signed a law forcing public employees to contribute 5.8 percent of their salaries to their pensions and at least 12.6 percent of their health care premiums. Do you think public employee unions will go along with reductions in pay and benefits to create a more sustainable state budget?**

**THA:** We just saw the Frontier Airlines pilot union accept cuts because it was either that or start looking for new jobs. On the other hand, in Wisconsin, the state employees union battled tooth and toenail. It's not that unions will never accept any changes or that they'll say, 'Yes, that's wonderful, we don't mind' when faced with tough choices. But it's going to continue to be a battle front.

The measure of how difficult a budget situation is for any state is when K-12 education finds itself on the table. It tends to be a high-priority program area regardless of party in most states.

***OUTLOOK: What trends are you seeing when it comes to state-level budget cuts?***

**AP:** K-12 education accounts for one out of every three general fund dollars spent by states. It's such a significant part of the budget picture that states have found it very difficult to exclude K-12 from their budget balancing. States provide just over half of all revenue for K-12 education – about 54 percent. The feds provide 6 percent or so. So when your largest source of funding for K-12 education begins to reduce its level of support, the end result is that local school districts have to make difficult decisions regarding personnel, teachers, and teachers' aides. We're seeing that play out across the country. The measure of how difficult a budget situation is for any state is when K-12 education finds itself on the table. It tends to be a high-priority program area regardless of party in most states.

***OUTLOOK: In the broader economy, what will be the impact of austerity measures taken to alleviate state shortfalls? Besides K-12, where will the pain be felt?***

**THA:** The impact is the same as when the manufacturing sector lays off people or makes cuts. There are three sets of impacts. One, it means fewer jobs and more people out of work. Second, you've got a loss of services that may be important to you. In California, they're chopping everywhere. In my hometown of Colorado Springs, Colorado, they turned off half of the street lights. They also took trash barrels out of the city parks so you have to carry your trash out with you. So, the impact may be just an inconvenience like that, or it may be some major program.

The third thing, and in some ways it may be most important, is that these cuts add to the feeling of malaise that we have – the idea that something is wrong and it's not getting better as it always did in the past. There's this feeling that this isn't the America we signed on for, and that maybe I better not spend money and buy that new car, or maybe I shouldn't repaint my house because it might get a whole lot worse. The good side of all of this is that Americans were not saving any money before the great recession hit, and now they are. Before, we actually had a negative savings rate, and now it is up to 5 or 6 percent.

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If people aren't spending, then factory orders aren't going up, demand for services isn't going up, and there's no reason for companies to hire more or expand. So it just adds to this sort of downward spiral we seem to have gotten stuck in.

or expand. So it just adds to this sort of downward spiral we seem to have gotten stuck in. People think, "Maybe it's not going to get better; maybe we're just going to be like Japan and not have growth for 20 years." I certainly don't think that, but that mindset is certainly out there, and that's a negative for the economy.

**OUTLOOK:** *The Obama stimulus package directed a lot of resources to state governments and helped them avoid painful cuts during the depths of the recession. Did the stimulus really help the situation or just delay the day of reckoning?*

**THA:** It did both. Did it delay the day of reckoning? Yes. But one would hope if you had 18 or 24 months to deal with these cuts rather than having to do it next week that you could be a little more thoughtful about it so it wouldn't have quite as negative an impact. The hope was that the stimulus money would pick up the economy and those cuts wouldn't have to be made. The economy is growing, but it's not growing fast enough or creating enough new

jobs to accommodate even the growth in labor force that comes with people graduating from high school or college. It was a valid plan to delay those cuts for a year and have the federal government, which can run deficits, pick up the slack. But the economy hasn't bounced back the way it has after most recessions.

**AP:** Given the balanced budget requirements that most states live under, as bad as the cuts were, they would have been much greater without those stimulus dollars. A lot of attention now will be focused on what's happening at the local level. With people getting their property tax assessments indicating that their home values continue to drop, the end result is less revenue for local governments which, like states, must balance their budgets. There are a lot more local governments, and that is where we're most likely to see the higher number of public sector layoffs.

**OUTLOOK:** *What states are performing better than others in terms of their budgets and why?*

**AP:** The plains states – South Dakota, Nebraska, North Dakota – have some of the lowest unemployment rates in the country. On the other end of the scale are states like California, Nevada,

**STATE AND LOCAL GOVERNMENT EMPLOYMENT IN MILLIONS**



Source: Center for Budget and Policy Priorities

Arizona and Florida that were at the epicenter of the housing sector collapse. And Michigan, because of its reliance on the manufacturing industry, has had its share of problems. Michigan's peak revenue was in fiscal year 2000, and they don't expect to return to that point until fiscal year 2020.

**OUTLOOK: *The states with the worst deficit problems have major population centers, such as California, New York and New Jersey, while many of the states that are doing better tend to be more rural. What kind of dynamic does that set up in terms of political solutions to the problem?***

**THA:** In the U.S. Senate, it doesn't make any difference because every state has two votes. But if you look at the House of Representatives, that's where the size of your state makes a difference. So people from California or New Jersey will have a bigger say in what things happen. I think the media – and that psychological effect I was talking about – also have a big impact. People pay more attention to what is happening in California than in North Dakota. The good times in North Dakota don't offset the fact, in people's minds, that there are bad times in California.

**OUTLOOK: *So will the federal government step in to help out the states with the worst problems in terms of unfunded liabilities?***

**THA:** There are two things I don't forecast: What the stock market is going to do or what politicians are going to do. But if I was a state government, I would not count on a bailout from Washington.

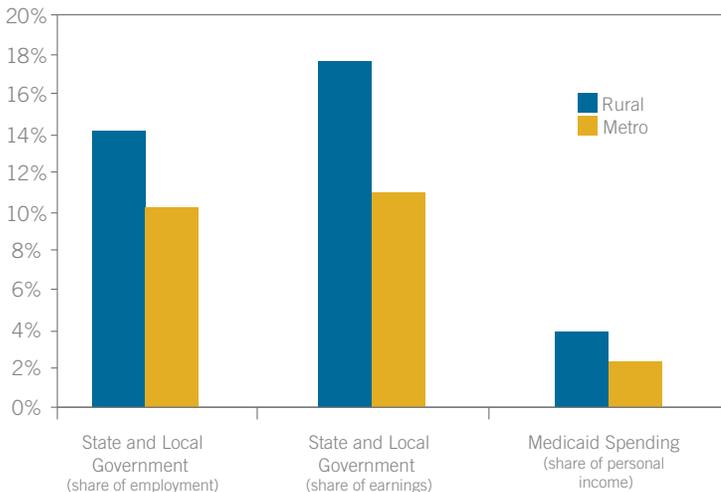
**OUTLOOK: *Given the political influence of public employee unions, have states been able to pare back their workforces?***

**AP:** We saw states, last year especially, that implemented furlough programs, hiring freezes and salary freezes. It was less so this year. Some states have made employees contribute more to their retirement system, to their health plans. As far as actual employment reductions in states, what's more common is vacancy savings, which is the elimination of vacant positions. Actual layoffs have occurred, but they have not been significant in their numbers. For the most part, states have taken other actions.

**OUTLOOK: *In general, are cities and other local governments in worse shape than states?***

**THA:** I think it depends. There's been a city or two that have declared bankruptcy, which is quite fascinating. Vallejo, California did it and Birmingham, Alabama's Jefferson County has been on the verge of it. States can't declare bankruptcy. But a big city in California will often be far worse off than the state of North Dakota or even a state the size of Colorado. My guess is that, generally, cities may have more options than states when it comes to cuts. Cities can turn off the street lights or layoff policemen. States and

## STATE AND LOCAL GOVERNMENT SPENDING URBAN VS. RURAL AREAS, 2008



Source: Federal Reserve Bank

the federal government have things that are mandated and can't be cut. In the long run some of those things can be changed by voters but in the short run states are saying the only places they can cut are prisons and higher education. But when you start cutting the firemen, police and school teachers it starts to hurt. When people complain about bloated, inefficient government, I don't think they normally mean teachers, policemen and firemen.

They're thinking about nice, cushy white collar jobs that pay too much or don't add a lot of value or provide too much regulation that people have to deal with.

### **OUTLOOK: What will it take for state governments to rebound?**

**AP:** Revenues are the key to state budget recovery. We did a survey recently and some states indicated that their

revenues for fiscal year 2011 were in line with fiscal year 1997 – 14 years ago. What has to rebound obviously is the employment situation. For every unemployed individual, there's one less payroll check that states can draw withholding from for services. The irony for states is that when revenue is at the weakest, demand for services from public assistance programs is at its highest. The flipside is when states are doing well; those same services are at the lowest demand.

### **OUTLOOK: Is it possible to quantify how the quality of life we've come to expect is being impacted by these cuts?**

**THA:** For people in most states or cities, I don't think our quality of life is going to be badly hurt. If a few kids who got put in prison for having an ounce of marijuana when they were in college get out, that's probably not a huge threat to our safety. I didn't even realize some street lights had been turned off in Colorado Springs until I started reading about it in the newspaper. The trash barrels in parks that are no longer being emptied by the city have been adopted by citizens and school groups. It's a positive development. It's a positive that people began to say, 'Hey, maybe as citizens we have some responsibility here. Maybe if I'm a little better off than somebody else I can pitch in and do a little more.' It's not the end of the world. ■

# Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 5/31/11. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

## KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

## ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

### US Treasury Securities

| 2011 | GDP   | CPI   | Fed Funds | 2-year | 10-year |
|------|-------|-------|-----------|--------|---------|
| Q1   | 1.80% | 5.20% | 0.16%     | 0.70%  | 3.50%   |
| Q2   | 3.20% | 3.60% | 0.10%     | 0.60%  | 3.30%   |
| Q3   | 3.20% | 2.20% | 0.13%     | 0.60%  | 3.30%   |
| Q4   | 3.40% | 1.90% | 0.15%     | 0.80%  | 3.40%   |
| 2012 | GDP   | CPI   | Fed Funds | 2-year | 10-year |
| Q1   | 3.00% | 2.10% | 0.18%     | 0.90%  | 3.50%   |

## PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

## IMPLIED FORWARD SWAP RATES

| Years Forward | 3-month LIBOR | 1-year Swap | 3-year Swap | 5-year Swap | 7-year Swap | 10-year Swap |
|---------------|---------------|-------------|-------------|-------------|-------------|--------------|
| Today         | 0.26%         | 0.36%       | 1.07%       | 1.92%       | 2.56%       | 3.14%        |
| 0.25          | 0.30%         | 0.44%       | 1.26%       | 2.10%       | 2.71%       | 3.27%        |
| 0.50          | 0.38%         | 0.57%       | 1.44%       | 2.28%       | 2.86%       | 3.35%        |
| 0.75          | 0.47%         | 0.73%       | 1.68%       | 2.47%       | 3.02%       | 3.50%        |
| 1.00          | 0.61%         | 0.95%       | 1.89%       | 2.67%       | 3.18%       | 3.59%        |
| 1.50          | 1.05%         | 1.43%       | 2.36%       | 3.04%       | 3.47%       | 3.85%        |
| 2.00          | 1.56%         | 1.93%       | 2.77%       | 3.39%       | 3.74%       | 4.05%        |
| 2.50          | 2.02%         | 2.39%       | 3.15%       | 3.66%       | 3.96%       | 4.21%        |
| 3.00          | 2.48%         | 2.85%       | 3.54%       | 3.94%       | 4.17%       | 4.36%        |
| 4.00          | 3.24%         | 3.62%       | 4.07%       | 4.34%       | 4.47%       | 4.60%        |
| 5.00          | 3.82%         | 4.19%       | 4.45%       | 4.58%       | 4.71%       | 4.75%        |

## HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

## FORWARD FIXED RATES

### Cost of Forward Funds

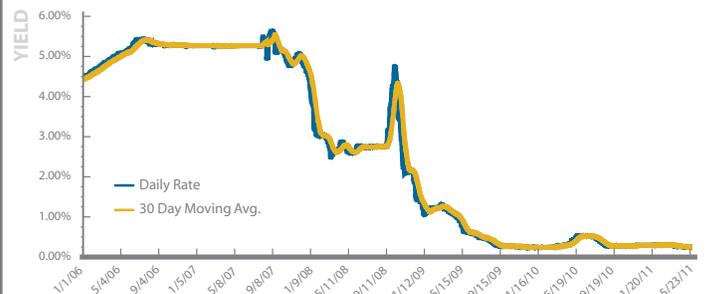
| Forward Period (Days) | Average Life of Loan |      |      |       |
|-----------------------|----------------------|------|------|-------|
|                       | 2-yr                 | 3-yr | 5-yr | 10-yr |
| 30                    | 7                    | 9    | 9    | 7     |
| 90                    | 17                   | 23   | 22   | 17    |
| 180                   | 33                   | 44   | 42   | 32    |
| 365                   | 79                   | 95   | 85   | 63    |

Costs are stated in basis points per year.

## SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

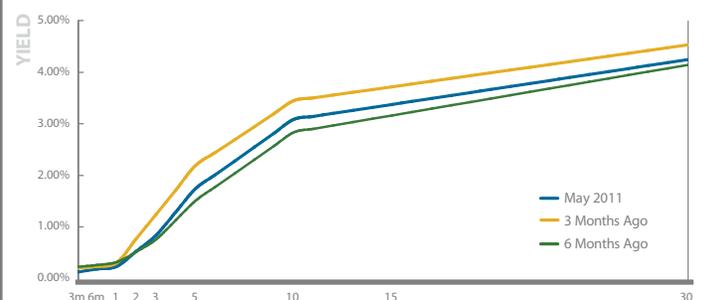
## 3-MONTH LIBOR



## RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

## TREASURY YIELD CURVE



## Farm Credit Administration Board Votes to Grant Preliminary Approval of CoBank-U.S. AgBank Merger

The board of the Farm Credit Administration has voted to grant preliminary approval of the proposed merger between CoBank and U.S. AgBank.

The FCA serves as the independent regulator for both banks and the rest of the Farm Credit System. On June 22, the agency's three-member board considered the merger at a special meeting at its headquarters in McLean, Virginia. The board voted unanimously to grant preliminary approval for the transaction, subject to certain conditions. The preliminary approval will enable CoBank and U.S. AgBank to submit the merger proposal to their stockholders for a vote later this summer.

"This is a critical milestone in the merger approval process," said John Eisenhut, chairman of the U.S. AgBank board of directors. "We appreciate the care and diligence with which the FCA considered our merger application, and we look forward to commencing our shareholder vote in the next few weeks."

Under statute and applicable regulations, the FCA reviews merger proposals involving Farm Credit entities to ensure they don't present safety and soundness issues, and also to ensure that disclosure materials prepared for stockholders adequately communicate key aspects of the merger. The agency's conditions for the CoBank-U.S. AgBank merger constitute post-merger requirements in a number of areas, including governance and reporting. The entire body of conditions will be provided in disclosure materials that will be sent to stockholders in connection with the merger vote.

"The FCA has thoughtfully evaluated our merger proposal with a long-term view of Farm Credit's mission and the important role the System plays in America's rural economy," said Everett Dobrinski, chairman of the CoBank board. "This action by our regulator reaffirms our belief that the merger will create a stronger, more durable bank that is better able to fulfill its mission and serve its customers for generations to come. We believe the conditions articulated by the FCA can be accommodated by the combined bank without significant financial or operational impacts."



### About CoBank

CoBank is a \$69 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy. In addition to serving its direct borrowers, the bank also provides wholesale loans and other financial services to affiliated Farm Credit associations and other partners across the country.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore. For more information about CoBank, visit the bank's web site at [www.cobank.com](http://www.cobank.com).

In December 2010, CoBank and U.S. AgBank executed a Letter of Intent to merge. The merged bank will continue to do business under the CoBank name and be headquartered in Colorado but will maintain U.S. AgBank's existing presence and operations in Wichita, Kansas, and Sacramento, California. It will also continue to be organized and operate as a cooperative, with eligible borrowers earning cash and equity patronage based on the amount of business they do with the organization. Robert B. Engel, CoBank's president & chief executive officer, will remain as the chief executive of the combined entity. Darryl Rhodes, president & chief executive officer of U.S. AgBank, will retire in connection with the merger.

Rhodes said the merger disclosure materials are designed to provide stockholders with a comprehensive view of the combined bank's governance structure and financial profile. "We are committed to giving the owners of both banks all the information they need to accurately assess this merger," Rhodes said. "We are confident that stockholders will appreciate the unique benefits afforded by the merger, which include significantly improved diversification, a stronger capital position, and an enhanced ability to deliver stable pricing and dependable patronage to customers over the long term."

Engel noted that the boards of the two banks have also approved a merger effective date of January 1, 2012. "We're extremely pleased with the progress we are making on integration planning," Engel said. "We're committed to delivering a seamless transition for our borrowers and to ensuring that they continue to receive the highest quality customer service."

The banks plan to distribute disclosure and voting materials to stockholders in the first half of July, with completed merger ballots due to be returned by September 7, 2011. If stockholders of both banks authorize the transaction, it would be deemed approved after a statutorily required 35-day reconsideration period and receipt of final regulatory approval from the FCA. ■

*Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.*