Determining Creditworthiness and Texas' Case for a Top Rating

By Jason Saving

Just as individual consumers' credit scores determine the availability and cost of borrowed funds, states' credit ratings assess their presumed ability to repay bond investors often decades into the future.

Eight states carry the highest, AAA bond grade from the country's three major credit ratings agencies. The "elite eight" are Delaware, Georgia, Iowa, Maryland, Missouri, North Carolina, Utah and Virginia. Texas narrowly misses inclusion, with a top rating from two of the three agencies.[1]

> To the ratings agencies, the AAA-rated states share one important trait: fiscal capacity, a superior ability to raise revenue within their borders to cover fiscal obligations.

The significance of credit ratings has been underscored in recent public debate regarding the rising federal debt and one firm's decision to withdraw its AAA assessment of the United States. The rating is important because top marks generally allow governments to borrow money at lower interest rates, thereby enabling their residents to spend less money servicing public debt. States issue debt for a wide variety of reasons, including the construction and maintenance of roads, bridges and schools and even day-to-day liquidity needs.

The eight states are an outwardly varied group. They aren't clustered in a particular region, benefiting from a vibrant geographic location, nor do they have similar industrial compositions. Demographically, they're also dissimilar. Utah is among the youngest and least diverse states, while Iowa is older and Georgia and Maryland are relatively more diverse.

To the ratings agencies, AAA-rated states share one important trait: fiscal capacity, a superior ability to raise revenue within their borders to cover fiscal obligations. This doesn't, in and of itself, guarantee that those states will meet their commitments. It does, however, signal that they are well-positioned to do so absent significant, unexpected economic or political developments.

Texas' credit rating is just below a consensus AAA but better than the national average. The state has advantages that include rapidly growing industries and extensive in-migration by people seeking better economic opportunity. It consistently ranks high among states with the best business climates. In addition, employment has grown about 1 percentage point faster in Texas than the nation—and faster than in each of the eight states with top credit ratings.

Texas' standing begs the question: What factors help determine fiscal capacity and a state's underlying ability to repay bondholders in a timely fashion, through good times and bad?

Industrial diversification, type of tax system, "rainy day" savings, population growth, business opportunity and employment levels all matter, as does investment in education and social services.

A Measurement of Risk

Simply put, a state's credit rating measures how much risk is associated with any given bond issuance. The better the rating, the better the terms on which credit will be provided.

The three major credit-rating issuers in the United States are Moody's Investors Service, Fitch Ratings and Standard & Poor's. Potential bond issuers are rated on a scale that ranges from AAA/Aaa for top-quality borrowers to B3/B- for borrowers whose paper carries a fair amount of risk (*Table 1*).[2] The ratings firms don't always agree— for example, Texas holds a AAA/Aaa rating from Fitch and Moody's but an AA+ from S&P. Generally, the ratings are similar because each company uses some of the same data to assess essentially the same proposition —the underlying risk associated with loaning money.

When a state's fiscal capacity is

Table 1
Agencies' Credit Ratings and What They Mean

Moody's	S&P	Fitch	Quality level
Aaa	AAA	AAA	Prime
Aa1	AA+	AA+	High grade
Aa2	AA	AA	
Aa3	AA–	AA–	
A1	A+	A+	Upper medium grade
A2	A	A	
A3	A–	A–	
Baa1	BB+	BB+	Lower medium grade
Baa2	BBB	BBB	
Baa3	BBB–	BBB–	
Ba1	BB+	BB+	Noninvestment grade/ speculative
Ba2	BB	BB	
Ba3	BB–	BB–	
B1	B+	B+	Highly speculative
B2	B	B	
B3	B–	B–	

high, it has the means to raise adequate revenue for new spending programs without compromising existing obligations. Most importantly, a superior fiscal capacity helps reassure investors that a state can make full and timely repayment of interest on its bonds.[3] When a state's fiscal capacity is low, it cannot easily raise revenue to meet new obligations and may face greater skepticism from investors, who demand higher interest rates on the state's debt to compensate for the greater perceived risk.

Evaluating Creditworthiness

Among the most relevant factors determining creditworthiness is the overall configuration of a state's economy. Decades ago, Texas largely centered on "cotton, cattle and oil" at a time when the Midwest and Northeast were diversifying into a more modern economic environment. When an economy is heavily dependent on one particular sector, its sudden downturn—which occurs periodically—can dramatically worsen state fiscal health, imperiling timely repayment of obligations. In contrast, diversification helps minimize the fiscal impact of sectoral downturns, much as individual investors incur less risk with a mutual fund than a specific stock.

The Texas economy has grown more similar to the well-diversified national economy. Chart 1 plots the degree to which some of the largest states mirror the national employment profile; complete resemblance equals 1. The trend was interrupted during the energy booms of the early 1980s and today, which temporarily boosted the size of the energy sector and made the state economy somewhat less diversified than it would otherwise be. On the other hand, energy booms also swell state coffers and create significant disposable income for Texas residents, helping offset the mild increase in credit risk that would ordinarily be associated with a temporary diversification diminution.

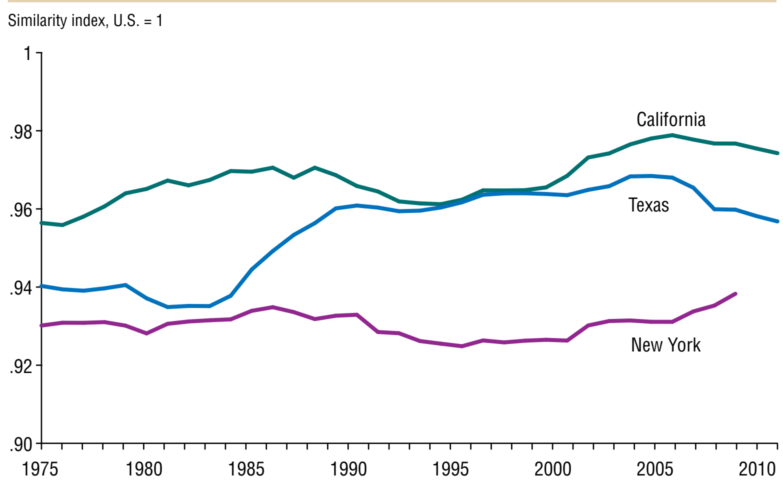
Of course, diversification does not entirely eliminate risk. Recent events have shown that when large parts of the overall economy falter simultaneously, even a well-diversified "portfolio" of industries cannot fully overcome fiscal pressures, leading many states to cut spending, raise taxes and borrow more. Still, a diverse mix to some degree guards against this and helps a state meet its obligations even during difficult economic times.

State tax systems can significantly shield government treasuries from the stresses of the overall business cycle—or amplify those stresses. Individual incomes typically rise faster than consumption during economic expansions as people find themselves better able to find jobs and obtain raises. They also fall faster than consumption during recessions as people seek to maintain a reasonable standard of living even as layoffs rise and job opportunities fall away. Thus, states heavily dependent on income taxes are more likely to ride the business cycle than other states, reaping outsized revenue gains during good times but suffering sizable revenue contractions during recessions. Conversely, states that primarily tax consumption won't receive windfalls during economic booms but will experience more stable revenue over time, offering hope to creditors that their debt-repayment promises are more likely to be respected even if an unanticipated downturn occurs.

Here, too, the Texas economy compares relatively favorably with its big-state peers (*Chart 2*). For instance, California's reliance on procyclical taxes such as an unusually progressive income tax ensures its revenue swings strongly with the business cycle, growing relatively rapidly in the boom years of 2003–06 but falling steeply during the 2007–09 period. Texas revenue remained more stable during both the boom and the bust as sales (consumption) taxation caused it to miss out on the early-decade income boom but also on the late-decade bust.

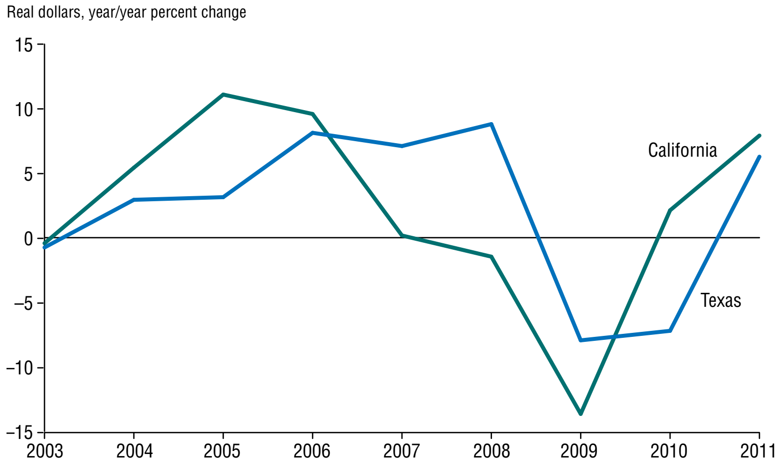
Another means by which a state can insulate itself during difficult times is an economic stabilization fund (ESF), better known as a rainy-day fund.

Chart 1
Texas' Economic Diversity Rises Over the Years



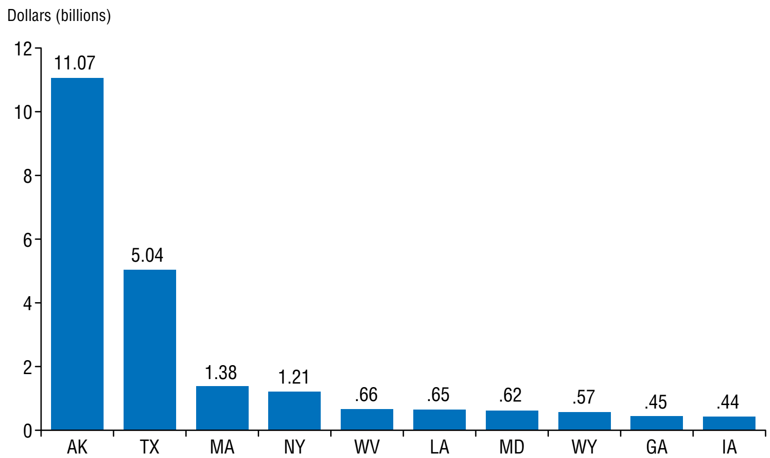
NOTE: The index measures the similarity of a state's industry mix with the nation's—a reading of 1 indicates the state has the same share of jobs in each industry sector as the nation, while 0 suggests that its mix differs to an extreme.
SOURCE: Bureau of Labor Statistics.

Chart 2 Tax Revenue Growth More Stable in Texas than California



SOURCES: Census Bureau; Bureau of Labor Statistics.

Chart 3 Alaska and Texas Have Highest Rainy-Day Fund Balances



NOTE: Data from 2011.

SOURCE: National Association of State Budget Officers.

During ordinary times, the fund receives a portion of annual state revenue, sometimes from specific taxes earmarked for this purpose. When unforeseen fiscal pressures emerge—often because a state has entered recession and revenue unexpectedly lags behind projections—the state can draw from the fund until the situation improves. In essence, the ESF acts as a silo in which a state can store money in anticipation of adverse economic shocks down the road.

Thirty-eight states have rainy-day funds, but most of the sums are quite small. Preparing for an unforeseen downturn often takes a backseat—for individuals and states—because it reduces available funds in the near term for other priorities that may at the time seem more pressing. Only two states, Alaska and Texas, have maintained rainy-day fund balances exceeding $2 billion over the last decade, in part because of unexpectedly strong energy production revenue (*Chart 3*). Texas' rainy day fund is expected to reach at least $8 billion by next August (the end of fiscal 2013), putting it in a relatively strong position to weather a future recession.

A state's likelihood to grow faster than its peers is an additional factor determining future creditworthiness. States offering more favorable business climates and better availability of land tend to grow relatively quickly, making them a better bet for stronger economic growth down the road. And as a state grows faster, it increases its fiscal capacity to repay debt without compromising other policy goals.

Texas employment has over the last several decades grown about 1 percentage point per year faster than the U.S. as a whole (*Chart 4*). The reasons include a low cost of living, ready labor availability, low corporate taxes and an education system that—while not among the nation's strongest—is sturdier than its southern neighbors.[4] Absent a change in one or more of these factors, this general trend is expected to continue.

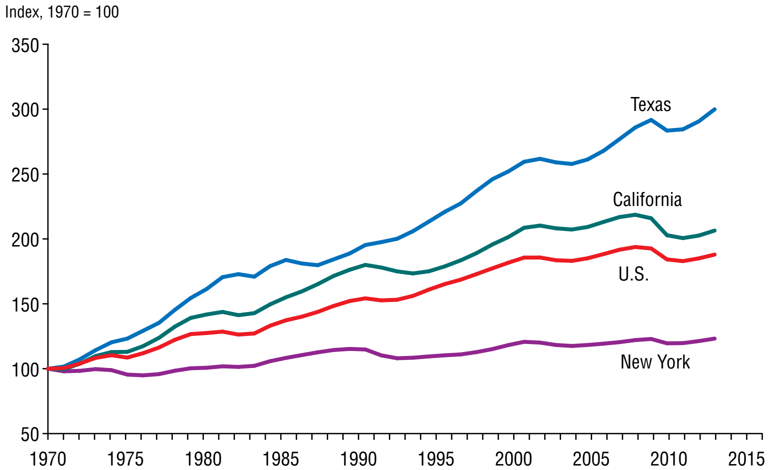
Moreover, independent assessments of the state business climates almost invariably rank Texas as among the nation's most hospitable (*Chart 5*). These ratings analyze factors such as the regulatory climate, access to capital, cost of living and labor availability to produce a comprehensive assessment of the extent to which a state is "open for business." Taken together, these factors suggest Texas is likely to outperform its peers in the near future.

Future Challenges

Education is among several factors that could potentially pare Texas' future fiscal capacity. The state has gradually reduced the role of local property taxes, a relatively stable revenue source dedicated primarily to schools, in favor of general-revenue funding by the state. This has been met with increasing legal pressure on Texas to increase aggregate funding for education. While a better education system would be almost universally welcomed, new general-revenue spending attenuates the state's fiscal capacity. Of course, a better-funded education system might improve productivity and thereby put Texas on a stronger economic growth path. If this were the end result, more education funding would eventually increase fiscal capacity and make Texas a better credit risk.

Social services spending, notably on

Chart 4
Texas Outperforms Other Big States, Nation in Employment



SOURCE: Bureau of Labor Statistics.

states, and a significant number of states have failed to fund them at the 80 percent threshold generally recommended by pension analysts. Like any private pension system, a state that saves too little for its retirees during their working years will find itself strapped for cash as retirements occur, especially when accompanied by declining population growth and increasing life expectancy.

While this day of reckoning may not occur for a while, forward-looking investors will on average demand more of a premium to purchase bonds from states whose fiscal capacities will predictably decline over time. Conversely, they will demand less from states that have maintained an 80 percent-or-better funding ratio and can more readily pay the remainder from general revenue without overly straining their fiscal capacities. Texas exceeds that threshold (*Chart 6*), with enough set aside to cover 82 percent of pension liabilities. But that still leaves a sizable gap for which additional appropriations could pressure general revenue down the road.

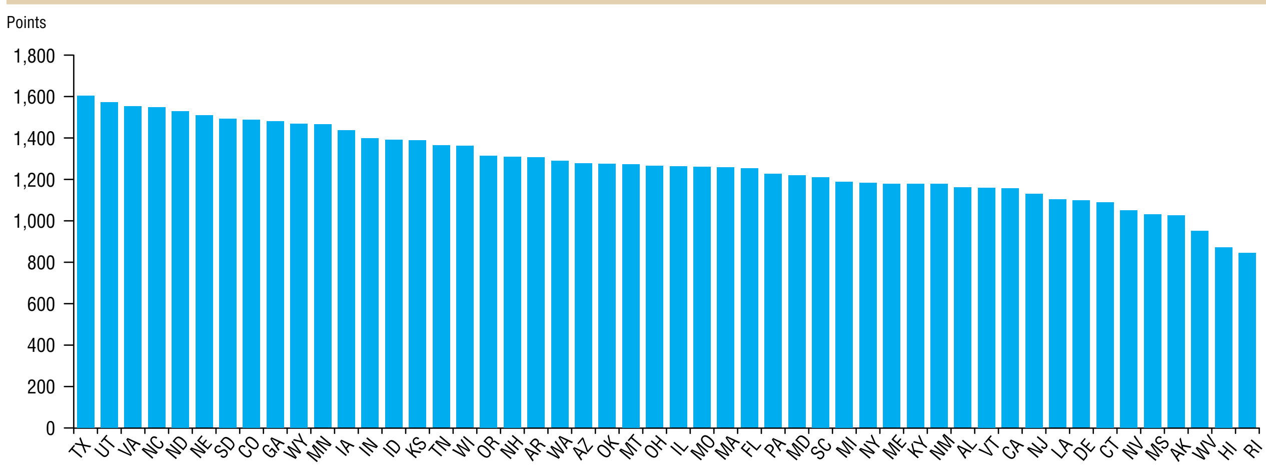
Another area where this willingness comes into play is overall revenue and expenditure levels. States such as Texas have historically opted for a relatively low level of per capita spending (*Chart 7*), with most going to the core state government functions of education, criminal justice, infrastructure and health.

Medicaid, poses another challenge for Texas (and many other states). Payments for Medicaid, the shared federal–state program that funds medical services to the poor, were once relatively steady in Texas but have grown rapidly in recent years with no clear sign of leveling out. If Medicaid continues to increase as a share of the state's overall budget, funding for other programs will have to be cut or taxes will have to rise.

These examples illustrate the limitations of fiscal capacity as it relates to credit ratings. While fiscal capacity plays an important role in their determination, *willingness* to meet fiscal obligations is also important. While a state that has no further resources to tap cannot meet new fiscal obligations no matter how fervently it might wish to do so, it also may choose not to fund the obligations even if it can.

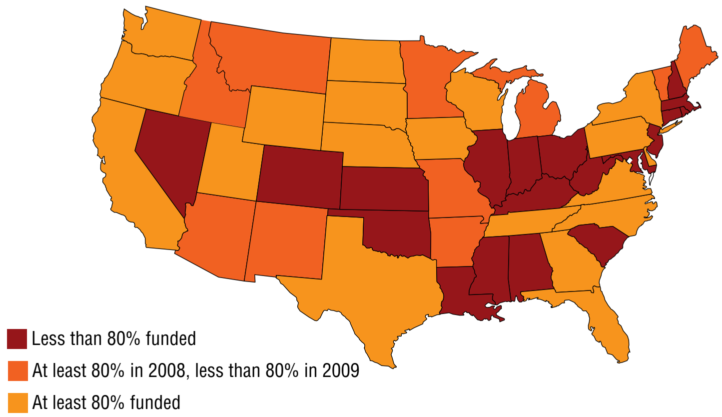
One area where this comes into play is state pension systems, whose promised benefits generally exceed policymakers' willingness to save on their behalf. Pension obligations are perhaps the largest single liability confronting

Chart 5
Texas Ranks Highest for Business Climate in 2012



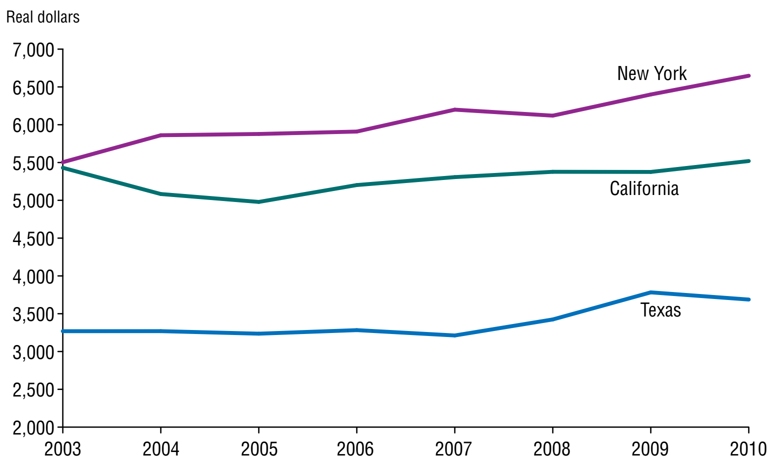
NOTES: CNBC assigns points over a range of factors that include cost of doing business and access to capital. Other organizations publish business-climate lists that use different sets of measures.
SOURCE: CNBC.

Chart 6 Texas Pension Funding Exceeds Recommended 80 Percent in 2008–09



SOURCE: Pew Center on the States

Chart 7 Texas on Low End of Per Capita State Spending



SOURCES: National Association of State Budget Officers; Bureau of Labor Statistics; Census Bureau.

This stance has been cited as a major reason Texas has grown faster than the nation. This has enabled the state to keep taxes low, fostering a business-friendly climate, but it also precludes some options that other states might pursue to more easily meet their fiscal obligations. Illinois, for example, recently improved its fiscal capacity by raising some fees and taxes, although its large and growing pension liabilities continue to influence its credit ratings.

It's also important to note that Texas emphasizes the importance of debt vis-à-vis other areas of the budget. The Texas constitution prioritizes state debt repayment above ordinary discretionary spending, which helps ensure spending reductions necessary over the course of the business cycle will not affect bondholders (and, therefore, the state's credit rating).

Texas in Perspective

Texas has one of the nation's higher credit ratings, reflecting its relatively diversified economy, comparatively stable tax system, large rainy-day fund and consistently strong growth rate.[5] Its pension system—a key obligation—is fairly well funded and offers constitutional protections to bondholders that interest payments will occur in a full and timely fashion. The state also offers a favorable business climate and is among the biggest destinations for migrants in the country, both of which strengthen the state's fiscal capacity. Yet, Texas also faces challenges involving education and Medicaid that, depending on how they are handled, could diminish that capacity down the road.

While noneconomic factors play a role in a state's individual circumstances, ratings are heavily influenced by each state's policy environment and how well that environment responds to the economic shocks with which states (or other entities) are regularly confronted. Decisions made by lawmakers and other officials can position a state to rise to a better credit rating—or fall to a lower one.

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Notes

[1] Ratings agencies base their evaluations on different sets of criteria, and this can cause ratings to vary.

[2] Below these are C-rated "junk" bonds that carry a significantly greater risk of default.

[3] The same is true at the national level.

[4] Scores from the National Assessment of Education Progress rank Texas 34th out of 50 states. Arkansas placed 41st, Oklahoma 46th, Louisiana 47th and New Mexico 48th.

[5] Reflecting the state's greater diversification, oil and natural gas production taxes were the No. 6 and No. 7 sources of revenue in 2011, collectively accounting for just under 7 percent of total state revenue. That is a bigger share of revenue than a few years ago but still not large enough to have much of an impact on Texas' overall creditworthiness.