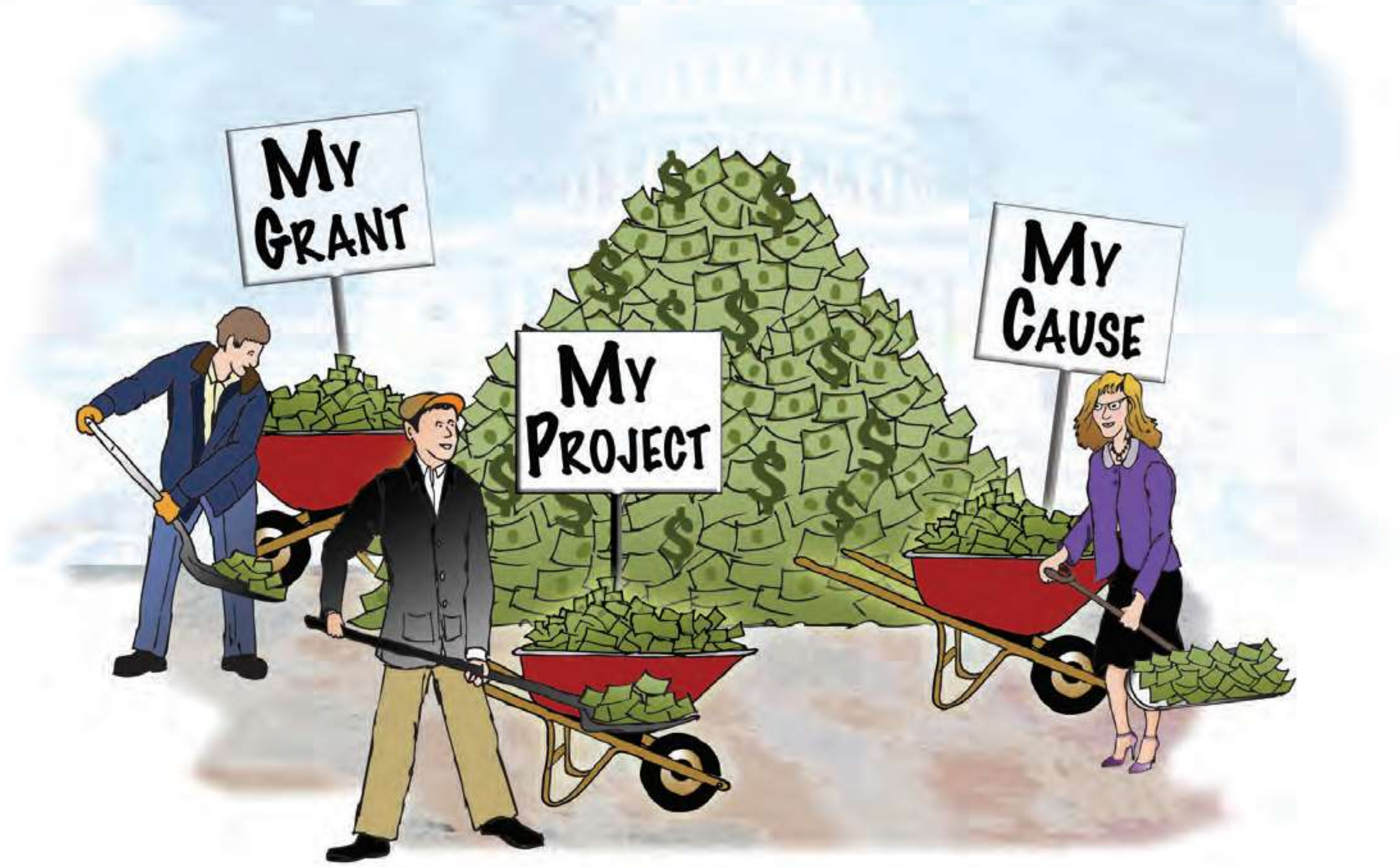
By John Haas, Ranson Financial Consultants

Graphic by Vicky McCallum

Budget$, revenue$, taxe$, deficit$, debt – and credit rating$



The news media – from print to television and radio and Internet bloggers – is filled daily with comments and opinions, some informed and some perhaps less so – concerning our state and federal finances. I thought it might be of interest to readers to provide a background article on credit ratings and how such issues might affect local units of government. Hopefully, this article will help make understanding these issues more clear rather than adding to the confusion confronting all of us during these difficult economic times.

National credit rating

Moody's Investors Services ("Moody's") announced during the week of August 24, 2009 that the debt of the United States of America is still rated Aaa (its highest rating!). This announcement is important because it is an opinion on the creditworthiness of the U.S. Federal Government. It is also important because a possible rating downgrade of the debt of the federal government could materially affect the ability of cities and rural water districts in Kansas to issue bonds at a reasonable rate, or in the most extreme case, to have the ability to issue bonds at all.

Moody's is one of the three major rating agencies located in the U.S. The other two rating agencies are Standard and Poor's ("S&P") and Fitch. The rating agencies have a very important role in the issuance of public debt. The complexity, depth and breadth of the public debt market have made it practically impossible for even the most sophisticated investor to evaluate the creditworthiness of most issuers of public debt (creditworthiness is defined as an evaluation of an issuer's ability to pay its operating expenses and debt service payments).

I have been involved in public finance since 1984. I feel very comfortable evaluating the credit-worthiness of small cities and rural water districts in the State of Kansas. However, any city greater than the size of the city of Wichita, Kansas or a bond issue that finances anything more exotic, such as a hospital, would be beyond my ability to determine its creditworthiness. The rating agencies employ individuals who are experts in different areas of public

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finance. These individuals are supposed to have the expertise to determine the creditworthiness of large units of government or exotic debt instruments such as mortgage revenue bonds or credit derivative swaps. Therefore, investors of public debt have become very dependent upon the rating agencies to quantify, measure and evaluate the risk of default, or the non-payment of debt service, by issuers of public debt.

The Moody's report

On August 28, 2009, www.Bloomberg.com reported: "The U.S.'s ability to cope with the credit crisis, its political stability and 'favorable' economic prospects all support the country's top Aaa credit ratings, according to Moody's Investors Service." The main points from the Bloomberg report include the following:

1. Although government financial strength is weakening as a result of intervention to support the financial system and the economy, other factors support a stable rating outlook.
2. The U.S. government and the Federal Reserve have spent, lent or committed more than $12 trillion in a bid to revive the economy and credit markets. The budget deficit is projected to reach $1.6 trillion this year and $1.4 trillion next year, according to the nonpartisan Congressional Budget Office. The Office of Management and Budget, in its August 25 mid-year economic review, added almost $2 trillion to the 10-year deficit estimate from its May forecast, to $9.05 trillion.
3. The federal government debt ratios, which Moody's considers most relevant to the rating, given the U.S.'s relatively decentralized fiscal structure, are rising steeply and will continue that trend at least through 2010," wrote Moody's analysts including Steven A. Hess in New York. "However a substantial portion of the rise results from asset purchases, meaning the government's net worth is less affected", Moody's analyst stated.
4. The budget deficit will fall to about four percent of output by 2015, boosting the ratio of debt to gross domestic product to 77 percent in 2019, the highest level since World War II, Moody's said. Unless action is taken now to rein in deficits, pressure on public finances from Social Security, Medicare and Medicaid will be "even more difficult to deal with," Hess wrote.

Federal budget deficits

Moody's biggest concern was the federal government's debt ratios. Debt by the federal government is created by budget deficits. A budget deficit or surplus is the difference between revenue received versus expenditures disbursed. Historically, according to data from the Federal Reserve, the U.S. has run annual budget deficits. The last budget surplus the federal government had was in the year 2001. The budget surplus in the year 2001 was about $128.2 billion. In the year 2001 revenue received by the federal government was approximately $2.0 trillion and expenditures were almost $1.9 trillion.

In the years immediately following the year 2001, revenues received by the federal government went down until they reached about $1.8 trillion in the year 2003. This may have been due to the tax cuts instituted in the year 2001 or the recession in the year 2001, or a combination of both. However, every year since the year 2003, revenues received by the federal government have increased. In the year 2008, the federal government received more than $2.6 trillion in revenue; an increase of over $671 billion or 33.7% more revenue than it received in the year 2001.

On the other hand, federal government expenditures continued to increase from the year 2001 through 2008. In the year 2008, federal government expenditures were more than $2.9 trillion; an increase of more than $1.0 trillion or 55.7% more than expenditures it disbursed in the year 2001. The largest budget deficit previously recorded was in the year 2004. The amount of the deficit in the year 2004 was more than $412.7 billion.

The Washington Times reported on August 25, 2009 that the White House announced that the annual budget deficit will exceed $1.50 trillion this year and for fiscal year 2010, and $1.12 trillion in fiscal year 2011 and $800 billion for fiscal year 2012. "For the 2010-2019 period, cumulative budget deficits will exceed $9 trillion." Are the historic, current and forecasted budget deficits due to too little revenue or too much spending? This is a question I will leave for the reader to research and decide. However, the concern of the author is the possible affect of future federal government budget deficits and related borrowing requirements on the ability of Kansas local units of government to issue bonds going forward.

Federal debt

Based upon the data I was able obtain from the Federal Reserve, I was disappointed to discover that the federal debt (the "Public Debt") has been in debt since the year 1800. In the year 1800, the Public Debt was almost $83 million. By the year 1835, the Public Debt was down to $33,733. But it did not take long for it to increase. In the year 1840, the Public Debt was more than $3.5 million, in the year 1845, the Public Debt was more than $15.9 million and in the year 1865, it was more than $2.6 billion. After 1865, the Public Debt steadily decreased until the year 1895. By the year 1920, the Public Debt was in excess of $25.9 billion. In the year 1985, the Public Debt was more than $1.9 trillion. Twenty-four years later in the year 2008, the Public Debt reached to more than $9.4 trillion. According to CNBC, the total amount of public debt as of August 27, 2009 was $11 trillion. With more than $9 trillion of expected budget deficits over the next ten years, one of the concerns expressed by some economists is "Who is going to buy this debt?" I thought it might be interesting to know the top ten holders of the Public's Debt. According to CNBC, the following is a list of the top 10 current holders of Public Debt:

1. Federal Reserve & U.S. Governmental Holdings $4.785 trillion
2. Mutual Funds $769.1 B
3. China $766.4 B
4. Japan $711.8 B
5. Other Investors $629.7 B
6. State & Local Governments $522.7 B
7. Pension Funds $464.4 B
8. United Kingdom $214.0 B
9. Oil Exporters $191.0 B
10. Caribbean Banking Centers $187.9 B

At one time, I was concerned about what would happen if China or other nations stopped buying America's debt. Not to worry – we would buy it ourselves! The Federal Treasury issues the debt and the Federal Reserve buys it. That is what is called monetizing the debt. The Federal Treasury prints the bonds, the Federal Reserve prints the money to buy the bonds from the Federal Treasury and the Federal Treasury spends the money that the Federal Reserve printed.

Implications to local units of government

If the rating agencies should downgrade the federal government's debt from its current Aaa rating, it could have a profound effect on local units of government in Kansas. First of all, the cost of borrowing for the federal government may go up. This could result in additional borrowing by the federal government, an increase in taxes, additional monetizing of debt or a combination of all three. The additional borrowing by the federal government could possibly take available money out of the municipal bond market. Even though we have not hit the limit, there is not an unlimited amount of money to buy debt or bonds. Higher taxes could lower your patrons' ability to pay water bills or local taxes. The current practice of monetizing the debt lowers the value of the dollar relative to other currencies. This lowers the cost of our goods exported to other countries, so they buy more (that's good), but it increases the cost of imports, thereby increasing the cost of selling water and other municipal services.

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The second potential impact of a federal government downgrade is the cost of borrowing by local units of government. The creditworthiness of an issuer of municipal bonds is traditionally compared to Federal Treasury Notes when interest rates are determined. Therefore, the higher the interest rates for Federal Treasury Notes, the higher the interest rate on the municipal bonds.

The third potential impact of a downgrade of the federal government's credit rating is a reduction in confidence. The United Nations and some countries have called for a replacement of the U.S. dollar as the world's reserve currency. A downgrade in the federal government's debt rating could accelerate this possible change and other countries might start dumping U.S. dollars. A dumping of U.S. dollars would most likely cause a downward spiral in the value of the U.S. dollar and create a very inflationary period for the United States. Inflation reduces the cost of debt of the country, but it hurts the standard of living of the citizens with higher prices for basic goods and materials. It also reduces the citizens' ability to pay for water and local taxes.

Conclusions

Some economists have the opinion that budget deficits and resulting additional debt is required to get us out of the current recession and to provide other essential services. Other economists do not. I do not know who is right. Maybe both sides are right and wrong. But what I do know is that the forecasted amount of federal government borrowing is without precedent. Therefore, the potential impact of such federal government borrowing is unpredictable. My recommendation is that you continue to make your water system as cost efficient as possible and plan ahead for future operating and capital expenditures. There are numerous programs through the Kansas Department of Health and Environment (KDHE) – Water Section to assist you with these matters. One of the best programs is the Kansas Public Water Supply Loan Fund.

The Kansas Public Water Supply Loan Fund

If you are looking to finance a water project, the interest rate for the Kansas Public Water Supply Loan Fund is 3.75% (as of the date of this article). Since its inception in 1997, the average interest rate for the Revolving Loan Fund is 3.93%. Its all time high was 4.80% in March of 2000; the all time low was 3.30% in April of 2007 (Please refer to the

Kansas Public Water Supply Loan Fund Historical Interest Rates													
Month	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
January		4.25	3.98	4.73	4.37	4.08	3.91	3.80	3.60	3.60	3.35	3.54	4.34
February		4.15	4.00	4.77	4.25	4.11	3.92	3.73	3.58	3.57	3.33	3.51	4.21
March		4.09	4.00	4.80	4.13	4.14	3.89	3.68	3.53	3.53	3.35	3.54	4.13
April		4.09	4.04	4.77	4.11	4.15	3.86	3.62	3.56	3.53	3.36	3.67	3.98
May		4.15	4.05	4.69	4.15	4.16	3.81	3.69	3.58	3.58	3.37	3.81	3.91
June		4.17	4.09	4.69	4.18	4.18	3.69	3.82	3.56	3.62	3.39	3.78	3.82
July		4.15	4.16	4.68	4.21	4.13	3.59	3.97	3.46	3.67	3.51	3.73	3.77
August		4.12	4.25	4.65	4.19	4.08	3.60	3.99	3.42	3.68	3.58	3.72	3.75
September		4.10	4.35	4.52	4.11	4.01	3.78	3.90	3.43	3.63	3.69	3.75	3.77
October		4.07	4.44	4.45	4.08	3.92	3.92	3.78	3.44	3.54	3.67	3.79	3.63
November	4.31	4.00	4.58	4.44	4.04	3.89	3.97	3.66	3.49	3.46	3.63	4.04	
December	4.29	3.98	4.65	4.45	4.04	3.88	3.88	3.62	3.55	3.49	3.57	4.17	
Average	4.30	4.11	4.22	4.64	4.16	4.06	3.82	3.77	3.52	3.58	3.48	3.75	3.93

chart entitled "Kansas Public Water Supply Loan Fund"). The Loan Fund is available to all Kansas municipalities for those projects that qualify. It has a 20-year amortization and only a one-percent loan origination fee. Without a doubt, this is the cheapest way to finance water projects in Kansas. The annual savings of using the Loan Fund versus general obligation bonds would be about $6,200 a year per million borrowed or $124,000 over the 20-year life of the borrowing. The Kansas Rural Water Finance Authority provides technical assistance to applicants to the Loan Fund. The Authority contracts for this specialized service with Ranson Financial Consultants. As a result, Rose Mary Saunders and I are available to assist you with the loan application free of charge. Please give us a call at 316-264-3400 if you have any questions or would like to have assistance. Also, contact KRWA at 785-336-3760 for more information.

Every year applications for water projects to be financed by the Kansas Public Water Supply Loan Fund are prioritized based upon a competitive ranking system. Every year, except for this year, all of the projects that have applied for funding have received funding. Due to the current credit situation causing a limited amount of funds to be available to finance projects, the ranking of a project has become very important. Those projects that correct drinking water compliance issues will probably be ranked higher than those that are for infrastructure improvements. Officials at KDHE have indicated they hope this temporary lack of funding availability will be solved in the near future. Therefore, continue to express interest if your city or RWD has a project. Your project may actually rank high enough to get funded or we can educate you on alternative means of financing your project.

John J. Haas is President of Ranson Financial Consultants, L.L.C. John has been a financial advisor to Kansas local units of government since 1978. He received a Master's Degree from the Hugo Wall Center for Urban Studies at Wichita State University and has a Certificate of Public Management and graduate hours in finance from Wichita State. John specializes in general public finance and analytical services.

Thoroughbred Systems, Inc. 116 S. E. 8th Ave.(Downtown) Topeka, KS 66603-3905
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After receiving her update Rossville, Ks City Clerk Lisa Stum wrote this email ...
"I don't think I will ever need to pull a paper file again.
All the information I need is on one screen.
I keep going back just to look at it. Great-Great-Great!"