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Research:

Iowa; Appropriation, Moral Obligation; Tax Secured, General Obligation

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Credit Profile

AFFIRMED	
$44.460 mil. Iowa sch infrastructure spl fd bnds ser 2001 dtd 11/01/2001 due 03/15/2003-2021	AAA/A+(SPUR)
Iowa ICR	AA+
$186.665 mil. Iowa vision Iowa spl fd bnds ser 2001 dtd 11/01/2001 due 02/15/2003-2020 & 08/15/2020	AAA/A+(SPUR)
OUTLOOK:	STABLE

Rationale

The 'AA+' issuer credit rating (ICR) on Iowa reflects the state's:

- Stable and diversifying economy;
- Conservative fiscal management with a demonstrated willingness to restrain spending to maintain fiscal integrity;
- Good finances, buoyed by statutory reserves; and
- Very low debt burden.

The 'A+' rating on the state's series 2001 Vision Iowa bonds and school infrastructure bonds reflects the state's moral obligation to replenish debt service reserve funds for the two issues in the event they are drawn upon to pay debt service.

After declining during the 1980s, Iowa's population rebounded during the 1990s and grew 5.3% to 2.9 million in 2000. While Iowa's economy retains strong ties to agriculture, the state is moving toward more value-added agriculture, including biotechnology. Growth in the state's substantial services and finance, insurance, and real estate (FIRE) sectors has diversified its economy away from the cyclical and often troubled durable manufacturing and agricultural sectors. The state's economic growth has been slowed by a tight labor market and reduced demand for agricultural exports, as well as slow domestic and international demand for related durable goods due to depressed livestock and commodity prices. Nevertheless, both income and employment growth have remained positive. Generally, this stability extends across the state's rural and urban areas. Iowa's 2002 unemployment rate was 3.7%, which was considerably lower than the nation's 5.7% level. The rate in October 2003 rose to 4.5%, significantly lower than the nation's 6.0%.

Iowa's financial operations have weakened since 2000 in the face of softened tax revenues caused by the sluggish economy. General fund tax receipts, which were flat in 2001, declined 1.7% in fiscal 2002 and rose only 0.3% in 2003. Reserves held in the economic emergency and cash reserve funds, which totaled $486 million (6.7% of general fund expenditures) at the end of fiscal 2001, dropped to $210.6 million (2.7%) at the end of fiscal 2003 following transfers from the funds--$221 million from the economic emergency fund and $99 million from the cash reserve fund--in fiscal 2002.

Total general fund revenues for fiscal 2003 decreased 2.3% from 2002, with personal income tax revenues increasing 1.8%, and sales and use tax revenues dropping 0.7%, which resulted in a general fund shortfall of $45.8 million for the year. Following the governor's 2.5% across-the-board budget cut in October 2003, which included cuts to school aid, the state projects that it will end fiscal 2004 with a small surplus. The combined economic emergency and cash reserve fund balance is projected to decline to $164.3 million (2.2%), following an anticipated $45.8 million draw from the cash reserve fund to cover the 2003 revenue deficit. Undesignated general fund reserves are projected to grow to $36.1 million at the end of 2004, which would give the state total reserves of $200.4 million, or 2.7% of expenditures.

Because Iowa is prohibited from exceeding $250,000 in GO debt without approval of the electorate, capital requirements have been met on a pay-as-you-go basis, or by lease issues. Of these outstanding lease issues, annual appropriated payments account for less than 1% of the general fund budget.

Outlook

The stable outlook reflects the expectation that Iowa's strong financial management will successfully address the state's current slowdown in revenue growth, allowing it to return to balanced operations and rebuild reserves in the near future.

Economy

Iowa continues to experience a tight labor market. While resulting in low unemployment rates, labor shortages in Iowa are holding down employment and income growth compared to the nation. Wage inflation caused by the tight labor market, however, remains subdued. The state's unemployment rate has been well below the nation's levels since 1987. Iowa's unemployment rate averaged 3.0% in 2001, which was substantially below the nation's 4.5% rate, and climbed to 3.7% in 2002, which was still considerably lower than the nation's 5.7% level. Meanwhile, the number of people employed grew to 1.6 million in 2002--the state's highest level of employment to date--but fell back to 1.57 million as of May 2003 as the unemployment rate continued to rise in 2003.

Despite several years of depressed farm commodity prices and reduced exports, recently, Iowa's economy has demonstrated resilience with positive income growth. In 2001, the state's per capita personal income grew 2.9% on top of growth of 6.3% in 1998, 4.3% in 1999, and 3.8% in 2000. As tracked by the U.S. Census Bureau, median 2000 household income was at $42,993 per capita for the state, which was 102% of the national level.

Agriculture provided 7.0% of Iowa's jobs in 2001, which was down from 8.7% in 1992, but just 3.4% of the state's income. After declining from 1997-2000, total farm cash receipts, including government payments, rose 1.3% to $13.2 billion in 2001. Iowa farmers are expected to benefit from the 2002 federal farm bill, which increases farm product support payments and additional payments for land conservation and alternative energy programs. The federal government expected to pay out $1.7 billion in fiscal 2002 and $1.4 billion in each of fiscals 2003-2007 to about 75% of Iowa's farmers.

Additional employment sectors bring diversity to the state's economy. In 2001, services employment grew to 28% from 25% in 1992; meanwhile, FIRE employment grew slightly during that time to 7.2% of total employment from 6.5%. Manufacturing employment declined to 13% from 14% from 1992-2001. Much of Iowa's services growth occurred in the Des Moines area--making the city the world's third-largest insurance center.

Iowa's economy faces challenges, including:

- A tight labor supply,
- An aging rural population,
- The continued loss of young workers to out-of-state employers, and
- A continuing population shift to urban from rural areas.

These issues will affect long-term policy decisions regarding the cost and scale of services around the state, particularly education, job training, and quality of life.

Finances

In 1992, Iowa initiated several key financial reforms, including the institution of "rainy day" funds. The rainy day funds are made up of the cash reserve and economic emergency funds. Currently, the funding target for both funds is 5.0% of appropriations, but will be changed to 7.5% for the cash reserve fund and 2.5% for the economic emergency fund beginning in fiscal 2005. As long as general fund revenues exceed or equal projections, a standing appropriation provides for the deposit of 1% of revenues into the rainy day funds, first to the cash reserve fund and then to the economic emergency fund. In addition, any general fund surpluses generated at the end of each fiscal year are transferred first to the cash reserve fund then to the economic emergency fund until the funding targets are hit. The rainy day reserves may only be spent for cash flow and budgetary emergency purposes. A three-fifths supermajority is needed to reduce the cash reserve fund below 3%.

These reserves allowed the state to absorb an operating deficit in fiscal 2002 and provided some cushion to cover future unplanned deficits. The two rainy day fund balances reached targeted funding levels in 1998 and incrementally increased each year, through 2001, with the size of the budget.

Iowa's policy to budget appropriations at just 99% of projected revenue was also instituted in 1992. To help keep the budget on target throughout the fiscal year, the state's revenue-estimating conference provides revenue projections four times a year in July, September/October, December, and March/April.

Iowa revised its 2002 budget several times during the fiscal year, and made 2.5% across-the-board budget cuts in October 2003, in reaction to the revenue-estimating conference's reduced revenue projections. The state made a total of $260 million in net appropriation reductions and adjustments to standing appropriations in 2002. Following the revenue-estimating conference's projection of $142.2 million in reduced revenues for fiscal 2004, $82.5 million in budget cuts was announced in October 2003. Gov. Thomas J. Vilsack's and the Iowa Legislature's proactive approach to maintaining fiscal integrity by making the necessary cuts to sustain fiscal stability is viewed as a major credit strength.

In 2001, Iowa issued $644 million of revenue bonds backed by 78% of the state's annual tobacco settlement payments. Net proceeds from the $604 million tax-exempt tobacco bonds were deposited into a special fund and reserved for health programs and certain other appropriations; the fund held $469 million at fiscal year-end 2002.

Debt

Iowa has no GO debt outstanding. Under the Iowa Constitution, the state is prohibited from issuing more than $250,000 in GO debt without the electorate's approval. In recent years, lease issues to provide funds for jail construction and a statewide fiber-optic network have met capital requirements. Of these outstanding lease issues, annual appropriated payments account for less than 1% of the general fund budget. Additional general capital needs have been limited and are funded through general operations. Capital programs for state highways are paid with a dedicated motor fuels sales tax, and capital costs associated with the clean up of underground storage tanks have been funded with revenue bonds secured by certain motor vehicle license taxes. Higher education capital funding is provided directly through the universities and secured by revenues pledged by each university. The state, however, reimburses its universities for tuition dollars used to pay debt service on academic revenue bonds.

In 2000, the state authorized the issuance of bonds backed by its moral obligation to fund two programs that were set up to improve local infrastructure. The "Vision Iowa" program authorized the sale of bonds to fund state and local cultural and recreational attractions, $196 million of which were issued in 2001. In 2001, the state also issued $44 million of bonds authorized by the Iowa School Infrastructure program to provide matching infrastructure grants to schools. State gaming and lottery revenues secure the bonds for both of these programs; the state's moral obligation pledge to replenish debt service reserve funds further secures the program bonds.

In December 2003, the state issued $575 million of TRANs, which are scheduled to mature on June 29, 2004, to address an anticipated cash flow shortfall. The last time the state issued cash flow notes was 2001.