

As the White House eagerly scans the economic landscape for signs of recovery, a looming drought in the form of state budget deficits could make any "green shoots" wilt. States face a cumulative shortfall of \$230 billion from this year through 2011, and there is little sign in bailout-weary Washington of any attempt to create yet another aid program to solve that problem. But if the federal government did want to hold that drought at bay, it has options: passing another stimulus plan; assisting states in the bond market; assuming a greater share of Medicaid payments. If the recovery stalls a few months from now, those may suddenly become central to the rescue efforts.

While discouraging talk right now of any federal response to state budget woes, the Obama administration is anxiously eyeing state efforts to close persistent budget gaps. So far, 42 U.S. states have slashed enacted budgets to cope with rising demand for services and plunging revenue, according to the National Governors Association. About half have also raised taxes.

Those policies run counter to Washington's efforts to prime the economic pump, with a \$787 billion stimulus plan, plus hundreds of billions of dollars more in new lending, mortgage relief and other efforts. About \$246 billion of the stimulus funds are already going to the states, to offset rising Medicaid costs, stave off education cuts and help with infrastructure problems. Friday, the Treasury made \$25 billion in bond authority available for state and local governments under the Recovery Zone Bonds program, a little-known piece of the massive stimulus law.

But all that money will start drifting away next year, when the administration hopes a recovery will be taking hold. And that is exactly when states anticipate their fiscal problems could be even worse. "The states have so few options to respond," said Nick Johnson, director of the state fiscal project at the Center on Budget and Policy Priorities, a liberal think tank. "Drawing down reserve funds, various accounting gimmicks -- those options are either gone or won't do enough. The remaining options threaten to slow the recovery."

If Washington were inclined to help, the easiest approach would be a second stimulus bill pouring more money directly into state coffers. But with a federal budget deficit approaching \$2 trillion, there is little chance of that.

So creativity is in order.

House Financial Services Committee Chairman Barney Frank has been searching for low-cost ways to step in. His staff has looked into a raft of measures to loosen state borrowing and lower the interest rates state governments must offer on their bonds. The Massachusetts Democrat would like to create a reinsurance fund, financed through premiums paid by bond sellers, which would offer bond purchasers additional assurance that their money is safe.

Legislation also could mandate that ratings companies such as Standard & Poor's would have to use the same criteria to rate state bonds as are used to rate corporate bonds -- a requirement that doesn't exist now, sometimes to the disadvantage of states. "Where there's the full faith in credit behind these municipal bonds, where the full taxing power of a state or city is behind them, they never default," Mr. Frank said, yet the bonds are "treated as if they're risky."

In the short run, the Treasury or Federal Reserve could use existing programs established to prop up consumer borrowing to underwrite state bond offerings, he said. That would bring more lenders into the state bond market and lower interest costs for cash-strapped states.

President Barack Obama suggested in a recent C-SPAN interview that some kind of clever bond-market moves may be in the works. "We are talking to state treasurers across the country, including California, to figure out are there some creative ways that we can just help them get through some of these difficult times," he said. But crafting the right balance would be tough.

Treasury officials have told California state legislators that the U.S. is monitoring the situation but isn't keen to provide assistance, according to people familiar with the matter. "It's hard to help just one state," says a government official. On the other hand, there is worry about setting up a broad short-term assistance program that some fret could turn into a permanent federal subsidy.

The move to bail out California -- or any other state -- is made harder by the current political climate, particularly opposition from home-state Republicans on Capitol Hill.

Rep. John Campbell, one of four California Republicans on Mr. Frank's committee, said a federal intervention would only halt state efforts to come to terms with budgets and could create incentives to spend even more. "The states are kind of on their own because the bullets are out of the federal gun," he said, "not because they couldn't print some more money but because I hope there's a recognition that printing and borrowing

more money is going to have extremely negative consequences."

In response, Mr. Frank shrugs: "How am I going to get representatives from Pennsylvania and New York to send money to California if Republicans from California are fighting it?"