

# 2014 Facts:

## State and Municipal Bankruptcy ■ Municipal Bonds ■ State and Local Pensions



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## State and Local Bankruptcy

States do not seek bankruptcy protection. Any federal law allowing states to declare bankruptcy would increase interest rates, rattle investors and markets, raise the costs for state government, create more volatility and uncertainty in financial markets, and erode state sovereignty under the 10th Amendment to the U.S. Constitution.

In 2011, the National Governors Association leadership issued a preemptive statement and a joint leadership letter with the National Conference of State Legislatures that declared opposition to any Congressional legislation that would permit states to file for bankruptcy protection. Opposition to such legislation continues today.

## States Are Constitutional Sovereigns

The mechanics of bankruptcy are inapplicable to a sovereign entity. Bankruptcy is not a legal option for states, as constitutionally recognized sovereigns. States have taxing authority and constitutional or statutory requirements to balance their budgets. By contrast, bankruptcy may be an option for some municipalities under Title IX of the federal Bankruptcy Code, depending on state law and other factors. This is because municipalities are legal corporations, not sovereign entities. Eligibility for Chapter IX relief is narrowly tailored by several factors. States determine whether their municipalities, as “political subdivisions, public agencies, or instrumentalities of the state,” may pursue this option. One key eligibility factor is that a municipality must be insolvent and unable to meet its obligations when they fall due.

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CSG – The Council of State Governments

NACo – National Association of Counties

NLC – National League of Cities

USCM – The U.S. Conference of Mayors

ICMA – International City/County Management Association

NASBO – National Association of State Budget Officers

NASACT – National Association of State Auditors, Comptrollers and Treasurers

GFOA – Government Finance Officers Association

NASRA – National Association of State Retirement Administrators

## Municipal Bankruptcies Are Limited

- Chapter IX is uniquely designed to allow certain public entities to reorganize debts while continuing to provide essential public services; however, it is inapplicable to states, as well as to a majority of counties and cities.
- Only 14 localities, or one out of every 1,525 eligible localities (0.06 percent), have sought bankruptcy protection over the past five years.
- Only 12 states specifically authorize Chapter IX filings for their general-purpose local governments and 12 states conditionally authorize such filings. Twenty-six states either have no Chapter IX authorization outlined, or such filings are prohibited.<sup>1</sup>
- There is no provision in Chapter IX of the federal Bankruptcy Code for a federal bailout, and filing under this section of the law is not a request for federal financial assistance.

## Municipal Bonds

Municipal securities are predominantly issued by state and local governments for governmental infrastructure and capital needs purposes. Most debt is issued not for operating budgets, but for capital projects, such as the construction or improvement of schools, streets, highways, hospitals, bridges, water and sewer systems, ports, airports and other public works. The recovery rate of payment for governmental debt exceeds the corporate recovery rate.

### Not All Municipal Debt and Defaults Are the Same

Municipal debt takes two forms: (1) General Obligation, or GO Debt, backed by the full faith and credit (taxing power) of a general purpose government like a state, city, or county, and (2) Non-GO debt that is issued by governments and special entities that is usually backed by a specific revenue source (special taxes, fees or loan payments) associated with the enterprise or borrower.

There are two types of defaults: (1) the more minor “technical default,” where a covenant in the bond agreement is violated, but there is no payment missed and the structure of the bond is the same, and (2) defaults where a bond payment is missed or in the rare event that debt is restructured at a loss to investors.

### Municipal Securities

- Between 2003 and 2012, states, counties, and other localities invested \$3.2 trillion in infrastructure through long-term tax-exempt municipal bonds;

the federal government provided \$1.3 trillion in support of public works.<sup>2</sup>

- On average, 12,000 municipal issuances are completed each year.

## Federal Tax-Exemption of Municipal Securities

- Municipal securities existed prior to the formation of the federal income tax in 1913. When first enacted and still today, the federal Internal Revenue Code exempts municipal bond interest from federal taxation. Many states also exempt from taxation the interest earned from municipal securities when their residents purchase bonds within their state.
- Due to the reciprocal immunity principle between the federal government and state and local governments, state and local governments are prohibited from taxing the interest on bonds issued by the federal government.

## Defaults Remain Low

- Municipal securities are considered to be second only to Treasuries in risk level as an investment instrument.
- While most municipal securities are issued for governmental infrastructure and capital needs purposes, state and local governments and other types of government authorities may issue bonds for other purposes, which include transactions in which the proceeds are borrowed by non-profit institutions (e.g., health care and higher education) and for economic development purposes.
- From 1970 through 2012, there were 73 rated municipal bond defaults of which only five were rated city or county governments. The majority of rated defaulted bonds were issued by not-for-profit hospitals or housing project financings; of the five defaults in 2012, three were of Moody’s-rated general government bonds.<sup>3</sup>
- Historically, municipal bonds have had lower average cumulative default rates than global corporates overall and by like rating category. Between 1970 and 2012, the average 10-year default rate for Moody’s Aaa-rated municipal bonds was zero compared to a 0.50 percent default rate for Moody’s Aaa-rated corporate bonds.<sup>4</sup>
- In the double-A rating category to which the majority of municipal ratings are assigned, average cumulative default rates are much lower for municipals than for corporates with the same double-A symbol.<sup>5</sup>

- Except for Arkansas, no state has defaulted on its debt in the past century. In that 1933 Arkansas default, bondholders ultimately were paid in full.

### **Debt Service is a Small and Well-Protected Share of State and Municipal Budgets**

- Debt service is typically only about 5 percent of the general fund budgets of state and municipal governments.
- Most state and municipal governments operate under a standard practice of paying their debt service first before covering all other expenses; in some cases this is required by law or ordinance.

### **Municipal Fiscal Health**

The fiscal condition of most cities is improving after seven years of declining tax revenues.<sup>6</sup> For counties, although the recovery remains fragile, there are signs of economic growth with about half of all county economies recovering or showing no declines over the last decade by 2013.<sup>7</sup>

In a study of city fiscal problems, Boston College researchers found that fiscal mismanagement (32 percent) and economic issues (28 percent) were the top two factors leading to financial problems. Pensions were a factor for 9 percent of the cities.<sup>8</sup>

## **State and Local Government Pensions**

- **State and local retirement systems are legally separate trusts, which currently hold \$3.72 trillion in assets<sup>9</sup>** for over 15 million working and 8 million retired employees of state and local government.<sup>10</sup> The pre-recession high was \$3.2 trillion.
- Public retirees and their employers contribute to their pensions while they are working. Public employees typically are required to contribute five to ten percent of their wages to their state or local pension.
- Public pension assets are accumulated, invested, and paid out over decades, not as a lump sum. Funded levels—the degree to which a plan has accrued assets to pay expected benefits for current and future retirees—among pension plans vary substantially. While some plans are more than 100 percent advance-funded, the average funded level in 2012 was 73 percent and 23 percent were less than 60 percent funded.<sup>11</sup>

- State and local employee retirement systems do not seek federal financial assistance. One-size-fits-all federal regulation is neither needed nor warranted and would only inhibit recovery efforts at the state and local levels.

### **State and local governments are taking steps to strengthen their pension reserves and have a long-term time horizon.**

- Between 2009 and 2013, 49 states have made changes to benefit levels, contribution rate structures, or both; many local governments have made similar fixes to their plans.<sup>12</sup>
- While pension obligations are often backed by explicit constitutional or statutory provisions, states are generally free to change their retiree health plans, including termination, as they do not carry the same legal protections. It is misleading and inappropriate to combine unfunded pension liabilities with unfunded retiree health benefits.

### **Long-term investment returns of public funds continue to meet expectations.**

- For the 25 year period ending June 30, 2013, which saw three economic recessions and four years of negative median public fund investment returns, actual public pension investment returns averaged 8.6 percent; the 10-year return was 7.1 percent.<sup>13</sup>
- As of December 2013, the average public plan investment assumption was 7.72 percent.<sup>14</sup>

### **Retirement systems remain a small portion of state and local government budgets.**

- On average, the portion of combined state and local government spending dedicated to retirement system contributions is less than five percent.
- While there are pension trusts that are fully funded with enough assets for current pension obligations, there also are legitimate concerns about the extent of underfunding. In most cases, a modest increase in contributions to take advantage of compounded interest, modifications to employee eligibility and benefits, or both, will be sufficient to remedy the underfunding problem.<sup>15</sup>

# Endnotes

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- 2 Emilia Istrate, NACo Director of Research, “Municipal Bonds Build America,” sources Thomas Reuters, February 2013; OMB, Table 9.2 – Major Public Physical Capital Investment Outlays in Current and Constant (FY2005) Dollar: 1940–2014; Congressional Research Tax-Exempt Bonds: A Description of State and Local Government Debt. 2012; OMB, Table 16-1. Estimates of Total Income Tax Expenditures for Fiscal Years 2012–2018, 2013, p.10.
- 3 [https://www.moodys.com/research/Moodys-Municipal-bond-defaults-have-increased-since-financial-crisis-but-PR\\_272561](https://www.moodys.com/research/Moodys-Municipal-bond-defaults-have-increased-since-financial-crisis-but-PR_272561), May 7, 2013.
- 4 Ibid.
- 5 Ibid.
- 6 *City Fiscal Conditions 2013*. National League of Cities. October 2013. <http://www.nlc.org/find-city-solutions/city-solutions-and-applied-research/2013-city-fiscal-conditions>
- 7 *County Tracker 2013: On the Path to Recovery*. National Association of Counties. January 2014. [http://www.naco.org/research/Research%20Documents/NACo\\_County\\_Tracker%202013.pdf](http://www.naco.org/research/Research%20Documents/NACo_County_Tracker%202013.pdf)
- 8 Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, and Mark Cafarelli, “Are City Fiscal Woes Widespread? Are Pensions the Cause?” December 2013, Center for State and Local Government Excellence and Center for Retirement Research at Boston College.
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- 10 “Pension Funding: A Guide for Elected Officials,” Report from the Pension Funding Task Force 2013, 3. [http://www.nasact.org/washington/downloads/announcements/03\\_13\\_Pension\\_Funding\\_Guide.pdf](http://www.nasact.org/washington/downloads/announcements/03_13_Pension_Funding_Guide.pdf)
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- 12 National Conference of State Legislatures and National Association of State Retirement Administrators, <http://www.nasra.org/content.asp?contentid=171> <http://www.ncsl.org/research/fiscal-policy/pensions.aspx>
- 13 Callan Associates, June 30, 2013
- 14 “Public Pension Plan Investment Assumptions,” NASRA Issue Brief, updated December 2013
- 15 “Pension Funding: A Guide for Elected Officials,” Report from the Pension Funding Task Force 2013. [http://www.nasact.org/washington/downloads/announcements/03\\_13\\_Pension\\_Funding\\_Guide.pdf](http://www.nasact.org/washington/downloads/announcements/03_13_Pension_Funding_Guide.pdf)

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