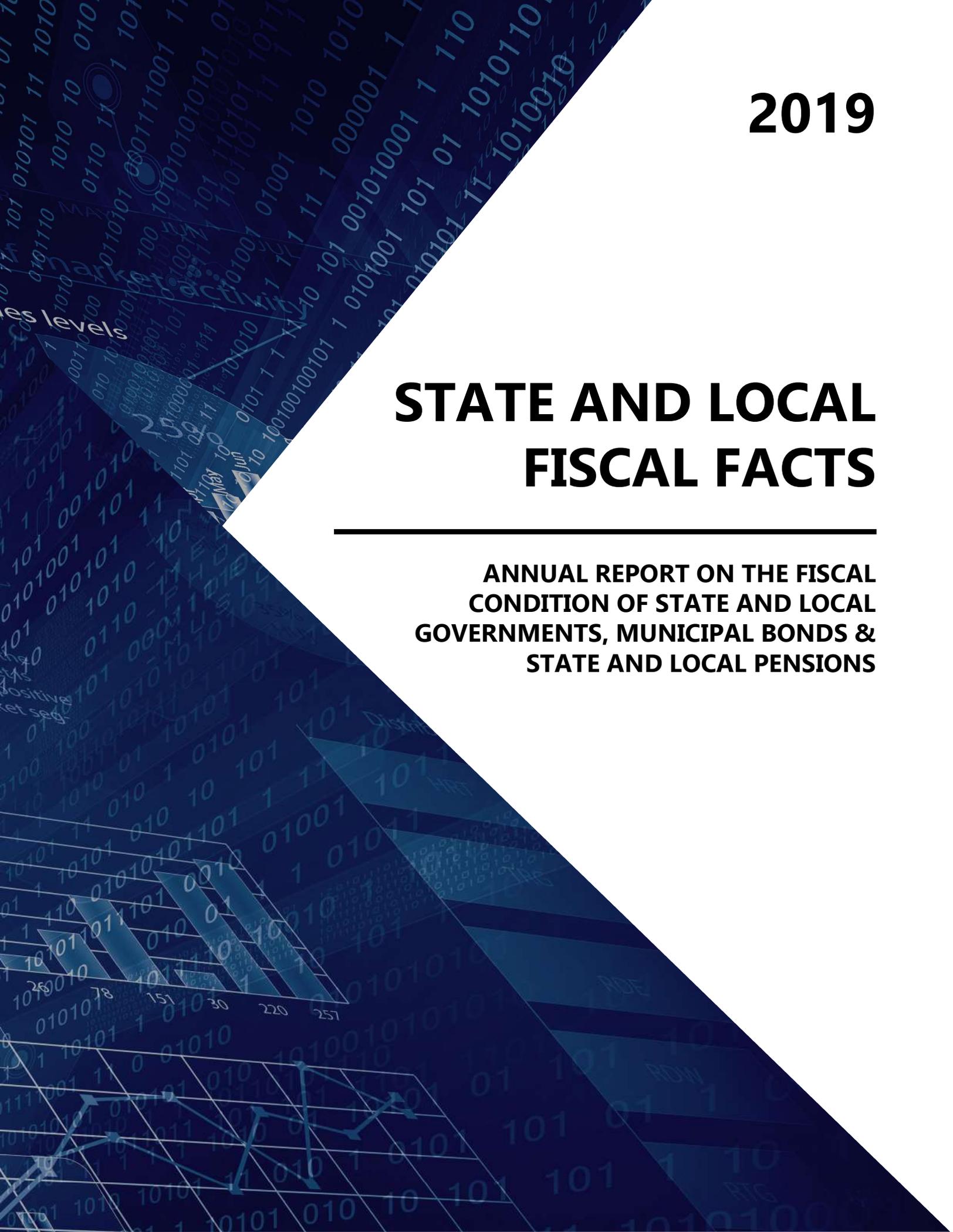


2019

STATE AND LOCAL FISCAL FACTS

**ANNUAL REPORT ON THE FISCAL
CONDITION OF STATE AND LOCAL
GOVERNMENTS, MUNICIPAL BONDS &
STATE AND LOCAL PENSIONS**



THE FISCAL CONDITION OF STATE AND LOCAL GOVERNMENTS

In the past few years, the fiscal conditions of state and local governments have stabilized, but improvements have been uneven. While challenges remain, officials have been taking steps to replenish rainy day funds and address long term structural imbalances.

STATE FINANCES¹

State fiscal conditions continue to show signs of improvement and greater stability. General fund revenue growth saw a significant uptick in FY 2018, led by personal income tax gains. This gave states more flexibility to increase their budgets in FY 2019 for core government services, targeted investments and one-time needs, as well as deposit additional money into their rainy day funds. Even with stronger revenue growth, state spending increases are moderate by historical standards as states focus on bolstering their reserves to prepare for the next downturn and seek long-term structural balance. While budget conditions vary by state, all states to some extent face long-term spending pressures in areas ranging from health care and pensions to adequately funding K-12 education and infrastructure.

- States enacted appropriation increases totaling \$41.1 billion for FY 2019, compared to increases of just \$12.7 billion approved in states' original budgets for FY 2018.
- Forty states reported FY 2018 preliminary revenues exceeded original projections and only seven states made mid-year budget cuts due to a revenue shortfall in FY 2018.
- Despite recent improvements, 30 states spent less in FY 2018 than the pre-recession peak in 2008, in real dollar terms.
- States have replenished some spending for areas cut back during the recession, including K-12 and higher education, corrections, and transportation.
- Most states continue to strengthen their rainy day funds, with 32 states reporting balance increases and the median rainy day fund balance rising to 6.4 percent as a share of general fund spending in FY 2018, from a recent low of 1.6 percent in FY 2010.

CITY FINANCES²

City fiscal conditions in 2018 show signs of weakening, though slightly more finance officers than last year are optimistic about the fiscal capacity of their cities. Tax revenue growth is experiencing a year-over-year slowdown, with the growth in service costs and other expenditures outpacing it. Taken together, the survey results suggest that cities are approaching the limits of fiscal expansion.

Property tax revenues grew 2.6 percent, compared to 4.3 percent in FY 2016; sales tax revenues grew 1.8 percent compared to 3.7 percent in FY 2016; and income tax revenues grew 1.3 percent compared to 2.4 percent in FY 2016.

Employee wages (88%), public safety (78%) and infrastructure (71%) are the most common areas in which cities increased spending.

COUNTY FINANCES

Counties still face a constraining fiscal environment many years after the national economic downturn. Forty-four (44) percent of county officials responding to a 2016 NACo survey indicated a reduction or elimination of a county program or service because of budget constraints or unfunded state and local mandates in the past fiscal year.³ Notably:

- Nearly three-quarters (73 percent) of states have escalated the number and/or cost of mandates for counties over the past decade, decreased state funding to counties over the past decade, or a combination of both.
- Property taxes and sales taxes are the main general revenue sources for most counties. According to a 2016 report published by NACo, all 45 states which allow counties to collect property taxes place limitations on their ability to do so.
- In 35 of the 45 states with county property tax authority, counties retain less than 30 percent of the property tax collected state-wide.
- Only 29 states authorize counties to collect sales taxes. Out of the 29 states, 26 impose a sales tax limit and 19 ask for voter approval.⁴

MUNICIPAL BANKRUPTCY

While the fiscal condition of state and local governments as a whole is improving, there are governments where fiscal stress continues. Generally, these governments' fiscal troubles are based on long-standing economic problems and other unique circumstances. It is important to note that municipal bankruptcy, while headline-grabbing, is rare and is not an option under state law for most localities.

- Bankruptcy is not a legal option for state sovereign entities. States have taxing authority and have constitutional or statutory requirements to balance their budgets.
- States determine whether their political subdivisions may pursue bankruptcy in the event of insolvency.
- Only 12 states authorize Chapter IX bankruptcy filings for their general-purpose governments, and 12 states conditionally authorize such filings. Twenty-six (26) states have either no Chapter IX authorization or such filings are prohibited.
- Bankruptcies remain rare and are a last resort for eligible municipal governments. Since 2010, only 9 out of 51 filings have been by general-purpose governments. The majority of filings have been submitted not by cities, but by lesser-known utility authorities and other narrowly-defined special districts throughout the country.⁵
- Chapter IX of the federal Bankruptcy Code does not provide for any federal financial assistance, and filing under this section of the law is not a request for federal funding.

FEDERAL INTERVENTION

The Founding Fathers believed in a limited and strictly defined federal role. The 10th Amendment reads "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." State and local governments can weather difficult economic periods and officials are taking steps to restore fiscal stability. Interference in the fiscal affairs of state and local governments by the federal government is neither requested nor warranted. Long-term issues such as outdated methods of taxation, rising health care costs, and growing pension liabilities are already being discussed by state and local government leaders, and changes in many areas are underway.

MUNICIPAL BONDS

MUNICIPAL BONDS

Municipal securities are predominantly issued by state and local governments for governmental infrastructure and capital needs purposes, such as the construction or improvement of schools, streets, highways, hospitals bridges, water and sewer systems, ports, airports and other public works. The volume of municipal bonds issued in 2018 was nearly \$350 billion. Between 2008 and 2018, states, counties, and other localities invested \$3.6 trillion in infrastructure through tax-exempt municipal bonds;⁶ the federal government provided almost \$1.5 trillion.⁷

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

The principal and interest paid on municipal bonds 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.
- Either under standard practice or as required by law or ordinance, debt service most often must be paid first before covering all other expenses of state and municipal governments.
- Municipal securities are considered to be second only to Treasuries in risk level as an investment instrument. The recovery rate of payment for governmental debt far exceeds the corporate recovery rate.

TYPES OF DEBT AND DEFAULT

Municipal debt takes two forms: General Obligation, or GO debt, backed by the full faith and credit of a general-purpose government like a state, city, or county; and Non-GO debt 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 when debt is restructured at a loss to investors.

From 1937 through 2017, there were only 677 municipal Chapter 9 filings, compared to 5,760 corporate Chapter 11 filings for 2017 alone.⁸ The majority of rated defaulted bonds were issued by not-for-profit hospitals or housing project financings, not including debt issued by Puerto Rico, a territory with debt default subject to the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA), a US Federal Law.⁹

Historically, municipal bonds have had lower average cumulative default rates than global corporates overall and by like rating category. Since 2007, the average 5-year default rate for municipal bonds was 0.15% compared to 6.92% default rate for corporate bonds.

- In the double-A rating category to which the majority of municipal ratings were assigned, average cumulative default rates are much lower for municipal bonds than for corporate bonds with the same double-A symbol.¹⁰
- There has been only one state that has defaulted on its debt in the past century, and in that case bondholders ultimately were paid in full.

The federal tax exemption for municipal bonds is an effective, efficient, and successful way for state and local governments to finance infrastructure. Municipal securities existed prior to the formation of the federal income tax in 1913. Since then, the federal Internal Revenue Code has exempted municipal bond interest from federal taxation. Over the past twenty years, the federal exemption has saved state and local governments on average 150-200 basis points in additional interest expense through the federal tax exemption.¹¹ In 2018 alone, state and local governments saved over \$7 billion in additional interest expense through the federal tax exemption.¹² Many states also exempt from taxation the interest earned from municipal securities when their residents purchase bonds within their state. Because of 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.

As a result of the 2017 tax reform law, beginning in 2018 state and local governments could no longer use tax-exempt bonds to advance refund outstanding bonds. Tax-exempt advance refundings helped state and local government take advantage of favorable interest rate environments, which resulted in reduced debt service costs, the freeing up of resources to be used for other important purposes, and a reduction in taxpayer and ratepayer burdens. Advance refundings helped issuers save more than \$14 billion from 2012-2017.

STATE AND LOCAL PENSIONS

Although some state and local government pension trusts are fully funded with enough assets for current pension obligations, there are legitimate concerns about the extent of underfunding in certain jurisdictions. In most cases, increases in contributions, or modifications to employee eligibility, or both, will be sufficient to remedy the underfunding problem.¹³

SIGNIFICANT REFORMS ENACTED

State and local employee retirement systems are established and regulated by state laws and, in many cases, further subject to local governing policies and ordinances. Federal regulation is neither needed nor warranted, and public retirement systems do not seek federal financial assistance. State and local governments have and continue to take steps to strengthen their pension reserves and operate under a long-term time horizon.

- Since 2009, nearly every state has made changes to pension benefit levels, financing arrangements, or both. Many local governments have made similar reforms to their plans.¹⁴

STATE AND LOCAL PENSIONS

- Accrued pension benefits are protected by U.S. and state constitutions, either through contract clauses or specific pension provisions. In some states, future accruals are protected by state constitutions, written contract, and/or case law.

However, states generally are permitted to change retiree health benefits, including terminating them, as in most cases they do not carry the same legal protections. Therefore, combining unfunded pension liabilities with unfunded retiree health benefits is misleading.

- Thirty-one (31) states hold approximately \$41 billion in other post-employment benefits (OPEB) assets as of FY 2015. This figure is up from \$33 billion reported for FY 2013.¹⁵

PENSION FINANCES

Public employees and their employers contribute to their pensions during employees' working years. Assets are held in trust and invested in diversified portfolios to prefund the cost of pension benefits for over 14 million working and 10 million retired employees of state and local government.¹⁶ Public pension assets are invested using a long-term horizon, and nearly all benefits are paid out not as a lump sum, but as monthly distributions in retirement.

Public employees typically are required to contribute 5 to 10 percent of their wages to their state or local pension. Since 2009, most states have increased required employee contribution rates.¹⁷

As of September 30, 2018, state and local retirement trusts held \$4.4 trillion in assets.¹⁸

For most state and local governments, retirement systems remain a relatively small portion of their budget. For the nation as a whole, the portion of combined state and local government spending dedicated to retirement system contributions is just below five percent.¹⁹ Current pension spending levels vary widely and are sufficient for some entities and insufficient for others.

Funded levels—the degree to which a plan has accrued assets to pay projected benefits for current and future retirees among pension plans—vary widely. Although a number of plans are near or above 100 percent advance-funded, on average, the funded level in 2017 was 72 percent, and 20 percent were less than 60 percent funded.²⁰

Many public pension plans have reduced their investment return assumption in recent years. Among the 128 plans measured in the Public Fund Survey, more than 90 percent have reduced their investment return assumption since FY2009. The median return assumption is 7.28 percent. For the 25-year and 30-year periods ending June 30, 2018, the median annualized public pension investment returns were 7.9 percent and 8.6 percent, respectively; and the 1-, 5- and 10-year medians were 8.2, 7.9 and 6.6 percent, respectively.²¹

It is important to note that essentially all major pension systems are focused on transparent reporting and disclosure. Close to 90% of these systems develop their comprehensive annual financial reports and summary plan descriptions based on national standards. Virtually all of these systems develop annual actuarial valuations; at an average of every five years, they evaluate how assumptions have matched reality; and they have produced formal funding policies.²²

ENDNOTES:

- ¹ "The Fiscal Survey of States," Fall 2017, National Association of State Budget Officers, <http://www.nasbo.org/reports-data/fiscal-survey-of-states>
- ² Christiana McFarland and Michael A. Pagano, "City Fiscal Conditions," 2018, National League of Cities, http://www.nlc.org/sites/default/files/2018-09/City%20Fiscal%20Conditions%202018_WEB.pdf
- ³ Natalie Ortiz, "Priorities in America's Counties 2016," July 2016, National Association of Counties, <https://www.naco.org/resources/priorities-americas-counties-2016-survey-county-officials>
- ⁴ Emilia Istrate and Daniel Handy, "The State of County Finances: Progress Through Adversity," October 2016, National Association of Counties, <http://www.naco.org/countyfinance> and Joel Griffith, Jonathan Harris, and Emilia Istrate, "Doing More with Less: State Revenue Limitations and Mandates on County Finances," November 2016, National Association of Counties, <http://www.naco.org/statelimits>
- ⁵ "Bankrupt Cities, Municipalities List and Map," Governing, <http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html>
- ⁶ GFOA Analysis of Thomson Reuters data
- ⁷ NACo Analysis of OMB, 2017 Budget, Table 9.2 and Table 14.1
- ⁸ GFOA and the Public Finance Network, "Understanding Financing Options Used for Public Infrastructure," February 2019, <http://www.gfoa.org/sites/default/files/PFNPrimer012019.PDF>
- ⁹ Pub. L. 114-187, June 30, 2016, 130 Stat. 549
- ¹⁰ Moody's Investor Service, "US Municipal Bond Defaults and Recoveries," 2017
- ¹¹ Justin Marlowe, "Municipal Bonds and Infrastructure Development - Past, Present, and Future," International City/County Management Association and Government Finance Officers Association, 2015, <https://icma.org/documents/municipal-bonds-and-infrastructure-development-%E2%80%93-past-present-and-future>
- ¹² Estimate based on GFOA analysis of 2018 issuance data
- ¹³ "Pension Funding: A Guide for Elected Officials," Report from the Pension Funding Task Force, 2013 [https://www.nasra.org/files/JointPublications/PensionFundingGuide\(1\).pdf](https://www.nasra.org/files/JointPublications/PensionFundingGuide(1).pdf)
For more information on state and local government retirement plan features and financing, see www.nasra.org, www.slge.org, and www.publicplansdata.org
- ¹⁴ National Association of State Retirement Administrators, "Significant Reforms to State Retirement Systems," December 2018, <https://www.nasra.org/files/Spotlight/Significant%20Reforms.pdf> and Jean-Pierre Aubry, Caroline V. Crawford, "State and Local Pension Reforms Since the Financial Crisis," Center for State and Local Government Excellence and Center for Retirement Research at Boston College, December 2016, <https://slge.org/resources/state-and-local-pension-reforms-since-the-financial-crisis>
- ¹⁵ Alex Brown, Joshua Franzel, and Lola Oduyeru, "Spotlight on Retiree Health Care Benefits for State Employees in 2015," Center for State and Local Government Excellence and National Association of State Retirement Administrators, May 2017, <https://slge.org/resources/spotlight-on-retiree-health-care-benefits-for-state-employees-in-fy-2015>
- ¹⁶ "Pension Funding: A Guide for Elected Officials," Report from the Pension Funding Task Force, 2013 [https://www.nasra.org/files/JointPublications/PensionFundingGuide\(1\).pdf](https://www.nasra.org/files/JointPublications/PensionFundingGuide(1).pdf) and Public Plans Data, <http://www.publicplansdata.org/quick-facts/national>
- ¹⁷ "Employee Contributions to Public Pension Plans," National Association of State Retirement Administrators (NASRA) Issue Brief, October 2018, <https://www.nasra.org/files/Issue%20Briefs/NASRAContribBrief.pdf>
- ¹⁸ Public Plans Data, <http://www.publicplansdata.org/quick-facts/national>
- ¹⁹ Jean-Pierre Aubry, Caroline Crawford, and Kevin Wandrei, "Stability in Overall Pension Plan Funding Masks a Growing Divide," Center for State and Local Government Excellence and Center for Retirement Research at Boston College, October 2018, <https://slge.org/resources/stability-in-overall-pension-plan-funding-masks-a-growing-divide> and NASRA Public Fund Survey Summary of Findings for FY2017, <https://www.nasra.org/publicfundsurvey>
- ²⁰ "Public Pension Plan Investment Return Assumptions," NASRA Issue Brief, February 2019, <http://www.nasra.org/return-assumptionsbrief>
- ²¹ "Public Pension Reporting and Disclosure: The Current State of Practice and Examples of What Works Well," Center for State and Local Government Excellence and National Association of State Retirement Administrators report, April 2017 <https://slge.org/resources/public-pension-reporting-and-disclosure-the-current-state-of-practice-and-examples-of-what-works-well>

ISSUED BY:



FOR MORE INFORMATION:

National Governors Association
Steven Parker, sparker@nga.org, 202.624.5369

National Conference of State Legislatures
Erlinda Doherty, erlinda.doherty@ncsl.org,
202.624.5400

The Council of State Governments
Andy Karellas, akarellas@csg.org, 202.624.5460

National Association of Counties
Deborah Cox, dcox@naco.org, 202.942.4286

National League of Cities
Christiana K. McFarland, ckmcfarland@nlc.org,
202.626.3036

The U.S. Conference of Mayors
Larry Jones, ljones@usmayors.org,
202.861.6709

International City/County Management Association
Elizabeth Kellar, ekellar@icma.org,
202.962.3611

Government Finance Officers Association
Emily Swenson-Brock, ebrook@gfoa.org,
202.393.8467

National Association of State Budget Officers
Kathryn White, kwhite@nasbo.org,
202.624.5949

National Association of State Auditors, Comptrollers and Treasurers
Cornelia Chebinou, cchebinou@nasact.org,
202.624.5451

National Association of State Retirement Administrators
Jeannine Raymond, jeannine@nasra.org,
202.624.1417