

# Facts You Should Know

State and Local Bankruptcy

Municipal Bonds

State and Local Pensions



## Issued by:

- NGA – National Governors Association
- NCSL – National Conference of State Legislatures
- 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

## FACTS: State and Local Bankruptcy

- **Unintended Consequences.** The national conversation now underway whether Congress should enact preemptive authority for states to file for bankruptcy is treacherous because of its unintended consequences. The mere existence of a federal law allowing states to declare bankruptcy would only serve to increase interest rates, rattle investors, raise the costs of state government, create more volatility in financial markets, and erode state sovereignty under the 10th Amendment to the U.S. Constitution.
- **States Versus Municipalities.** The bankruptcy conversation further demonstrates a basic misunderstanding about the function and operation of states and local government.
  - Bankruptcy is not a legal option for states, as constitutionally recognized sovereigns, because states have taxing authority and constitutional or statutory requirements to balance budgets. The mechanics of bankruptcy, moreover, are inapplicable to a sovereign entity.
  - Alternatively, bankruptcy may be an option for some municipalities under Title IX of the federal Bankruptcy Code 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. According to the Congressional Budget Office, 23 states have not passed laws on municipal bankruptcy while 26 states authorize Chapter IX filings (i.e. 12 states impose no restrictions; 14 states require approval from a state authority before filing). Currently, only Georgia legally prohibits its municipalities from filing under Chapter IX.
- **State Actions.** Post-Great Recession, growing budget deficits have confronted most states that are required to balance their budgets annually or biennially. States have risen to this challenge by making tough spending cuts and, when necessary, raising taxes, which is within their power as sovereign entities.
  - During this time, unfunded pension and health care liabilities have also grown because of the lower rate of return on investments and deferred annual contributions. In 2010 alone, at least 20 states modified their pension plans to help mitigate and eliminate unfunded liabilities.
  - Throughout this difficult period, states never contemplated walking away from their obligations to residents or the bond markets by requesting that the federal government allow states to receive bankruptcy protection.
  - NGA leadership issued a preemptive statement on January 25, and again in a February 4 joint leadership letter with the NCSL that declared opposition to any congressional legislation that would permit states to file for bankruptcy protection.

## FACTS: Municipal Bonds

### ■ Municipal Securities

- There are approximately 1.5 million municipal bonds outstanding, totaling \$2.9 trillion, 70% of which are owned by individual investors. Nearly 12,000 issuances completed each year.
- Municipal securities are considered to be second only to Treasuries in risk level as an investment instrument.
- Municipal securities are predominantly issued by state and local governments for governmental infrastructure and capital needs purposes. However, state and local governments and other types of government authorities may issue bonds for a variety of 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.

### ■ Federal Tax-Exemption of Municipal Securities

- Municipal securities existed prior to the formation of the federal income tax. When the federal income tax was enacted, it specifically carved out income from municipal bonds interest as exempt from federal taxation. Additionally, many states also exempt from taxation the interest from municipal securities, for bonds purchased 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.

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

- Municipal debt takes two forms: (1) General Obligation, or GO Debt, that is 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 are usually backed by a specific revenue source (special taxes, fees or loan repayments) associated with the enterprise or borrower.
- There are two types of default: (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 debt is restructured at a loss to investors.

### ■ Defaults Are Rare

- Since 1970, there have been only 54 defaults (excluding technical defaults) in the municipal sector and only 4 of these defaults were from city or county governments; 78% came from health care- and housing-related projects issued by special entities. (Moody's)
- The historical default rate in the entire municipal sector is less than 1/3 of 1%, compared to a corporate default rate that exceeds 10%. (Fitch). This default rate is significantly lower than the corporate bond default rate. Between 1970 and 2006, triple-A municipal bonds' default rate was 0% compared to a 0.52% default rate for triple-A corporate bonds. (Moody's)

- Except for Arkansas in 1933, no state has defaulted on its debt in the past century. It is important to note that in the 1933 Arkansas default, bondholders were paid in full.
- The recovery rate of payment for governmental debt exceeds the corporate recovery rate, with a recovery rate for general obligation and tax-backed debt at 100%.
- Reports of a growing number of defaults in the state and local government sector are not based on facts, nor current budget estimates and economic data.

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

- Debt service is typically only about 5% of the general fund budgets of state and municipal governments.
- Most debt is not issued for operating budgets, but rather for capital projects that help governments pay for public projects, such as the construction or improvement of schools, streets, highways, hospitals, bridges, water and sewer systems, ports, airports and other public works.
- 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.

#### ■ **Bankruptcy Does Not Necessarily Mean Default**

- In many municipal bankruptcies, the jurisdictions have not defaulted on their debt/municipal bonds and have protected investors (including the largest in history—Orange County, CA in 1994).

## **FACTS: State and Local Government Pensions**

#### ■ **Public Pension Plans Are Not In a Current Crisis.** Most state and local employee retirement systems have substantial assets to weather the economic crisis. There is currently \$2.7 trillion already set aside in pension trusts for current and future retirees.

- Public pensions are funded and paid out over decades; state / local government retirees do not draw down their pensions all at once.
- 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.

#### ■ **Public Pension Liabilities, Debt Loads, and Retiree Health Benefits Are Issues With a Long-Term Time Horizon.**

- More state and local governments enacted significant modifications to improve the long-term sustainability of their retirement plans in 2010 than in any other year in recent history.
- In the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures, or both; many local governments have made similar fixes to their plans.<sup>1</sup>
- While pension obligations are legally binding, often backed by explicit state constitutional or statutory guarantees, states are generally free to change any provision of their retiree health plans, including terminating them, because they do not carry the same legal protections. Therefore, it is misleading to combine unfunded pension liabilities with the unfunded retiree health benefits as an argument for impending pension meltdown.

#### ■ **Long-Term Investment Returns of Public Funds Continue to Exceed Expectations.** Over the last 25 years that saw three economic recessions and four years of negative median public fund investment returns actual public pension investment returns averaged 9.25 percent, which exceeded projections.<sup>2</sup>

- These actual returns exceed the 8% average public pension investment assumption, as well as the average assumed rate of return used by the largest corporate pension plans.<sup>3</sup>

#### ■ **Retirement Systems Remain a Small Portion of State and Local Government Budgets.** The portion of state and local government spending dedicated to retirement system contributions is about three percent.<sup>4</sup> Pensions are a trust that public retirees and their employers contributed to while they were working.

- While there are pension trusts that are fully funded with enough assets for current pension obligations, there are legitimate issues with underfunding because of the Great Recession and stock market declines. Some experts argue that a modest increase in contributions to take advantage of compounded interest, modifications to employee eligibility and benefits, or both, may be sufficient to remedy the underfunding in most states.<sup>5</sup>
- The unprecedented number of benefit and financing changes in public plans over the last few years will help to minimize any required increases. The vast majority of public employees are required to contribute a portion of their wages—typically, five to ten percent—to their state or local pension, and these contribution rates are being raised in many state and local governments.

#### ■ **Pension Dollars Help the Economy of Every Jurisdiction.** Public employees live in every city and county in the nation. More than 90 percent retire in the same jurisdiction where they worked. The over \$175 billion in annual benefit distributions from pension trusts are a critical source of economic stimulus to communities throughout the nation, and act as an economic stabilizer in difficult financial times. Recent studies have documented public retirement system pension distributions annually generate over \$29 billion in federal tax revenue, more than \$21 billion in annual state and local government tax revenue, and a total economic impact of more than \$358 billion.<sup>6</sup>

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#### NOTES

<sup>1</sup> Pensions and Retirement Plan Enactments in 2010 State Legislatures, National Conference of State Legislatures

<sup>2</sup> Investment Return Assumption for Public Funds: The Historical Record, Callan Investments Institute Research

<sup>3</sup> Milliman 2010 Pension Funding Study

<sup>4</sup> NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems

<sup>5</sup> The Funding of State and Local Pensions, Center for State and Local Government Excellence

<sup>6</sup> Pensionomics: Measuring the Economic Impact of State and Local Pension Plans, National Institute on Retirement Security