

# State and Local Fiscal Facts: 2016

State and Local Finances · Municipal Bonds · State and Local Pensions



The Council of State Governments



## Fiscal Condition of State and Local Governments

In the past few years, state and local government revenues have been slowly improving. While challenges remain, officials have been taking steps to replenish rainy day funds and address long-term structural imbalances.

### State Finances<sup>1</sup>

For states, 2015 brought a moderate improvement in fiscal conditions. While stable state fiscal conditions for 2016 are projected, powerful macro conditions such as weak commodity prices, stock market volatility, and global uncertainties could destabilize this projection. General fund spending and revenues are projected to increase for the sixth consecutive year based on states' enacted budgets. Since the end of the Great Recession, states have transitioned to a sustainable period of fiscal rebuilding, but progress remains slow and fiscal challenges are likely to continue due to rising spending demands in areas such as healthcare and education and limited gains in revenue collections.

- Forty-three states enacted higher general fund spending in FY16 than in FY15.
- States have enacted minimal mid-year spending cuts over the last several years, indicating that states' fiscal situations have stabilized.
- States have replenished some spending for areas cut back during the recession, including K-12 and higher education.
- Thirty-nine states exceeded their FY 2015 revenue projections, and most states expect to meet or exceed their FY 2016 revenue projections as well.

### City Finances<sup>2</sup>

City fiscal conditions continue to show modest improvement but remain weakened since the Great Recession. Growth is slow and fiscal challenges are likely to continue. A number of factors determine the revenue performance, spending levels and overall fiscal condition of cities. Among the factors most negatively influencing city conditions are increases in infrastructure demands, and employee and retiree-related costs including pensions, healthcare and wages. Positive factors include the value of the city tax base, health of the local economy, and in most cities, the drop in gas and oil prices.

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- Property tax revenue has increased and is anticipated to have positive growth in 2016.
- Sales and income tax revenues continue to show positive rates of increase.
- Ending balances have returned to pre-recession levels.
- Despite improvements in tax sources, and in the general fund, the pace of growth is concerning. Cities are operating at only about 90 percent of pre-recession revenues.
- City finance officers are optimistic but more fiscally conservative and are cautiously preparing for the next economic downturn.
- Management of infrastructure and employee-related costs and volatilities such as gas and oil prices, inflation and state aid could continue to affect fiscal sustainability long term.

### County Finances<sup>3</sup>

For counties, recovery has accelerated; however, challenges remain. County economies grew strongly last year, yet most have not returned to pre-recession levels on jobs and unemployment. Notably:

- Recovery accelerated on unemployment rates and home prices, but GDP recovery was less pronounced.
- Economic recovery is spreading more rapidly, but most economies still have not recovered.
- Economic recovery is creating an uneven geography of opportunity.
- Real wage growth has not kept pace with productivity gains.

### 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 bankruptcy, while headline-grabbing, is rare and is not an option 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 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.<sup>4</sup>

- 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 balance between state and federal power. 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 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. Between 2003 and 2014, states, counties, and other localities invested \$3.5 trillion in infrastructure through long-term tax-exempt municipal bonds<sup>5</sup>; the federal government provided \$1.46 trillion.<sup>6</sup>

On average, 11,600 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 that debt is restructured at a loss to investors.

From 1970 through 2014, there were 92 rated municipal bond defaults, of which only six were rated city or county governments. The majority of rated defaulted bonds were issued by not-for-profit hospitals or housing project financings.

Historically, municipal bonds have had lower average cumulative default rates than global corporates overall and by like rating category. Between 1970 and 2013, the average 10-year default rate for Moody’s Aaa-rated municipal bonds was zero compared to a 0.49 percent default rate for Moody’s Aaa-rate corporate bonds.<sup>7</sup> Furthermore, over the last five years, during which state and local governments struggled to recover from the Great Recession, rated state and local GO defaults were remarkably low at 0.005 percent.<sup>8</sup>

- In the double-A rating category to which the majority of municipal ratings were assigned, average cumulative default rates are much lower for municipals than for corporates with the same double-A symbol.<sup>9</sup>
- 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.

### **Federal Tax Exemption**

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. Between 2000 and 2014 the federal exemption saved state and local governments an estimated \$714 billion in additional interest expenses.<sup>10</sup> 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.

### **State and Local Pensions<sup>11</sup>**

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, a modest increase in contributions to take advantage of compound interest, or modifications to employee eligibility and benefits, or both, will be sufficient to remedy the underfunding problem.<sup>12</sup>

### **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 are taking steps to strengthen their pension reserves and operate under a long-term time horizon.

- Between 2009 and 2014, every state made changes to pension benefit levels, contribution rate structures, or both. Many local governments have made similar fixes to their plans.<sup>13</sup>
- Although pension obligations in some states are backed by explicit state constitutional protections or statutes, states generally are permitted to change retiree health benefits, including terminating them, as they do not carry the same legal protections. Therefore, it is misleading to combine unfunded pension liabilities with unfunded retiree health benefits.
- Thirty-three states hold approximately \$33 billion in other post-employment benefits (OPEB) assets as of FY 2013. This figure is up from 18 states reported for the period FY 2009-FY 2011. At the same time, state government units offering retiree health care benefits have declined during the past decade.<sup>14</sup>

### **Pension Finances**

Public retirees and their employers contribute to their pensions while they are working. Assets are held in trust and invested in diversified portfolios to prefund the cost of pension benefits<sup>15</sup> for over 14 million working and 9 million retired employees of state and local government.<sup>16</sup> Public pension assets are accumulated, invested, and paid out over decades, not as a lump sum.

- Public employees typically are required to contribute 5 to 10 percent of their wages to their state or local pension. Since 2009, 36 states have increased required employee contribution rates.<sup>17</sup>
- As of September 30, 2015, state and local retirement trusts held \$3.56 trillion in assets.<sup>18</sup>
- For most state and local governments, retirement systems remain a relatively small portion of their budget. On average, the portion of combined state and local government spending dedicated to retirement system contributions is four percent.<sup>19</sup> 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 expected benefits for current and future retirees - among pension plans vary substantially. Although a number of plans are more than 100 percent advance-funded, on average, the funded level in 2014 was 74 percent, and 20 percent were less than 60 percent funded.<sup>20</sup>
- Many public pension plans have reduced their return

assumption in recent years. Among the 126 plans measured in the Public Fund Survey, two-thirds have reduced their investment return assumption since FY2008. The median return assumption is 7.75 percent. For the 25-year period ending June 30, 2015, the median annualized public pension investment return was 8.4 percent; the 10-year median was 6.6 percent.<sup>21</sup>

## Endnotes

- <sup>1</sup> The Fiscal Survey of States, Fall 2015, National Association of State Budget Officers, <http://bit.ly/23UBmSI>; National Conference of State Legislatures, Survey of Legislative Officers; Summer and Fall 2015.
- <sup>2</sup> City Fiscal Conditions, 2015, National League of Cities, <http://bit.ly/1iOaDDs>
- <sup>3</sup> County Economies 2015, National Association of Counties, <http://www.naco.org/resources/county-economies-opportunities-challenges>
- <sup>4</sup> Bankrupt Cities, Municipalities List and Map, Governing, <http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html>
- <sup>5</sup> Bond Buyer/Thomson Reuters 2014 Yearbook.
- <sup>6</sup> NACo analysis of OMB 2016, Table 9.2 and Table 14.1, CRS 2015, Tax-Exempt Bonds: A Description of State and Local Government Debt.
- <sup>7</sup> Moody's Investor Service - US Municipal Bond Defaults and Recoveries, 1970-2013, May 7, 2014.
- <sup>8</sup> Municipal Market Analytics (MMA).
- <sup>9</sup> Moody's Investor Service, [https://www.moodys.com/research/Moodys-Municipal-bond-defaults-remain-low-in-number-but-new--PR\\_298814](https://www.moodys.com/research/Moodys-Municipal-bond-defaults-remain-low-in-number-but-new--PR_298814)
- <sup>10</sup> Justin Marlowe, "Municipal Bonds and Infrastructure Development – Past, Present, and Future," International City/County Management Association and Government Finance Officers Association, 2015, <http://bit.ly/1Q6RWKJ>
- <sup>11</sup> *Public Plans Database*. [www.publicplansdata.org](http://www.publicplansdata.org)
- <sup>12</sup> "Pension Funding: A Guide for Elected Officials," Report from the Pension Funding Task Force 2013, <http://bit.ly/1Q6S2lr>
- <sup>13</sup> National Conference of State Legislatures and National Association of State Retirement Administrators, <http://bit.ly/1PLWmVh>; <http://www.ncsl.org/research/fiscal-policy/pensions.aspx>; <http://www.nasra.org/reform>
- <sup>14</sup> Joshua Franzel and Alex Brown, "Spotlight on Retiree Health Care Benefits for State and Local Employees in 2014," Center for State and Local Government Excellence and National Association of State Retirement Administrators, December 2014, <http://slge.org/wp-content/uploads/2014/12/OPEB-Spotlight-12.14.pdf>
- <sup>15</sup> Federal Reserve, *Flow of Funds Accounts of the United States: Flows and Outstandings, Third Quarter 2015*, Table L.120, <http://www.federalreserve.gov/releases/z1/current/z1.pdf>
- <sup>16</sup> "Pension Funding: A Guide for Elected Officials," Report from the Pension Funding Task Force 2013, 3, <http://bit.ly/1Q6S2lr>
- <sup>17</sup> "Employee Contributions to Public Pension Plans," National Association of State Retirement Administrators (NASRA) Issue Brief, February 2015, <http://www.nasra.org/contributionsbrief>
- <sup>18</sup> Federal Reserve, *Flow of Funds Accounts of the United States: Flows and Outstandings, Third Quarter 2015*, Table L.120, <http://www.federalreserve.gov/releases/z1/current/z1.pdf>
- <sup>19</sup> "State and Local Government Spending on Public Employee Retirement Systems," NASRA Issue Brief, February 2015, <http://www.nasra.org/costsbrief>
- <sup>20</sup> Alicia H. Munnell and Jean-Pierre Aubry, "The Funding of State and Local Pensions: 2014-2018," June 2015, Center for State and Local Government Excellence and Center for Retirement Research at Boston College, <http://slge.org/publications/the-funding-of-state-and-local-pensions-2014-2018>
- <sup>21</sup> "Public Pension Plan Investment Return Assumptions," NASRA Issue Brief, May 2015, <http://www.nasra.org/returnassumptionsbrief>

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