Facts You Should Know

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

2012 FACT SHEET

FACTS: State and Local Bankruptcy

Unintended Consequences. The mere suggestion that Congress should enact preemptive authority for states to file for bankruptcy is pernicious because of its predictable consequences. Any federal law allowing states to declare bankruptcy would only serve to 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.

States Versus Municipalities. The bankruptcy conversation further demonstrates a basic misunderstanding about the function and operation of state and local governments.

The mechanics of bankruptcy are inapplicable to a sovereign entity. 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. 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 Moody's Investor Service, 21 states and the District of Columbia have not passed laws on municipal bankruptcy while 28 states either authorize or provide conditional or limited Chapter IX filings. Currently, only Georgia and Puerto Rico legally prohibit municipalities from filing under Chapter IX.

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

State Actions. Long term fiscal constraints have put budgetary pressures on most states, which are required to balance their budgets annually or biennially. States have risen to this challenge by making tough spending cuts and, in some cases, raising taxes, which is within their power as sovereign entities. During this time, unfunded pension and health care liabilities have also grown, due chiefly to the lower rate of return on investments and deferred annual contributions. Since 2009, more than 40 states have reduced their pension plan costs, unfunded liabilities, or both, by modifying their pension plans.

Throughout this difficult period, no state contemplated walking away from its obligations to residents or the bond markets by requesting that the federal government allow states to receive bankruptcy protection.

In 2011, NGA leadership issued a preemptive statement and a joint leadership letter with the NCSL that declared opposition to any congressional legislation that would permit states to file for bankruptcy protection. Opposition to such legislation remains in 2012.

FACTS: 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 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.

Municipal Securities

- There are approximately 1.5 million municipal bonds outstanding, totaling $3 trillion, 70 percent of which are owned by individual investors.
- On average, 12,000 issuances are completed each year.
- 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.

Federal Tax-Exemption of Municipal Securities

- Municipal securities existed prior to the formation of the federal income tax. Both when first enacted and today, the federal income tax specifically states that income from municipal bond interest is exempt from federal taxation. Additionally, many states 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.

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 is 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 in the rare event that debt is restructured at a loss to investors.

Defaults Are Rare

- From 1970 through 2011, there were 65 rated municipal bond defaults. Only five rated city or county governments defaulted during this period. The majority of rated defaulted bonds were issued by not-for-profit hospitals or housing project financings. (Moody’s)
- In the first nine months of 2011, municipal bond defaults were down 69 percent compared to the same period in 2010 (S&P).
- This default rate for municipal securities is significantly lower than for corporate bonds. Between 1970 and 2006, triple-A municipal bonds’ default rate was zero compared to a 0.52 percent default rate for triple-A corporate bonds. Additionally, the average one-year default rate for all municipals

was just 0.01 percent versus 1.57 percent for corporates, and in the single-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 single-A symbol (Moody's[1]).

- 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 percent.
- 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 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.

Bankruptcy Does Not Necessarily Mean Default

- In many municipal bankruptcies, the jurisdictions have not defaulted on their debt/municipal bonds and investors have been paid, including the well-publicized bankruptcy of Orange County, CA in 1994.

FACTS: State and Local Government Pensions

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 $200 billion in annual benefits distributed 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.[2]

- **With nearly $3 trillion set aside in pension trusts for current and future retirees, most states and cities have substantial assets to weather the economic crisis**
  - Public pensions are paid out over decades; state and 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.
- **State and local governments are taking steps to strengthen their pension reserves and have a long-term time horizon.**
  - Since 2009, more than 40 states have made changes to benefit levels, contribution rate structures, or both; many local governments have made similar fixes to their plans.[3]
  - While pension obligations are often backed by explicit state constitutional or statutory guarantees, states are generally free to change any provision of their retiree health plans, including termination, as they do not carry the same legal protections. It is misleading to combine unfunded pension liabilities with unfunded retiree health benefits as an argument that a pension meltdown is impending.
- **Long-term investment returns of public funds continue to exceed expectations.**
  - Over the last 25 years, which saw three economic recessions and four years of negative median public fund investment returns, actual public pension investment returns averaged 8.8 percent, which exceeded projections.[4]
  - These actual returns exceed the 7.9 percent average public pension investment return assumption, as well as the average assumed rate of return used by the largest corporate pension plans.[5]
- **Retirement systems remain a small portion of state and local government budgets.**
  - The portion of combined state and local government spending dedicated to retirement system contributions is about four percent.[6,7] Pensions

are a trust to which public retirees and their employers contributed while they were working.

- 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, due primarily to the Great Recession and stock market declines. 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.[8]

- 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 by many state and local governments.

Endnotes

1 *U.S. Municipal Bond Defaults and Recoveries, 1970-2009,* Moody's Investors Service, February 2010

2 Pensionomics: Measuring the Economic Impact of State and Local Pension Plans, National Institute on Retirement Security

3 Pensions and Retirement Plan Enactments in 2011 State Legislatures, National Conference of State Legislatures

4 Median Returns for Periods Ended 12/31/10, Callan Associates

5 Milliman 2010 Pension Funding Study

6 NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems

7 *The Impact of Public Pensions on State and Local Budgets,* Center for Retirement Research at Boston College, Alicia H. Munnell, Jean-Pierre Aubry, and Laura Quinby, October 2010.

8 *State and Local Pensions: An Overview of Funding Issues and Challenges,* Center for State and Local Government Excellence, January 2011.

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