# State and Local Fiscal Facts: 2017

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

## 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 Finances[1]

For states, 2016 brought a moderate improvement in fiscal conditions, and general fund spending is on track to grow modestly in 2017 for the seventh consecutive year based on states' enacted budgets. Fiscal improvement has been uneven across states due to numerous factors such as declining energy prices, differing tax and spending policies, regional economic disparities, and changes in population and demographics. States also face rising spending demands and long-term budget pressures in areas including healthcare, education, infrastructure, and pensions.

- Thirty-two states spent less in FY2016 than the pre-recession peak in 2008, in real dollar terms.
- Half of states reported FY2016 preliminary revenues fell short of original projections and 19 states enacted mid-year budget cuts, while 20 states had revenues come in above projections.
- 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 29 states making deposits in fiscal 2016, and 25 states projecting increases for fiscal 2017.

### City Finances [2]

City fiscal conditions are strengthening, driven by better-than-anticipated revenue growth and solid performance of ending balances. A number of factors determine the revenue behavior, 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.

- Property tax revenue has increased and is anticipated to continue to grow.
- Sales and income tax revenues continue to show positive rates of increase.


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- Ending balances have returned to pre-recession levels (adjusted for inflation).
- City finance officers are optimistic, but as fiscal conservatives, they are cautious and preparing for the next economic downturn.
- Management of infrastructure and employee-related costs and volatilities such as gas and oil prices, inflation, and intergovernmental aid will continue to affect fiscal sustainability long term.

### 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[4]:

- 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.
- General revenue recovery has been slow and uneven across counties - nearly half of counties (46 percent) had not recovered to 2007 levels by 2013.
- The cost of mandated services is rising faster than inflation. Almost half (48 percent) of counties recorded overall 2013 expenses above 2007 levels, even when taking into account inflation.
- States are limiting counties' revenue authority to fund essential services. Property taxes and sales taxes are the main general revenue sources for most counties. While counties in 45 states collect property taxes, 42 states place limitations on county property tax authority. Only 29 states authorize counties to collect sales taxes, but with restrictions. Twenty-six (26) impose a sales tax limit and 19 ask for voter approval.

### 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 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 2016 hit $445 billion, which surpassed the previous high set in 2010 of $433 billion.[6] Between 2007 and 2016, states, counties, and other localities invested $3.8 trillion in infrastructure through tax-exempt municipal bonds;[7] the federal government provided almost $1.5 trillion.[8]

On average, 11,000 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 1970 through 2015, there were 98 rated municipal bond defaults, of which only seven 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 2015, the average 10-year default rate for Moody's Aaa-rated municipal bonds was zero compared to a 0.40 percent default rate for Moody's Aaa-rated corporate bonds.[9] Furthermore, even though state and local governments have struggled to recover from the recession in recent years, the current rate for rated state and local GO defaults, excluding Puerto Rico, is remarkably low at 0.002 percent.[10]

- 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.[11]
- 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.[12] In 2015 alone, state and local governments saved over $8 billion in additional interest expense through the federal tax exemption.[13] 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[14]

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.[15]

**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.

- Between 2009 and 2014, every state made changes to pension benefit levels, financing, or both. Many local governments have made similar reforms to their plans.[16]
- 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 they do not carry the same legal protections. Therefore, combining unfunded pension liabilities with unfunded retiree health benefits is misleading.
- Thirty-three (33) 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 FY2009-FY2011. At the same time, state government units offering retiree health care benefits have declined during the past decade.[17]

**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.[18] Public pension assets are invested using a long-term horizon, and nearly all benefits are 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.[19]
- As of September 30, 2016, state and local retirement trusts held $3.82 trillion in assets.[20]
- 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.[21] Current pension spending

*For the purposes of this fact sheet, Puerto Rico is excluded due to the unique relationship that exists between the United States and its territories.

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 substantially. Although a few plans are more than 100 percent advance-funded, on average, the funded level in 2015 was 74 percent, and 20 percent were less than 60 percent funded.[22]
- Many public pension plans have reduced their investment return assumption in recent years. Among the 127 plans measured in the Public Fund Survey, more than three-fourths have reduced their investment return assumption since FY2009. The median return assumption is 7.5 percent. For the 25-year and 30-year periods ending December 31, 2016, the median annualized public pension investment returns were 7.8 percent and 8.3 percent, respectively; the 1-, 5- and 10-year medians were 7.5, 8.3 and 5.2 percent. [23]

## Endnotes

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## For More Information:

**National Governors Association**
David Parkhurst · (202) 624-5300, dparkhurst@nga.org
Caroline Sevier · (202) 624-5376, csevier@nga.org

**National Conference of State Legislatures**
Max Behlke · max.behlke@ncsl.org, (202) 624-3586

**The Council of State Governments**
Andy Karellas · (202) 624-5460, akarellas@csg.org

**National Association of Counties**
Dr. Emilia Istrate · (202) 942-4285, eistrate@naco.org

**National League of Cities**
Christiana McFarland · (202) 626-3036, mcfarland@nlc.org

**The U.S. Conference of Mayors**
Larry Jones · (202) 861-6709, ljones@usmayors.org

**International City/County Management Association**
Elizabeth Kellar · (202) 962-3611, ekellar@icma.org

**National Association of State Budget Officers**
Stacey Mazer · (202) 624-5382, smazer@nasbo.org

**National Association of State Auditors, Comptrollers and Treasurers**
Cornelia Chebinou · (202) 624-5451, cchebinou@nasact.org

**Government Finance Officers Association**
Michael Belarmino · (202) 393-8024, mbelarmino@gfoa.org

**National Association of State Retirement Administrators**
Jeannine Markoe Raymond · (202) 624-1417, jeannine@nasra.org