

SPECIAL COMMENTARY:
STATES IMPLEMENT **THE BIG RESET**; MICHIGAN LEADS THE WAY

March 2011

State lawmakers continue to confront large budget deficits. Revenues have been growing for four consecutive quarters,¹ but the wind-down of federal stimulus and the use of one-time cash to balance prior years' budgets will result in \$112 billion in budget deficits for FY 2012.² In response, lawmakers have ramped up restructuring efforts.

In this *Special Commentary*, we discuss the credit impact of these reforms, which have been in part compelled by the federal government's fiscal situation. We also highlight Michigan, where lawmakers' local government and pension tax reforms likely foreshadow changes in other states.

**DRAMATIC POLICY REFORM CHARACTERIZES FIRST QUARTER OF 2011:
CHANGE WE CAN INVEST IN?**

In February 2010, the National Governor's Association published a policy paper entitled **The Big Reset**. The bipartisan document outlined strategies to redesign state and local government for a decade of austerity.³

Although overlooked when released, reform proposals from **The Big Reset** underpin most of the dramatic restructuring efforts now underway in the states. In the first quarter of 2011 alone, lawmakers proposed or enacted Big Reset-type changes in the areas of pension reform, healthcare, Medicaid, labor relations, corrections, K-12 education, higher education, taxation, state mandates and local governance. Officials are demonstrating the will to make unpopular decisions, including rescinding collective bargaining rights (WI, OH, OK, TN, and NH), cutting education spending (PA, OH, MI), consolidating local governments (NJ, MI), reforming corrections systems (CA, PA, IL, NY, FL), raising taxes (CT, MN, CA), and reigning-in pension costs (virtually every state).

From a credit standpoint, bond investors benefit from most of these reforms. The changes generally preserve cash, increase governmental flexibility and help match spending with long-term revenue growth.

However, policy U-turns typically unsettle voters, taxpayers and investors and dramatic change invites political backlash and headline-grabbing news stories. The next 12-24 months may witness public employee work stoppages, fisticuffs

among activists and lawmakers or threats of violence by angry voters.⁴ These events could trigger price volatility in the municipal market.

There may also be financial hiccups along the way. Several states have cut local aid dramatically. These cuts improve state credit quality, but they can harm the credit quality of local issuers, including school districts. Some local issuers are likely to suffer periodic strains on cash flow as a result of state aid cuts.

Defaults of high-grade state and local issuers remain very unlikely, but municipal investing over the next several years will require patience. Restructuring state government is a two-steps-forward / one-step-backwards process. Enacting a politically palatable mix of policy solutions is likely to take several budget cycles.

IN THIS SPECIAL COMMENTARY:

- » Credit impact of lawmakers' restructuring efforts
- » Michigan local government and pension tax reforms

EXAMPLES OF REFORMS / CUTS PROPOSED OR ENACTED, (JANUARY - MARCH 2011)*

Source: News articles, state legislatures, Center on Budget and Policy Priorities, and National Association of State Legislatures.

Pensions	<p>Increase employee contributions: (AL, FL, KS, ME, MT, NM, ND, RI, VA, WI, others).</p> <p>Close fund and convert new employees to 401k plan: (FL, KY, NC).</p> <p>Reduce cost-of-living adjustment for current employees: (NJ, ME, OH).</p> <p>Reduce promised benefits: (IL, NJ, ME, OH).</p>
Retiree Healthcare	<p>Contribution increase: Require retirees to contribute more to state-subsidized healthcare premiums (IL).</p>
Employee Healthcare	<p>Contribution cap: Limit state employers premium contribution to \$1,400/mo. (today's monthly premium cost).</p> <p>All future healthcare cost increases would be borne by the employee (OR).</p> <p>Require higher co-pays: (MI, NJ, others)</p> <p>Municipal Employees: Require municipal employees to enroll in state-administered health plan (MA).</p>
Medicaid	<p>Managed Care: Move long-term and chronically ill patients to managed care (NY).</p> <p>Dollar cap on state payments: (CA)</p> <p>Reduce payments to medical providers: (CO, IL, MS, NB, NV, OH, others)</p> <p>Reduction in services provided: (CT, GA, KS, MA, others)</p> <p>Paring of eligibility: Roll back of Medicaid expansion to childless adults (AZ).</p>
Labor Relations	<p>Collective Bargaining: Repeal of collective bargaining rights for certain public employees and/or specific issues: (WI, OH, TN, OK, NH, IL).</p> <p>Increased power for agency heads: Give public agency heads full authority to determine wages once bargaining contracts expire: (NH).</p>
Corrections	<p>Give nonviolent offenders alternatives to prison: (PA)</p> <p>Abolishing death penalty: Saves significant money; defense attorneys laid off (IL).</p> <p>Prison closure: Closing duplicative state prisons (NY).</p> <p>Privatization.: Prisons and probation services would be privatized in 1/4 of counties (FL).</p>
K-12 Education	<p>Cuts to education programs: (AL, PA, MI, OH, NE, FL, CO, IA, KS, NV, NM, NY, WA).</p> <p>Increase in funding for charter schools: (NC)</p> <p>Permit teacher furloughs for economic reasons: (PA)</p>
Higher Education	<p>Three year path to college degree: (OH)</p> <p>Cuts to higher education funding: (AZ, CA, GA, MI, MN, PA, ID, NV, MO, NY, OR)</p>
Taxation	<p>Tax Simplification: Elimination of earned income tax credit (MI), Broadening sales tax base (CT, RI), Elimination of deductions (HI), Extend temporary tax hike (NC).</p> <p>Income Tax Increase: (CT, MN)</p> <p>Growth-based tax change: Taxing pension income (MI, IL, HI), Reducing corporate rates (WI, PA, AZ, FL, MI, NJ, NC).</p>
Local Government	<p>Consolidation: Merge local police and fire departments (NJ).</p> <p>Changes to Municipal Insolvency Rules: (MI, IN, RI).</p> <p>Mandate relief: Prevailing wage requirements reduced or eliminated: (OH, CT).</p>

*Proposals made by Governor or powerful lawmaker (committee chair, majority leader, etc.)

THERE WILL BE NO BAILOUT

Today's state restructuring efforts reflect, in part, the federal government's poor financial condition and voter distrust of Congress. States cannot rely on continued federal stimulus as they did in the years following the Great Depression and during the last two years. Federal revenues have fallen to 16 percent of GDP, and federal debt is at a post-war high, as shown in the charts to the right.

By comparison, states are in *relatively* sound condition. State and local debt burdens have remained stable for several decades, and balanced budget amendments, constitutional debt limits, spending caps, line item veto authority and other fiscal tools have helped states limit the size of their annual and cumulative deficits.⁵

While public trust in the federal government to do the "right thing" "most or all of the time" is near post-war lows,⁶ voters continue to express relatively more confidence in state lawmakers' ability to handle states' fiscal stress. Trust in local government remains very high.⁷

AS GOES MICHIGAN, SO GOES THE NATION?

Few states have been as creative about restructuring as Michigan. In particular, Michigan lawmakers are implementing unique reforms with respect to local governance and pension taxation. Similar reforms are likely in other states in future budget cycles.

Michigan's local government reform effort is arguably the most sweeping restructuring plan in the country. In March, Governor Rick Snyder signed into law an Emergency Financial Manager (EFM) bill that effectively turns struggling municipalities into state-administered departments upon a finding of severe financial distress. The law grants vast authority to "emergency financial managers" to modify or terminate collective bargaining agreements, privatize local services, or file for Chapter 9 of the bankruptcy code, among other powers.⁸ Another bill, now under consideration, would simplify the process to consolidate or merge local governments. A third bill would force local governments to compete for state aid, which would be awarded only if savings goals materialized.

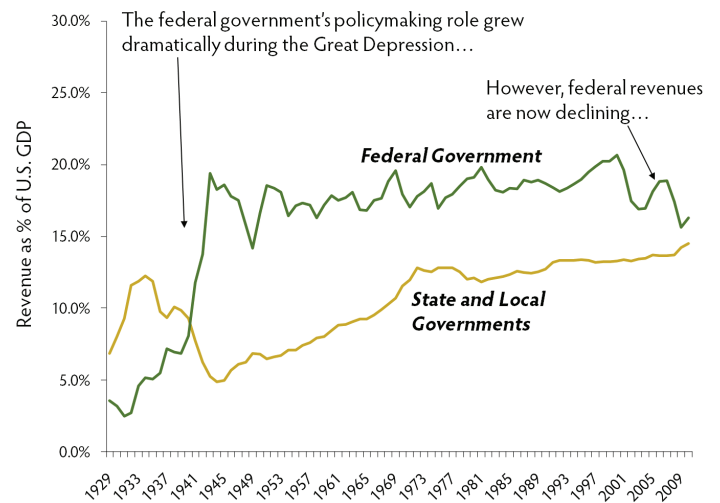
Taken together, the EFM law and the other bills redistribute the balance of state and local government power in Michigan. They transfer power to the state from local governments during times of financial distress by *forcing* local decision-makers to take swift action to correct budget imbalances. These reforms are reminders that local governments' powers are delineated by state law and that states typically act to protect the credit quality of their local issuers. In fact, one of the major purposes of Michigan's EFM law is to "protect the credit of this state and its political subdivisions."⁹

Other states are likely to follow Michigan's lead in reforming local governance and the procedures used to unwind unsustainable local finances. Last year, California lawmakers considered changes to local insolvency rules and Rhode Island and Indiana enacted reforms. However, no state has gone as far as Michigan to provide non-bankruptcy solutions for struggling local governments. Michigan's proposals to simplify consolidations and mergers and make state aid incentive-based are exceptional.

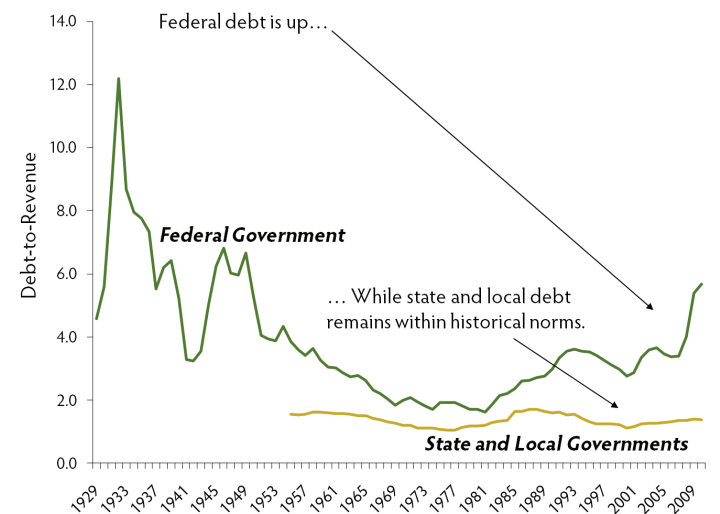
Michigan's other trend-setting reform is Governor Snyder's proposal to tax residents' pension income. Among states that impose personal income taxes,

FEDERAL REVENUE DOWN AND DEBT UP

Source: Bureau of Economic Analysis NIPA tables, 4/2011.



Source: Federal Reserve Flow of Funds, U.S. Treasury, and Bureau of Economic Analysis NIPA tables, 4/2011.



Note: State and local debt figures are conservative; they include economically defeased debt.

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at least 37 provide some form of tax relief to those with pension income.¹⁰ Most of these states exempt a large swath of retirees' pension income. Some states exempt all or nearly all of pension income.¹¹

Taxing pension income is extremely unpopular with retirees who vote in outsized numbers, but Michigan's pension tax proposals are positive for the state's long-term credit quality. Pension taxes increase the marginal cost of retirement while lowering the marginal cost of labor. The result is a more competitive, employment-friendly tax structure. Governors in Hawaii and Illinois are also proposing pension tax changes, but their proposals are not

as dramatic as those in Michigan. More states are likely to advance similar proposals. States are seeking new revenue options that minimally impede growth.

Breckinridge continues to monitor state policy developments and their impact on credit quality. Last year, we wrote that municipal credit quality was likely to diverge over the next several budget cycles. We continue to witness this divergence across states and within them. On balance, the policies proposed in the first quarter of 2011 have been good news for investors in state and local bonds. There are several more years to go.

¹ See "State Revenue Report," Rockefeller Institute of Government, February 2011. Available at: http://www.rockinst.org/pdf/government_finance/state_revenue_report/2011-02-01-SRR_82.pdf.

² See Center on Budget and Policy Priorities website. Data available at: <http://www.cbpp.org/slideshows/?fa=stateFiscalCrisis>.

³ See "The Big Reset: State Government After the Great Recession," February 23, 2010. Available at: <http://www.nga.org/Files/pdf/1002STATEGOVTAFTERGREATRECESSION.PDF>.

⁴ For example, when Connecticut lawmakers enacted dramatic policy changes in the early 1990s, elected officials were told to remove the lawmaker-identifying license plates from their state-owned vehicles to avoid voters' wrath. See "Connecticut Wars Against the Income Tax," *Connecticut History*, Vol 49, No. 1 (2010)

⁵ See Presentation by David Nowakowski, *Roubini Global Economics*, "Municipal Fiscal Stress, Bankruptcy, and Pensions," April 2011.

⁶ Only 29% of Americans trust the federal government to "do what is right 'always' or 'most' of the time." See Pew Research Center poll, February 22 – March 1, 2011. Available at: <http://pewresearch.org/pubs/1913/poll-trust-washington-anger-government-gay-marriage-support-abortion>.

⁷ Confidence in state government's ability to "handle state problems" decreased from 67% (2004-08) to only 51% in 2009. However, this level of "trust" is far higher than that for the federal government (29%). Trust in local government remained near 70%. See September 10, 2009 Gallup poll. Available at: <http://www.gallup.com/poll/122915/trust-state-government-sinks-new-low.aspx>.

⁸ See Act No. 4 of the Public Acts of Michigan, 2011.

⁹ See Sec. 3 of Act No. 4 of the Public Acts of Michigan, 2011.

¹⁰ The term "pension" as used here includes all forms of non-social security income, e.g. 401k income, IRA income, private pension income, or income from a public pension plan. See Ronald Snell, "State Personal Income Taxes on Pensions & Retirement Income: Tax Year 2010," National Conference of State Legislatures, February 2011. Available at: <http://www.ncsl.org/documents/fiscal/TaxonPensions2011.pdf>.

¹¹ For example, in Alabama, Hawaii, Illinois, Kansas, Louisiana, Massachusetts, Michigan, Mississippi, New York, and Pennsylvania federal, state, and local pension income is exempt from taxation. See NSCL report. Cited above in note 8.

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