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## AN UPDATE ON STATE AND MUNICIPAL FISCAL CONDITIONS

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#### Recovery will be a Multi-year Process

Thirty-one months after the onset of the Great Recession, state and local governments continue to struggle with large deficits and daunting long-term challenges. While the fiscal condition of U.S. state and local governments can be characterized as grim, Breckinridge remains very confident that high-grade municipal bond issuers will capably navigate through what is likely to be a multi-year recovery process. In this Special Commentary, we offer an update on the current fiscal conditions and long-term challenges faced by states and municipalities and the reforms currently underway.

### ENORMOUS FISCAL CHALLENGES

#### A Failure to Match Revenues and Expenses

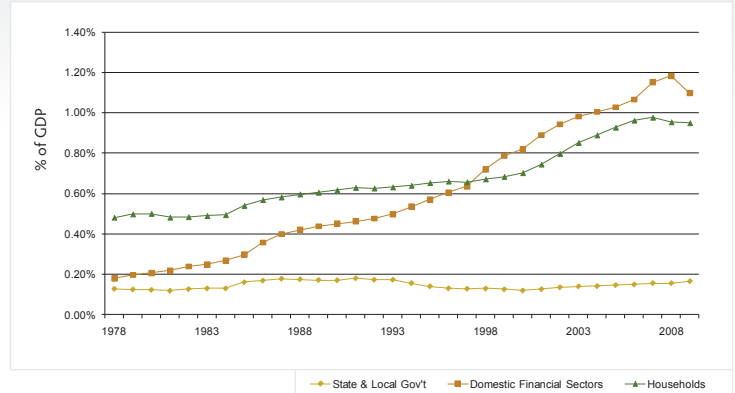
Nearly half of U.S. states expect general fund deficits of 10 percent or more in FY 2011.<sup>1</sup> Two-thirds of states expect double-digit deficits in FY 2012 as federal stimulus funds run out. Municipal budgets are just as tight. More than 70 percent of city governments cut their workforces this year.<sup>2</sup> In most municipalities, service provision will decrease again in FY 2011 and FY 2012 absent new taxes.<sup>3</sup> Delays and cuts in state aid will only exacerbate the situation.

Later in this decade, state and local governments will have to contend with additional financial burdens, including new health care and education mandates, growing pension and retiree health care costs, increased social-service needs spawned by an ageing population, and possibly tax competition with a bulkier federal government. Additionally, state and local budget pressures may contribute to a weak economy with slow growth and deflationary overtones.

Investors should expect more negative headlines for several budget cycles as lawmakers grapple with unrelenting deficits. Today's fiscal challenges result from a failure to perform basic budget math by matching ongoing revenues with ongoing expenses. Excessive state and local borrowing is not the cause – as shown in the following chart.

### US CREDIT MARKET DEBT AS A % OF GDP

Source: Federal Reserve Flow of Funds



The fact is debt is more likely to help governments restructure their operations than overwhelm them. Consider the options for Illinois, where outstanding debt is 4 percent of gross state product and borrowing costs are only \$2 billion per year or 4 percent of budget. Nonetheless the state faces a \$13 billion deficit.<sup>4</sup>

Illinois could achieve a growth-stabilizing, balanced budget through a mix of borrowing, tax hikes and spending cuts over several years. Or Illinois could default on its debt – a course of action that provides little budget relief, damages the state economy, permanently impairs the state's ability to finance infrastructure and has severe legal and political consequences. Clearly, at current debt levels default makes little common sense, which is why states and municipalities are choosing to investigate and implement numerous reforms to navigate through their fiscal challenges.

### OFFICIALS AIM TO RESTRUCTURE OPERATIONS

#### As in Past Budget Crises

Public officials understand their predicament. The National Governor's Association has labeled the post-Great Recession environment "The Big Reset" and has outlined steps to downsize government – a process it says will take years, ending "only when state budget health is restored."<sup>5</sup> At the local level, some well-respected leaders, including former Harvard University professor and current New York City Deputy Mayor Stephen Goldsmith, are calling for a new era of public management with fewer rules, simplified administration and better monitoring of performance.<sup>6</sup>

Today's reform efforts are consistent with prior eras of fiscal stress. State and local governments restructured their tax codes and spending priorities in the 1930s. In the 1960s and 1970s, governments professionalized their workforces, improved financial transparency and moved decisively away from gas taxes as a revenue

<sup>1</sup>Melissa Maynard, "As State Revenues Tick Upward, Budget Gaps Remain," Stateline.org, July 27, 2010.

<sup>2</sup>Christiana McFarland, "State of America's Cities Survey on Jobs and the Economy," National League of Cities (May 2010).

<sup>3</sup>Ibid.

<sup>4</sup>See Illinois 2008 Comprehensive Annual Financial Report, Note 8 and Bureau of Economic Analysis GSP data for 2008.

<sup>5</sup>See "The Big Reset: State Government After the Recession," National Governor's Association, p. 14 (February 23, 2010).

<sup>6</sup>See Stephen Goldsmith, "Fewer Rules More Results," *Governing Magazine* (July 21, 2010).

source. The 2010s are likely to witness municipal consolidation, mandate relief, employee-benefits reform, privatization of municipal services and other changes. On a broader level, there may be a shift in the proportional sizes of federal, state and local government and their relative responsibilities for health care, education, retirement security and other public services.

## EXAMPLES OF RESTRUCTURING, REFORM AND INNOVATION

Breckinridge has previously argued that the municipal market is likely to diverge in credit quality over the next several years (see Pension Webinar, May 2010). We expect investors to reward governments that implement reforms quickly and aggressively while punishing the laggards. Given the level of official rhetoric, we think it is important to share some of the significant restructuring steps that are being taken at the state and local level.

### Pension Reform

Many of the recent reforms related to pension and health benefits were considered illegal and unfathomable by labor leaders and policymakers only one year ago. Previously, it was far easier to change the benefits for future hires than for existing workers and retirees. It is significant then that some states have changed benefits for current workers or retirees.

- » In 2010, Colorado, Minnesota and Wyoming cut benefits for current workers or retirees. Retroactive benefit cuts appear to be coming even in the heavily unionized Northeast. In New Jersey, the state treasurer refused to rule out benefit cuts for those already retired and the former head of the state's Division of Pension and Benefits announced his belief that the state can legally change benefits for current workers.<sup>7</sup>
- » In 16 states, pension contributions, vesting periods and retirement eligibility ages have been increased for new employees. For example, to qualify for a pension in Missouri, new employees must now contribute 4 percent of their pay versus no required contribution previously, and work until age 67 versus age 62.
- » In California, two major state labor unions voluntarily renegotiated pension benefit agreements recognizing that the status quo is unaffordable.

Changes to pension accounting rules will require governments to increase their reported unfunded liabilities beginning in 2011. This is likely to incent additional reforms.

### Municipal Consolidation and Shared Local Services

In order to cut costs, municipalities are consolidating services such as school systems and sharing other local services.

- » Small public school systems in Massachusetts are discussing mergers to create fewer, regional districts.
- » In Pennsylvania, the governor proposed consolidating 80 percent of state school districts.
- » In Nebraska, lawmakers proposed reducing the number of counties from 93 to 30.

- » The Michigan Municipal League Foundation launched a program to advise local governments on sharing services and the new Michigan Finance Authority consolidated 10 state authorities into one for all state borrowing.
- » In Nevada, lawmakers passed a law requiring cities and counties to study consolidation and provide an analysis by September.

### Outsourcing

States and cities are outsourcing various services such as janitorial services and trash collection. Some have taken it to extremes. For example, tiny Maywood, Calif. dismissed its entire staff and outsourced all city services, including its police force. Public safety has been turned over to Los Angeles County, as is the case with 42 of the county's 88 cities.

### Unpopular Taxes Approved by Voters

In a clear indication that public sentiment is shifting in favor of reform, voters in several areas have passed tax increases – typically one of the last measures voters will approve.

- » Oregon voters approved two new tax measures that raise taxes on households with taxable income over \$250,000, and hike minimum taxes on corporations. This was the first voter-approved statewide income tax increase since the 1930s.
- » In an unusual measure, the San Diego City Council asked voters to approve a temporary sales tax to be levied only if certain financial reforms are met. Most reforms relate to pension and health care benefits and competitive bidding for projects.
- » Arizona voters recently approved an additional 1 percent sales tax by a 64 percent vote. It is expected to generate \$1 billion in revenues.
- » The Durham, N.C. City Council approved a 2.2 percent property-tax rate increase to close a budget deficit and continue voter-approved bond projects.
- » In Texas, more than 100 school districts held special "tax rollback" elections, which empower voters to approve tax hikes in excess of legal limits. The measures have passed in more than 60 percent of districts.

### Asset Sales and Public/Private Partnerships

Many states are selling or mortgaging assets, or privatizing services to raise revenues. Buildings, roads, prisons and even land are on the block.

- » Wyoming is trying to sell two square miles of the Grand Teton National Park.
- » Arizona sold and leased back certain state buildings and mortgaged others.
- » Atlanta is exploring Public/Private Partnerships for certain infrastructure projects to facilitate cost sharing with the private sector.

Individually, none of these measures resolves any state or local government fiscal imbalance. However, collectively these efforts represent major steps to reform a system that, in many instances, no longer functions effectively. Public frustration with the status quo is spreading. Investors may be witnessing the beginnings of large-scale change in how state and local governments do business.

<sup>7</sup>Jason Method, "Can NJ keep its pension promises? No way, many officials concede," *Asbury Park Press* (July 25, 2010).

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