States of Denial

This quarter, we discuss the deteriorating condition of state and local budgets to determine whether American state finances present a legitimate source of systemic financial risk.

Overview

States have closed budget shortfalls totaling over $430 billion over the past three years using a combination of budget cuts, tax increases, withdrawals from reserves and federal stimulus.[1] At least 46 states struggled to close their budget shortfalls for the current fiscal year (FY 2011), with 40 states projected to have funding gaps next year.[2] Exhibit 1 shows that compared to the previous recession, state budget shortfalls are significantly larger this time around,[3] driven in large part by the severity and duration of the most recent recession.

While the recession certainly exacerbated pre-existing funding gaps, the underlying factors contributing to these funding gaps are both cyclical and secular in nature.

Cyclical Factors

One of the lingering legacies from the last recession is high unemployment, which reduces consumption and state income tax receipts while increasing demand for Medicaid and other essential services. Inflation adjusted state revenues are still 12% below where they were at the beginning of the recession.[4]

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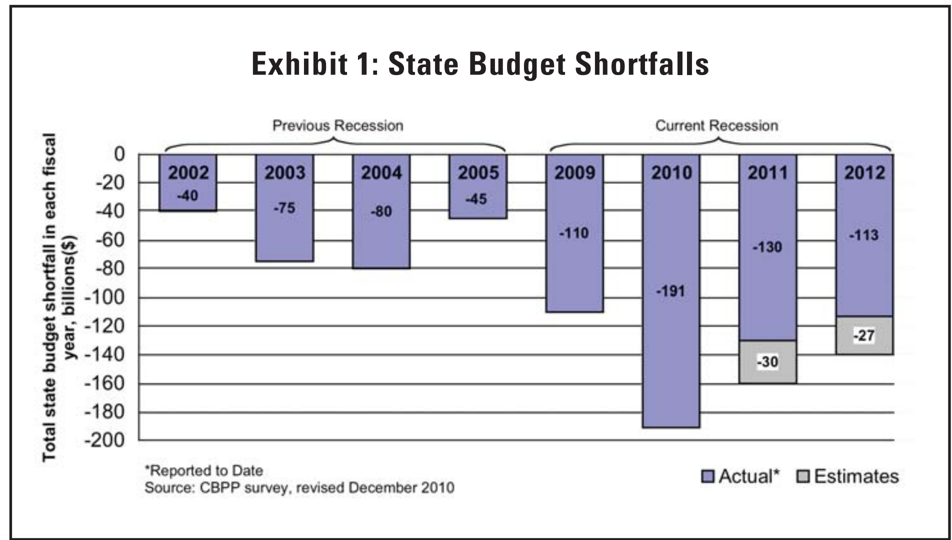
Exhibit 1: State Budget Shortfalls



*Reported to Date
Source: CBPP survey, revised December 2010

Over the past three years, however, the true extent of revenue decline has been masked by over $158 billion in federal aid money funneled to states. Most of this aid has come in the form of increased Medicaid funding, which is set to expire in June 2011, leaving states with only $59 billion in aid for FY 2011 and $6 billion in FY 2012.[5] The removal of federal aid will undoubtedly highlight some of the more problematic, secular issues (i.e., unfunded pension liabilities) that are likely to significantly impact state budgets for years to come. (Exhibit 2, next page)

Secular Issues

For years, public sector employees all across the U.S. have been promised lavish retirement benefits, including retirement incomes based on their final (peak) salaries, early retirement ages and inflation-linked health benefits. With revenues hit hard by the recession, states and municipalities are finding that these defined benefit plans are expensive promises to keep. By law, states must guarantee public pension fund debts, which means retirees take precedence over other creditors - leaving taxpayers with the tab. In order to meet pension obligations and balanced-budget requirements, some states are having to lay off active workers in order to pay for retirement benefits of retired workers.

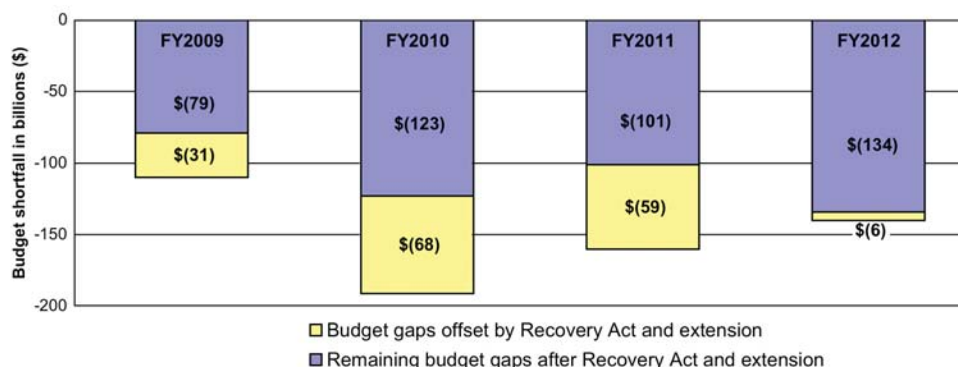
How did we get here? Part of the problem is that these liabilities have been disguised

(continued)

1 McNichol, Elizabeth, Phil Oliff and Nicholas Johnson. "States Continue to Feel Recession's Impact." Center on Budget and Policy Priorities. December 16, 2010.
2 Not all states have been affected by the economic downturn. Mineral-rich states, including Alaska, Montana and New Mexico, all experienced revenue growth on the back of high oil prices, while only one state, North Dakota, has not reported budget shortfalls in recent years.
3 McNichol, Elizabeth, Phil Oliff and Nicholas Johnson. "States Continue to Feel Recession's Impact." Center on Budget and Policy Priorities. December 16, 2010.
4 As of 3Q2010. Center on Budget and Policy Priorities Analysis of Rockefeller Institute, Census Bureau and Bureau of Labor Statistics data.
5 McNichol, Elizabeth, Phil Oliff and Nicholas Johnson. "States Continue to Feel Recession's Impact." Center on Budget and Policy Priorities. December 16, 2010.

Global Theme (continued from 1)

Exhibit 2: State Budget Shortfalls After Use of Recovery Act Funds



Source: CBPP analysis using data from U.S. Dept of Health and Human Services, U.S. Dept of Education, Congressional Budget Office, and state budget documents.

for years by rules established by the Government Accounting Standards Board, which allows individual states to discount their pension liability by the assumed rate of return on the assets,[6] in most cases around 8%. Using this discount rate, the Center for Retirement Research estimates that public pensions in the U.S. had total liabilities of $2.9 trillion versus assets of $1.9 trillion as of December 16, leaving roughly $1 trillion in unfunded liabilities.[7] However, there are those who argue that 8% returns are unrealistic and that a more appropriate discount rate to use would be the risk-free rate (Treasury yields) given that pensions are legally protected in many states. Using the risk free rate, the value of pension liabilities balloons to $5.3 trillion, leaving roughly $3.4 trillion in unfunded liabilities.[8]

By setting unrealistically high expected rates of return, state governments have also been able to reduce their annual contributions. Fund accountants have used smoothing techniques (such as averaging gains and losses over a five-year period) to paper over investment losses so as to make losing years look like winners. By smoothing out returns, the actual results of any one year cannot be used to calculate annual contributions, which gives state governments some funding flexibility over the short term, but ultimately delays their ability to catch up with losses. When states have tried to reform their pension schemes (by increasing the retirement age or ending inflation adjustments, for example), they have been targeted primarily at new employees, since attempts at reforming benefits for existing workers and retirees have been challenged in court. The problem is that reforms aimed at new employees actually do very little to address the problem given that the bulk of the liabilities consist of obligations to those already employed or retired.

Assuming liabilities continue to grow at their current trajectory, many states will be close to exhausting their funds by 2028, according to study by Joshua Rauh and Robert Novy-Marx.[9] They estimate that unless serious reforms are enacted, seven states will have exhausted their pension assets by 2020, with 16 states having benefit obligations absorbing more than 30% of their revenue. (Exhibit 3, next page)

As a result, we see a looming battle brewing between states and public sector unions that will take years to play out. In the meantime, states will have to find new ways of plugging their budget shortfalls.

Conclusion

There is no legal mechanism for a state to file for bankruptcy,[10] but cities and counties certainly can. Since local governments are dependent on aid from states, financial strains at the state level are felt at the city and county level. Investors therefore fear a rash of defaults in the $2.8 trillion municipal bond market. Influential analyst Meredith Whitney brought these fears into the mainstream when she forecast that 50 to 100 cities could default on their municipal bonds over the next 18 months on a recent 60 Minutes segment.[11]

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6 Note that private sector companies are no longer allowed to used assumed returns when calculating their pension fund liabilities. They must use their corporate bond yields.

7 According to the Center for Retirement Research at Boston College (http://crr.bc.edu)

8 Rauh, Joshua D. "Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities"; National Bureau of Economic Research (NBER) May 15, 2010.

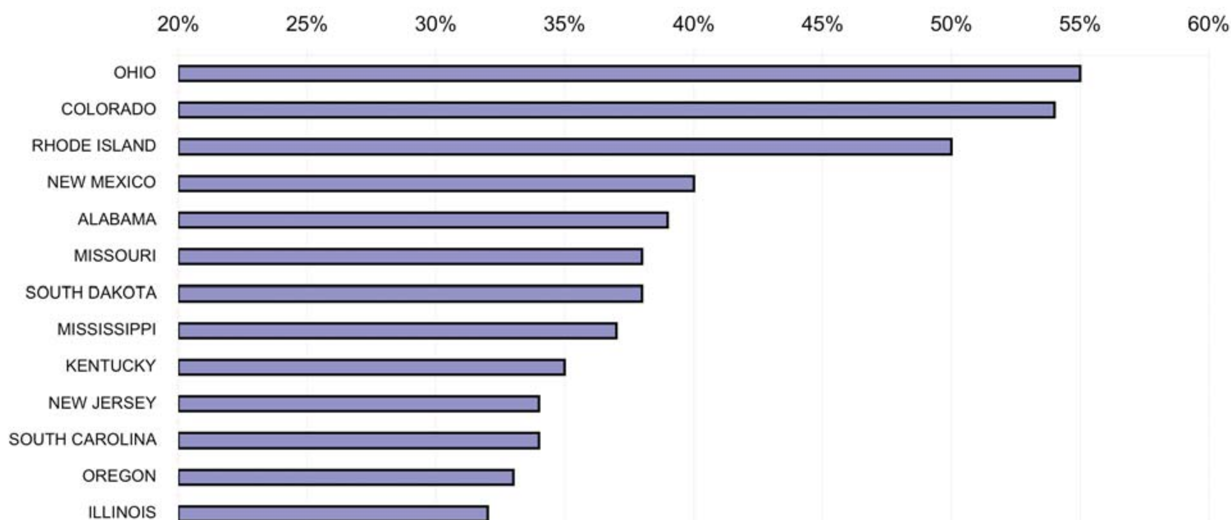
9 Rauh, Joshua D. "Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities"; National Bureau of Economic Research (NBER) May 15, 2010.

10 Rubino, John. "The Next Big Short" CFA Magazine; Nov-Dec 2010

11 Kroft, Steve. "State Budgets: The Day of Reckoning" 60 Minutes, CBS; December 19, 2010.

Global Theme (continued from 2)

Exhibit 3: Pension Cost as Percentage of State Revenue*



* Assumes 2008 revenues grow at 3%; 8% annual return on assets reinvested in full
Source: Rauh, Joshua D. "Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities"; National Bureau of Economic Research (NBER) May 15, 2010.

We agree that some municipal defaults are likely, however, we do not expect that the default fire will spread uncontrollably, for two reasons: 1) the municipal bond market is less interconnected than the mortgage bond market and 2) the federal government will remain as a backstop. That said, the headline risk associated with defaults in the current environment is very real, even if muni-bond default rates have actually decreased (from 204 in 2009 to 72 in 2010).[12] This time around, the catalyst for the types of price dislocations we witnessed in the fall of 2008 will be credit downgrades, which will force many institutional investors[13] to sell out of their holdings, creating trading opportunities in the process.

In conclusion, while we do expect some municipal bond defaults on the horizon, we do not forecast a coming tidal wave of defaults, nor do we view states finances as a source of systemic financial risk, at least over the next 18-24 months. While improving economic conditions may serve to lessen the short-term budget pressures, the looming public pension time bomb must be addressed, no matter how powerful the public unions or voting block they represent. ▪

12 Mysak, Joe. "Default Is A Dirty Word to America's Willing and Able." Bloomberg, November 28, 2010.
13 Particularly those whose investment policy guidelines prohibit them from owning anything less than investment grade securities in their portfolios.