2012 Outlook: U.S. Local Government Tax-Supported

Outlook Report

Rating Outlook

Pressures Continue: A lack of recovery in property taxes and state aid combined with growing pension funding costs have further reduced financial flexibility for local government issuers. Fitch Ratings believes that the weak real estate market will continue to yield flat-to-declining assessed valuations and property tax revenue.

The tax-supported sector comprises many diverse issuers, with varying security types, credit characteristics, revenue structures, legislative environments, and governmental responsibilities. Given its broad scope, Fitch does not assign a rating outlook for the sector as a whole. However, Fitch expects that the broad array of pressures discussed below will result in a continued above-average rate of downgrades compared to historical norms.

Fitch expects the majority of rating actions to be affirmations. Most downgrades will continue to be in the one-to-two-notch range. More severe downgrades are possible but expected to be uncommon.

Dynamic Labor Conditions: The ability to reduce expenditures is key due to pressure to maintain or lower tax rates and few available sources of new revenue. Fitch expects this to be accomplished primarily by limiting services or gaining labor concessions, as less difficult spending reductions have largely been exhausted.

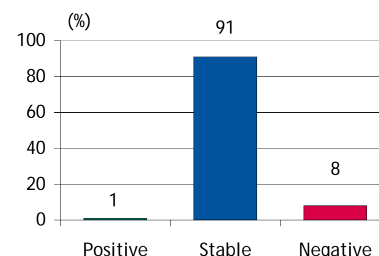
Real Estate-Related Strain: Special tax bonds whose pledge depends on the performance of property taxes without potential offset from either rate increases or expenditure controls are especially at risk given the trend of stagnant or declining property taxes. Fitch expects this trend to continue into 2012. General obligation and related bonds will also continue to be affected.

State Aid Prospects Dim: Fitch expects constrained revenue growth for states in 2012. Even positive trends would be unlikely to benefit local units significantly given the prevailing public pressure to reduce taxes and government spending. Fitch expects that school districts will be at risk of a disproportionate share of downgrades and that those downgrades will occur in states with the most severe funding cuts and least flexibility afforded to districts to offset those cuts.

Management Tools Still Available: Financial managers have recently become more realistic in their expectations of recovery and are making more concerted efforts to sustainably bring spending in line with revenues. In addition, Fitch expects use of reserves to continue but at a lower rate in recognition of the continued need for a solid cushion during the likely slow revenue recovery.

Pension Obligations Increase: Annual required pension contributions will continue to grow. Investment returns have generally failed to keep pace with assumptions, and difficult budget environments have led some entities to underfund actuarial contributions. Fitch expects pension reform to continue in the upcoming year.

U.S. Tax-Supported Rating Outlooks[a]



[a]Includes Rating Outlooks and Rating Watches.

Related Research

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Key Issues

Pension Obligations Continue to Grow

Budget balance in 2012 would be difficult even with a static expenditure base, but increasing actuarially required contributions (ARCs) for pensions can over time crowd out other spending needs in the absence of revenue growth. Even full ARC funding can result in declining liability funded ratios if investment returns continue to fall short of discount rate assumptions or if prior declines in asset values are smoothed in over time.

Fitch views positively the increased focus on pension pressures by government officials and managers. Fitch expects governments to continue the trend of pension reform that includes adding a separate tier for new employees, introducing or extending defined contribution plans, increasing employee contributions, reducing COLAs for recipients, and exploring the legal limits of altering pension payments.

Many local units are members of state-sponsored plans and must depend on relief from the state to avoid increasing payments. This relief has so far come in the form of payment deferrals that are repaid over a fixed time period with interest and increased employee payment requirements. Fitch expects both increased pension requirements and such efforts to find avenues of relief to continue.

Fitch is most concerned about issuers that have a large unfunded liability and fail to make the full ARC payment, where the ARC is a sizable part of their budget. For those local governments in the few states in which the state itself is responsible for pension contributions, such as school districts in Texas and Ohio, pensions are only a credit concern to the extent the state's pension burden causes it to reduce local funding.

Dynamic Labor Conditions

For many governments, pension costs are part of the broader dynamic between labor and management. Limiting pension benefits or requiring increased pension contributions from existing employees effectively reduces compensation and makes achieving additional labor concessions more challenging.

Fitch views positively what appears increasingly to be a shared awareness by management and labor that meaningful revenue recovery is not likely in the near term. As a result, expectations on both sides appear more realistic and the climate more conducive to compromise on salary and benefits. However, management efforts to 'do more with less' by asking unions to accept pay freezes, increased healthcare contributions, work rule changes, and other efficiencies are still met with mixed reaction. While management views these types of accommodations as economic necessities, some labor groups believe they have already made significant concessions and are instead opting to force management to choose between increased revenues (mostly in the form of taxes) or reduced services, both of which can be politically unpopular. Some labor groups agree to concessions in exchange for a guarantee of no or limited layoffs, which can improve productivity but reduce management's flexibility in the future.

Fitch believes that management's ability to reduce spending even under the most flexible labor conditions is somewhat limited. Core services such as education and public safety can only be reduced so much before the goals of those services are threatened. Legal requirements to provide such services also constrain the ability to reduce them. Public safety has not commonly

Related Criteria

U.S. Local Government Tax-Supported Rating Criteria, Aug. 15, 2011

Tax-Supported Rating Criteria, Aug. 15, 2011

been targeted for cuts to date but Fitch expects to see more labor discussions include cuts in these services in 2012.

Real Estate-Related Strain

Although non property-tax revenues continue to show some growth, Fitch believes the continued weakness in the real estate markets, the lagged impact of price changes on property tax levies, the heightened volume of appeals, and resistance to tax increases, may lead to more disappointing results in 2012 for property-related revenues and securities that are highly or solely dependent on them.

As stated in Fitch's U.S. Structured Finance 2012 Outlook: While U.S. home prices are nearing a bottom, Fitch does not believe they are there yet, and prices will continue to decline in 2012. Improvements in borrower affordability and historically low interest rates will continue to be offset by weak consumer confidence, tighter credit availability, and, most importantly, a huge overhang of existing and shadow inventory that needs to be cleared. In addition, distressed sales, which according to the National Association of Realtors averaged approximately 30% of existing sales this year, will continue to pressure prices in 2012 and add volatility. Under Fitch's base case view, U.S. home prices remain approximately 13% above sustainable values — albeit with significant regional variations. With that said, Fitch believes this further correction will occur over several years with declines coming from inflation-eroding (modestly declining) nominal values. "

In addition to general obligation bonds for governments whose revenues are concentrated in property taxes, bonds that are vulnerable to property tax declines include tax increment financing (TIF) bonds and limited obligation or revenue bonds secured by ad valorem taxes or property-based special assessments. Such bonds that were structured with fairly low debt service coverage levels under the expectation of growth will likely experience continued strain as debt service coverage narrows.

Caps on assessments muted growth during the real estate boom and drops during the subsequent market decline. However, that cushion has largely been eroded. Therefore even if market value declines are relatively mild, AV declines may be the same or larger than in prior years. In addition, given the lag between price changes and AV, property tax revenues included in fiscal 2013 budgets will commonly be based on 2011 activity, which has generally been negative compared to that of 2010. Fitch recognizes that implementing property tax increases is difficult in the current environment but believes governments that have the legal ability to implement such increases have a greater level of financial flexibility than those that do not.

State Aid Prospects Dim

Fitch does not expect restoration of pre-recession funding levels to local units regardless of the performance of state revenues during 2012. In their budgets for the current fiscal year, most states were able to achieve balanced operations due in large part to reduced spending on aid to local governments. This along with the improving revenue trends helped states offset the absence of federal stimulus.

Most states have resolved to maintain if not reduce their tax burden on residents. The benefit of any revenue recovery would therefore be targeted towards taxpayers rather than locally-funded programs. The level of impact on local units will depend in part on the type of government, with school districts that get significant amounts of funding from states affected the most and cities that do not rely on state aid being unaffected.

The impact also varies from state to state. Among the most extensive cuts are those to school districts in Texas, Florida, Pennsylvania, and Ohio. In addition, districts are adjusting to the end of the federal stimulus program; some districts budgeted such funds sparingly, using the last of them in fiscal 2012.

Since education funding is a sizable component of state budgets, school districts will likely be targets for any future state budget reduction programs. Districts have already withstood notable reductions, are generally highly dependent on state aid, and have minimal discretionary revenue-raising authority. Only a portion of reductions have been offset with such flexibility as the ability to reallocate categorical aid and increase employee pension contributions. Given the magnitude of cuts already made, Fitch believes fiscal 2013 budgets will be very challenging for school districts even if state funding is level. It will be especially difficult for those that are responsible for funding teacher and other employee pension funds. Some relief will accrue to districts in states in which the state is responsible for these payments, or in which the state requires increased employee contributions.

Management Tools Still Available

Revenue raising will remain difficult in 2012, although some governments are able to maintain a constant or inflation-adjusted property tax levy even if AV is declining. Other tax revenue increases are uncommon and are generally associated with a specific project or program and are often time-limited.

By and large, officials believe that there will be no significant economic rebound in 2012 and are acting accordingly by cutting spending, bringing unions back to the bargaining table, and more clearly presenting the circumstances and trade-offs to taxpayers and residents. In addition, Fitch believes renewed efforts to preserve reserves, albeit at weaker levels than prior to the recession, will continue as managers realistically prepare for the possibility of very slow growth and unexpected needs.

Some governments chose to draw down reserves earlier in the downturn, believing that the downturn would be short-lived, and spending cuts were unnecessary. Although the prior level of reserves is no longer available, these entities still may have the ability to lower spending without significantly affecting service levels. Fitch’s greatest concern in this regard is for governments that have both cut services significantly and spent down a large portion of their reserves.

Government officials are reviewing all facets of service provision, including (as mentioned above) areas such as public safety that have traditionally been immune from expenditure reductions. Fitch expects that such actions as wage freezes and requiring employee contributions to pensions and healthcare will continue to be important components of spending control efforts.

Some governments are evaluating nonrecurring sources of funding to boost reserves, such as the sale or lease of property or other assets, but these measures are generally not expected to be directed towards budget balance. More common is the restructuring of debt for near-term budget relief, although this generally results in an increase in spending over time and indicates financial stress.

2011 Review

Trends in Tax-Supported Rating

	2011[a]	2010	2009	2008
Downgraded	10	8	8	3
Upgraded	4	3	6	7
Rating Outlooks Revised to Negative	6	3	7	3
On Negative Rating Outlook or Rating Watch Negative at Year-End	8	7	10	4
On Positive Rating Outlook or Rating Watch Positive at Year-End	1	1	2	3

[a]Through Nov. 30.

Rating downgrades in 2011 (through Nov. 30) continued to outpace upgrades and were more common than in prior years. However, most local government ratings were affirmed with Stable Rating Outlooks. Special tax bonds had a higher rate of downgrades in 2011 than did the sector overall at 13%, reflecting the more volatile nature of pledged revenue and lack of ability to control expenditures for most special tax bonds..

In addition to a larger percentage of downgrades in 2011 than in previous years, the number of Rating Outlooks that were revised to Negative (for 11 months) and ended the period Negative were both higher than in 2010. Fitch therefore expects downgrades in 2012 to at least match if not exceed the 2011 level. Upgrades and ratings with Positive Rating Outlooks as of Nov. 30 remained modest, and Fitch expects that trend to continue in 2012.

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