STATE AND LOCAL FISCAL FACTS - 2020

THE FISCAL CONDITION OF STATE AND LOCAL GOVERNMENTS

Before the COVID-19 crisis, state fiscal conditions were strong following a decade of revenue growth and bolstering reserves. Many state and local governments had taken steps to replenish rainy day funds and address long-term structural imbalances.

STATE FINANCES[1]

Most states saw two consecutive years of moderate-to-robust growth in general fund revenue in FY 2018 and FY 2019 that exceeded budget projections. This revenue growth led to budget surpluses that states largely used for additional rainy-day fund deposits and one-time investments. Even with this stronger growth in revenues, state spending increases continued to be moderate by historical standards as states focused on long-term structural balance and building reserve funds. As demonstrated by FY 2020 enacted budgets and revenue forecasts, state officials remained cautious about new ongoing spending commitments, given long-term spending pressures and anticipation of the next downturn. Spending and revenue trends continued to vary by state due to a combination of factors, including demographic trends, regional disparities in economic performance, significant fluctuations in oil and gas prices for energy-rich states, and fiscal policy decisions. The COVID-19 pandemic and its economic impacts have altered state fiscal conditions sharply and dramatically, resulting in steep revenue declines in personal income and sales taxes that states rely on for most of their general fund revenue. More data on these impacts will become available soon. However, prior to this crisis:

- States enacted appropriation increases totaling $39.1 billion for FY 2020, with roughly half of the new money going towards K-12 and higher education.
- Forty-six states reported FY 2019 preliminary revenues exceeded original projections, the most states to do so since FY 2006.
- Despite recent improvements, 25 states spent less in FY 2019 from their general funds than the pre-recession peak in FY 2008, adjusted for inflation.
- States had replenished some spending for areas cut back during the recession, including K-12 and higher education, corrections, and transportation.
- Most states continued to strengthen their rainy-day funds, with 41 states reporting balance increases in FY 2019 and the median rainy-day fund balance rising to 7.6 percent as a share of general fund spending in FY 2019, from a recent low of 1.6 percent in FY 2010.

CITY FINANCES

Coming into 2020, city revenue growth had been plateauing with property and sales tax revenues growing less than two percent, and income tax revenues growing just .6 percent.[2] Weakening fiscal conditions have been evident in the Midwest as overall general fund revenues in cities there declined by 4.4 percent. These communities have struggled economically and fiscally to recover from the Great Recession. Elsewhere across the South, West and Northeast, cities of all sizes experienced slower growth in general fund revenues and property tax receipts over the last year, but growth nonetheless. Still, three out of four finance officers across the country were confident in the ability of their local government to address expenditures and meet the financial needs of their communities.

With the onset of the economic downturn induced by the pandemic, cities, towns and villages across the nation anticipate budget shortfalls of over $360 billion between 2020 and 2022,[3] with shortfalls varying significantly by state. Stunning unemployment growth is projected to result in $134 billion in revenue losses just for 2020, representing 21.6% of total own-source revenue. By state, revenue losses for cities, towns and villages in 2020 is expected to be the most significant in Pennsylvania and least in Connecticut.

Without additional support, cities are turning to their options of last resort, severely cutting services at a time when communities need them most, to layoff and furlough employees, who comprise a large share of America's middle class, and to pull back on capital projects, further impacting local employment, business contracts and overall investment in the economy.[4] These cuts will also exacerbate infrastructure challenges, which will place future fiscal burden on local, state and federal government.

$360 Billion

Estimated city budget shortfalls between 2020 and 2022.

COUNTY FINANCES

County economies are the building blocks of regional economies, states and the nation. Prior to the COVID-19 pandemic, county governments were already struggling to return to pre-recession levels. In fact, despite our resilience and abilities to maintain balanced budgets, only 806 county economies out of the nation's 3,069 county governments recovered to their pre-recession levels.

Now faced with this new public health crisis, already strained county budgets are facing extreme fiscal pressure as we work daily to stop the spread of COVID-19. New research from the National Association of Counties (NACo) shows the COVID-19 pandemic could have a $144 billion budgetary impact on counties of all sizes through fiscal year 2021, including $114 billion in lost revenue from county-collected sales tax and local fees and an additional $30 billion in COVID-19 response costs.[5]

Furthermore, counties are limited in our ability to raise additional revenue, even when additional expenditures make it imperative to balance budgets. For example, in 35 of the 45 states with county property tax authority, counties retain less than 30 percent of the property tax collected state-wide. When it comes other revenue sources such as sales tax, only 29 states authorize counties to collect sales tax. Out of the 29 states, 26 impose a sales tax limit.

This tremendous loss of revenue and increase in costs may ultimately result in cuts to essential county services that counties use to address the COVID-19 pandemic including public safety, social services, child protective services, mental health, homelessness, jail diversion, reentry and more. To maintain mandated balanced budgets, many counties have already been forced to cut costs by furloughing or laying off workers, a step many county governments have already taken. On average, these counties have furloughed about 14 percent of the total county workforce.

MUNICIPAL BANKRUPTCY

Because of the current economic crisis, some governments face considerable fiscal stress. It is important to note that municipal bankruptcy 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.
- 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 2019 was nearly $422 billion. Between 2009 and 2019, states, counties, and other localities invested $4.2 trillion in infrastructure through tax-exempt municipal bonds[6]; the federal government provided almost $1.5 trillion.

On average, 12,000 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.

Since the end of 2007, there were 90 municipal Chapter 9 filings, compared to 35,878 corporate Chapter 11 filings for just 2015-2019. The majority of rated defaulted bonds were issued by not-for-profit hospitals or housing project financings, not including debt issued by Puerto Rico, a territory with debt default subject to the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA), a US Federal Law.

Historically, municipal bonds have had lower average cumulative default rates than global corporates overall and by like rating category. The municipal default rate is 0.27% of outstanding par currently in payment default (excluding Puerto Rico issuers), compared to the average 5-year default rate of 6.92% for corporate bonds.[7]

- 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.[10]
- 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. Over the past twenty years, the federal exemption has saved state and local governments on average 150-200 basis points in additional interest expense through the federal tax exemption. In 2018 alone, state and local governments saved over $7 billion in additional interest expense through the federal tax exemption.[12] Many states also exempt from taxation 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.

As a result of the 2017 tax reform law, beginning in 2018 state and local governments could no longer use tax-exempt bonds to advance refund outstanding bonds. Tax-exempt advance refundings helped state and local government take advantage of favorable interest rate environments, which resulted in reduced debt service costs, the freeing up of resources to be used for other important purposes, and a reduction in taxpayer and ratepayer burdens. Advance refundings helped issuers save more than $14 billion from 2012-2017.

STATE AND LOCAL PENSIONS

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 a significant majority of cases, increases in contributions, or modifications to employee eligibility, or both, will be sufficient to remedy the underfunding problem, while for others, interventions that go beyond traditional reforms will be needed in order to establish sustainable paths forward.[8]

State and local retirement systems indicate they are currently weathering the COVID-19 crisis – their administrative operations have successfully been moved remotely; billions of dollars in monthly payments to retirees, reaching virtually every city and town in the nation, are being made on time and in full; and trillions of dollars in public pension fund assets continue to be managed and invested in the financial markets.[9]

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, within the fifty states, 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.

- Since 2009, every state has made changes to pension benefit levels, financing arrangements, or both. Many local governments have made similar reforms to their plans.[10]
- 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 in most cases they do not carry the same legal protections. Therefore, combining unfunded pension liabilities with unfunded retiree health benefits is misleading.
- Twenty-eight (28) states hold approximately $52 billion in other post-employment benefits (OPEB) assets as of FY 2017. This figure is up from $41 billion reported for FY 2015.[11]

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 15 million working and 10 million retired employees of state and local government. Public pension assets are invested using a long-term horizon, and nearly all benefits are paid out not as a lump sum, but as monthly distributions in retirement.

Public employees typically are required to contribute 5 to 10 percent of their wages to their state or local pension.[12] Since 2009, most states have increased required employee contribution rates. As of December 31, 2019, state and local retirement trusts held $4.82 trillion in assets.[13]

For most state and local governments, retirement systems remain a relatively small portion of their budget. For the nation as a whole, the portion of combined state and local government spending dedicated to retirement system contributions is just below five percent.[14] Current pension spending 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 widely. Although a number of plans are near or above 100 percent advance-funded, on average, the funded level in 2018 was 73 percent and 18 percent were less than 60 percent funded.[15]

Many public pension plans have reduced their investment return assumption in recent years. Among plans measured by the National Association of State Retirement Administrators, nearly all have reduced their investment return assumption since FY 2009. The median return assumption is 7.25 percent and the actual investment returns exceed this assumption for most time periods. For the 25-year and 30-year periods ending December 31, 2019 the median annualized public pension investment returns were 8.2 percent and 8.3 percent, respectively; and the 1-, 5- and 10- year medians were 17.7, 7.1 and 8.2 percent, respectively.[16]

State and local government retirement systems are focused on transparent reporting and disclosure, and develop comprehensive annual financial reports and summary plan descriptions based on national standards. In addition, they conduct annual actuarial valuations, periodic experience studies and risk assessments, and maintain formal funding policies.[17]

ENDNOTES

[1] The Fiscal Survey of States," Fall 2019, National Association of State Budget Officers, https://www.nasbo.org/reports-data/fiscal-survey-of-states

[2] Christiana K. McFarland and Michael A. Pagano, "City Fiscal Conditions," 2019, National League of Cities, https://www.nlc.org/sites/default/files/2019-10/CS_Fiscal%20Conditions%202019Web%20final.pdf

[3] Christiana K. McFarland and Brenna Rivett. *Fiscal Impact of the Pandemic Recession on Cities, Towns and Villages.* National League of Cities. 2020 https://www.nlc.org/sites/default/files/users/user57221/Impact%20of%20COVID-19%20on%20Cities%20Brief-Final.pdf

[4] Christiana K. McFarland and Spencer Wagner. *Essential Municipal Employees Vulnerable to Severe Cuts.* National League of Cities, CitiesSpeaks May 6, 2020. https://citiesspeak.org/2020/05/06/essential-municipal-employees-vulnerable-to-severe-cuts/

[5] NACo's estimate of additional expenditures was calculated using survey data from a sample of small, medium-sized and large counties reporting on the cost of COVID-19 in their counties. NACo's estimate of the loss of sales tax revenue, business license tax revenue and revenue from charges and fees assumes a tiered loss applied from March 2020 through FY2021. The loss of income tax revenue is calculated using a 4.1% unemployment rate for Dec. 2017, as compared to a 4.4% rate for March 2020, predicted 20% rate for April and May 2020, predicted 15% rate for June and July 2020, predicted 10% rate for the remainder of 2020, and predicted 6-10% for 2021. County revenue and expenditure data comes from NACo's analysis of U.S. Census Bureau - Census of Individual Governments: Finance. 2017 numbers were adjusted to reflect inflation rates for 2018 and 2019.

[6] GFOA Analysis of Thomson Reuters data

[7] GFOA Analysis of Municipal Market Analytics, Inc. data and Moody's Investor Service, "US Municipal Bond Defaults and Recoveries," 2017

[8] "Pension Funding: A Guide for Elected Officials," Report from the Pension Funding Task Force, 2013 https://www.nasra.org/files/JointPublications/PensionFundingGuide(1).pdf. For more information on state and local government retirement plan features and financing, see www.nasra.org, www.slge.org, and www.publicplansdata.org

[9] National Association of State Retirement Administrators survey, "Retirement Systems' Response to COVID-19 Outbreak," March 2020

[10] National Association of State Retirement Administrators, "Significant Reforms to State Retirement Systems," December 2018, https://www.nasra.org/files/Spotlight/Significant%20Reforms.pdf and Jean-Pierre Aubry, Caroline V. Crawford, Caroline V. Crawford, "State and Local Pension Reforms Since the Financial Crisis," Center for State and Local Government Excellence and Center for Retirement Research at Boston College, December 2016, https://slge.org/resources/state-and-local-pension-reforms-since-the-financial-crisis

[11] Alex Brown, Joshua Franzel, and Lola Oduyeru, "Spotlight on Retiree Health Care Benefits for State Employees in 2015," Center for State and Local Government Excellence and National Association of State Retirement Administrators, May 2017, https://slge.org/resources/spotlight-on-retiree-health-care-benefi ts-for-state-employees-in-fy-2015

[12] "Employee Contributions to Public Pension Plans," NASRA Issue Brief, September 2019, https://www.nasra.org/files/Issue%20Briefs/NASRAContribBrief.pdf

[13] Federal Reserve of the U.S., Financial Accounts of the United States, Fourth Quarter 2019

[14] "State and Local Government Spending on Public Employee Retirement Systems," NASRA Issue Brief, December 2019, https://www.nasra.org/files/Issue%20Briefs/NASRACostsBrief.pdf

[15] Jean-Pierre Aubry, Caroline Crawford, and Kevin Wandrei, "Stability in Overall Pension Plan Funding Masks a Growing Divide," Center for State and Local Government Excellence and Center for Retirement Research at Boston College, October 2018, https://slge.org/resources/stability-in-overall-pension-plan-funding-masks-a-growing-divide and NASRA Public Fund Survey Summary of Findings for FY2018, https://www.nasra.org/publicfundsurvey

[16] Callan Public Fund Returns and "Public Pension Plan Investment Return Assumptions," NASRA Issue Brief, February 2020, https://www.nasra.org/files/Issue%20Briefs/NASRAInvReturnAssumptBrief.pdf

[17] "Public Pension Reporting and Disclosure: The Current State of Practice and Examples of What Works Well," Center for State and Local Government Excellence and National Association of State Retirement Administrators report, April 2017, https://slge.org/resources/public-pension-reporting-and-disclosure-the-current-state-of-practice-and-examples-of-what-works-well

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