ENSURING STATE AND MUNICIPAL SOLVENCY

Financial Innovations Lab™ Report

Milken Institute

Kauffman
The Foundation of Entrepreneurship

October 2010

Financial Innovations Labs™ bring together researchers, policymakers, and business, financial, and professional practitioners to create market-based solutions to business and public-policy challenges. Using real and simulated case studies, participants consider and design alternative capital structures and then apply appropriate financial technologies to them.

This Financial Innovations Lab™ report was prepared by Betsy Zeidman and Rick Palacios Jr. of the Milken Institute and Robert E. Litan of the Ewing Marion Kauffman Foundation.

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Acknowledgments

We thank those who participated in this Financial Innovations Lab, and in the roundtable on municipal finance at the 2010 Milken Institute Global Conference. They made invaluable contributions to the ideas and perspectives summarized in this report. The Milken Institute especially thanks the Kauffman Foundation for its support of our work and its partnership in developing this session. We also wish to acknowledge the significant efforts of our colleagues at the Milken Institute: Glenn Yago, Caitlin MacLean, Jill Scherer, Karen Giles, Lisa Renaud, Jim Barth, and Jennifer Manfrè. We'd also like to thank Wendy Guillies, Barbara Pruitt, and Harold Bradley of the Kauffman Foundation.

About the Milken Institute

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> **human capital:** the talent, knowledge, and experience of people, and their value to organizations, economies, and society;
> **financial capital:** innovations that allocate financial resources efficiently, especially to those who ordinarily would not have access to them, but who can best use them to build companies, create jobs, accelerate life-saving medical research, and solve long-standing social and economic problems; and
> **social capital:** the bonds of society that underlie economic advancement, including schools, health care, cultural institutions, and government services

By creating ways to spread the benefits of human, financial, and social capital to as many people as possible—by *democratizing* capital—we hope to contribute to prosperity and freedom in all corners of the globe.

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The Ewing Marion Kauffman Foundation is a private nonpartisan foundation that works to harness the power of entrepreneurship and innovation to grow economies and improve human welfare. Through its research and other initiatives, the Kauffman Foundation aims to open young people's eyes to the possibility of entrepreneurship, promote entrepreneurship education, raise awareness of entrepreneurship-friendly policies, and find alternative pathways for the commercialization of new knowledge and technologies. In addition, the Foundation focuses on initiatives in the Kansas City region to advance students' math and science skills, and improve the educational achievement of urban students, including the Ewing Marion Kauffman School, a college preparatory charter school for middle and high school students set to open in 2011. Founded by late entrepreneur and philanthropist Ewing Marion Kauffman, the Foundation is based in Kansas City, Mo. and has approximately $2 billion in assets. For more information, visit**www.kauffman.org**, and follow the Foundation on **www.twitter.com/kauffmanfdn** and **www.facebook.com/kauffmanfdn**.

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The sooner governments address their long-term structural challenges, the better off they and their residents will be.

Introduction

As the recession drags on, states and municipalities find themselves in a deep hole. For the first time since the Great Depression, income, sales and property taxes have declined in unison.[1] The cyclical challenges are clear: falling tax receipts, high unemployment, tepid investment returns, and overall economic uncertainty.

But even more daunting are the long-term structural issues that are simultaneously coming to a head: trillions of dollars in unfunded pension obligations, the escalating costs of other post-employment benefits (OPEB), record numbers of retirees poised to tap pensions and benefits, increasing longevity, and significant revenue/expenditure mismatches.

Against this urgent backdrop, the Milken Institute and the Kauffman Foundation hosted a Financial Innovations Lab in July 2010. Unlike any previous meeting addressing current conditions in state and municipal finance, the Lab brought together a diverse group of state and local officials, union representatives, experts from the capital markets, money managers, academics, public-sector attorneys, and representatives from bond rating agencies.[2] Together they explored both immediate fixes and broader strategies that could help prevent future crises.

It's clear that achieving long-term solvency for states and municipalities will require painful paradigm shifts. There is no simple approach that will work for all 91,000 local governmental units in the U.S.[3] But the sooner governments address their long-term structural challenges, the better off they and their residents will be. The short-term expediency of simply laying off workers to meet hard budget constraints is not sustainable in the long run and will deprive citizens of services (safety, sanitation, education) they want and deserve. The Lab produced some noteworthy options, including:

- adopting standardized actuarial assumptions, perhaps similar to corporate-sector accounting standards
- implementing multi-year budgeting plans/rainy-day funds
- reassessing possible economies of scale from shared services/consolidation
- bringing together all the key stakeholders—government workers and the unions that represent them, bondholders, and citizen-taxpayers—in jurisdictions facing the most immediate problems to find ways of sharing the burden of fiscal adjustment to ensure long-run solvency
- establishing control boards as a last resort for states and municipalities in extreme distress
- possibly providing short-term federal aid to states and municipalities that actively implement steps to restructure their finances

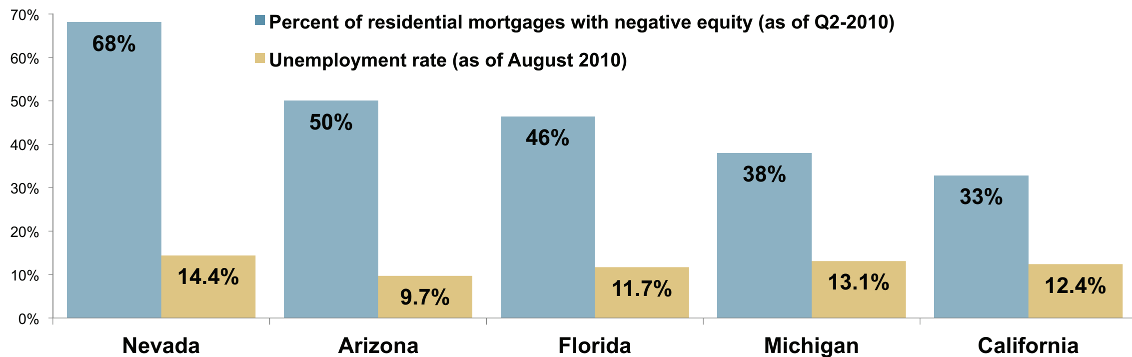
The Lab sparked a critical conversation, and this report summarizes the information and perspectives shared during the day's proceedings.

The Scope Of The Problem

The Great Recession has driven the national unemployment rate sharply higher, from 5.0 percent in December 2007 to 9.6 percent in August 2010.[4] Many parts of the country are in even worse shape, with several states now posting double-digit jobless rates.[5] Bleak job prospects have caused households to focus on reducing debt and scaling back consumption, a trend that has caused a drop in sales and income tax receipts. In addition, the states with the highest unemployment levels have also suffered disproportionately from the bursting of the housing bubble (see figure 1), leading to a drop in property values and related tax receipts. As sales and property taxes represent the largest portions of state and local tax revenue (see figure 2), the fall in revenues has been sharper and longer in duration than in past recessions (see figure 3).

FIGURE 1

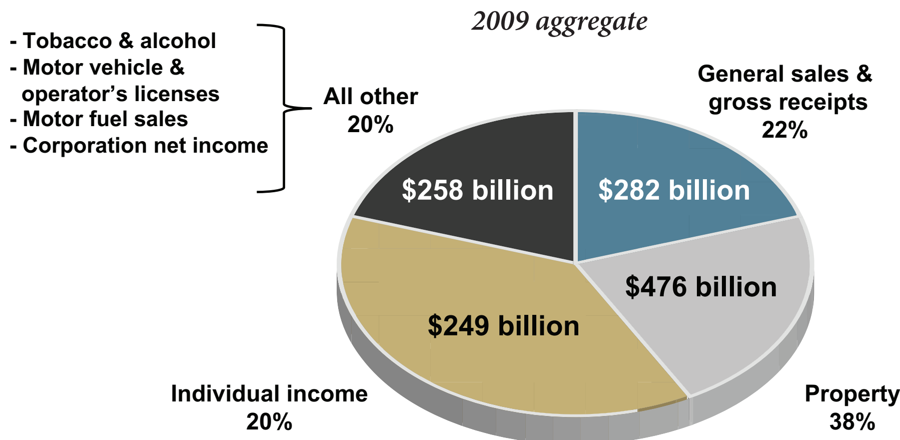
States hardest hit by the housing bubble and facing high unemployment



Sources: CoreLogic, Bureau of Labor Statistics.

FIGURE 2

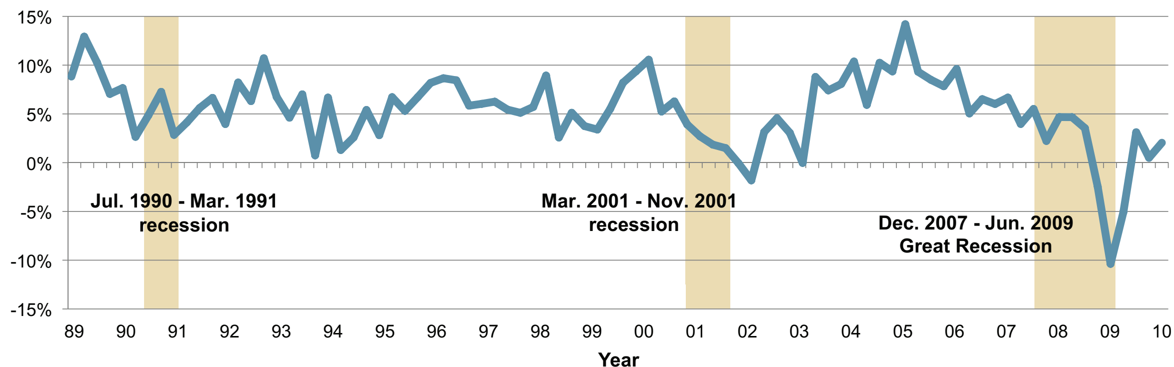
Sources of U.S. state and local revenue by type of tax



Source: U.S. Census Bureau.

FIGURE 3

Total state and local tax revenue



Source: U.S. Census Bureau (Q2-2010).

In fiscal year 2010, 48 states faced shortfalls—a record gap of $192 billion, or 29 percent of total state budgets.[6] But while the federal government can run perpetual deficits, that's not the case at the state level. With the exception of Vermont, all states have some type of annual or biennial balanced-budget law. As a result, during times of economic distress, states with budget gaps are forced to cut spending, increase taxes, or find other sources of revenue.

Figure 4 shows the results of a June 2010 survey by the National Association of State Budget Officers reporting a variety of approaches to addressing these gaps. Targeted and across-the-board spending cuts and layoffs led the list, with furloughs and reductions in local aid close behind.[7] A few states introduced or increased fees, such as user fees (15), court fees (14), or fees related to transportation (11), higher education (10) and business (9). But with current debt levels and ongoing economic uncertainty, the political reality is that raising taxes is generally a non-starter.

FIGURE 4

How have states responded so far?

Strategy	# of states that used strategy	Strategy	# of states that used strategy
Targeted cuts	36	Salary reductions	12
Across-the-board cuts	28	Transportation-related fees	11
Layoffs	26	Higher education-related fees	10
Furloughs	22	Business-related fees	9
Reduction of local aid	22	Cuts to state employee benefits	9
Tapped rainy day fund	19	Early retirement	6
User fees	15	Privatization	3
Court-related fees	14	Gaming/gambling expansion	3
Reorganization of agencies	14	Lottery expansion	2

Sources: National Governors Association, National Association of State Budget Officers (June 2010).

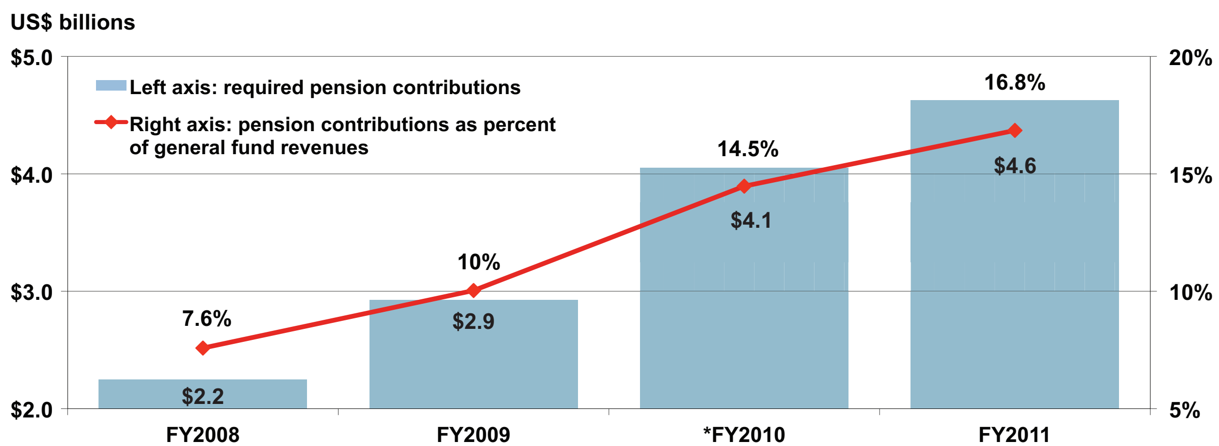
One expenditure that is difficult, and in some cases impossible, to adjust is the allocation to pensions. Public-sector retirement benefits are constitutionally protected in most states, with case law setting precedent.[8] This inability to modify plans creates a serious structural dilemma. Many states' pension contributions have grown dramatically as a share of a general fund revenues (see Illinois, for example, in figure 5). At the aggregate level, state and local government pensions suffered losses of $835 billion during the height of the financial meltdown (see figure 6); through the first quarter of 2010, less than 50 percent of those losses had been recouped.

Furthermore, the accounting standards that determine public-sector pension liabilities are opaque when compared to those that apply in the private sector. In fact, the Governmental Accounting Standards Board (GASB) recently released a statement highlighting several public-sector accounting issues as potential targets for reform.[9] For example, as opposed to the private-sector's market value approach, most states use an *actuarial smoothing* period of five years,[10] with states such as Arizona smoothing returns over ten years.[11] Because of this approach, public pension funding levels over the next several years will continue to reflect the gains and losses of 2008–2009.[12] In addition, public-sector pension liabilities are currently discounted at unrealistic rates of return, which can lead to an understating of liabilities and subsequent overstating of pension funding ratios.

To make matters worse, many states and municipalities authorized increases in retirement benefits during good times when solid investment returns were the norm. Yet they failed to adequately set aside funds to keep these promises if conditions changed.[13] More than half of states had fully funded pension systems in FY2000, but only four (Florida, New York, Washington, and Wisconsin) could make a similar claim in FY2008.[14]

Beyond their pension obligations, state and local governments are confronting growing health-care costs. Medicare is the largest health-related budget item, and the share of total operating revenues allocated to retirees' health benefits is projected to more than double by 2050 (see figure 7).

FIGURE 5 *Illinois public pension growth*

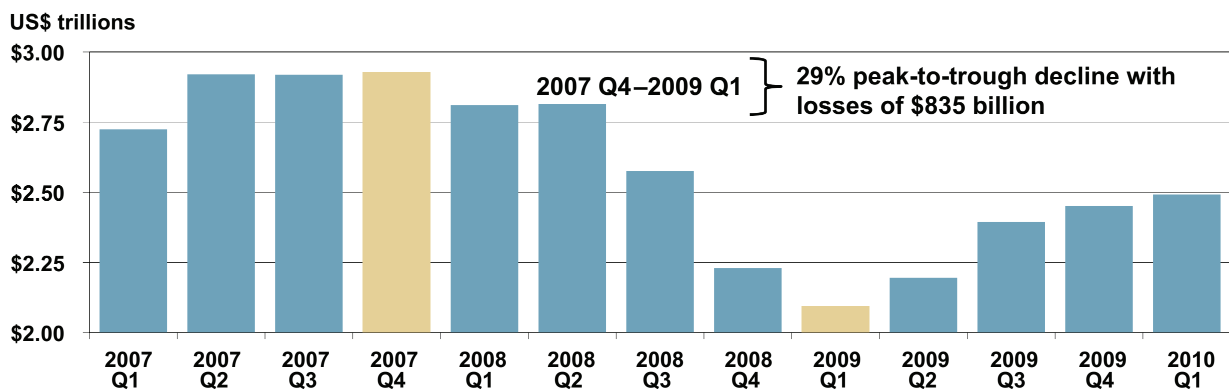


*FY2010 general fund pension contribution was largely financed by issuance of $3.5 billion in pension obligation notes.
Note: Includes debt service on FY2003 pension obligation bonds.
Source: Illinois state budget FY2011 (March 2010).

Alarmingly, it was not until FY 2008 that states and municipalities with annual revenue exceeding $100 million were even required to report liabilities for other post-employment benefits (OPEB). Historically, the public sector funded these benefits on a pay-as-you-go basis (i.e., in retirement as opposed to the accrual years of actual employment), and thus the majority of OPEB liabilities are unfunded. A 2009 U.S. Government Accountability Office (GAO) research brief found that in aggregate, all 50 states and the 39 largest local governments had set aside less than 5 percent of their reported $559 billion total OPEB liabilities.[15] Moreover, OPEB liabilities are not calculated with a uniform methodology. Actuarial assumptions such as the discount rate and rate of inflation for health-care costs can have a dramatic influence on total reported liabilities.

FIGURE 6

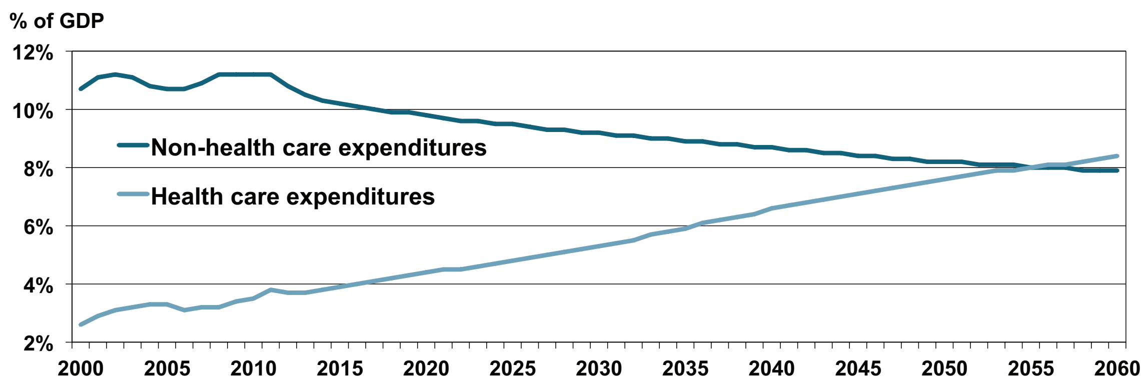
Total holdings and investments of state and local government employee retirement systems



Source: U.S. Census Bureau.

FIGURE 7

Health and non-health expenditures of state and local governments, as percent of GDP

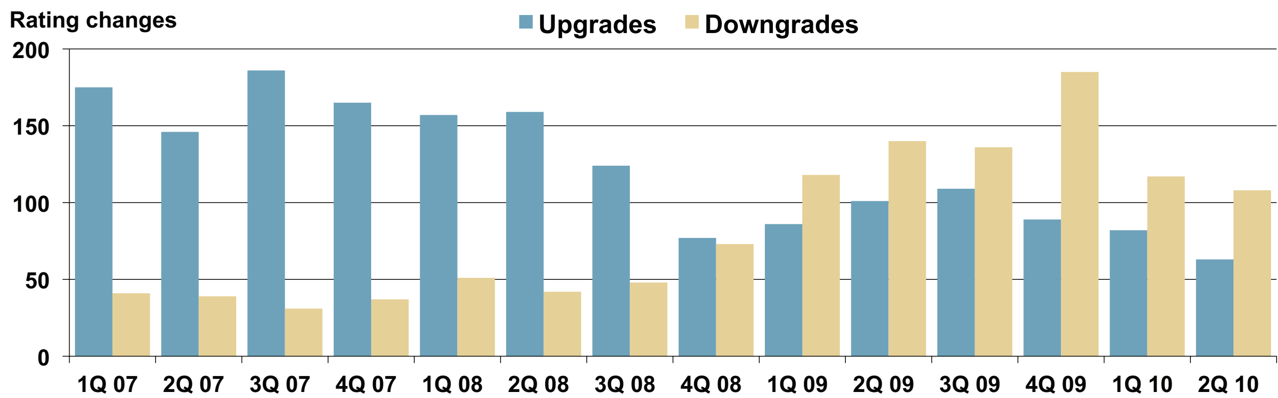


GAO, State and Local Governments' Fiscal Outlook (March 2010).

Given these conditions, the municipal bond market—a critical source of funding—has come under pressure. In recent years, municipal bond downgrades have risen sharply (see figure 8). General obligation (GO) bonds in California, Illinois, Arizona, and Michigan have all experienced downgrades since 2007.[16] Lower bond ratings can increase borrowing costs for states, as bond investors require additional yield to compensate for increases in perceived investment risk. This increase is reflected in credit default swap (CDS) contracts on state GO debt, which are now trading at levels comparable to European sovereigns (see figure 9). And while demand for municipal debt has remained steady (through August 2010, year-to-date issuance was up 1.4 percent on a year-over-year basis to $262.5 billion[17]), it could prove more difficult to find willing buyers if defaults do occur.

FIGURE 8

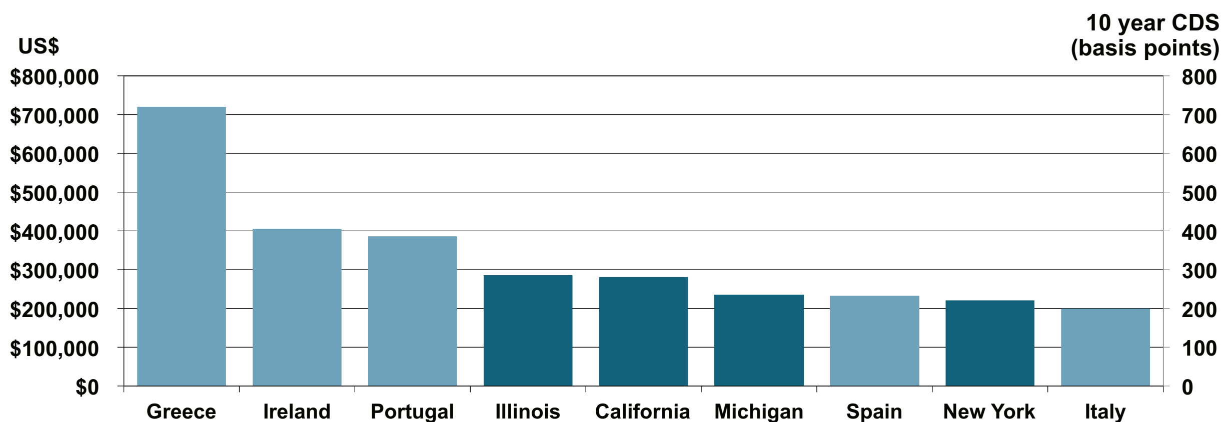
Quarterly municipal rating revisions



Source: Moody's Investors Service.

FIGURE 9

Annual cost of insuring $10 million in debt against default

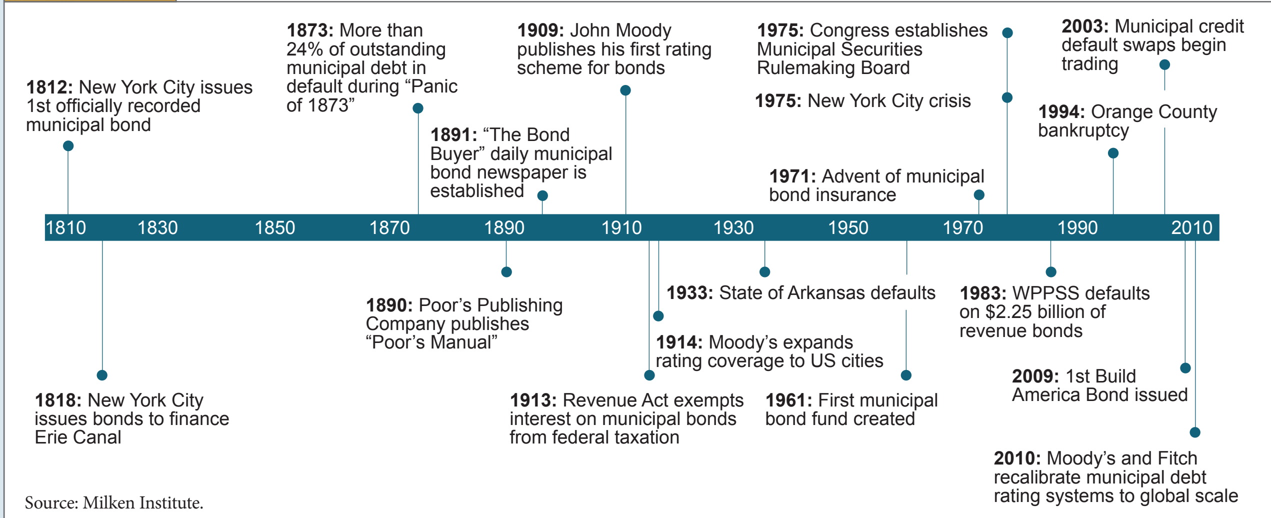


Source: Bloomberg (October 4, 2010).

Snapshot of the U.S. Municipal Bond Market

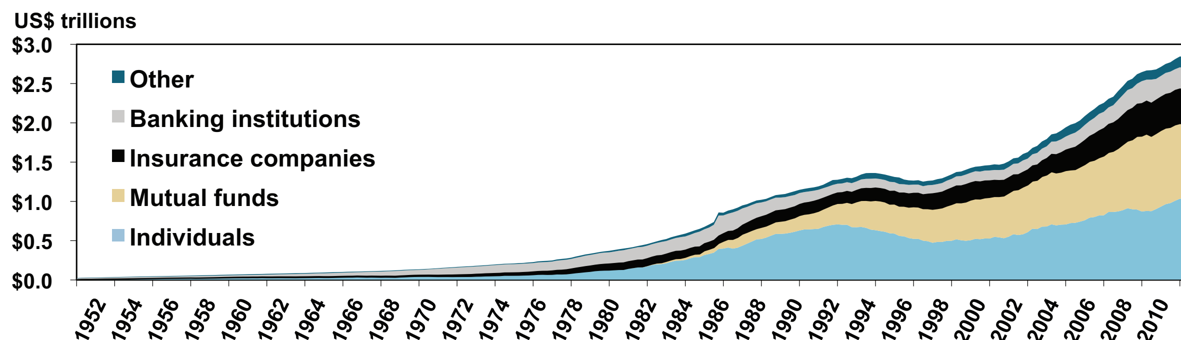
The U.S. municipal bond market has existed for roughly 200 years, serving as a source of financing for early-19th-century infrastructure projects such as the Erie Canal (see figure 10). Over the last 58 years, the U.S. municipal bond market has blossomed from $25 billion to its current level of $2.84 trillion (see figure 11). Of the $2.84 trillion in outstanding municipal debt, the largest holders are households (36 percent), mutual funds (34 percent), and insurance companies (16 percent).[18] Roughly 90 percent of total U.S. issuance in 2009 went to general purpose use ($128 billion), education ($92 billion), transportation ($49 billion), health care ($46 billion), and utilities ($40 billion).[19]

FIGURE 10 *200 years of municipal finance*



Source: Milken Institute.

FIGURE 11 *Holders of U.S. municipal securities*



Source: Federal Reserve.

Bondholders, unions, public employees, and taxpayers alike may have to share the financial burden of getting states and municipalities on sounder footing.

PART 1

Overview of Financial Innovations Lab Findings

In July 2010, as the Financial Innovations Lab was convened, the national media was beginning to take note of the worrisome condition of state and local government finances, focusing in particular on pensions. The Lab's agenda covered this and other challenges, and considered both short-term and long-term remedies.

The balance of this report summarizes the discussion that took place, with four categories of recommendations: 1) solutions for municipal expenditure restructuring; 2) solutions for generating additional, sustainable municipal revenue; 3) suggestions for municipal process reform; and 4) suggestions for federal/state partnerships with conditions attached.

Solutions for municipal expenditure restructuring include such concepts as:

- achieving economies of scale by sharing and consolidating basic services
- introducing managed competition where applicable[20]
- phasing in defined-contribution (DC) or hybrid cash balance retirement plans in lieu of traditional defined-benefit (DB) pension plans
- eliminating pension spiking[21]
- reducing costs associated with correctional facilities
- using preemptive collective burden sharing among all key parties—bondholders, union representatives, public-sector employees, and taxpayers—to avoid Chapter 9

Solutions for generating additional, sustainable municipal revenue include:

- broadening the tax base to capture generally under-taxed areas of the economy such as services
- allowing more municipalities to have access to the income tax
- restructuring the property tax

With respect to **suggestions for municipal process reform**, Lab participants proposed:

- implementing multi-year budgeting
- revising public-sector compensation incentives to focus less on deferred compensation and more on active employment rewards/benefits
- mandating adequate rainy-day reserve fund contributions in periods of economic expansion that can be tapped during downturns

- for situations that require it, launching discussions among the key stakeholders in each jurisdiction over how to share the needed fiscal adjustments (formal bankruptcy as a "solution" for municipalities was recognized to be a lot more complex than it may appear, and in any event, is unavailable for states)
- revisiting the idea of financial control boards or oversight authorities
- increasing the transparency of public-sector actuarial assumptions, (e.g., discount rate method; smoothing period; longevity and retirement pattern assumptions; maturity of workforce; future value disclosures; and asset structure/volatility)
- requiring long-term maintenance fund reserves for large-scale infrastructure projects

Suggestions for federal/state partnerships proposed tying federal dollars to budget restructuring covenants (e.g., more realistic public pension rate-of-return assumptions; elimination of pension spiking; uniform pension benefit contracts for future employees; and revenue efforts on behalf of taxpayers). Models that could leverage such a covenant scheme include:

- a "race-to-solvency" initiative
- having the federal government act as a buyer of pension obligation bonds (POBs)
- using federal money to bridge public pension liability gaps that result from downward adjustments to actuarial rate-of-return assumptions

Glenn Yago (left) and Betsy Zeidman of the Milken Institute listen as Robert Litan of the Kauffman Foundation frames the issue for attendees.

PART 2

Ideas for Alleviating Current Budget Issues & Preventing Future Crises

Solutions for Restructuring Municipal Expenditures

Service cuts so far have been the most common approach to closing state and local municipal budget gaps. The National League of Cities predicts local government workforce reductions of nearly 500,000 in the current and upcoming fiscal years. These job losses will sap the strength of the recovery and conceivably, in a worst-case scenario, cause a setback.[22]

Recognizing the impact of such cuts on the quality of life for residents and businesses, Lab participants reached beyond short-term fixes and aimed to identify sustainable ways to restructure spending patterns and long-term liabilities. Solutions addressed both the funding crisis in many employee DB pension plans and the broader issues of government operations.

Bridging Pension Plan Funding Gaps

Elected officials, pension fund fiduciaries, and representatives from public employee labor unions all participated in the Lab discussions. While there was vigorous debate on the source of the problem (i.e., the size of the contracts vs. management of the plans), participants generally agreed that a DB plan could be a good model when properly managed. Pensions can have a significant and beneficial impact on the broader economy as well: Each dollar paid out in state and local pension benefits supports $2.36 in total economic output, and for every dollar contributed by taxpayers to state and local pension funds, $11.45 in total output is supported in the national economy.[23]

While some states have maintained their funding levels (including Florida, which was represented at the Lab), most are in serious trouble and will have to undergo restructuring going forward. An expert noted that even for the City of New York, which has been responsibly paying its annual required contribution (ARC), the current path is not sustainable or affordable; the city's contribution has increased by $6.5 billion in 10 years.

Possible ways to tackle these challenges include:

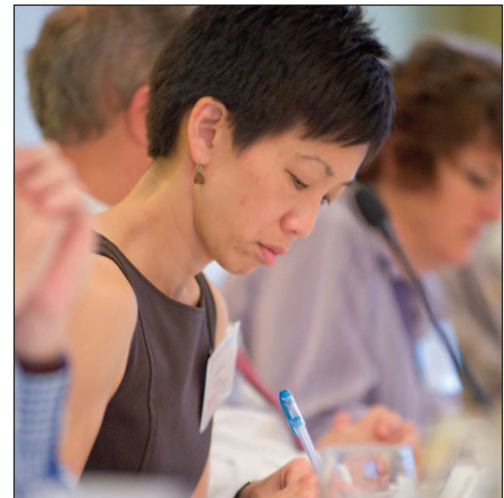
- **Phase in DC or hybrid retirement models in lieu of traditional DB plans**
  Given the legal challenges inherent in revisiting contractual pension commitments, several Lab participants suggested phasing in DC or hybrid cash balance plans for all new employees. For example, existing workers' DB plans could be frozen and replaced with DC plans going forward, if laws permit. Alternatively, plans could adopt mandatory DC layers on top of conservative DB base plans. A tiered system could incorporate certain variables (such as date of hire, retirement age cutoffs, cost-of-living estimates, and vesting periods) into the pension entitlement equation, allowing for a long-term stabilization of retirement liabilities.

- **Eliminate pension spiking**
  The practice of adding accrued sick, vacation, and other pay categories to a public-sector employee's final-year salary to determine pension payments should be eliminated.
- **Allow private-sector employees to participate in public pension system**
  In addition to absorbing the 50 percent of working individuals who currently do not have access to an employer-based retirement plan, allowing private-sector employees to participate in public pension plans would provide a much-needed capital boost to troubled state retirement plans. New participants would also benefit from greater access to a professionally managed, highly diversified investment pool in addition to reduced investment fees and financial literacy programs.[24] Additionally, this solution could help address the broader societal challenge of large numbers of private-sector workers without adequate retirement savings.

Beyond the Lab suggestions, other ideas for pension plan funding resolution include increasing public-sector employee contribution rates, as well as placing limits on total retirement benefit packages.

Containing the Rising Costs of Government Operations

Governments at all levels are exploring ways to reduce their operational costs; there is a renewed focus on streamlining organizational structures and processes. One approach is managed competition, which is the process of allowing both public and private entities to compete for contracts. First implemented in Phoenix during the 1970s, managed competition has proven successful in areas such as public transportation, document management, human resources management, fines/accounts collections, refuse collection, park management/maintenance, and catering.[25] Moreover, research has shown that when properly implemented, managed competition can produce annual savings between 10 and 30 percent of costs.[26]



Valerie Chang represented the MacArthur Foundation during the daylong workshop.

Additional solutions for improved governmental operations that were discussed during the Lab include the following:

- **Reduce fragmentation and improve productivity/efficiency within municipal governance**
  As previously noted, there are more than 91,000 local governmental units within the U.S.[27] Often services are duplicated at the city and county level, or in small municipalities that are adjacent to one another. One participant noted that Pennsylvania is divided into more than 2,500 local jurisdictions. But other states have been able to adopt a more centralized delivery of services, resulting in lower tax requirements. California's joint powers authority (JPA), which allows local units to share various functions in addition to issuing bonds, was cited as a possible model for eliminating fragmentation.

  Lab participants argued that shared services and consolidation could be brought to bear on pension plans. Pennsylvania, for example, currently has more than 3,100 local government pension plans, with

an average of 12 employees, $10 million in assets, and an annual cost of roughly $2,000 per employee. Efficiency improvements could also be applied in education, concentrating on back-office functions and possibly district consolidation.

However, it was also noted that shared service arrangements are often difficult or impermissible under collective bargaining agreements. In addition, consolidation shouldn't be viewed as a panacea; the cost savings associated with consolidation can vary widely by school district size.[28]

- **Reduce costs associated with correctional facilities**
  The corrections industry represents a growing portion of state budgets, second only to Medicaid over the past two decades, and exceeding $50 billion annually.[29] It costs on average roughly $50,000 per year to incarcerate a prisoner in California. Restructuring corrections expenditures offer states an opportunity to reduce costs via lasting policy initiatives.

  Possible options include: 1) review and reform sentencing guidelines; 2) improve and expand prisoner re-entry programs to reduce recidivism rates; 3) initiate enhanced community parole and probation oversight; and 4) modify release conditions for lower-risk geriatric and chronically ill inmates who require costly health care while in prison.[30]

  Other cost-reduction strategies for state and local governments include:[31]

  - **Streamline current staffing models and logistics channels**
  - **Create objective oversight committees to conduct cost-benefit analysis for partnering and privatization of public-sector services**
  - **Re-evaluate demand for services and remove underutilized programs**

Understanding Chapter 9 Bankruptcy

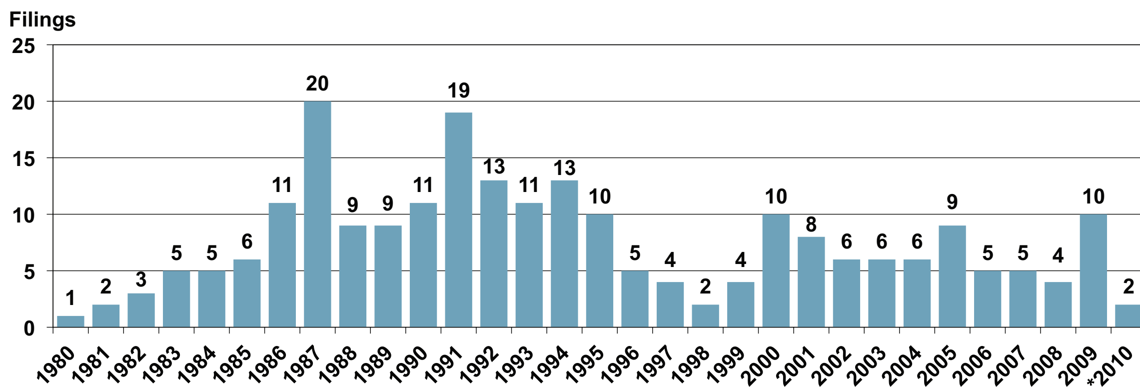
Municipal Chapter 9 filings have been quite rare over the last three decades (see figure 12). Moreover, since 1970, Moody's-rated municipal issuers have experienced only 54 defaults.[32]

While an investor's ultimate fear is that of a municipal bankruptcy, the legal right to actually declare Chapter 9 is not clear-cut. No state can declare bankruptcy, and each state's law dictates whether its local municipalities are able to file Chapter 9. Municipal filings are specifically authorized in only 16 states; conditionally authorized in seven states; granted with limited authorization in three states; and prohibited in two states.[33]

The formalities involved in filing Chapter 9 represent a formidable gauntlet. In order to qualify for a Chapter 9 filing, the municipality in question must pass the following eligibility requirements: 1) bankruptcy must be specifically authorized by state law; 2) the debtor must satisfy the insolvency test, which is a fact-intensive determination, based on an inability to pay debts as they become due; 3) the debtor must genuinely seek to effect a plan that will satisfy creditors, not just buy time or frustrate creditors; 4) the debtor must have first tried to avoid filing for bankruptcy by negotiating with creditors, unless impractical.[34]

On top of the legal complexities associated with *entering* Chapter 9 status, implementing bondholder restructuring agreements during the bankruptcy case can be demanding. Not all municipal bonds are treated equally in these cases.

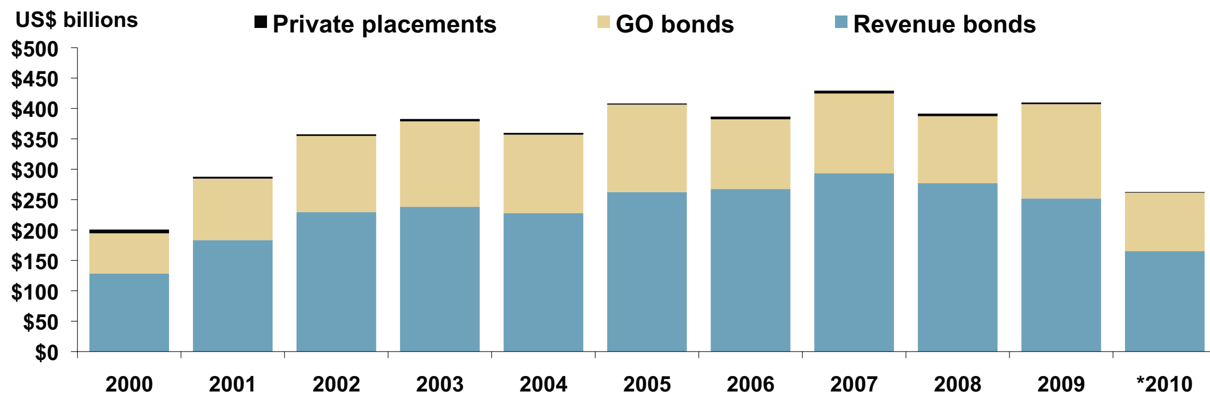
FIGURE 12 *Annual Chapter 9 filings by municipalities*



* through May 7, 2010
Source: James E. Spiotto, Chapman & Cutler LLP

FIGURE 13

Annual U.S. municipal bond issuance



* through August 2010
Source: Thomson Reuters.

As long as dedicated revenue streams remain intact, special revenue bonds (i.e., bonds with exclusive recourse to the revenues generated by a specific project or program) maintain quasi-immunity with regards to restructuring—and revenue bonds have accounted for roughly two-thirds of average annual municipal issuance over the last decade (see figure 13). Even among GO bonds (bonds with recourse to the general taxing power of the issuer), there are subcategories (such as those that are secured with tax liens) that may also be largely insulated from intensive restructuring.

Moreover, given the dependence of many municipalities on the capital markets, mustering the political will to restructure bond debt can be daunting, especially if the capital markets are viewed as a possible source of funding to emerge from Chapter 9.

Additionally, any Chapter 9 plan of adjustment for debt restructuring generally requires a two-thirds approval from creditors.[35] With 36 percent of outstanding municipal debt held directly by individual investors and another 34 percent held indirectly through mutual funds, the task of achieving two-thirds approval could be prohibitive.[36] Similar voting thresholds would apply to the holders of pension- and OPEB-related claims that would be adjusted under a plan (public employees and retirees). Although there are alternatives to obtaining the necessary blessing from creditors, these also may pose obstacles to a smooth restructuring.

Sharing the Burden: A Fresh-Start Solution to the Expenditure Dilemma?

As they struggle to cope with daunting revenue/expenditure mismatches as well as massive long-term pension and OPEB liabilities, will municipalities utilize bankruptcy as a strategic option moving forward? A proposal was raised to "prepackage" Chapter 9 (that is, by formulating a "plan of adjustment" and soliciting the agreement of creditors prior to commencing a Chapter 9 case), using an approach similar to the one employed in the recent (and apparently successful) turnaround of General Motors.

However, municipal finance experts noted that a Chapter 9 filing is not an option for states, and is typically not the best solution for municipalities (see sidebar). It is a lengthy, expensive and complex process with long-lasting repercussions. After Vallejo, Calif., filed for bankruptcy in 2008, its mere eligibility to be a debtor under Chapter 9 was contested for roughly a year prior to a final decision permitting the city to proceed with its case.

Several attendees also pointed out that if a streamlined Chapter 9 process were institutionalized, borrowing costs for all municipalities would undoubtedly rise, with investors demanding higher returns to compensate for an increase in the probability of bond defaults. Others observed that Chapter 9 was not a panacea for restructuring pension and OPEB liabilities since a municipality would still need to find a way to cover the liabilities (albeit potentially a reduced amount, over time.) On the other hand, in certain emergency situations or following the exhaustion of other alternatives, Chapter 9 does provide the tools to address ballooning pension and OPEB liabilities. Shaky fiscal conditions are likely to push many municipalities closer to bankruptcy.

Lab participants explored an alternative to this clearly undesirable option: Preemptive and collective burden sharing, a process by which *all* key stakeholders (bondholders, union representatives, public-sector employees, and taxpayers) would share a financial hit in order to assure the long-term sustainability of the municipal entity. Public-sector employees could be grouped into age-specific pension arrangements, with younger and more recent hires expected to make larger contributions to their retirement and health-care plans, thus driving down long-term liabilities. With respect to bondholders, various approaches to debt restructuring could be implemented (e.g., extending maturity dates and reducing current interest payment arrangements, among other possible treatment options).

A crisis drove New York City to adopt this arrangement during its 1975 fiscal meltdown. Faced with an over-whelming operating deficit, billions in outstanding short-term debt, and shut out from the credit markets, the City had in effect run out of money and could no longer fund its day-to-day operations. As a solution, state as well as federal intervention avoided a default and subsequent bankruptcy. The Municipal Assistance Corporation (MAC), an independent corporation/entity of the state, was authorized to sell bonds to meet the borrowing needs of the City. The MAC demanded various forms of burden-sharing, including bond modifications, multi-tiered pension enactment, union wage deferrals, tuition increases, a 30% increase in transit fares, and across-the-board tax increases.[37]

Henry Kevane, an attorney with Pachulski Stang Ziehl & Jones, explained why Chapter 9 filings are not the simple solution many people assume.

Whether a burden-sharing agreement such as New York's 1975 MAC could be reached in today's fractured political climate was debatable (although if financial conditions of particular jurisdictions worsen, some sort of burden-sharing should become more politically acceptable, and indeed necessary). In essence, since a Chapter 9 bankruptcy is generally considered an undesirable and onerous last resort (see sidebar), shared financial sacrifice can perhaps be a less painful, more strategic option for municipalities and other parties with vested interests.

Solutions For Generating Additional, Sustainable Municipal Revenue

Revenue-side solutions to bolster public-sector coffers included:

- **Broaden the Tax Base**

  During the Lab, Mike Pagano of the University of Illinois at Chicago pointed out that only 11 percent of all municipalities have the authority to levy income or payroll taxes, while 55 percent have access to the sales tax.

  Michael Mazerov from the Center on Budget and Policy Priorities cited research demonstrating the possible benefits associated with expanding the taxation of services (see figure 14). Given the evolution of the U.S. from a manufacturing to service-based economy, Mazerov noted that levying sales taxes on services could make state tax systems fairer, more stable, more economically neutral, and easier to administer.[38] But it was pointed out that states with relatively high taxes such as New Jersey have not necessarily fared better during the recent economic downturn. Moreover, cities that rely heavily on the top-tier income bracket for tax revenue need to be cautious of mobile wealth. For example, facing an onslaught of tax increases, New Jersey experienced a net outflow of roughly $70 billion in wealth from 2004 through 2008.[39] Overall, Lab participants felt that increasing taxes would obviously be a challenge in the face of current economic and political realities.

- **Restructure the property tax**

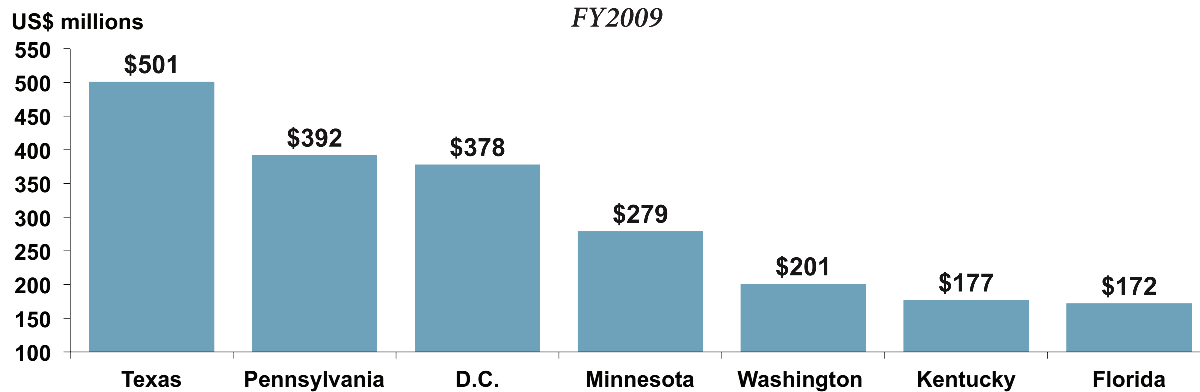
  While property taxes represent more than a third of aggregate U.S. state and local municipal revenues, they have historically lagged the overall business cycle.[40] Because of the challenge presented by this delayed revenue, Lab participants proposed ideas to improve upon the existing property tax structure. Pagano advocated moving away from a general property tax toward a split-rate tax structure in which the value of land and the value of structures/improvements on the land are taxed at different rates. Participants also explored reconsidering the tax-exempt status of educational and medical institutions.

- **Make the cost of public services more transparent to validate revenue needs**

  One gray area within public-sector finances is that of service cost metrics. Convincing Americans that they have to pay for the services they want is critical to enacting sustainable revenue-side solutions. Providing greater transparency with regard to the actual costs of state and city-level services may help taxpayers better understand, value, and prioritize revenue generators that facilitate their quality of life.

FIGURE 14

Revenue forgone from failure to impose sales tax on select services



Source: Michael Mazerov, Center on Budget and Policy Priorities (July 2009).

Suggestions for Municipal Process Reform

In order for states and local municipalities to move beyond the current crisis, structural process reforms need to be implemented, especially with regard to transparency and sustainability. The following solutions were proposed during the Lab.

- **Re-think public-sector employee incentive schemes**

  Currently, the public sector's employee incentive scheme is skewed towards deferred compensation. In order to reduce the long-term liabilities associated with this arrangement, Lab participants suggested that states and local municipalities revise compensation structures. This system would place more emphasis on rewarding and incentivizing public-sector employees during their working life rather than creating motivations for retirement.

- **Standardize actuarial assumptions and increase their transparency**

  Public-sector actuaries calculate the actuarial required contribution (ARC) as the amount that must be set aside annually to fund the present value of future benefits accrued in the current year, plus the amortized cost of any unfunded liabilities. A municipality's actual contribution is subsequently compared with the ARC to assess whether funding is sufficient.

  But state and city officials (and some actuaries themselves) note that it's hard to understand or determine how long-term liabilities are quantified. Consequently, funding levels cannot be compared across plans, and the credibility of a specific ARC is often suspect. Lab participants recommended making public accounting assumptions fully transparent and/or coming up with standardized assumptions that are similar to the process used in corporate accounting. Assumptions of concern included: 1) discount rate method; 2) smoothing period; 3) longevity assumptions; 4) retirement pattern assumptions; 5) maturity of workforce; 6) future value disclosures; 7) asset structure/volatility.

- **Revisit the idea of financial control boards and oversight authorities**

Financial control boards and oversight authorities can provide a method of layered fiscal oversight. The prime historical example remains the New York State Financial Control Board, formed in 1975 to deal with New York City's fiscal crisis. Aside from reviewing the city's annual rolling four-year financial plan, the Control Board maintains the power to re-impose a control period if various covenants are broken (e.g., required debt service payments and deficit thresholds).[41]

Other states such as North Carolina, Vermont, and Pennsylvania possess similar oversight mechanisms. During the Great Depression, North Carolina's Local Government Commission (LGC) was created to address problems in local government finance. In its modern-day form, the LCG operates as a division within the Department of the State Treasurer, maintaining oversight and approval responsibilities for all local government finance in addition to managing state and local debt issuance and interfacing with bond rating agencies.[42] Vermont's Capital Debt Affordability Advisory Committee (CDAAC) is responsible for conducting an annual review of the state's tax-supported GO debt and submitting to the governor and General Assembly an estimate of the maximum amount of new long-term GO debt that should be authorized for the next fiscal year.[43] While the CDAAC's estimate is advisory, it has historically been adopted by the state as a bonding limit.[44]

Furthermore, Lab participants suggested the Pennsylvania Intergovernmental Cooperation Authority (PICA) as a potential model for layered fiscal oversight. Created in 1991 to provide financial assistance to Philadelphia, PICA still exercises advisory and review powers over Philadelphia's financial affairs, including the power to review and approve five-year financial plans prepared at least annually by the city.[45] Pennsylvania possesses an additional layer of fiscal supervision for all of its local municipalities in the form of the 1987 Financial Distressed Municipalities Act, also known as Act 47. Under this law, distressed municipalities are overseen by the state's Economic Development Corporation and relinquish all budgetary decision-making authority.[46]

With specific regard to pensions, a Public Pension Funding Authority (PPFA) was discussed as one possible oversight mechanism. In theory, the PPFA would serve as an objective yet binding fact-finding authority to determine the critical steps required for funding or restructuring unfunded pensions, with the power to use its determinations as the basis for a pre-packaged plan of debt adjustment.[47]

Mike Musuraca, a former union official who is now a private equity investor with Blue Wolf Capital Partners, shares his ideas.

- **Require infrastructure project maintenance reserves**

In order for states and municipalities to better prepare for the long-term costs associated with infrastructure projects, Lab participants suggested that maintenance reserve funds be set aside prior to any voter-approved

infrastructure project, as is already the case in states such as Utah and Missouri. Build America Bonds have been widely used since their introduction in 2009; it was suggested that issuers be required to submit a maintenance cost plan for the estimated duration of a project's lifespan in order to receive the 35 percent federal subsidy.

- **Mandate use of emergency stabilization/rainy-day funds**

  The current funding situation came about because states and municipalities did not set aside adequate rainy-day reserve funds that could be tapped in the event of an economic downturn. After reaching 11.5 percent of aggregate state general fund expenditures in FY2006, rainy-day balances are expected to drop to just 5.8 percent in FY2011.[48] Lab participants suggested implementing a mechanism similar to that of Massachusetts, which deposits 0.5 percent of the total revenues from taxes in the preceding fiscal year into a stabilization fund.[49] Mandated rainy-day fund contributions would help address budget dilemmas going forward.

- **Implement multi-year budgeting**

  Forty-four states practiced biennial budgeting in 1940, yet just 20 do so in 2010. Of these, only Oregon, North Dakota, and Wyoming undertake true biennial budgeting (i.e., the passing of a consolidated two-year budget).[50] Lab participants unanimously agreed that multi-year budget planning, as opposed to annual budgets, would benefit states. In theory, multi-year budgets would force policymakers to assess revenue/expenditure stability or lack thereof over the long run, deterring one-off, unsustainable expenditure increases.

Suggestions For Federal/State Partnerships

As evidenced by the recent congressional fight over increased support to the states, there is neither public appetite nor federal budgetary largesse for assistance. However, there are some approaches to delivering federal assistance that could create incentives for greater fiscal responsibility. For example, federal dollars can be tied to state and municipal budget restructuring covenants, similar to that of an International Monetary Fund or World Bank assistance model. Additionally, collateral could be pledged.

The following is a short list of public-sector covenants proposed at the Lab:

- Adopt standardized actuarial assumptions similar to corporate-sector accounting standards, (e.g., no smoothing and more realistic rate-of-return assumptions)
- Phase in a uniform pension benefit contract for incoming employees
- Benefit packages are rolled back to more realistic and sustainable levels
- Pension packages cannot exceed 100 percent of pre-existing salary
- All pension spiking provisions are eliminated, with minimum basis for retirement earnings being the last five years of employment
- Adequate revenue effort on behalf of taxpayers

Models that could leverage a covenant scheme include:

- **Set up a "Race to Solvency"**

  Several Lab participants suggested using federal money to motivate states to get through emergency budget shortfalls and fiscal crises. In order to qualify for federal dollars, states would have to develop budgetary plans that demonstrated long-term fiscal stability. This initiative could be modeled on the Department of Education's "Race to the Top," which fostered competition among the states and tied funding to the establishment of specific criteria.

- **Bridge the liability gap to enable more realistic rate-of-return assumptions**

  In calculating long-term liabilities, states currently use rate-of-return assumptions ranging from 7.25 percent to 8.5 percent (see figure 15). If states switch to a lower discount rate, the present value of their liabilities would rise significantly. Lab participants suggested having the federal government bridge the funding gap that would result from lowering rate-of-return assumptions to more realistic and sustainable levels. Rather than a steep and hasty one-time reduction, discount rates could be lowered gradually over several years, with various covenants attached to all federal funding used to bridge the discount assumption gap.

- **Treasury becomes buyer of POBs**

  Pension obligation bonds (POBs) have been issued for more than 25 years by states and local governments to cover pension fund obligations, with California and Illinois accounting for the largest share of activity.[51] While the federal government does not typically participate in POB offerings, it was suggested that in fiscal crises, this policy could be reversed. Accordingly, the federal government could purchase state and city POBs at favorable rates, thus acting as a quasi-subsidy for issuers. To better align incentives, the participation rate or exposure of the federal government would be linked to the Lab's proposed covenants. In essence, POB issuers would be ranked, with those in dire conditions forced to abide by the most restrictive covenants prior to federal participation. As an example, in 2008, the state of Connecticut issued a POB to fund $2 billion of the unfunded liability in its Teachers' Retirement Fund, with a covenant attached requiring the state to fully fund its annual actuarially recommended contribution to the Teachers' Retirement Fund.[52]

FIGURE 15 *Assumed rates of return*

Assumed rate of return	# of states with rate	States
7.25%	2	NC, SC
7.50%	7	GA, IN, IA, KY, TN, VA, WV
7.75%	7	CA, FL, ID, ME, MD, SD, UT
7.80%	1	WI
8.00%	22	AL, AZ, AR, DE, HI, KS, MI, MS, MO, MT, NE, NV, NM, NY, ND, OH, OK, OR, PA, TX, WA, WY
8.25%	6	AK, LA, MA, NJ, RI, VT
8.50%	5	CO, CT, IL, MN, NH

Source: Pew Center on the States.

Public officials will have to avoid the temptation to adopt quick fixes and instead make fundamental decisions about spending and revenue priorities.

Conclusion

The financial crisis facing states and municipalities has been brewing for quite some time. For many years, governments entered binding agreements for long-term obligations without giving adequate consideration to the potential difficulty of making payments. Many assumed ever-increasing investment returns would match the obligations inherent in popular programs. A discount rate based on overly optimistic return scenarios dramatically understated the gaps in funding status. Deferred payments allowed the presumption that there would always be time to catch up on funding in the future.

But the events of the last two years dashed those rosy assumptions and created two sets of problems for state and local governments: The recession slashed operating revenues just as it increased demand for expenditures, and the lack of increasing investment income exposed the impossibility of governments' meeting their pension and health-care obligations.

During the Financial Innovations Lab, experts explored some (though certainly not all) of the underlying challenges and potential market-based solutions. There were no silver bullets or clever financial mechanisms to save the day. Instead, the group focused on back-to-basics approaches: regulatory and public policy initiatives such as long-term planning, realistic investment and actuarial assumptions, rainy-day funds, more efficient and competitive operations, transparency, shared services and shared sacrifice, and an updated model of generating increased revenue.

Beyond these specific ideas for closing the gap, the Lab participants also acknowledged the importance of a human dynamic—that is, political will. Many of the decisions impacting state and municipal finances are made by individuals who feel bound by the expectations of their constituents. Short-term re-election concerns may outweigh long-term considerations for sustainability and prudence. If the structural deficits of the state and municipal system are to be addressed, public officials will have to avoid the temptation to adopt quick fixes and instead make fundamental decisions about spending and revenue priorities.

Michael Genest (left) of Genest Consulting makes a point while Bradley Belt of Palisades Capital Management listens intently.

If financial conditions continue to deteriorate in individual states and municipalities, pre-emptive burden-sharing arrangements ought to emerge as a practical resolution that can be taken well before things reach an ultimate breaking point. Hopefully the nation won't have to experience a cascade of crises before responsible government officials find the political courage to make difficult choices. Our overall quality of life—from schools, parks, roads, and transit to a safety net for the most vulnerable citizens—depends on this happening sooner rather than later.

Appendix

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