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NEWS RELEASE

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Claims That Bond Debt, Pension Costs Will Cause Imminent State and Local Budget Meltdown Are Exaggerated

A spate of recent articles regarding the fiscal situation of states and localities have created the misguided impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown, according to a major new report from the Center on Budget and Policy Priorities. These articles mistakenly lump together states' and localities' current, largely recession-related fiscal problems with longer-term issues relating to bond indebtedness, pension obligations, and retiree health costs.

Most states are projecting large operating deficits for fiscal year 2012, as revenues remain well below pre-recession levels even as the economic downturn has increased the need for public services. States are required by law to close these deficits before the start of the fiscal year, just as they have done in each of the past three years. In contrast, states have several decades to address the above longer-term issues, whose size recent articles have tended to exaggerate.

"Overheated claims about state and local budget problems not only are inaccurate, but also could lead policymakers to take unwise steps such as allowing states to declare bankruptcy or forcing them to change the way they report their pension liabilities as a condition for issuing tax exempt bonds," said Iris J. Lav, senior advisor to the Center and the report's lead author.

Bond Indebtedness

Recent claims that states and localities have run up huge bond indebtedness, in part to finance operating costs, and that a number of localities may default on their bonds are greatly exaggerated, the report explains.

States and localities have issued bonds almost exclusively to fund infrastructure projects, not finance operating costs, and while the amount of outstanding debt has increased slightly over the last decade it remains within historical parameters. Today, interest payments on state and local bonds generally absorb just 4 to 5 percent of current expenditures — no more than they did in the late 1970s

Moreover, municipal bond defaults have been extremely rare; the three rating agencies calculate the default rate at less than one-third of 1 percent. Between 1970 and 2009, only four defaults were from cities or counties. Most defaults are on bonds to finance housing or hospital construction and reflect problems with those individual projects, not with localities' overall fiscal health.

In short, there is no bubble in the municipal bond market, as some have claimed.

Pension Obligations

Claims that states and localities have $3 trillion in unfunded pension liabilities that may drive them into bankruptcy are similarly exaggerated, according to the report.

The oft-cited $3 trillion figure is based on valuing future liabilities on a so-called "riskless rate," which looks at future costs assuming a rate of return based on conservative investments such as Treasury bonds. This is distinct from the amount that pension funds actually would have to contribute to their funds to cover their liabilities. State pension trust funds are invested a diverse mix of stocks, bonds, and other instruments and have earned a much higher return in recent decades than riskless investments. If one follows accepted state and local accounting rules and calculates pension liabilities using the historical return on plans' assets, the unfunded liability stands at a more manageable $700 billion.

In most states, a modest increase in funding and/or changes to pension eligibility and benefits should be sufficient to remedy underfunding, the report explains. The small number of states that have skipped contributions or increased benefits without corresponding funding likely will have to make larger changes. But states and localities have the next 30 years in which to remedy any pension shortfalls; they generally should avoid increasing pension contributions as long as the economy remains weak and they are struggling to provide basic services.

Retiree Health Insurance

Observers claiming that states and localities are in dire crisis typically add to unfunded pension liabilities about $500 billion in unfunded promises to provide state and local retirees with continued health coverage. But these promises are of a different nature than pensions, the report explains.

While pension promises are legally binding, retiree health benefits generally are not. States and localities generally are free to change any provisions of the plans or terminate them entirely. In addition, retiree health plans differ widely from state to state, indicating that states have clear choices in the provision of retiree health benefits.

State Structural Deficits

The confusion between short- and long-term deficits and the overstatement of the latter problems draw attention away from the need to modernize state and local budget systems, the report concludes.

States suffer from "structural deficits," or the failure of revenues to grow as quickly as the cost of services during healthy economic times. Structural deficits stem in large part from out-of-date tax systems, which in many states have remained largely unchanged for decades. Few states tax the sales of services on the same basis that they tax the sale of tangible goods, for example, and few adequately tax the rapidly growing incomes at the top of the income ladder.

Most states' budget processes also require overhaul. For example, few state budgets include accurate projections of revenues and expenditures for as much as four or five years into the future. This makes it difficult for lawmakers to understand the long-term impact of policy proposals.

"We'd all be better off addressing these basics of state and local finance than proclaiming a crisis based on exaggerations of imminent threats," Lav said.

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The Center on Budget and Policy Priorities is a nonprofit, nonpartisan research organization and policy institute that conducts research and analysis on a range of government policies and programs. It is supported primarily by foundation grants.