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Bernstein
Global Wealth Management

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Municipal Market Update: State and Local Governments Face Difficult Decisions

Warnings of the dangers facing holders of US municipal bonds abound in the press: *Forbes* asserts that states and cities are having trouble paying their bills, the *New York Times* reports signs of debt overload, and the *Wall Street Journal* reports that investors will face terrible problems ahead. Are municipalities the next investment class to face a meltdown? Will we see a rash of municipal defaults?

The warnings about municipal bonds revolve around three primary issues: operating-budget shortfalls; the amount of municipal debt outstanding; and growing concerns about unfunded pension liabilities. We address each of these issues fully, but here's our perspective in brief:

- Tax revenues have stabilized, but at lower levels, and with federal stimulus money winding down early next year, state and local governments will need to find ways to balance their budgets using all of the arrows in their quiver—cuts in spending, tax and fee increases, reductions to employee salaries and benefits, and budget cuts.
- While the amount of outstanding debt has grown, growth has been in line with personal-income growth, so we aren't alarmed. For the largest states, debt service represents just 5% of their budgets on average, a reasonable number historically.
- Unfunded pension liabilities are a serious concern. While most states are in relatively good shape and have ample time to address this problem, some are facing significant shortfalls and need to take corrective action very soon.
- Some municipalities will default, but this occurs even in good times. In fact, last year defaults totaled about $6.4 billion, but that represents just 0.2% of the total debt outstanding.

Municipal officials will need to make tough decisions in the months ahead, but we believe most will pull through in solid shape. Our actively managed municipal portfolios are structured to safeguard against state and local governments that face these serious financial problems, and we are systematically analyzing each issuer's options and willingness to address its pension obligations.

Part 1: Municipal Budget Shortfalls

A Dearth of Appealing Options

It will be a long, grueling summer for municipal officials as they struggle to pass balanced budgets for fiscal year 2011. State governments are hard-pressed because most depend on economically sensitive tax revenues—personal income taxes, sales taxes, and corporate income taxes for the bulk of their budgets (*Display 1*). These have seen sharp declines over the last couple of years, and today most states have more expenses than revenues.

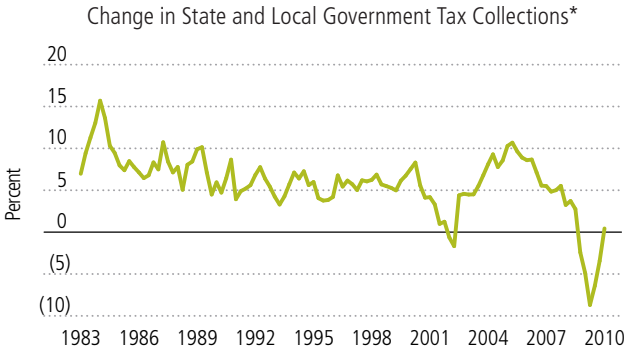
Revenues from taxes are closely tied to economic growth, so to counteract the cyclicality of their tax revenue base, municipalities build up reserves, or "rainy day" funds, during good times. In fact, prior to the start of the financial crisis, reserves stood near record levels. The severity and length of the recent recession, however, have drained most rainy day funds. To balance budgets, legislators must either make painful cuts in services or raise taxes. While most aim to have this done at the start of the fiscal year on July 1, we expect to see lots of political wrangling, very tough decisions, and late budgets.

Good News: State Tax Revenues Have Stabilized

The good news is that overall tax revenues have now stabilized—a very positive sign (*Display 2*)—even though they're still significantly below pre–credit crisis levels. Corporate income tax revenues are actually higher today than they were when the financial crisis began three years ago (*Display 3*). Revenues from sales taxes are still modestly lower, but the real problem for

Display 2

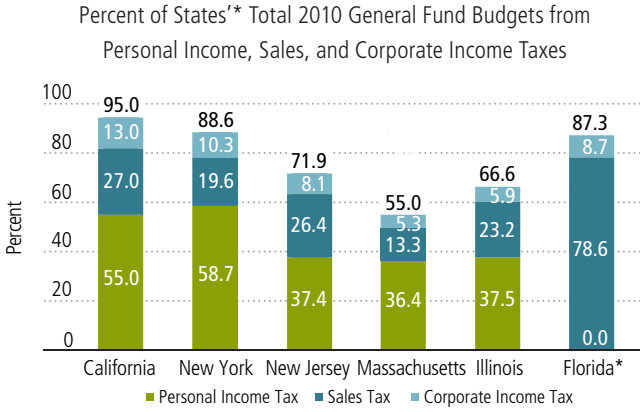
Tax Revenues Have Recovered with Economic Growth



**Year-over-year percent change as of March 31, 2010*
Source: Municipal Market Data Corp., US Bureau of Economic Analysis, and AllianceBernstein

Display 1

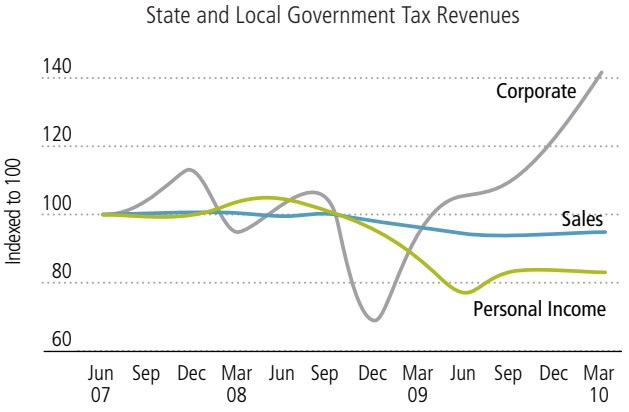
States Depend on Economically Sensitive Revenues



**States shown have the greatest debt outstanding. Florida has no personal income tax.*
Source: Moody's 2009 State Debt Medians Report, July 2009; state budgets; and AllianceBernstein

Display 3

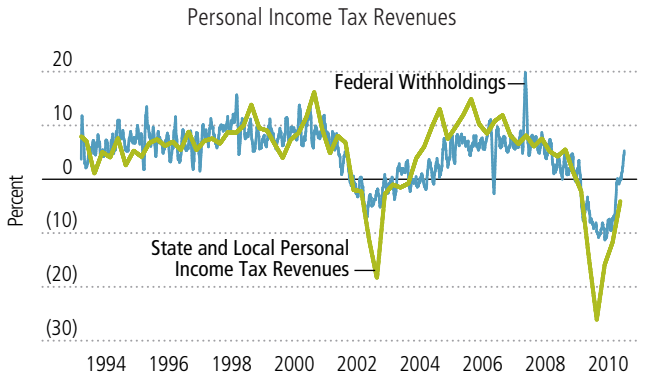
Corporate Taxes Are Up and Sales Taxes Have Bottomed



As of March 31, 2010
Source: US Bureau of Economic Analysis and AllianceBernstein

Display 4

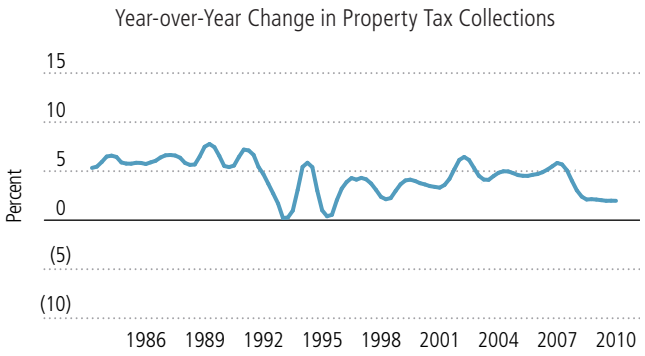
States Are Confronting Lower Personal Income Tax Revenues



Federal withholdings are a 20-day moving average year-over-year percent; state and local personal income tax revenues are a quarterly year-over-year percent.
Source: Municipal Market Data Corp., US Bureau of Economic Analysis, and AllianceBernstein

Display 5

Local Governments Depend on Property Taxes, Which Have Been Relatively Stable



Year-over-year change through March 31, 2010
Source: Municipal Market Data Corp., US Bureau of Economic Analysis, and AllianceBernstein

most states remains lower personal income tax revenues; this isn't surprising given the fact that the economy hasn't grown quickly enough to significantly reduce the level of unemployment. Even here, though, we feel there's reason to be optimistic, because federal withholding tax collections have risen, and this trend has yet to be reflected in published state and local tax collection data (*Display 4*). As the display shows, these two data series usually follow similar paths.

How Are Local Governments Managing?

Local governments face somewhat different challenges, as their primary source of revenue is property taxes. Despite the fact that the financial crisis was associated with sharply dropping home values, property tax revenues have generally remained stable (*Display 5*). There is a good reason for this: In order to maintain a stable revenue flow, property taxes are typically structured to move much more slowly than housing prices.

In New York City, for example, property values are assessed every year, but the increase on houses is limited to no more than 6% per year and 20% over any five-year period. Increases in the assessed value of office and apartment buildings, condominiums, and co-ops are phased in over a five-year period. From a tax perspective, this smooths out the impact of sharp changes in property values, which makes it far easier to forecast annual tax collections. In Virginia, properties are assessed annually, and rates are set to a level that will essentially balance the local government's budget. In California, due to Proposition 13, assessments on a property can generally rise only up to 2% per year. Yes, property taxes can and do rise faster when housing prices and construction are climbing, because sales "reset" the level. But given the restrictions on annual assessed value increases, the assessed value of much of the housing stock is well below its market value—even with the drop in property values. So the tax payments of many homeowners don't drop despite declines in their property values.

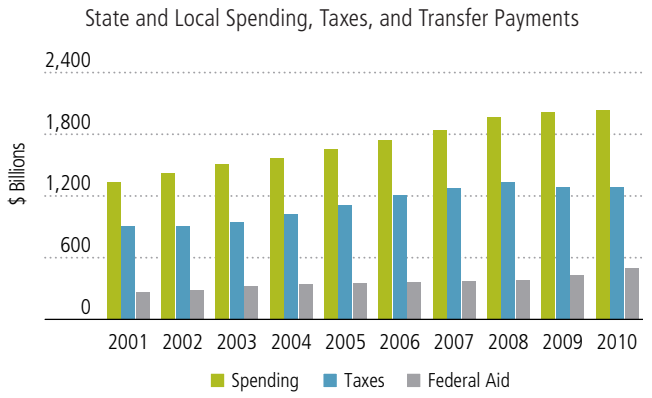
The biggest financial challenge for local governments is the fact that the financial support they historically have gotten from their states is likely to be cut.

Tough Choices Ahead

So if revenues have stabilized, why are state and local governments still struggling to balance their budgets? *Display 6, following page,* provides part of the answer. From fiscal years 2001 through 2008, tax revenues, federal aid, and spending for state and local governments all grew at the same steady pace, an annual rate of about 5.6%. But since then, tax revenues have *declined* at an annual rate of about 2%, while spending has *grown* by about 1.7%. This is the gap that must be closed.

Display 6

Municipal Tax Revenues Have Declined While Spending Has Risen



Source: US Bureau of Economic Analysis and AllianceBernstein

To help, the federal government allocated an additional $177 billion in aid to state and local governments as part of its $789 billion stimulus package. With the stimulus package, federal aid has grown by an annual average rate of 13.5% over the last two years. However, the stimulus aid will end in fiscal year 2011, leaving an additional small hole in the budgets of states and local governments. In fiscal year 2012, when all the stimulus money has been spent, states and localities will face a far more difficult challenge.

Even so, we conservatively estimate that on average the shortfall in fiscal year 2012 will be about 4% to 5%, which is clearly manageable, although difficult choices will have to be made. For this reason we don't foresee widespread defaults or bankruptcies. However, some states and localities will have shortfalls far above the overall average and will have to aggressively employ available gap-closing options. These include raising taxes or fees, cutting spending, sales of assets, and deficit financing. But it is important to note that the larger issuers—the type we normally invest in—have the resources to solve their financial problems and a powerful incentive to avoid defaults so as to maintain access to the public credit markets. What they will need, however, is the political will to do it.

Let's take a dive into the nitty-gritty world of state budgets for examples of how this is being accomplished today and the types of actions we expect to see more of in the next few years.

How Budgets Are Being "Balanced"

The administration of states and localities is more of an art than a science, and some are clearly better at it than others. Some are able to make sound decisions and implement them quickly and efficiently. Others muddle along, and still others make a series of poor choices that may affect their bond rating but still allow for the payment of all debt obligations.

Virginia is an example of a state making good choices; it typically passes balanced biennial budgets on time and frequently makes necessary midyear adjustments. The current budget includes pay freezes for state employees, employee furloughs, and cuts to local governments, including school districts. However, even Virginia used some onetime solutions, such as deferring a portion of its annual pension contributions.

Oregon focused on the revenue side of the equation and approved a package of corporate tax hikes and an increase in the state's top individual income tax rate from 9% to 11% to help balance the budget.

Arizona is facing serious financial problems, but in addition to cost cutting, the state is using a wide range of measures to raise revenues. In May, voters approved a three-year sales tax increase that provided an additional $1 billion per year in revenue. The state also raised $1 billion by selling state buildings and leasing them back. This provides substantial revenues to help balance the budget today, but at the expense of future lease costs; in some ways this can be compared to the issuance of bonds to pay for operating expenditures. In fact, the state did some of that as well when it recently sold bonds backed by future lottery revenues and used all of the proceeds to fill part of the current year gap. Deficit financing is a reasonable short-term approach to get over a rough patch, but if such methods are abused, serious problems loom down the road.

New York is an example of a state making very poor decisions: The state recently announced that its shortfall may be $1 billion more than the $9.2 billion already estimated. The New York State Legislature has been called the "most dysfunctional legislature in America." Its inability to adopt a budget—already now more than two months overdue—is evidence that it deserves that dubious distinction. At the moment, it appears

that the only way the governor can get the legislature to cut spending is by threatening to shut down the state government. In our view, New York has the wherewithal to solve its budget problems through spending cuts, taxes, or both, but so far it has not shown the willingness to take these painful measures.

While the choices will be difficult and the political battles fierce, we believe the vast majority of municipalities will ultimately make the hard choices to balance their budgets.

Municipalities Rarely Default

There are almost 90,000 units of local government in the United States. With such a large number, there are always some in financial trouble, even in good economic times. What is comforting, however, is how few actually miss payments of interest or principal.

According to Moody's, from 1970-2009, the cumulative 10-year default rate for municipal bonds has been only 0.1%. Compare that to the 11.1% rate for corporate bonds. Why is the municipal default rate so much lower? Because, unlike companies, which can just pack up, municipalities can't disappear. They have to continue to provide police, fire, and sanitation services. In addition, they need access to the public credit markets for capital and cash flow purposes. If they default, they'll lose that access. Many believe we're in uncharted territory today, but municipalities have faced both good and bad business cycles over the last 40 years.

Going back further, our analysis shows that even during the Great Depression, municipalities maintained a remarkable record of paying their debt. In 1935, the worst year for defaults during that period, only 1.8% were in default. By 1937 practically all the defaults by larger issuers had been cured, and the average default recovery rate was a remarkable 97%.

Today, a very small group of municipal issuers have filed, or may file, for bankruptcy. Four that have had a certain amount of press are Harrisburg, Pennsylvania; the Las Vegas Monorail Company; the Sierra Kings Health District in Reedley, California; and Vallejo, California. In addition, Jefferson County in Alabama and Detroit, Michigan, have gotten attention. Most recently, the smallest and poorest city in Rhode Island—Central Falls—entered receivership, which can be viewed as a precursor to bankruptcy. In aggregate, the debt of these issuers represents only 0.3% of municipal debt outstanding. It's important to note that the problems of each of these issuers existed prior to the start of this recession and were identifiable by municipal credit research.

Given the severity of the recent recession, the low number of defaults and bankruptcy filings among municipal issuers is a testament to just how stable the municipal bond market really has been. This should not be a surprise: Most municipalities manage their budgets in a responsible way.

Part 2: Municipal Debt Burdens

On top of their budget troubles, have state and local governments been on a borrowing binge? Are they now overleveraged? Claims that California is the next "Greece" and that municipal bonds will be the next debt meltdown can be found in the media almost daily. However, these warnings demonstrate a fundamental misunderstanding of municipal finance in the US and what has been the actual trend of state and local governmental borrowing.

Reports of Growth in Municipal Debt Are Overblown

The fact that the volume of outstanding municipal debt has doubled over the last 10 years and has outpaced economic growth is, at first glance, alarming. Viewed from a longer-term perspective, however, the amount of state and local government debt is within its historical range as a percent of GDP (*Display 7*). From this vantage point, state and local governments' debt burdens are not out of proportion, although they are at the high end of their usual range. Furthermore, the debt burdens of those states most often cited as suffering from the worst fiscal problems don't begin to come close to that of Greece (*Display 8*). But with all the turbulence in the financial markets over the last few years, historical comparisons bring little solace to most investors. So let's address the question on the minds of many: Can state and local governments afford the debt they have issued?

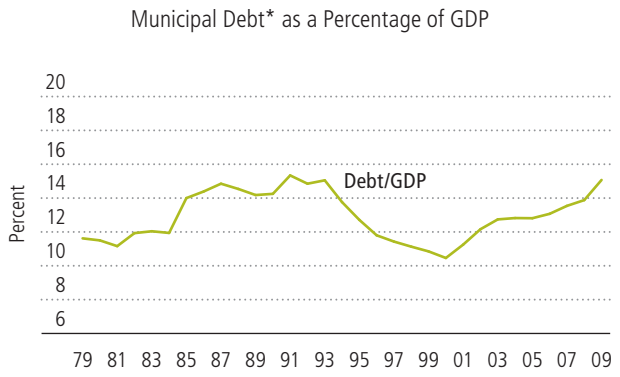
Debt Burdens Are Manageable

Ultimately, municipal issuers' solvency will depend on both their ability and willingness to pay debt service. Fortunately, debt service generally represents a small portion of issuers' budgets, and the debt has long-dated maturities; among the largest states, for example, debt service represents only 5% of annual spending on average (*Display 9, following page*). Furthermore, most of this is infrastructure debt, not debt being paid on money borrowed to support basic operations.

In an era of "shared sacrifice," some critics claim that municipalities will simply stop paying their debt. The argument makes no sense. Not only is debt service a small part of budgets on average, but governments have a critical need to safeguard their access to capital. If they fail to pay bondholders, they are likely to be shut out of the credit markets—or at best will have to pay a substantial penalty in the cost of capital. New York City learned this painful lesson in the 1970s: The city defaulted and for a time lost all access to long- and short-term debt markets; it paid dearly in the subsequent years in the form of a deteriorating infrastructure.

Display 7

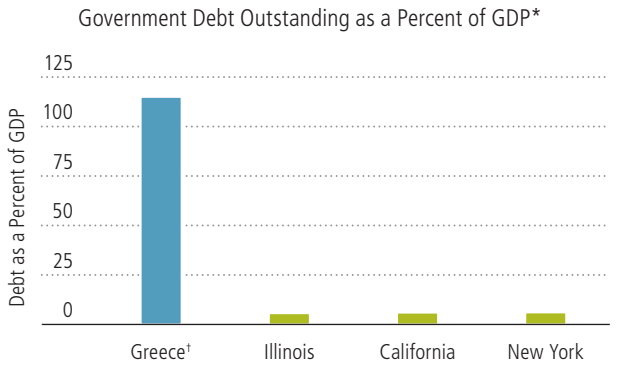
Municipal Debt Remains at Manageable Levels



**Municipal debt does not include prerefunded, nonprofit, or industrial development bonds.*
Source: Federal Reserve Flow of Funds Accounts and US Treasury Department

Display 8

States Have a Much Lower Debt Burden than Greece



Ratios are for net tax supported debt.
**GDP for states is actually personal income, a close proxy for GDP.*
†2009 GDP in Greece was calculated by using an average 2009 exchange rate of $1.393/euro.
Source: Bureau of Economic Analysis, Eurostat, Hellenic Republic Ministry of Economy and Finance, state financial reports, and AllianceBernstein

Municipalities Issue Primarily Infrastructure Debt

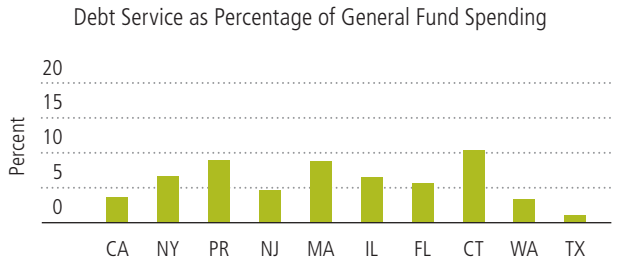
Municipal bonds are issued primarily for infrastructure projects such as the construction of new bridges, courthouses, schools, or roads. In moderate doses this debt is productive, as these are assets that have a long, useful life, increase a city's or state's appeal, and add value to the economy in the form of jobs. Such debt typically matures at regular intervals over the life of a project. *Display 10, top,* shows that the percent of maturing debt in the municipal bond market by year is essentially level. In effect, principal is being repaid like a home mortgage, whereas many forms of corporate or sovereign debt (think Greece) are fundamentally different. States do not roll over their debt. Rather, debt is retired using revenues, not new borrowing. So, unlike Greece, municipal issuers are not faced with a wave of maturing debt requiring refinancing, and therefore, the chances of a widespread liquidity crisis due to maturing debt are remote. Compare this to US Treasury debt, where over 80% matures within seven years (*Display 10, bottom*).

State and Local Governments Do Little Deficit Financing

State and local governments are almost universally required to pass balanced budgets—a particularly difficult task today (see "Part 1: Municipal Budget Shortfalls"). Over the past three years, the worst recession in several generations, along with slower-than-expected revenue growth and/or higher-than-expected expenses, created significant budget gaps. But even in the face of the Great Recession, the total shortfall in state and local government finances last year amounted to only $44 billion—which may seem like a lot, but represents only 1.6% of total municipal debt outstanding. Most state and local government officials save in good economic times and spend down those savings in poor ones (*Display 11, following page*). Today, struggling to adjust to this new environment and balance their budgets, they have used up their "rainy day fund" savings. But history has shown that state and local governments will adapt to slower growth and bring their spending in line with their revenues. When the economy stabilizes and growth resumes, they will retire any deficits and

Display 9

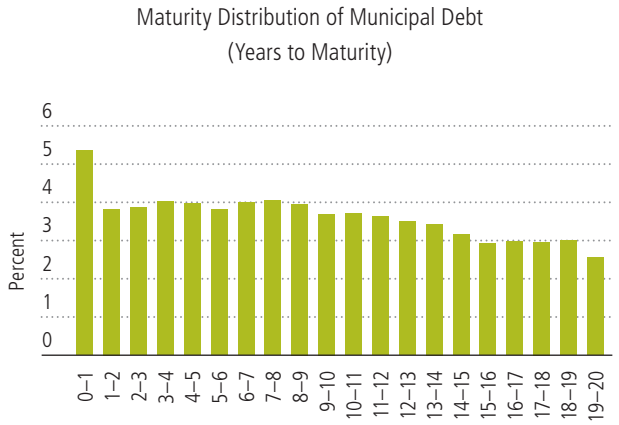
Debt Service Costs Are a Small Part of State Budgets



Source: US Census Bureau and AllianceBernstein

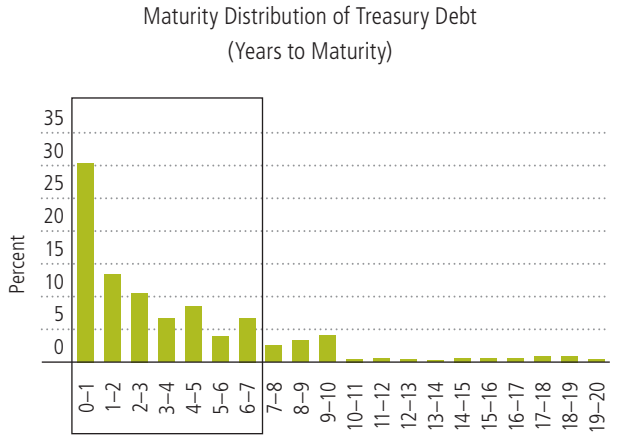
Display 10

Municipal Debt Is Spread Out Across the Maturity Spectrum…



Source: Barclays Capital, Federal Reserve Flow of Funds Accounts, and AllianceBernstein

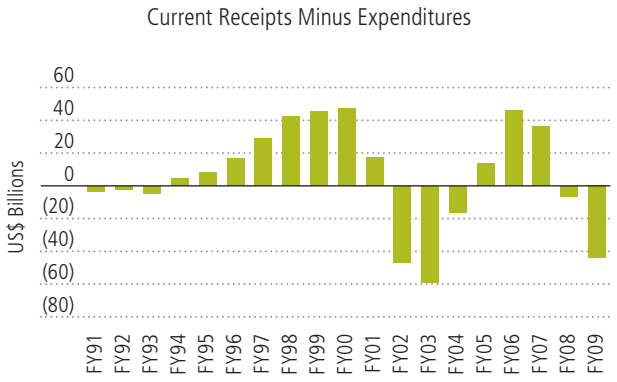
…While US Treasury Debt Is Primarily Short-Term



Marketable securities only
Source: US Treasury Department and AllianceBernstein

Display 11

Net State and Local Government Savings



Historical analysis does not guarantee future results.
Source: Bureau of Economic Analysis and AllianceBernstein

replenish their rainy day funds. This pattern, coupled with the reluctance of state and local governments to put downward pressure on their credit ratings, means that the amount of municipal debt issued to finance deficits has historically been limited to a very small proportion of total debt outstanding. Recent examples of deficit financing include California's Proposition 1A bonds and Arizona's Lottery Revenue bonds. In both cases, these bonds were part of a larger financial deficit reduction program and marked an *exception* in municipal finance, *not a rule*.

Could a Liquidity Crisis Happen? Yes, but It Doesn't Necessarily Mean Default

Manageable debt service and limited refinancing needs suggest there is very little chance of a widespread liquidity crisis in the municipal market. Unfortunately, that doesn't preclude some municipal issuers that have been poorly managed from being shut out of the credit markets. A liquidity crisis can strike when an issuer loses creditability, and that can occur even with a small amount of debt outstanding.

Let's take a look at one seriously challenged state: Illinois is an issuer that needs to sell notes and bonds to pay its bills this year. Due to a lack of political will to balance its budget, the state has accumulated a deficit of about $6 billion, which is about a quarter of its annual budget. Illinois has the resources to solve its financial problems, but with elections coming this November, the political will to raise taxes and cut expenses is what's lacking. Instead, it hopes to generate needed cash through the sale of $1.3 billion in cash-flow notes, $1.2 billion in bonds secured by future tobacco settlement payments, and long-term pension bonds, which it will use in lieu of paying cash into its woefully underfunded pension fund. The big question is whether investors will refuse to lend Illinois money this summer and thereby trigger a liquidity event. Currently, it appears investors will buy the state's bonds, but the eroding price of those bonds is also eroding investor confidence.

Even if Illinois were to experience a liquidity event, default isn't inevitable, since general obligation debt payments take precedence over other expenditures, just as they do in most other states. If there are insufficient funds in the state's general obligation bond retirement and interest fund to pay debt service, there is a statutory, irrevocable, and continuing appropriation of all amounts necessary to make debt payments. Accordingly, bondholders would get paid, while many state authorities and local governments would have to wait in line.

Our Portfolios: The Importance of Research

Because local governments will receive even less money from states this year, local governments and smaller issuers overall may find themselves in the most trouble. Among the approximately 65,000 issuers in the municipal market, there is a core group of about 3,000 issuers that encompasses states, large local governments, and large issuers of essential purpose revenue bonds. For the most part, Bernstein selects bonds from this core group of issuers; these have good financial disclosure practices, allowing us to thoroughly vet their financial operations.

Although the amount of outstanding municipal debt has grown overall, growth has been in line with that of personal income. Given that debt service represents just 5% of the budgets of the largest states on average—a reasonable percentage relative to history—and that most municipal debt is infrastructure debt that will improve the health of state and local governments over time, we think municipal debt is manageable. We also believe that the media has inaccurately portrayed the debt position of most units of government.

Part 3: Municipal Pension Obligations

Investors today are worried that underfunded pension plans of some states will require such a ramp-up in pension contributions that states will face difficult choices: They will have to either raise taxes or cut spending dramatically—or default on their obligations to retired employees and bondholders. A number of recent studies have reported that the retirement-benefits shortfall is in the trillions of dollars, although the numbers floated have varied widely. Yes, unfunded pensions are a formidable problem that must be addressed, and there is no simple fix. Fortunately, the projected shortfalls span a period of more than 30 years; even under conservative assumptions, most states' pension assets are currently sufficient to meet obligations for at least a decade. Some states are in a much better position than others, but even those in the worst straits have the capacity to meet their challenges, provided they take action in the near term. But no solution will be easy, because difficult decisions about increasing revenues, lowering expenses, and/or reducing retirement benefits will be required. States are taking concrete steps now to manage their pension obligations, including increasing employee contributions to the plan, raising retirement ages, and increasing vesting requirements.

What Is an Unfunded Pension Liability?

In a defined-benefit pension plan, a state government promises that when a worker retires, the state will make benefit payments tied to the employee's age, tenure, and late-career salary. To prepare for this, states typically contribute to and oversee their own pension funds, pools of money dedicated to providing retirement benefits to state workers. A pension fund that is 100% funded has enough assets to meet the benefits of workers as they retire, as long as the markets return what the fund's managers have built into its underlying assumptions. If a plan is underfunded or has a shortfall, it is deemed to have insufficient assets to meet its future obligations. For example, a plan that is 50% funded is likely to run out of money to pay retirees, absent corrective actions.

Long-Term Nature of Pension Obligations Provides Window of Opportunity

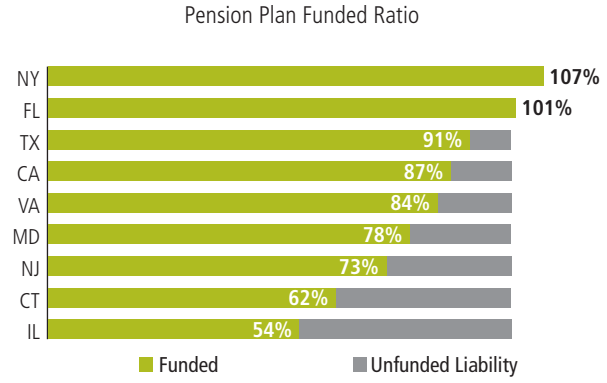
Actuaries and academics are locked in a policy debate about what the correct expected investment rates are; over the long term, funds have returned 8%, but expecting funds to bring in that sort of return today and into the future may be optimistic. Depending on the rates used and because of the long-term nature of the liabilities, estimates for expected shortfalls can vary widely. Regardless of whether pension liabilities are actually $400 billion, $1 trillion, or $2 trillion, any of these amounts looks big in a headline. But let's put it in context: $1 trillion represents 57% of state expenditures today. News headlines announcing "Pension Liabilities Consume More than Half of State Budgets" fail to take into account the important fact that pensions, like debt, are paid over long periods, often 30 years or more. So the total liability (which is based on actuarial assumptions) is less important than the states' ability to produce sufficient cash flows to make payments to fund future liabilities.

Funded Ratios Have Been Hit by Market Losses

A state is acting responsibly with regard to funding its pension commitments if it has established an actuarially sound funding plan and sticks to it. Funding

Display 12

Some States Have Seriously Underfunded Pension Plans



Funded ratios as of the end of fiscal year 2008
Source: The Pew Center on the States and AllianceBernstein

efforts thus are typically assessed in two ways—by the ratio of assets to liabilities (with an 80% funding level considered typical today) and by whether or not the sponsor is paying 100% of the annual required contribution (ARC—which is determined by actuarial analysis). Disappointing investment returns over the past 10 years have made it difficult for state pension funds to maintain a funding ratio of 100%. *Display 12, previous page,* shows the pension plan funded ratio for a group of states. How responsible states have been varies tremendously. Incredibly, New York, whose legislature has been called one of the most dysfunctional in the country, is 107% funded, according to its actuaries. Illinois occupies the other end of the spectrum, with only a 54% funding level.

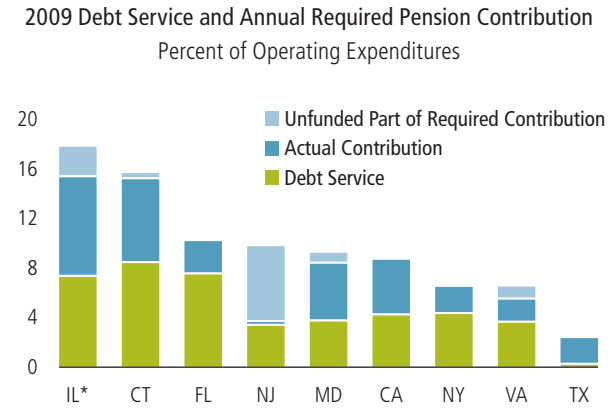
Many states have reduced or even eliminated their contributions during the current economic downturn to free up money for other necessities; as a result, the unpaid portion of the total ARC for some states is substantial. And when they fail to make these required contributions, their unfunded liability grows exponentially, leading to even larger required contributions ahead.

Systematically Incorporating Pension Obligations in Our Research

In analyzing municipal credit, we looked at the cost of debt service (since pension payments are only a portion of a state's total debt), as well as the amount paid into pension funds and the portion of the total ARC that wasn't paid, if any (*Display 13*). For many states, debt service plus ARC amounts to less than 10% of the annual budget, a manageable amount. Still, we recognize that some states are facing a far more urgent situation. In Illinois, for example, about 18% of the budget is earmarked for the combination of debt service and pension contributions. Such a large percentage tends to crowd out spending for other state expenditures like aid to education or park maintenance, presenting difficult choices for state officials. In fiscal 2010 Illinois had to resort to borrowing $3.4 billion to make its pension contribution, and it may resort to borrowing another $3.7 billion in fiscal 2011 for the same purpose. Connecticut also has very high liabilities but has made room in its budget to make nearly its full

Display 13

In Most Cases, Costs Are Manageable if States Take Action



**Illinois made its pension contribution but issued bonds to pay for it.*
Source: Pension plan comprehensive annual financial reports, state comprehensive annual financial reports, state offering statements, and AllianceBernstein

ARC. For years New Jersey has shortchanged its ARC payments, resulting in a growing unfunded pension liability and the specter of substantially larger required contributions in the future.

States Are Taking Corrective Actions

The questions we're asking regarding all municipal issuers that are underfunded are: 1) How big is the shortfall relative to their resources? and 2) How will the shortfall be remedied? Although tax increases and expense cuts will likely be part of the solution, states can also make changes in their pension plans now that will greatly affect payouts down the road (*Display 14, following page*). Growing voter dissatisfaction with overly generous public-sector benefits has encouraged some states to take steps to reduce their future payments, and we expect others to follow. In certain states, like Illinois, the legislature made adjustments despite vehement union opposition. And in California, the governor and the state's largest labor union reached a tentative labor agreement that raises the employee pension contributions, extracts one day of unpaid leave per month (effectively a 5% cut in pay), and rolls back pension benefits to pre-1999 levels for new hires. This is the seventh union to agree to concessions, and it brings the total number of state workers covered under new agreements to more than half of the state workforce.

Other states have increased employee contributions to their plan, raised the retirement age, and increased vesting requirements. In 2010, five state legislatures passed benefit reductions or increased employee contributions; 10 other states did both. For example, New York created a fifth pension tier for new employees that requires them to contribute 3% of their annual compensation to fund their pension, and the state also extended the retirement age. It is estimated that this change will save New York $48 billion over the next 30 years. While altering new-hire retirement benefits doesn't reduce current benefit payments, the adjustments do have a small but immediate effect on the overall pension liability. This in turn reduces the contribution the state is required to make to the pension fund. As employees under the new benefit structure make up more and more of the workforce, these savings will grow. Of course, given that most of the plans in place for current workers have legal protection, states will have to work through the "bulge" of existing participants until the employees under newer, less expensive plans make up a greater part of the state's public-sector workforce.

Some states have even begun reducing the current levels of benefits, which in turn reduces the size of the "bulge" of the workers associated with the older plans. Notably, Colorado and Minnesota have passed changes to cost-of-living adjustments (COLA) for current retirees; these actions are currently being litigated. Other states are closely monitoring these developments, as changes to current benefits were considered untouchable until recently. Should the courts uphold the COLA limits, it's likely that other states will follow suit.

In addition, many states have pushed for a switch to defined contribution plans to achieve cost savings. As of November 2009, only 14 states offered a defined contribution or hybrid plan, with only four offering just a defined contribution plan. In 2010 Utah passed legislation that will close the defined benefit plan to new employees; instead, they can choose either a defined contribution plan or a hybrid plan. Clearly, moving to a defined contribution plan quickly and dramatically reduces retirement costs—and we may see more states shift toward such plans.

Display 14

Solving the Pension Problem Will Require Difficult Trade-Offs

Goal	Action
Make Required Contributions	▪ Raise Taxes ▪ Cut Spending
Retain Flexibility	▪ Underfund when times are tough and overfund when times are good
Reduce Retirement Benefits	▪ Require employee contributions ▪ Eliminate cost-of-living increases
Improve Investment Returns	▪ Take more risk?
Stop the Bleeding	▪ Establish defined contribution plan for new employees

We Are Monitoring States' Progress

Our analysis indicates that the vast majority of states' pension funds will remain healthy long enough for them to make the necessary adjustments. We are continually assessing states' plans and incorporating into our analysis any changes being made to improve plan longevity. And we are carefully monitoring the few states that our models have identified as weaker than average and that have not yet made adjustments to their plan or contribution strategy. If a state shows pronounced weakness, we will avoid its bonds.

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