U.S. Local Government Downgrades to Persist

Property Taxes and Labor Key Drivers
Special Report

Continued Stress for Many Local Governments: Fitch Ratings expects the acute fiscal stress currently facing many municipalities to continue. Although the large majority of municipal ratings are expected to be maintained over the near to medium term, downgrades will likely outpace upgrades by a wide margin. Of 2012 year-to-date rating actions through July, 12% of local government tax-supported rating actions were downgrades, while upgrades were a scarce 2%. Fitch anticipates an increase in defaults and bankruptcies, although it does not expect them to be widespread.

Willingness to Pay Questioned: The heightened discussions regarding municipal bankruptcy and default and the recent actions of a few California cities raise the question of whether stressed municipalities' willingness to pay bondholders is eroding. Actions of this type on a broader scale would represent a marked departure from most municipal governments' long-demonstrated willingness to avoid default and bankruptcy. Over the past year, seven local U.S. governments have filed for bankruptcy, out of an estimated 52,000 U.S. municipalities and school districts.

Bankruptcy Talk Has Consequences: Fitch has long stated it takes discussions by city officials of bankruptcy or default seriously, immediately triggering an examination of whether the rating accurately reflects the level of financial stress implied by such discussions and whether bankruptcy or default is a serious consideration. If the latter is the case, negative rating action will result. Recent examples include Fitch's downgrades of Detroit, MI and Howell Township, MI.

Labor Expenses Key to Financial Flexibility: The ability to manage labor costs is often crucial to maintaining credit stability, with total labor-related compensation generally accounting for about two-thirds of municipal budgets. Labor environments tend to vary widely by state as, for example, there are 23 states in the U.S. that do not require employees to join and pay dues to established unions as a condition of employment (right-to-work states). Fitch is particularly concerned where inflexible labor contracts with onerous provisions, or external arbiters, severely impede fiscal adjustments.

State Intervention Varies and Can Affect Outcomes: States with effective fiscal intervention mechanisms to address distressed local governments can help stabilize finances and limit credit deterioration. These mechanisms can assist where local decision makers have been unable or unwilling to take difficult spending and revenue actions and where refinancing options are limited. State intervention programs vary from very strong (e.g. North Carolina and Michigan) to very weak or non-existent (e.g. California and Alabama).

Problems Not Limited to California: The recent bankruptcy filings in California reflect one of the more difficult local government fiscal environments in the U.S. California was among the hardest hit states from the real estate crash. Yet due to Proposition 13 and other initiatives, the ability of California municipalities to increase tax revenue is among the most constrained in the nation. Fitch expects fiscal crises are more likely in states that, like California, lack flexibility on both revenue-raising and spending control.

Related Research

The Perils of Considering Municipal Bankruptcy, Jan. 27, 2010

Local Fiscal Stress and State Intervention, June 5, 2012

Fitch: Credit Impact of Labor Changes is Greater for Local U.S. Governments than States, March 21, 2011

Analysts

Dan Champeau
+1 212 908-9188
daniel.champeau@fitchratings.com

Amy Laskey
+1 212 908-0568
amy.laskey@fitchratings.com

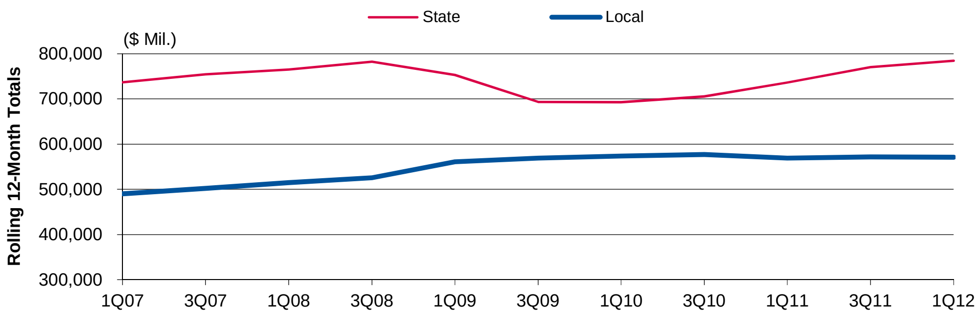
Richard Raphael
+1 212 908-0506
richard.raphael@fitchratings.com

Vincent Barberio
+1 212 908-0505
vincent.barberio@fitchratings.com

Continued Stress for Many Local Governments

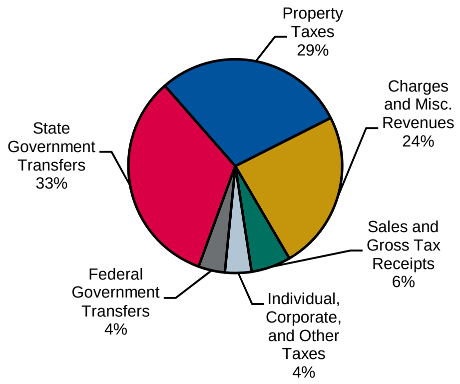
State governments typically have revenue sources that are economically sensitive. In contrast, local governments are more reliant on property taxes, which are linked, on a lagged basis given the assessment process, to real estate values that are slower to recover than the underlying economy. This is clearly demonstrated in the Bureau of the Census data that show state government revenues falling more sharply in the downturn but recovering more quickly than local government revenues. In fact, local government revenues have continued to decline as the real estate markets on which they are dependent struggle to find the bottom.

Total Tax Revenue — State and Local



Declining AVs have reduced property tax revenues in many locations given the legal and practical constraints on raising tax rates. Fiscal 2013 property AV figures are being released and show a generally flat trend. Fitch's mortgage-backed securities group's most recent home price sustainability projection indicates that prices nationwide will decline another 8% before reaching a bottom in late 2013. A slow recovery is expected thereafter. Projections vary by state, from those that are deemed undervalued to those that remain up to 30% above sustainable levels (*see the state-by-state breakdown in the Sustainable Market Value Decline Projections table in Appendix B on page 9*). Therefore, Fitch does not generally expect to see much, if any, improvement in AV in the near future, although some locations will show stronger or weaker results.

Total Local Government Revenues By Source 2008–2009



Source: U.S. Census Bureau, 2009 Annual Surveys of State and Local Government Finances.

The sizable reductions in state funding to local governments abated in fiscal 2013, although Fitch believes potential federal cuts to states present a risk of further shifts from states to locals. School districts, counties, and cities that provide social services are the recipients of most state aid to local governments; therefore, they are most at risk of cuts.

Pension reform efforts that are being enacted in many states provide longer-term benefits to local participants, although most have little, if any, impact on near-term budgets. Despite these reforms, annual required contributions (ARCs) on an actuarial basis have been trending higher,

Related Criteria

Tax-Supported Rating Criteria, Aug. 14, 2012

U.S. Local Government Tax-Supported Rating Criteria, Aug. 14, 2012 in some cases dramatically, as investment returns have not kept pace with actuarially assumed rates. For example, the latest annual returns of the nation's two biggest public sector pension funds — the approximately $233 billion California Public Employees Retirement System (CalPERS) and the approximately $150 billion California State Teachers Retirement System (CalSTRS) pension funds — were 1% and 2%, respectively. Although it is noted that returns vary considerably from year to year, these returns are well below the funds' targeted returns.

Fitch considers underfunding pension contributions to be a nonrecurring budget-balancing measure that will increase long-term liabilities even if investment returns match somewhat optimistic expectations. Other post-employment benefits are an additional, although often lesser and more flexible, burden *(see Fitch Research "Improving Comparability of State Liabilities," dated March 18, 2012, available on Fitch's Web site at www.fitchratings.com).*

Reserve levels, which have been diminished in recent years, are still strong in many cases. Fitch believes use of reserves as an element of budget balance will continue but at a slower rate as local governments recognize they can no longer rely on reserves as a bridge to a more positive budgetary environment. Therefore, Fitch believes most local governments will continue to retain at least a moderate level of reserves. Diminished operating fund balances have led to an erosion of liquidity and an increased need for cash flow borrowing or other short-term measures to retain adequate liquidity.

Management's ability to anticipate and promptly address budget and liquidity shortfalls remains of the highest importance to credit quality. The emphasis in budget balancing from use of reserves to offset short-term revenue shortfalls to addressing long-term revenue weakness on a recurring structural basis is viewed positively. Management strength is enhanced by adherence to sound financial and debt policies despite the challenges involved.

Willingness to Pay Questioned

One of the municipal market's long-held fundamental credit strengths has been issuers' demonstrated willingness to repay their debts. For the most part, this still holds true as many municipalities have taken the difficult measures required to maintain fiscal solvency, avoid bankruptcy, and preserve bondholders' credit standing. In certain cases, bankruptcy filing has been averted when the state stepped in to provide assistance and oversight, often through fiscal control boards rather than increased funding. The historically low municipal bankruptcy and default rates have generally enabled broad and relatively inexpensive market access to the large number of local government borrowers. If recent actions by Stockton, San Bernardino, and Mammoth Lakes, CA lead to a lessening of the stigma associated with municipal bankruptcy and a meaningful increase in bankruptcies and defaults, investor sentiment and pricing will likely be impacted (particularly for similar types of issuers).

Bankruptcy compromises bondholder security. Therefore, the consideration of bankruptcy as a viable option for relief in itself calls into question the issuer's commitment to repaying debts. Fitch believes that the more bankruptcy is publicly discussed as an option for financial relief, the more its tarnish wears off, increasing the likelihood of its actual use.

Although each case is somewhat unique, municipalities may intend to use the threat of bankruptcy as the ultimate tool to gain concessions from labor and other strong constituencies, rather than to harm bondholders. Fitch believes this type of brinksmanship can escalate, forcing follow-through, and resulting in outcomes that were perhaps not originally intended. A bankruptcy filing may be used to prioritize and evaluate a large set of obligations, and even if rearranging labor agreements are the priority, bond payments can be collateral damage.

The cities of Stockton and San Bernardino, CA are seeking to solve their problems in part by defaulting on their obligations to bondholders and the financial guarantors backing the debt. Stockton's restructuring proposal does not include significant restructuring of existing labor contracts. San Bernardino has not yet submitted a proposal, but its interim emergency operating plan targets debt repayment rather than labor concessions for savings. While Vallejo also defaulted on bonded debt, it sought and obtained a court rejection of a labor contract and renegotiated existing labor contracts. In the case of Central Falls, Rhode Island, labor contracts were significantly restructured in bankruptcy, including pension benefits. Whether the more recent cases in California are ultimately successful remains to be seen, but they represent not only a very troubling departure from municipal governments' demonstrated willingness to avoid default on long-term bonded debt but also a specific targeting of bondholders.

Bankruptcy Talk Has Consequences

In the past year, seven local U.S. governments have filed for bankruptcy protection under Chapter 9 of the U.S. Bankruptcy Code. The cases arose in five different states, including three California cities in the recent past (Stockton, San Bernardino, and Mammoth Lakes, none of which are rated by Fitch). As a matter of perspective, there are roughly 52,000 municipalities and school districts in the U.S. and an estimated 55,000 U.S. municipal debt issuers.

Although it is reasonable to assume that elected officials will occasionally make informational inquiries about the bankruptcy code, such discussions will trigger an inquiry by Fitch. If bankruptcy is being actively considered, Fitch will almost certainly downgrade the entity's rating significantly. Consideration of bankruptcy not only indicates severe financial stress but also a willingness to, perhaps, compromise the credit standing of bondholders through a bankruptcy filing.

Fitch has long held that discussions of bankruptcy by city officials are to be taken seriously and at face value. Such bankruptcy deliberations may reflect a strategy to exact concessions from labor or other constituencies and not bondholders. Nevertheless, bankruptcy is a blunt instrument, and provisions of the code require that all creditors be treated equitably, bringing into question whether bondholders can be surgically isolated from the blanket diminishment of creditors in bankruptcy. While there are examples where the priority of GO bondholders was affirmed in bankruptcy based on a statutory lien, such as Central Falls, RI, such outcomes are far from assured. In many states, such as California, unsecured general fund debt, and not GO debt secured by specific and unlimited property tax levies, dominates municipal debt structures, which are exposed in Chapter 9 bankruptcy.

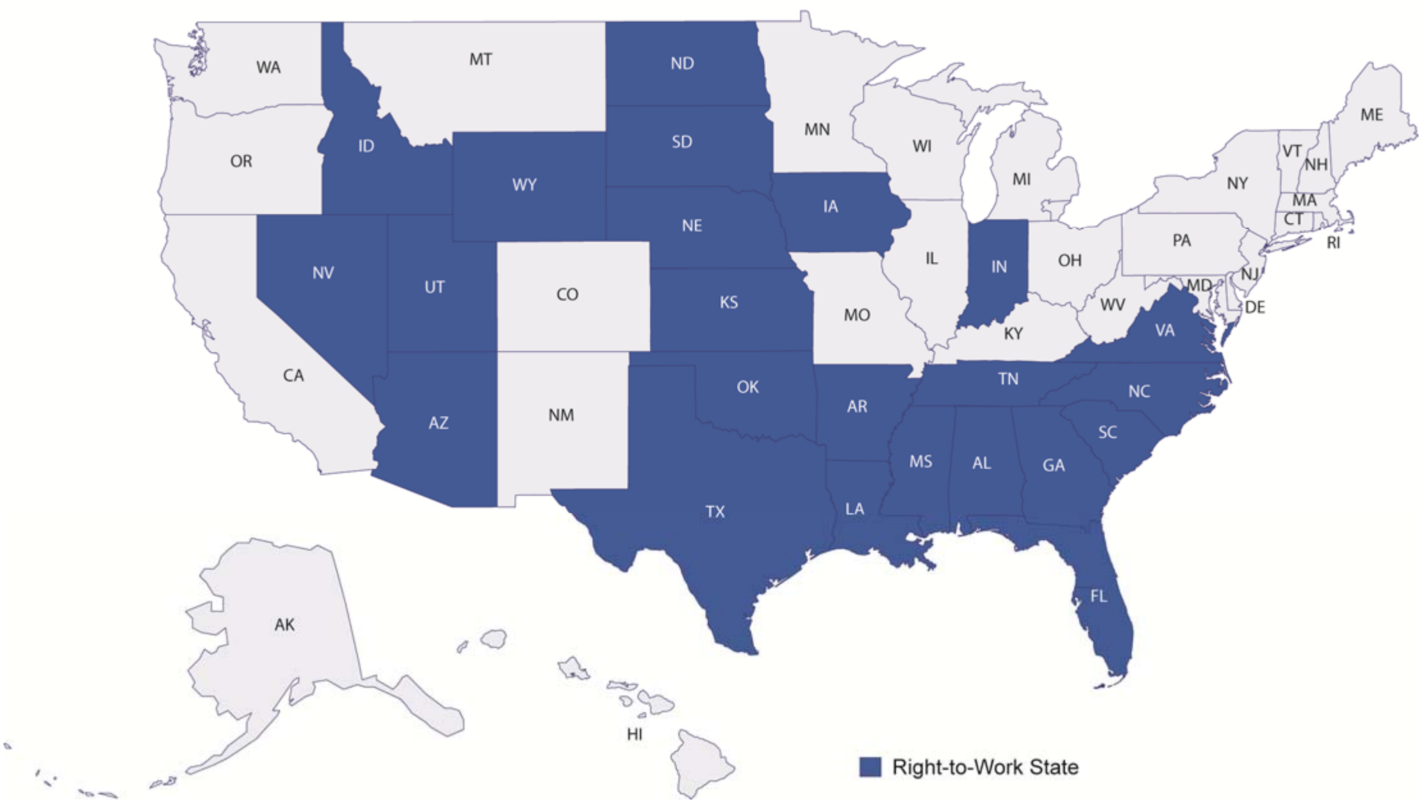
Labor Concessions Key to Flexibility

It has always been a tenet of municipal credit that at some point paying debt service may come in conflict with, and be superseded by, a government's obligation to provide essential services such as education, public health, and safety. Many local governments have experienced fairly steep revenue losses during this downturn, and the growth outlook now is for flat to slow tax base growth for the next couple of years and a restricted tax-raising environment given the strong anti-tax climate. Yet persistent growth in fixed costs such as pensions and healthcare is causing a reexamination by state and local governments of just what services are affordable in this environment. Service reductions accompanied by layoffs have been implemented on a broad scale in recent years, particularly in those jurisdictions most affected by the housing market crash. However, at some point a legal and/or practical limit to service reductions is reached.

Local government is labor intensive. Fitch estimates that employee compensation, including salary, wages, and benefits, typically makes up about two-thirds of local government budgets and in some cases can be as high as 70%–80%. Therefore, in this limited revenue environment, achieving labor compensation savings is essential in order to avoid severe service reductions and achieve affordable government and sustainable cost growth. In fact, where the legal capacity to raise taxes exists but the current climate politically precludes it, tax raising will likely not become a practical alternative until constituents believe the limits of service reductions have been reached and all has been done to maximize labor productivity. Where legal limits to raising taxes are included in state statutes or constitutions, achieving labor savings is even more paramount to maintaining financial solvency.

The ability to effect labor cost savings varies widely, hinging on state and local labor laws governing labor contracts, including the right to collectively bargain, compulsory binding arbitration, applicable case law, and contract requirements regarding staffing, salary, and wage levels. In states that do not have so-called right to work laws, particularly in the Northeast and Midwest and on the West Coast, leverage over labor can be more limited. See below for a map illustrating right to work states.

Right-to-Work States



Cooperative interaction between labor and management takes on more importance, but ultimately local government leverage and the ability to achieve outcomes is more restricted. Where cooperation fails, the political will of local and state governments to confront the labor environment takes on more significance *(see Fitch Research on "Fitch: Credit Impact of Labor Changes is Greater for Local U.S. Governments than States," dated March 21, 2011, available on Fitch's Web site at www.fitchratings.com)*.

As the need for sizable expense cuts increases, Fitch has sharpened its focus on labor-related issues. Fitch reviews staffing and service level trends, particularly in public safety and local education. Discussions with government officials center on annual compensation trends and labor concessions (whether in the context of collective bargaining or otherwise) as a credible indication of cooperation and shared sacrifice. Of major concern are entities locked into multiyear contracts with scheduled compensation increases and no salary reopeners. In some cases, past concessions came at the steep price of contract extensions that ramped up compensation increases and no layoff clauses, which can lead to even more inflexibility.

Where these dynamics affect the ability of governments to effectively manage resources, ratings have and will continue to be negatively affected, in some cases significantly. If collective bargaining agreements have expired, control over compensation and other contract terms may be impeded by collective bargaining mandates, including binding arbitration. Arbitration awards can pose a severe challenge to a government's financial security, particularly if they involve unbudgeted retroactive payments.

State Intervention Varies and Can Affect Outcomes

The powers of financial intervention vary by state and will be affected by the strength of laws governing labor contracts, benefits (including pension obligations), and service provisions, as previously discussed. These laws can reduce the impact of all but the most powerful control mechanisms, although the specter of a state takeover of a local government's operation can provide incentive to local stakeholders to make decisions that will pre-empt such events. Even with these limitations, the powers of state control boards can be quite effective in enforcing measures to halt or reverse financial deterioration. The absence of state involvement, or actions by a state that exacerbate local government distress, such as with Jefferson County, AL, can be a rating negative.

North Carolina has one of the nation's strongest mechanisms. The state local government commission monitors local entities' finances on an ongoing basis and intervenes once it has detected a deteriorating situation. The intent of this system is to avoid, rather than remediate, a crisis. Pennsylvania's Act 47 provides limited state oversight to distressed local governments. While a number of Pennsylvania cities have been under state supervision for many years, it is possible that matters would have been more severe absent such actions taken by the state.

In Connecticut and New York, the state can pass special legislation to deal with a specific distressed municipality. Such legislation has included debt refinancing vehicles and the creation of control boards with approval powers over budgets and financial plans and varying authority over labor agreements. Rhode Island may appoint a fiscal overseer to develop a three-year plan to achieve fiscal stability; if this is ineffective, the state may appoint a budget commission with powers over spending, borrowing, fees, and government structure. Additionally, the governor and treasurer led the legislative effort to enact a statutory lien on local GO debt, establishing its primacy over other obligations, including pensions, in the case of the Central Falls bankruptcy.

Michigan recently instituted Public Act 4, which Fitch views as perhaps the strongest program in the nation, as it allows a state-appointed emergency manager to "reject, modify, or terminate terms and conditions of an existing contract." However, an initiative to repeal it is on the November ballot.

Problems Not Limited to California

The recent Chapter 9 bankruptcy filings in California reflect perhaps the most difficult local government fiscal environment in the U.S. Some of the metropolitan areas hit hardest by the housing bust are located in California, particularly in the inland cities and the far-flung reaches of Los Angeles and San Francisco. In California, the resulting declines in AVs of real property cannot be offset with property tax rate increases, as generally can be done in other hard-hit states such as Florida, due to limitations imposed by Proposition 13. Other limitations from past initiatives also reduce municipal flexibility, including limitations on raising taxes or user charges.

Additionally, sales taxes, another major revenue source for cities, have been affected in a number of hard-hit areas. California city budgets, backed by a less stable revenue system, are dominated by essential public safety spending, with labor compensation costs in some cases exceeding 80% of spending.

Yet the pro-labor culture prevails strongly in California, with strong unions and collective bargaining history making it difficult to achieve significant labor cost adjustments. While AB 506 was intended to slow down the bankruptcy filing process, it has effectively provided a negotiating period, as revealed in the Stockton case, for cities to leverage and seek to exact concessions from creditors. To date, it does not appear to have reduced the likelihood of bond default or municipal bankruptcy.

Appendix A

Total Local Government Revenues By Source 2008–2009

(%)

	Property Taxes	State Government Transfers	Charges and Miscellaneous Revenues	Sales and Gross Receipts Taxes	Individual, Corporate, and Other Taxes	Federal Government Transfers
Connecticut	58	30	9	0	1	3
New Hampshire	56	28	13	0	1	3
Rhode Island	54	27	14	0	1	4
New Jersey	52	28	17	0	1	2
Maine	47	31	18	0	0	3
Massachusetts	44	35	14	1	1	6
Illinois	43	32	10	7	2	6
Hawaii	43	9	29	7	5	8
Wisconsin	38	42	16	2	1	2
Virginia	35	33	17	8	4	3
Texas	34	26	28	7	1	4
Michigan	33	48	12	1	2	4
Florida	32	21	35	5	2	4
North Dakota	32	31	25	5	1	6
South Dakota	31	24	28	10	1	6
Montana	30	35	28	0	1	7
New York	29	35	10	10	12	4
Kansas	29	31	30	7	1	2
Iowa	28	31	30	6	1	4
Pennsylvania	28	38	17	1	10	5
Maryland	28	34	8	2	23	5
Missouri	27	27	26	12	5	4
Colorado	26	22	31	14	2	4
Alaska	26	34	26	7	1	7
Indiana	26	33	33	0	6	2
Oregon	26	32	30	2	4	6
Georgia	26	26	33	12	1	3
West Virginia	26	40	24	2	4	4
Nebraska	25	19	47	4	3	2
Ohio	25	36	23	4	9	4
South Carolina	25	28	39	3	3	2
California	24	42	21	6	2	4
Minnesota	24	39	32	1	1	3
Nevada	23	31	33	6	2	5
Idaho	23	38	36	0	1	2
Arizona	22	31	31	10	2	4
Utah	22	29	36	8	1	4
Delaware	21	42	29	0	5	2
Wyoming	21	39	31	6	1	3
North Carolina	20	31	36	7	1	6
Mississippi	20	37	37	1	1	4
District of Columbia	19	0	12	14	20	36
Oklahoma	18	33	31	14	1	3
Kentucky	17	33	34	4	9	4
Washington	17	28	39	9	2	4
Tennessee	17	21	50	8	1	2
Vermont	15	62	19	1	0	3
Louisiana	15	31	27	20	1	6
New Mexico	14	49	20	11	1	5
Alabama	11	31	38	11	5	5
Arkansas	10	51	23	13	0	3

Source: U.S. Census Bureau, 2009 Annual Surveys of State and Local Government Finances.

Appendix B

Sustainable Market Value Decline Projections

(%)

	2006	2008	2010	Current
AK	20–25	15–20	10–15	10–15
AL	15–20	10–15	10–15	5–10
AR	15–20	5–10	5–10	Sustainable
AZ	>30	20–25	Sustainable	Undervalued
CA	>30	20–25	15–20	5–10
CO	>30	20–25	25–30	20–25
CT	>30	20–25	20–25	10–15
DE	>30	25–30	20–25	15–20
FL	>30	>30	10–15	Sustainable
GA	15–20	5–10	Sustainable	Undervalued
HI	>30	>30	>30	25–30
IA	15–20	10–15	10–15	5–10
ID	25–30	25–30	10–15	Sustainable
IL	25–30	5–10	Undervalued	Undervalued
IN	10–15	5–10	5–10	Sustainable
KS	5–10	Sustainable	Sustainable	Undervalued
KY	15–20	10–15	15–20	10–15
LA	15–20	10–15	10–15	5–10
MA	>30	25–30	25–30	20–25
MD	>30	>30	20–25	10–15
ME	>30	25–30	25–30	>30
MI	25–30	5–10	Sustainable	Undervalued
MN	>30	25–30	15–20	Sustainable
MO	20–25	15–20	10–15	5–10
MS	5–10	Sustainable	Sustainable	Undervalued
MT	20–25	20–25	25–30	25–30
NC	15–20	15–20	10–15	Sustainable
ND	5–10	Sustainable	Sustainable	Sustainable
NE	15–20	5–10	5–10	Sustainable
NH	>30	25–30	25–30	20–25
NJ	>30	25–30	>30	>30
NM	10–15	5–10	Sustainable	Undervalued
NV	>30	20–25	Undervalued	Undervalued
NY	>30	25–30	25–30	25–30
OH	10–15	Sustainable	Sustainable	Undervalued
OK	Sustainable	Sustainable	Sustainable	Undervalued
OR	>30	25–30	15–20	Sustainable
PA	25–30	20–25	15–20	5–10
RI	>30	25–30	15–20	10–15
SC	20–25	15–20	10–15	5–10
SD	5–10	Sustainable	Sustainable	Undervalued
TN	10–15	5–10	5–10	Sustainable
TX	Sustainable	Sustainable	Sustainable	Sustainable
UT	15–20	15–20	10–15	5–10
VA	>30	25–30	20–25	20–25
VT	25–30	20–25	15–20	10–15
WA	>30	25–30	10–15	Sustainable
WI	20–25	10–15	5–10	Sustainable
WV	Sustainable	Sustainable	Sustainable	Undervalued
WY	10–15	10–15	5–10	Sustainable
U.S.	>30	20–25	15–20	5–10