STATE AND MUNICIPAL DEBT: THE COMING CRISIS?

HEARING

BEFORE THE

SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS

OF THE

COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

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CONTENTS

STATE AND MUNICIPAL DEBT: THE COMING CRISIS?

WEDNESDAY, FEBRUARY 9, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TARP, FINANCIAL SERVICES AND
BAILOUTS OF PUBLIC AND PRIVATE PROGRAMS,
COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room HVC–210, The Capitol Visitor Center, Hon. Patrick T. McHenry (chairman of the subcommittee) presiding.

Present: Representatives McHenry, Guinta, Buerkle, Amash, Meehan, Walsh, Gowdy, Ross, Quigley, Maloney, Welch, Yarmuth, Cooper, and Cummings (ex officio).

Staff present: Lawrence Brady, staff director; John Cuaderes, deputy staff director; Peter Haller, senior counsel; Christopher Hixon, deputy chief counsel, oversight; Robert Borden, general counsel; Joseph Brazauskas and John Zadrozny, counsels; Tyler Grimm and Ryan Hambleton, professional staff members; Michael Bebeau and Gwen D'Luzansky, assistant clerks; Molly Boyl, parliamentarian; Katelyn Christ, research analyst; Drew Colliatie, staff assistant; Adam Fromm, director of Member liaison and floor operations; Justin LoFranco, press assistant; Linda Good, chief clerk; Laura Rush, deputy chief clerk; Suzanne Sachsman Grooms, minority chief counsel; Jason Powell and Steven Rangel, minority senior counsels; Davida Walsh, minority counsel; Ronald Allen, minority staff assistant; Jesse Feinberg, minority legislative assistant; Lucinda Lessley, policy director; and Carla Hultberg, minority chief clerk.

Mr. MCHENRY. The committee will come to order. This is our first meeting of the TARP, Financial Services and Bailout to Public and Private Programs. I will begin by making an opening statement.

I certainly appreciate the panel of witnesses being here and taking the opportunity to be here. Today's hearing is an opportunity to discuss growing concerns over the potential fiscal crisis looming for States and municipalities. Over the past 3 years, we have seen a culture arise where every institution claimed it was too big to fail. An all-too-eager President and an all-too-compliant Congress kept putting taxpayers on the hook for trillions of dollars. Our budget deficit has reached an all-time high and the national debt is crippling our economy.

Now we are facing the consequences of bad government policy in yet another way. State and municipal governments who are preparing for aggregate budget shortfalls totaling roughly $125 billion this year are struggling under a trillion dollar burden of unfunded pension liabilities, plummeting tax revenues and an unforgiving bond market. We must understand the magnitude of this problem to avoid the reactionary ad hoc decisionmaking that fueled the Federal action of the 2008 financial crisis.

This is not about one analyst. This is about the looming fiscal crisis in States and municipalities and the lack of transparency in their pension obligations. Let's be clear about this. The perfect storm is brewing. Already State and municipal governments are coming to Washington hat in hand expecting a Federal bailout like so many others. But the era of the bailout is over.

That does not mean, however, that Congress must turn a blind eye or a deaf ear to the crisis unfolding in State and local governments. The beauty of federalism lies in the fact that the National Government does not tell the States how to manage their own affairs, at least ideally. The burden of federalism is that when one State, or all 50 States, are in a crisis, we must work together to solve them for the good of the country. Since 1990, State and local government spending has increased roughly 70 percent faster than inflation. The vast majority of the States now find themselves in a fiscal straitjacket caused primarily of the looming burden of paying out trillions of dollars in lucrative public sector union pensions and health care benefits that come at the expense of taxpayers.

For the last 3 years, funding from the Stimulus Act has masked the severity of the State fiscal challenges. In fact, there was $140 billion in transfers from the total government to the States included in the stimulus. States now say that more money would help them through their current rough patch. The reality, however, is that the money States receive from the stimulus has, in many ways, made them worse off. A lot of the funding comes with "maintenance of effort" requirements that force States to keep funding programs after Federal funding dries up this year. More money from Washington would just delay the day of reckoning and only further complicate State fiscal situations. Besides, we don't have any more money. And beyond that the simple fact is that the government has outgrown our capacity to pay for it.

There will be severe consequences for not changing course. Young teachers fresh out of college and ready to give back to their communities will be told that their school districts cannot provide them with reasonable retirement benefits because they are cash-strapped to pay for the exorbitant benefits of others. Firefighters, policemen and other public servants facing the reality that their vital jobs offer no promise of rising standards of living for their family or benefits will simply opt for a different career path.

In the end, people will recognize that their government has failed them. But not only that, they believe that their government has actively hurt them.

While we have the opportunity to change that, we are responsible to try. This is why we are here today, to come to a better understanding of the crisis at the State and local government level, to assess its causes and to consider available solutions. With that in mind, in this hearing and I intend to shed light on how the States arrived at their current predicament, what is the current extent of their fiscal distress, and what needs to be done in terms of available solutions.

My friend and colleague from California, Representative Devin Nunes, has a proposal that would require greater transparency at the point of most urgent concern, the pension problem. I have been happy to work with him on this legislation. I look forward to hearing from both sides on any and all possible solutions, and that is why we have this great panel here today.

Let there be no mistake though. Much is required to get our fiscal House in order not just at the State and local levels but here in Washington, DC.

But reckless spending fueled by bottomless borrowing and guaranteed by endless bailouts is an unsustainable course.

[The prepared statement of Hon. Patrick T. McHenry follows:]

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Rep. Patrick McHenry, Chairman
"State and Municipal Debt: The Coming Crisis?" Subcommittee Hearing
February 9, 2010

Today's hearing is an opportunity to discuss growing concerns over the potential fiscal crisis looming for states and municipalities. Over the past three years we have seen a culture arise where every institution claimed it was "too big to fail." An all-too-eager President and an all-too-compliant Congress kept putting taxpayers on the hook for trillions of dollars. Our budget deficit has reached an all-time-high, and the national debt is crippling our economy.

Now we are facing the consequences of bad government policy in yet another way. States and municipal governments, who are preparing for aggregate budget shortfalls totaling roughly $125 billion this year, are struggling under a trillion-dollar burden of unfunded pension liabilities, plummeting tax revenues, and an unforgiving bond market.

We must understand the magnitude of the problem to avoid the reactionary, ad hoc decision-making that fueled federal action in the 2008 financial crisis.

This isn't about one analyst. It's about the looming fiscal crisis in states and municipalities and the lack of transparency in their pension obligations.

The perfect storm is brewing, already state and municipal governments are coming to Washington, hat-in-hand, expecting a federal bailout like everyone else.

But the era of the bailout is over.

That does not mean, however, that Congress must turn a blind eye or deaf ear to the crisis unfolding in state and local governments. The beauty of federalism lies in the fact that the national government does not tell the states how to manage their own affairs. The burden of federalism is that when one state – or all 50 states – are in a crisis, we must work together to solve them for the good of the country.

Since 1990, state and local government spending has increased roughly 70 percent faster than inflation. The vast majority of the states now find themselves in a fiscal straitjacket, caused primarily by the looming burden of paying out trillions of dollars in lucrative public sector union pension and healthcare benefits that come at the expense of taxpayers. For the last three years, funds from the stimulus act have masked the severity of state fiscal problems. In fact, there was $140 billion in transfers to states included in the stimulus. States now say that more money would help them through their current rough patch. The reality, however, is that the money states received from the stimulus has, in many ways, made them worse off. A lot of the funding came with "maintenance of effort" requirements that force states to keep funding programs after federal funding dries up this year.

More money from Washington would just delay the day of reckoning and only further complicate state fiscal situations. Besides, we don't have any money to offer. ***The simple fact is that government has outgrown our capacity to pay for it.***

Rep. Patrick McHenry, Chairman
"State and Municipal Debt: The Coming Crisis?" Subcommittee Hearing
February 9, 2010

There will be severe consequences for not changing course. Young teachers, fresh out of college and ready to give back to their communities, will be told that their school districts cannot provide them with reasonable retirement benefits because they are cash-strapped to pay for the exorbitant benefits of others. Firefighters, policemen, and other public servants – facing the reality that these vital jobs offer no promise of rising standards of living for their families – will simply opt for a different career path.

In the end, people will recognize that their government has failed them. But not only *that*, they will believe that their government has actively hurt them. While we have the opportunity to change that, we are responsible to try.

That is why we are here today: to come to a better understanding of the crisis facing state and local governments, to assess its causes, and to consider available solutions. With this hearing, I intend to shed light on how states arrived at their current predicament. What is the true extent of their fiscal distress? We need to understand all available solutions. My friend and colleague from California, Rep. Devin Nunes, has a proposal that would require greater transparency at the point of most urgent concern, the pension problem. I've been happy to work with him on this legislation. I also look forward to hearing from both sides on any and all possible solutions.

Let there be no mistake. Much is required to get our fiscal house in order at the national, state, and the local levels. But reckless spending fueled by bottomless borrowing and guaranteed by endless bailouts is an unsustainable course.

Mr. MCHENRY. And with that, I now recognize the ranking member, Mr. Quigley of Illinois, for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman for holding this extraordinarily important and timely hearing, and congratulations on your new post as chairman. The record should reflect that you and your staff have been extraordinarily accommodating and cordial to myself and my staff. Obviously the issues are too important to divide us in any light, and I also thank you for doing that. Any time I take complimenting you shouldn't count against my time to speak.

I want to thank our four witnesses for testifying today. And I agree, it is really in a sense not about bailouts or bankruptcies, because I don't think either one of those options can work, or is optimal. But as you know, I'm from Illinois, and you don't need to tell me about how bad its finances are and how critical these issues are. Illinois has gone through decades of bad financial decisionmaking under both Democrats and Republicans. Illinois now has an $8 billion backlog in payments, and a gaping $136 billion hole in its pension system, leaving its pension less than 50 percent funded.

It should be no surprise then that the rating agencies has downgraded Illinois bond issuances several times in the past months. Last year Illinois bonds carried the worst credit risk of any U.S. State and were only slightly less risky than bonds from Iraq. According to Laurence Msall of the Civic Federation, this bad rating was costing Illinois taxpayers $551 million a year extra in interest payments. And total debt service in Illinois is expected to increase by 33 percent between now and the year 2017.

The only way Illinois was able to climb out from a bottom rung was to raise State income taxes a whopping 66 percent, an outcome no one wanted.

This tax increase brought Illinois's bond rating back up and reduced borrowing costs, but only by passing those costs on to Illinois taxpayers. Illinois has to reform its pension system, but it also has to reform its whole way of doing business which has left retirees vulnerable and taxpayers on the hook. As Professor Dershowitz said of Harvard's shrinking endowment after the 1990's boom, a lesson for all of us. People forgot the story of Joseph in Genesis, during the 7 good years, you save for the several lean years. Illinois didn't save for the 7 lean years and now it has to deal with the consequences. That said, what's going on in Illinois is not necessarily what's going on everywhere else.

True, most States have recently rung up large deficits thanks to a collapse in tax revenues during the recession. But the short term fiscal problem will improve as our economy gets going again. The real problem is an actuarial problem unique to six to eight States, including Illinois which suffer from long-term structural imbalances. The culprits are rising health costs, underfunded pension plans, and poor financial management.

Some of these pension plans look particularly bad right now because of the collapse in the value of pension assets. But even an appreciation in asset value will lead several State pension plans underfunded.

The municipal bond market is now responding to legitimate concerns about the long-term structural imbalances in these six to eight States. But I believe we would be correct to distinguish these bad apples from the other 40-some States that have been relatively well managed and only have temporary deficits. That is why a one-size-fits-all approach like bankruptcy for States could do more harm than good.

What we have to avoid is any rash actions that would contribute new risk factors to the bond market. State and local governments across the country need to continue building roads and bridges, and we don't want to make the financing any more expensive than it already is. So we need to be crystal clear that although there are national interests at stake, the onus must be on those State governments to reform themselves. And they need to reform sooner than later, a default on payments would make it obscenely expensive for all States to borrow. Taxpayers would bear the brunt of these costs either through higher taxes or through reduced public services and a move toward austerity.

Mr. Chairman I don't want an Illinois problem or a New Jersey problem to become a national problem. These States have to institute commonsense reforms to shore up their finances. At the same time government's mission matters, and successful reform will ensure that workers get the pensions they have earned through their years of service. All we need is the political will to get it done.

I look forward to hearing from our witnesses on this matter and the discussions of the next possible steps. Thank you and I yield back.

[The prepared statement of Hon. Mike Quigley follows:]

Opening Statement, February 9, 2011, Subcommittee on TARP and Financial Services
Rep. Mike Quigley, Ranking Member

Mr. Chairman, I'd like to begin by thanking you for convening today's timely hearing on municipal debt.

I'd also like to thank our four witnesses for generously contributing their time and expertise to this discussion.

As you know, I'm from Illinois—you don't need to tell me about how bad its finances are.

Illinois has gone through decades of bad financial decision-making, under both Republicans and Democrats.

Illinois now has an $8 billion backlog in payments and a gaping $136 billion hole in its pension system, leaving its pensions less than 50 percent funded.

It should be no surprise, then, that the rating agencies have downgraded Illinois bond issuances several times in the past twelve months.

Last year, Illinois bonds carried the worst credit risk of any U.S. state, and were only slightly less risky than bonds from Iraq!

According to Laurence Msall ("Ma-sall") of the Civic Federation, this bad rating was costing Illinois taxpayers $551 million extra per year in interest payments.

And total debt service in Illinois is expected to increase by 33 percent between now and 2017.

The only way Illinois was able to climb up from the bottom rung was to raise state income taxes a whopping 66 percent, an outcome no one wanted.

This tax increase brought Illinois's bond rating back up and reduced borrowing costs, but only by passing those costs onto Illinois taxpayers.

Illinois has to reform its pension system, but it also has to reform its whole way of doing business, which has left retirees vulnerable and taxpayers on the hook.

As Professor Alan Dershowitz said of Harvard's shrinking endowment after the '90s boom—

—'people forgot the story of Joseph in Genesis: during the seven good years, you save for the seven lean years.'

Illinois didn't save for the seven lean years and now it has to deal with the consequences.

That said, what's going on Illinois is not necessarily what's going on everywhere else.

True, most states have <u>recently</u> run up large deficits, thanks to a collapse in tax revenues during the recession.

But this short-term <u>fiscal</u> problem will improve as our economy gets going again.

The real problem is an <u>actuarial</u> problem unique to 6-8 states, including Illinois, which suffer from long-term structural imbalances.

The culprits are rising health care costs, underfunded pension plans, and poor financial management.

Some of these pension plans look particularly bad right now because of the collapse in value of pension assets.

But even an appreciation in asset value will leave several state pension plans worryingly underfunded.

The municipal bond market is now responding to legitimate concerns about the long-term structural imbalances in these 6-8 states.

But I believe we would be correct to distinguish these bad apples from the other 40-some states that have been relatively well managed and have only temporary deficits.

This is why a one-size-fits-all approach, like bankruptcy for states, could do more harm than good.

What we have to avoid is any rash action that would contribute new risk factors to the bond market.

State and local governments across the country need to continue building roads and bridges, and we don't want to make the financing any more expensive than it already is.

So we need to be crystal clear that although there are national interests at stake, the onus must be on these 6-8 state governments to reform themselves.

And they need to reform sooner rather than later—a default on payments would make it obscenely expensive for all states to borrow.

Taxpayers would bear the brunt of these costs, either through higher taxes or through reduced public services in a move towards austerity.

For example, bridges and roads and other necessary public works would have to be financed at very high interest rates or simply never get built.

Mr. Chairman, I don't want an Illinois problem or a New Jersey problem to become a national problem.

States like Illinois and New Jersey have to institute commonsense reforms to shore up their finances.

At the same time, government's mission matters, and successful reform will ensure that workers get the pensions they've earned through their years of service.

All we need is the political will to get it done.

I look forward to hearing from our witnesses on this matter, and to their discussion of possible next steps.

Thank you and I yield back.

Mr. MCHENRY. I thank you, Mr. Quigley, and you certainly have been wonderful to work with and we certainly appreciate that. This certainly isn't a shirts versus skins or Republican versus Democrat issue. I think trying to understand the depths of this problem certainly behooves both the Parties and the American people and their right to know. I want to begin, before we introduce the panel, we have the mission statement of the Oversight Committee, and at the chairman's request, I would like to read that for all that are here today:

We exist to secure two fundamental principles: First Americans have the right to know that the money Washington takes from them is well spent. And second, Americans deserve an efficient effective government that works for them. Our duty on the Oversight and Government Reform Committee is to protect these rights. Our solemn responsibility is to hold government accountable to taxpayers because taxpayers have a right to know what they get from their government. We will work tirelessly in partnering with citizen watchdogs to deliver the facts to the American people and bring genuine reform to the Federal bureaucracy.

This is the mission of the Oversight and Government Reform Committee.

So with that in mind, I would like to introduce today's panel. Nicole Gelinas is the Searle Freedom Trust fellow at the Manhattan Institute and a contributing editor of City Journal. Gelinas writes an urban economics and finance, municipal and corporate finance, and business issues. She is a Chartered Financial Analyst, charter holder and member of the New York Society of Securities Analysts. Her most recent book, "After the Fall: Saving Capitalism from Wall Street—and Washington" was about the financial crisis of 2008 and was published in November 2009.

David Arthur Skeel is the S. Samuel Arsht professor of corporate law at the University of Pennsylvania Law School. He is the author of "Icarus in the Boardroom" published in 2005 and "Debt's Dominion: A History of Bankruptcy Law in America" published in 2001, as well as numerous articles and other publications.

Eileen Norcross is a senior research fellow with the Social Change Project and the lead researcher on the State and Local Public Policy Project. Her work focuses on the questions of how societies sustain prosperity and the role civil society plays in supporting economic resiliency. Her areas of research include fiscal federalism and institutions, State and local governments and economic development.

Iris J. Lav is a senior adviser with the Center on Budget and Policy Priorities. Prior to joining the Center, she was associate director of public policy for the American Federation of State, County and Municipal Employees and senior associate at a consulting firm.

Thank you all for being here today. Members will have 7 days to submit opening statements for the Record. It is the policy of this committee that all witnesses be sworn in before they testify.

Will you please rise and raise your right hands?

[Witnesses sworn.]

Mr. MCHENRY. The record will reflect that all answered in the affirmative. Thank you. And we will certainly begin, Ms. Gelinas, with you. You will have 5 minutes to give your opening statement.

At 1 minute remaining, the yellow light will come up. If you could summarize your opening statements, everyone has that for the Record, and we will begin with you.

STATEMENTS OF NICOLE GELINAS, SEARLE FREEDOM TRUST FELLOW, MANHATTAN INSTITUTE; PROFESSOR DAVID SKEEL, S. SAMUEL ARSHT PROFESSOR OF CORPORATE LAW, UNIVERSITY OF PENNSYLVANIA LAW SCHOOL; EILEEN NORCROSS, SENIOR RESEARCH FELLOW, SOCIAL CHANGE PROJECT AT THE MERCATUS CENTER; AND IRIS LAV, SENIOR ADVISOR, CENTER ON BUDGET AND POLICY PRIORITIES

STATEMENT OF NICOLE GELINAS

Ms. GELINAS. Yes. Good morning, Chairman McHenry, Ranking Member Quigley, members of the subcommittee. Thank you for inviting me to testify today on this important topic.

Congress is right to worry about the choice between bailing out States and watching as they risk repudiating their long-term obligations to bond holders and other creditors, including union members. The good news is that Congress can still act to avoid this difficult choice. The bad news is that a State bankruptcy statute is not going to be the answer. Sometimes arriving at a solution means eliminating the bad solutions. So I will talk for a few moments about why State bankruptcy is not the answer and talk for my remaining moments about what are some of the answers.

Proponents of a bankruptcy statute for States say that special interests have taken over the State budgeting process, that there is no prospect of States getting their long-term pension obligations, health care obligations to retirees and debt obligations under control absent an external force outside the State political process. Proponents believe that this could be the external force. In this scenario, States could threaten bankruptcy to wring concessions from their creditors, particularly labor unions, changing future pension benefits, health care benefits, and the like. Bondholders who would be worried about this prospect would force States to do this before they get into a crisis situation.

As a practical matter, though, bankruptcy is unlikely to help States solve their fiscal problems and actually would add new problems. One reason is how States have structured their bond obligations. When many people think of money that a State owes, they think of a State's general obligation bonds, bonds against which the State has pledged its full faith and credit to pay back its debt.

States do not issue only general obligation bonds, though. They issue bonds through hundreds of public authorities. New York State, for example, owes nearly $80 billion in debt, only about $3½ billion of that is through general obligation debt. The remainder is through hundreds of these public authorities, special purpose vehicles and so forth. Each of these authorities is its own corporation. It is not an agency or an arm of the State. It has its own board of directors, its own covenants with bondholders, its own legal and contractual agreements with not only bondholders, but employees and retirees.

There is no practical way for a State to pool all of this debt together in one place along with pension and health care obligations handed over to a judge and pare it back, at least not without violating thousands of preexisting covenants, contracts with bondholders and State laws. And this gets to Congressman Quigley's points that the Congressman made in his opening statements, changing the rules mid-game would affect not only States that have gotten themselves into trouble with their own decisions, such as New York, California, Illinois and New Jersey, but also States that are not running these long-term deficits.

Introducing a bankruptcy statute would force bondholders to all States to question the legal regime. It would take many months to sort out the uncertainty. During those months, it is quite likely that States would have to pay more on their debt.

Another practical problem with bankruptcy is that States are not like corporations where one person can be authorized to speak for the State. In a corporate bankruptcy, you have a CEO, an agent of the CEO and a small board of directors all speaking as one. In a State bankruptcy, hundreds of State lawmakers could not give their power to a Governor to speak in one voice. If bankruptcy would not eclipse the normal processes of democracy, you would still have hundreds of lawmakers speaking in different voices before a judge, no way for a judge to simply take over this process of democracy solve a State's obligations from on high.

Another problem is that States do not owe pension benefits for the most part. States administer pension benefits on behalf of local governments, cities, towns and school districts. So bankruptcy for the State would not take care of pension obligations. Municipalities can do that through changes in State law, require changes in State law but municipalities can already declare bankruptcy if that is a way for them to deal with their pension obligations. So this does not add a benefit to municipalities who owe pension and health care benefits.

What are some of the other solutions that Congress can look to to help States and municipalities pare back their benefits? One thing is making sure to States that Congress understands that States already have the tools to deal with these things themselves. States can change their laws that govern pensions. States can change their laws that govern contracts, health care benefits. They do not need to look to Congress to do this for them.

And with that, I will conclude my opening remarks. Thank you.

Mr. MCHENRY. Thank you, Ms. Gelinas.

[The prepared statement of Ms. Gelinas follows:]

Hearing
"State and Municipal Debt: The Coming Crisis?"
February 9, 2011
Subcommittee on TARP, Financial Services, and Bailouts of Public and Private Programs
Committee on Oversight and Government Reform
House of Representatives

Testimony of
Nicole Gelinas, CFA
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(646) 839-3353

Chairman McHenry, Ranking Member Cummings, and members of the Subcommittee, good morning. Thank you for inviting me to testify today on this important topic.

As federal stimulus runs out and states from California to New Jersey face a third year of multi-billion-dollar budget deficits, Congress is right to worry about how to avoid bailing out states and their investors. The bad news is that a federal statute allowing for state bankruptcy is unlikely to be the answer. The good news is that Congress can still act to avoid the choice between bailing out states and watching as they repudiate their long-term contractual, legal, and constitutional obligations to bondholders and other creditors, including labor union members.

Proponents of a bankruptcy statute for states believe that special interests such as unions and hospital lobbies have taken over the political process in many state capitals and are thwarting states' ability to control their costs without an external force. Proponents also believe that bankruptcy could be this external force. In this scenario, states could threaten bankruptcy to wring concessions from creditors, particularly labor unions, to whom states owe hundreds of billions of dollars in future pension and healthcare commitments. Bondholders, worried about the prospect of losses in bankruptcy, would help this process along.

As a practical matter, though, state bankruptcy is unlikely to help states solve their fiscal problems. Nor would bankruptcy allow the federal government to avoid the bailout question. Bankruptcy also does not address the key drivers of states' fiscal problems—provision in their laws and constitutions that restrain states from balancing their books, and federal grants for programs like Medicaid and education that encourage higher spending.

There is good reason to expect that a state bankruptcy would create more problems than it would solve. For one thing, states have made their commitments to creditors not through single "state" entities that could go before a bankruptcy judge with one voice, but through hundreds, in some cases thousands, of legal entities. Each of these legal entities has its own pre-existing agreements with bondholders and other creditors, set out in individual contracts and in state laws.

An illustration: When many people think of state bond obligations, they think of "general obligation" debt—that is, debt for which states have obliged their "full faith and credit" to pay. But a state such as New York, for example, with one of the highest per-capita debt burdens in the nation, owes only $3.5 billion in "general obligation" debt. New York owes the remainder of its $78.4 billion in debt through hundreds of special "authorities," including the Transitional Finance Authority, Metropolitan Transportation Authority, the Dormitory Authority, and others.

Legally, each of these authorities is not a government agency reporting to the governor and the legislature, but a "public-benefit corporation." Each has its own board, its own rules, and its own contractual agreements with creditors, from bondholders to, in some cases, union members. Under some agreements, the state allows bondholders the first claim on certain tax revenues, even before the state allows itself to use these revenues for public services. Under other agreements, bondholders depend only on speculative revenues, such as those from tolls, for repayment.

As a practical matter, a bankruptcy judge could not take the gross amount that New York owes to bondholders and other creditors through these hundreds of corporations and put it all in one large pool along with pension and healthcare obligations to pare back all three categories of commitments, at least not without violating many pre-existing private contracts, bond covenants, and precedents. Bondholders who had lent money to a specific state authority under specific covenants would be concerned that the federal government had changed the rules mid-game.

Just as states do not owe their debt through a single entity, they do not owe their pension obligations through a single entity. In fact, though state governments often run large pension funds through state trusts, including Calpers and CalSTRS in California, it is local governments, including cities, towns, and school districts, not the state governments, that owe the bulk of what people think of as "state" pension benefits. Cities, towns, and school districts, however, can already declare bankruptcy, if their home states allow it, so state bankruptcy would add no benefit here.

Another practical problem for state bankruptcies is the fact that it is difficult to understand how a federal judge could overturn the real obstacle to sound state budgeting practices: state constitutions and state laws. California's Constitution, for example, mandates that tax revenue must first pay California's education costs, and second pay its general-obligation debt costs. New York's constitution mandates that the state uphold its commitments to all pensioners, past and future. New York law mandates that when some labor contracts expire, the workers covered by such agreements continue to get automatic pay raises.

State laws that ensure burdensome pension benefits and union-contract outcomes may be bad practice, but no one has argued that they violate the U.S. Constitution. Therefore, a federal judge cannot overturn them – only state legislatures, governors, and voters can do that. With no ability to overturn bad state statutes and constitutional provisions against the will of governors and state lawmakers, a federal bankruptcy judge would have little power. Furthermore, states would have to opt into a federal bankruptcy code—if state lawmakers are unwilling to repeal these laws, why would they pass a law allowing a federal judge to disregard them?

Relatedly, one of the issues that has plagued state finances—and, indeed, that plagues democracy in general—is that no single elected official speaks for a state. In a corporate bankruptcy, a CEO or his designee, backed by a small board, is authorized to speak for the entire company. In a state bankruptcy, though, a governor could not simply assume powers that rightly belong to individual lawmakers and alone speak for the state.

Because each state differs from every other state in its constitution and body of law, the prospect of state bankruptcies would not offer much predictability to bondholders who might hope to take one bankruptcy case and apply its lessons to another. If, for example, New Jersey were to declare bankruptcy under a new federal statute, and New Jersey's governor and legislator were able to work with creditors under a judge to pare back liabilities under the unique constraints of New Jersey's Constitution and body of law, the blueprint would not be of much practical help to California bondholders, who would have to consider how bankruptcy would work in the context of that state's unique constitution and body of law.

As for avoiding bailouts: state bankruptcy is far from a sure thing here. We remember, of course, that Chrysler and General Motors declared bankruptcy and received federal bailouts. Moreover, the Bush and Obama White Houses offered the two automakers tens of billions of dollars in taxpayer money not for market reasons but for political and social reasons: neither president wanted to run the risk that the automakers and their suppliers would exacerbate the recession by laying off millions of workers. Similarly, should states run into such acute trouble, the White House and Congress would have to make a political and social decision about how much aid, if any, to offer to avoid mass layoffs and service cuts. Tweaking laws that govern financial markets could not eliminate the need for this hard decision.

Fortunately, the prospect of state bankruptcy is unnecessary for states to change their ways. As my colleague E.J. McMahon has written, states already possess the tools to pare back their future liabilities before these commitments grow even more burdensome. For one thing, lawmakers and governors across the nation can change the laws that allow state workers to collectively bargain their wages. Similarly, lawmakers and governors can change constitutions and laws to pare back retirement benefits for future workers (and, in some cases, current workers).

Congress can help states take the right steps. States spend the vast majority of their taxpayer money on education and healthcare (including labor costs for these functions). These costs are driven in part by federal mandates and federal matching dollars. Congress could gradually convert the federal Medicaid program into a block-grant program, rewarding states for saving money rather than spending it. Congress could also tie some future education aid to changes in states' treatment of local teachers' retirement benefits, ensuring that funds are directed to students, not to labor unions. Further, in its upcoming transportation-bill reauthorization, Congress could offer more capital investment money to states whose governors and lawmakers take steps to pare back future workforce liabilities so that they can afford to maintain the infrastructure that they hope to build or upgrade with federal money.

Finally, if Congress wants to raise the prospect that a state could someday default on its debt, it would have to raise the prospect that a large bank or money-market fund, too, could suffer large losses as a result of that default. After all, banks own $229 billion in state and local debt, and money-market funds own another $332 billion. Creating a process for a state or multiple states to default on debt obligations without first ensuring that a large bank can go through the bankruptcy process could create economic chaos, forcing Congress, in the end, to save the state or the bank. This is hardly a good choice.

Thank you, again. I am happy to take questions and comments.

[Further reading:
Nicole Gelinas, "The Market Won't Fix States' Woes," *Boston Globe*, January 23, 2011.
EJ McMahon, "State Bankruptcy is a Bad Idea," *Wall Street Journal*, January 24, 2011.
Nicole Gelinas, "Bankruptcy: No Cure for Broke States," *New York Post*, January 24, 2011.
Nicole Gelinas, "Better Stimulus for States: Cash for Cuts," *Investors Business Daily*, July 12, 2010.]

Mr. MCHENRY. Mr. Skeel.

STATEMENT OF DAVID SKEEL

Mr. SKEEL. It's a great honor to appear before you, and I'm tempted to say everything that Nicole just said, "not." Not exactly that. But I will just make one comment at the outset, and that is we have lots of experience dealing with complicated bankruptcies. So the fact that it is a multitude of entities is not news in the bankruptcy context. I'd be happy to address questions about that or either of the other issues that were just raised if folks are interested.

Currently, if a State's functional crisis spirals out of control, we really only have two options: The first is that a State might simply default on some of its obligations, declaring itself unable to pay. The second option is for the Federal Government to bail out one or more of the States as it bailed out financial institutions like Bear Stearns, Fannie Mae, Freddie Mac and AIG during the recent financial crisis. I believe that both of these alternatives are deeply problematic and that Congress should enact a bankruptcy law for the States, not as a first resort, but as an absolute last resort in the event that everything else fails.

The claim that we don't need a bankruptcy law for States strikes me as a little bit like saying there's no need for a fire department because most homeowners have never had fires in their houses, if and one starts the homeowner can probably stop it before the crisis gets out of control. Each of these things is true, but we still need fire departments for the rare case when a fire does burn out of control.

In the remainder of my discussion, I would like to make three simple points: First, bankruptcy would provide several enormously important benefits that we don't have in the absence of bankruptcy. Second, it is constitutionally permissible, in case you all are concerned about that, as well you should be. Third, the law could be tailored to address any particular concerns you might have about things like it being too easy for a State to file or there be the bankruptcy law being too harsh for particular kinds of constituencies.

So let me say, to the extent I have time, a brief word about each. First the benefits that bankruptcy would provide for a troubled State. One of the main benefits bankruptcy would provide is a way to restructure some kinds of obligations that probably can't be restructured outside of bankruptcy. And I would include pensions in that. There are real limits on what can be done with pensions outside of bankruptcy. I would include bonds in that category as well.

The other huge benefit of bankruptcy is if it is necessary as an absolute last resort, is it brings everybody to the table. We don't just have one or two constituencies that get singled out to make sacrifices. We get everybody to the table, and we ask how can we distribute the sacrifices so that it makes sense and we can put our finances on a fiscally sustainable course.

My second point is that bankruptcy is fully constitutional, even with respect to States. All that needs to be done there, there are genuine State sovereignty concerns, and they need to be honored, but they can be honored so long as we make sure the bankruptcy law is entirely voluntary, meaning that a State couldn't be thrown into bankruptcy against its will, and the bankruptcy law would also need to ensure that State decision, governmental decision-making functions were not interfered with. All of these are things we already do with respect to municipal bankruptcy.

My final point is that the law can be tailored to deal with any concerns you may have. A lot of the discussion, a lot of the criticism of State bankruptcy seems to assume there's only one possible State bankruptcy law we can have, and it's going to require us to cut everything down to zero. That's not the case. If you're worried about States being too anxious to file for bankruptcy, that there will be strategic use of bankruptcy, I think that is a not really a serious worry. But if you are worried about it, all you have to do is put some entrants requirements on bankruptcy. We already do this with municipal bankruptcy.

If you're worried about the bond markets, you're worried the bond markets are going to be concerned because they're afraid that bonds are going to be written down to zero, you put restrictions as a prerequisite to doing anything with bonds.

So the final point is simply that we can tailor the bankruptcy law to address any concern we may have. My bottom line is bankruptcy is not a perfect solution. It would be messy. It is an absolute last resort, but it's better than the other last resorts which are States simply defaulting on their obligations or a Federal bailout.

Mr. MCHENRY. Thank you, Mr. Skeel.

[The prepared statement of Mr. Skeel follows:]

Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Committee on Oversight and Government Reform

United States House of Representatives

February 9, 2011

Thank you for the opportunity to testify about "State and Municipal Debt: The Coming Crisis?" It is a great honor to appear before you today. I will be devoting my remarks to the question of whether Congress should enact a bankruptcy law for states as an option for a state whose financial crisis is otherwise insurmountable.

The financial condition of many states is worse than at any time since the Great Depression of the 1930s. In the past several weeks, a number of state governors have announced plans for aggressive measures to restore some measure of fiscal health.[1] Most states surely can get through the crisis on their own, particularly now that the worst effects of the Great Recession seem to have eased somewhat. Hopefully, even the most troubled states will be able to put their financial houses in order. But some are in such dire financial straits that there is serious and legitimate doubt as to whether they can put their finances on more sustainable footing on their own.

What will happen if the crisis spirals out of control in one or more of these states, or another crisis hits in the future? Currently, there are only two real options. The first is that a state might simply default on some or all of its obligations, declaring itself unable to pay. This has rarely happened in modern American history. No American state has defaulted since Arkansas during the great Depression. But it is no longer unthinkable. The second option is for the Federal government to bail out one or more of the states, much as it bailed out financial

[1] See, for example, Conor Dougherty & Amy Merrick, *Governors Chop Spending*. Wall Street Journal. Feb. 7, 2011, at A1.

institutions like Bear Stearns, Fannie Mae, Freddie Mac and AIG during the recent financial crisis.

In my view, both of these alternatives are deeply problematic. In other contexts, a person or an entity that is in deep financial distress can use bankruptcy to restructure their obligations. I believe that Congress should enact a bankruptcy law for states, to provide a similar option for states as an alternative to a default or a federal bailout in the event that all else fails.

Some have argued that a bankruptcy option is not necessary, because nearly all of the states will be able to muddle their way through their fiscal predicament. This is like saying there's no need for a fire department because most homeowners never have fires in their houses and if one starts they can probably stop it in time. This is true, but we still need fire departments for the rare case where a fire burns out of control.

Others have argued that the "mere mention" of a possible bankruptcy law could cause panic in the bond markets. These concerns are greatly overstated. The critics who issue these dire warnings often predict catastrophe for both state and municipal bonds, for instance, but we already have a bankruptcy law for municipalities. This law has not led to a collapse of municipal credit throughout the nation; a bankruptcy law for states wouldn't either. Indeed, under some circumstances, the possibility of restructuring can actually increase the value of the bonds that are restructured, by putting them on sustainable footing.

Now, more than ever, we need a fire department for state fiscal crises, a solution of last resort that does not depend on using a major federal bailout as a backstop. Although I believe that the concerns that have been raised by critics are exaggerated, they should be addressed by adjusting the bankruptcy law, rather than by foregoing the benefits that bankruptcy offers as a solution of last resort.

In the reminder of my discussion, I'll briefly discuss three key questions with respect to a bankruptcy law for states:

1) What are the benefits of a bankruptcy law for states?
2) Would it be constitutionally permissible?
3) How might the law be tailored to address particular concerns that have been raised?

What are the Benefits?

Enacting a bankruptcy law for states would provide two hugely important benefits. First, it would enable a state to restructure obligations that are difficult or impossible to restructure under ordinary state law. Second, bankruptcy brings every constituency to the table, and ensures that the necessary sacrifices are distributed fairly, rather than visited on one or two disfavored constituencies. Let me describe each of these benefits, especially the first, a little more fully.

As just mentioned, bankruptcy would enable a troubled state to restructure obligations that could not easily be restructured outside of bankruptcy. The key to understanding this benefit is the Contracts and Bankruptcy Clauses in Article 1, sections 8 and 10 of the Constitution. Under the Contracts Clause, states are prohibited from altering an existing obligation, even if it would be in everyone's interest that the obligation be restructured.[2] This makes it extremely difficult for a state to modify an existing union contract or bond unless the union or bondholder agrees to the restructuring. As a result, there are serious risks that the other parties to state contracts will refuse to alter contracts even if the contractual obligations are unsustainable. These difficulties are magnified by the fact that many states have enacted Constitutional or statutory provisions that make obligations even more difficult to restructure.

The Constitution gives Congress much more authority to provide for the restructuring of a state's obligations. The Bankruptcy Clause authorizes Congress to enact bankruptcy laws. Not

[2] "No State shall ... pass any ... Law impairing the Obligation of Contracts." Const. Art. 1, sec. 10.

only this, but the Contracts Clause applies only to the states. It does not prevent Congress from providing for the restructuring of existing contracts.[3]

Congress's authority has important implications for key obligations such as public employee contracts (including health benefits), pensions, and bonds. Public employee contracts are not impossible to renegotiate under state law, but it is very difficult to do so. A state often cannot restructure a union contract absent the union's agreement, which unions have often resisted even when the contract's terms were highly unrealistic. Other measures are possible, such as firing large number of workers or passing legislation prohibiting or interfering with unions. But in many states the threat to simply fire large numbers of employees is not credible; in other states, it is credible but would be a draconian response to fiscal problems. In bankruptcy, if the parties fail to reach agreement, the court can terminate the contract. In practice, the threat of termination has encouraged the parties to restructure their contracts to make them more realistic and sustainable.

With pensions, many states now make it nearly impossible to restructure existing pension obligations, no matter how generous, and it is very difficult to restructure even future (that is, not yet earned) obligations to existing employees. Many of the most important protections for pensions would be fully honored in bankruptcy, and rightly so. If a state has set aside funds for its pension obligations, these funds would continue to be available only for the pension obligations. (In technical terms, the pension beneficiaries have a property right in the funds; this property right is likely to be protected by the Fifth Amendment'sTakings Clause). But bankruptcy might provide the authority to restructure the state's obligations to existing employees to make its pension promises more realistic and sustainable.

Even in bankruptcy, it is highly unlikely that any state would severely retrench on its pension promises, even if this were legally permissible. But even a relatively modest restructuring of the state's pension obligations could make the longterm prognosis for its pensions far better.

[3] In addition, the Supremacy Clause gives federal bankruptcy law priority over a conflicting state law. Congress and the courts have long given significant respect to state law—particularly with respect to property rights—but a federal bankruptcy law takes precedence over a conflicting state law.

Under existing state law, a state's general obligation bonds often cannot be adjusted in any way, even though they are simply general obligations of the state. This has the effect of giving a financially troubled state an either/or choice. It can either continue to pay the bonds, even if severe cuts to other constituencies are not enough to stop its crisis, or the state can simply stop paying.[4] Bankruptcy provides an intermediate option. A state's bonds could be restructured along with its other obligations.

This brings us to the other major benefit of bankruptcy. If one benefit of bankruptcy is the ability to restructure obligations that are extremely difficult to restructure in the absence of a bankruptcy option, the other signal benefit is that bankruptcy ensures that most or all of a state's constituencies make sacrifices, not just one or two. Absent a bankruptcy option, much of the sacrifice may be borne by public employees and the beneficiaries of state services, for instance, while other constituencies are protected. Bankruptcy brings every constituency to the table, and makes it much more likely that sacrifices will be distributed more broadly and fairly.

Would Bankruptcy for States be Constitutionally Permissible?

For corporations and private entities, Congress's ability to enact bankruptcy laws is beyond question. But states are different, because they are both public and sovereign. Can Congress enact a bankruptcy law for sovereign entities like states?

The answer is clearly yes, but any bankruptcy law that Congress enacted would need to respect state sovereignty, which is protected by the Eleventh Amendment, as well as the Tenth Amendment and the overall structure of the Constitution. Two protections are especially important. First, the law must be structured so that it is entirely voluntary: the state would be authorized to invoke bankruptcy, but its creditors could not throw the state into bankruptcy involuntarily. Second, the law must not usurp the state's governmental functions. The state

[4] In theory, there might be a third option: trying to use an exchange offer to restructure the obligations. This faces more practical impediments than a restructuring in bankruptcy.

should be the one to decide whether to cut taxes or raise spending, not a bankruptcy judge or other official.

Fortunately, we already have a template for how this might work. For more than seventy years, we have had a set of bankruptcy provisions—now located in Chapter 9 of the Bankruptcy Code-- for cities and other municipalities. Because cities are instrumentalities of the states, municipal bankruptcy raises the same state sovereignty issues as a new bankruptcy law for states. In 1938, the Supreme Court ruled that a municipal bankruptcy law that had been enacted the year before and was the predecessor of today's Chapter 9 was fully constitutional. A law that "expressly avoids any restriction on the powers of the States or their arms of government," and "is carefully drawn so as not to impinge upon the sovereignty of the states" does not run afoul of states' sovereignty.[5]

How Might the Law Be Tailored to Address Concerns?

It is important to keep in mind that Congress has great flexibility in deciding what kinds of provisions to include in any bankruptcy law. I have just described how the law can be tailored to honor state sovereignty by limiting it to voluntary bankruptcy and expressly preserving the state's governmental powers. Other concerns also can easily be addressed by fine-tuning the bankruptcy law. Let me give three illustrations.

First, some critics worry that bankruptcy would be too tempting an option for a state that has serious financial difficulties. Although I believe that this concern is mistaken, and that states are highly unlikely to use bankruptcy except as an absolute last resort, Congress could reduce any temptation by making it more difficult to file for bankruptcy. This is what Chapter 9 already does for municipal bankruptcy by prohibiting a city or other municipality from filing for bankruptcy unless it is insolvent, has been authorized by the state to file for bankruptcy, and

[5] United States v. Bekins, 304 U.S. 27, 51 (1938). It is worth noting that the Supreme Court has held in other contexts that Congress's powers under the Bankruptcy Clause take priority over state sovereignty concerns. See, for example, Central Virginia Community College v. Katz, 546 U.S. 356 (2006)

satisfies several other requirements.[6] A state bankruptcy law could include similar restrictions. It also could require that both the governor and a majority of legislators approve any bankruptcy filing.

Second, as I noted at the outset, some pundits are now issuing dire warnings about the effect that a bankruptcy law for states would have on the bond markets. Although I think this concern also is greatly overblown, Congress could easily adjust the bankruptcy law to limit the risk of bond market turmoil. Congress could establish a special priority for bonds, or require that any state priority status be honored in bankruptcy. Alternatively, Congress could prohibit a state from restructuring its bond obligations unless the bankruptcy judge or other decision maker determines that the restructuring is not likely to have deleterious effects on the bond markets.

Third, some might worry that the bankruptcy of a state is too large and complex for a single bankruptcy judge to handle. This concern, which I share, can be addressed by providing for state bankruptcy cases to be heard by a panel of judges, rather than a single decision maker. Under one model, decision making authority might be given to a panel of three federal district court judges, chosen at random from a list of district court judges who have financial and bankruptcy expertise.

I list these examples only for illustrative purposes. Congress could easily include other kinds of provisions as well.[7]

Conclusion

I do not mean to suggest that bankruptcy would be a simple, silver bullet solution to a state's travails. It wouldn't be. It would be complicated and messy, and should be used only as a last resort. But, just as we needed to enact a municipal bankruptcy law in the 1930s, we need a bankruptcy law for states now.

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[6] The requirements are set forth in 11 U.S.C § 109(c).
[7] I have discussed possible adjustments to union contracts elsewhere. for instance. David Skeel. *A Bankruptcy Law—Not Bailouts—for the States*. Wall Street Journal. Jan 18, 2011. at A17.

Mr. MCHENRY. Ms. Norcross.

STATEMENT OF EILEEN NORCROSS

Ms. NORCROSS. Chairman McHenry, Ranking Member Quigley, and members of the subcommittee, thank you for inviting me to testify today on this important topic. The recent recession exposed several longstanding problems in State budgets that, if left unaddressed, the underlying causes for these short-term budget gaps, including public sector pension benefits and the rising cost of health care, are certain to worsen States' prospects for stability and economic growth. But with reform today, States can mitigate the worst while meeting their promises to employees and taxpayers.

The recent downturn is only one cause for recent State budget gaps. State and local spending has grown faster than States' own source revenues and the private economy over the past several decades. The fastest growing area of State budgets is Medicaid. States have avoided showing deficits in part due to Federal funds, and an increasing reliance on debt finance, and in some cases, by deferring their contributions to pension systems, not funding health care benefits or borrowing to make pension payments. These techniques help States show balance, grow spending and pass the costs on to the future.

Without any changes, GAO anticipates State and local governments will require an annual and sustained reduction in spending of 12.3 percent or an equivalent increase in revenues between 2009 and 2058, to close a projected $9.9 trillion fiscal gap.

In addition, State and local governments face a large funding gap in their pension systems. Governments report the unfunded liability for State and local pensions at $1 trillion but economists estimate it closer to $3½ trillion.

According to government accounting standards, the discount rate used to value plan liabilities may be based on what the assets are expected to return when invested, an average of 8 percent annually. This violates economic theory which says the value of the liability is independent from how it is financed. Choosing the discount rate requires matching that rate with what's being valued, in this case, a public sector pension which is safe, government guaranteed and thus should be matched with a rate that reflects that safety, such as the yield on Treasury bonds, currently at 4 percent.

The circular logic of government pension accounting standards has had several consequences for pension funding. It has lead to the undervaluing of pension promises and amount necessary to be set aside to fund the promise, plans have been encouraged to embrace more investment risk, including increasing their risk exposure after the recent market downturn to make up for losses.

Union leaders and politicians in negotiations in the 1990's when the market was booming, often boosted benefit formulas because plans looked overvalued on paper. Governments have also, as mentioned, deferred payments to the system and issued bonds.

When are plans likely to run out of assets? Economist Joshua Rauh of Northwestern University estimates under the generous assumption, the State's own assumption, of an 8 percent annual return on pension assets that by decade's end, eight States will run out of assets to pay their beneficiaries. Illinois will require $11 billion annually beginning to 2019 in this scenario. New Jersey will require $10 billion annually in 2021.

A less dire scenario is offered by the Center for Retirement Research at Boston College to remain funded by 2014, Illinois will require 13 percent of its budget to ensure fund solvency, New Jersey will require 12½ percent of its budget. This requires choices these States have, to date, have avoided making. Other economists and actuaries have reduced equally dire scenarios as Dr. Rauh. But ultimately I stress it is incumbent upon State Governors and treasurers to ask actuaries to stress test their pension systems under a range of assumptions.

I believe the biggest impact the Federal Government can have in helping the States is in the area of Medicaid reform and mandate relief. For State pensions, I have two recommendations, first, transparent and accurate accounting. Governments must stress test their pension systems and model the cash-flows to determine what will be needed to set aside to pay these promises. These scenarios should include the risk free discount rate as recommended by economists. The data, method and assumptions should be made available to the public.

Second, stabilize public sector pension systems, to pay what has been promised by minimizing the burden on taxpayers, States should consider freezing and reducing the cost of living adjustment in current defined benefit plans, increasing the retirement age, increasing contributions from workers and importantly close the defined benefit plan and move workers to defined contribution plan.

The last reform will allow workers more flexibility, shift risk away from taxpayers and end the political and fiscal manipulation of worker benefits which has turned what was supposed to be a safe investment for public sector workers into a gamble for both employees and taxpayers. Accurate accounting will enable States to know the tradeoffs necessary today and delay will only ensure what is a big problem turns into a crisis by decade's end. Thank you. I look forward to your questions.

Mr. McHenry. Thank you, Ms. Norcross.

[The prepared statement of Ms. Norcross follows:]

MERCATUS CENTER
George Mason University
TESTIMONY
BRIDGING THE GAP BETWEEN ACADEMIC IDEAS AND REAL WORLD PROBLEMS

STATE AND MUNICIPAL DEBT: THE COMING CRISIS?
FEBRUARY 9, 2011

Eileen Norcross
Senior Research Fellow

House Committee on Oversight and Government Reform

Chairman McHenry, Ranking Member Quigley, and distinguished members of the subcommittee, thank you for inviting me to testify today on the important fiscal issues facing state and local governments. The duration and depth of the recent recession exposed several long-standing problems in state budgets. These problems, if left unaddressed, are certain to worsen states' future prospects for fiscal stability and sustainable economic growth. However, by making the necessary structural reforms today, states can mitigate the worst while meeting promises to both public employees and taxpayers.

Since the start of the 2008 recession much focus has been given to the fiscal future of state and local governments. In aggregate, states have closed $530 billion in budget gaps through a combination of tax increases, spending cuts and stimulus dollars.[1] States have also used a variety of accounting maneuvers to achieve budgetary balance including trust fund transfers, debt issuances and IOUs to vendors.[2]

Revenues are starting to recover, but are short of 2008 levels.[3] The situation varies in individual states, with some states projecting more robust revenues and other states anticipating a more modest and slower

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[1] National Conference of State Legislatures, "Projected Revenue Growth in FY 2011 and Beyond," http.//www.ncsl.org/documents/fiscal/Projected_Revenue_Growth_in_FY_2011_and_Beyond.pdf

[2] For a catalog of recent fiscal maneuvers used by states to balance their budgets see, Eileen Norcross "Fiscal Evasion," Mercatus Center Working Paper No. 10-39 July 2010 http.//mercatus org/sites/default/files/publication/Norcross Fiscal%20Evasion.%20State%20Budget%20Gimmicks.%20Updated%208.23.10.pdf

[3] The Fiscal Survey of the States, National Governors Association, National Association of State Budget Officers, June 2010. http.//nasbo org/Publications/FiscalSurvey/tabid/65/Default.aspx

recovery. This year, state operating deficits are projected to be $125 billion, and in some states are anticipated to continue into 2014.[4] But as the National Conference of State Legislatures (NCSL) notes, even if revenues recover to pre-recession levels, state and local governments will continue to face fiscal pressures due to a combination of factors including the stimulus phase-out, depletion of one-time revenues, expiration of tax increases, and the mounting pressure from rising caseloads and deferred spending.[5] The Government Accountability Office (GAO) projects without any policy changes the state and local government sector will face a $9.9 trillion "fiscal gap" between FY 2009 and FY 2058.[6]

These yearly gaps and the spending pressure presented by Medicaid, K-12 education, and the uncertainty presented by the recently enacted health care bill, must be considered together with the growing funding instability in state and local pension plans. Economists estimate that the unfunded liability faced by state and local government pensions amounts to $3.5 trillion and that without significant reform, plans many plans will begin to run out of assets, beginning with Illinois in 2018.[7] Vested pension benefits are considered contractual obligations, the equivalent of general obligation debt.

States must act today to stabilize and reform their pension systems if they are to meet these obligations to workers. Avoiding reforms today ensures that states will have to confront even more difficult and unpopular budgetary choices than they have faced during the past recession.

[4] National Conference of State Legislatures, "State Budget Update: November 2010" http://www.ncsl.org/LinkClick.aspx?fileticket=AqSBWjZkwK8%3D&tabid=21829

[5] NCSL, "Projected Revenue Growth in FY 2011 and Beyond," p. 10.

[6] Government Accountability Office, "State and Local Governments: Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs," GAO-10-899, July 2010. http://www.gao.gov/new.items/d10899.pdf

[7] Rauh, Joshua D., Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities (May 15, 2010). Available at SSRN: http://ssrn.com/abstract=1596679. According to Rauh, five pension plans including Alaska, Florida, Nevada, New York and North Carolina never run out of assets to pay benefits.

MERCATUS CENTER George Mason University TESTIMONY
BRIDGING THE GAP BETWEEN ACADEMIC IDEAS AND REAL WORLD PROBLEMS

In my testimony I will address what drives budget gaps, and the size and impact of public employee pensions on state budgets. I will conclude with recommendations for reform.

WHY STATES STRUGGLE TO BALANCE THEIR BUDGETS

The recent downturn is only one cause for state budget gaps. Pressure has been building in the states over a much longer period. Simply, put, in the aggregate, state and local spending has grown faster than the private economy in real terms.[8] Between 2000 and 2009, state and local government spending grew nearly twice as fast as the private sector.

What does this mean for state budgets? State spending grew faster than state own-source revenues in 47 states between 1977 and 2007.[9] The fastest growing area in state budgets is Medicaid. In 1987 Medicaid represented 10 percent of state spending on average. In 2009 it represented 21 percent.[10]

While state spending grew faster than state revenues during the period, states mainly showed surpluses. The reason is that states, in addition to relying on own-source revenues, also fund expenditures with federal funds and state debt. GAO finds that the state and local sector in aggregate remained in surplus over this 30 year period in part due to growth in federal funds.[11] Some states avoided showing deficits in part because federal funds grew slightly faster than states' own-source revenues.[12] In addition, between 1995 and 2007, state and

[8] Matthew Mitchell, "State Spending Restraint. An Analysis of the Path Not Taken," Mercatus Center Working Paper, No. 10-48, August 2010 p. 2. http://mercatus.org/publication/state-spending-restraint

[9] Government Accountability Office, "Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs," GAO-10-899, July 2010. http //www.gao.gov/new items/d10899 pdf

[10] Ibid., Matthew Mitchell
[11] GAO 10-899, p 14.
[12] Ibid.

local governments became increasingly reliant on debt to finance capital projects, freeing up revenues for current spending. [13]

In sum, many states have been able to show budgetary balance while revenues failed to keep pace with spending growth partly due to federal funds and debt. In addition some states have made a habit of deferring —in part or in full—their contribution to pension plans, by not funding health care benefits, and by issuing bonds to make pension payments.[14] These techniques helped states show budgetary balance, grow spending, and pass the cost of funding plans onto future taxpayers.

States are now looking to a future with slower economic growth and dramatically increased federal deficits and debt. States will have to rethink how they are budgeting. GAO anticipates that without any change in current policy, state and local governments will require a sustained reduction in spending, or increase in revenues of 12.3 percent annually to close an anticipated $9.9 trillion fiscal gap between FY 2009 and FY 2058.[15]

The federal government plays a significant role in state budgets, largely through the Medicaid program. Medicaid is one of the main spending drivers in state budgets. In 2009 the stimulus increased the FMAP to states on the condition that states maintain or expand enrollment. With stimulus funding spent by the end of this year, states are left with a permanently larger program unless they can make adjustments. This has led several states to ask the federal government for a waiver to the newly enacted health care bill that would allow states to reduce Medicaid enrollment between now and 2014. There will be a large but currently unknown fiscal responsibility placed on the states with the enactment of the health care bill which will seriously constrain states in their ability to maintain their current budgets, and fund future obligations.

[13] Ibid.
[14] Eileen Norcross, "Fiscal Evasion", p 16-18.
[15] Ibid, GAO

That is, the growing fiscal pressure in state budgets due to rising health care costs must be considered alongside the shortfalls in state and local pension plans which will require greater revenues in the near term to ensure these plans remain funded. The choice by some governments to defer obligations and treat pensions as a future problem has exacerbated plans' underfunded status.

PUBLIC SECTOR PENSIONS AND THE EFFECTS ON STATE BUDGETS

State and local governments report an estimated pension shortfall of $1 trillion. However, when using methods that economists agree are correct, the shortfall increases to $3.5 trillion. In either case, many state and local governments face a very significant obligation beginning in the near term. Meeting this obligation requires that state and local governments institute pension reform now.

The magnitude of pension underfunding stems from how pension obligations have been valued which has informed how governments have managed plan funding and benefit levels. The dramatic downturn in the market in recent years is harmful but is not the primary cause for plan underfunding.

Pension plans have been systematically weakened by interactions between actuarial practice and the tendency for governments to make unrealistic promises to employees, and the choice of governments to contribute less than what plan actuaries recommend to fund plans over a period of years.

Current government actuarial practice assumes that plan assets can earn high rates of return, leading actuaries to calculate employer contributions that are lower than needed to fund plan liabilities. Actuarial practice is based on guidance provided by two government accounting standards Government Accounting Standards

Board (GASB) 25 and Actuarial Standards of Practice (ASOP) 27 which state that a liability may be discounted according to what the assets are expected to return when invested.

On average states have assumed an annual return of 8 percent and have used this to measure their pension liabilities. This principle is misguided. According to economic theory and practice how a liability is valued is independent from how it is financed.[16] Instead, the discount rate used to value the liability should reflect the relative safety (or risk) of what is being valued, in this case, a risk-free, government-guaranteed pension. Thus economists recommend the discount rate used should reflect the safety of a government-guaranteed pension, such as the yield on Treasury bonds, currently at 4 percent.

Several things result from the discount rate approach currently used by state and local governments.[17] First, plan managers have an incentive to take on more investment risk to realize higher expected returns on plan assets. This has led public plans to change the mix of their investments and move towards higher-risk equities.[18] In 1990, 40 percent of public sector pension assets were held in equities, rising to 70 percent in 2006, roughly 10 percent higher than the allocation of pension assets to equities in private pension systems.[19]

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[16] For a discussion see, Eileen Norcross and Andrew Biggs, "The Crisis in Public Sector Pensions: A Blueprint for Reform in the States," Mercatus Center Working Paper, No 10-31, June 2010. http //mercatus org/sites/default/files/publication/WP1031-%20NJ%20Pensions.pdf

[17] Discounting allows one to value a future benefit in today's dollars, it asks, "how much is needed to be set aside today to pay a promised amount in the future?" The discount rate is the interest rate selected to perform this calculation. Discounting, is essentially, reverse compounding.

[18] Before the 1980s, most systems held their assets mainly in fixed-income securities, investment choices were restricted by legal lists. In the 1980s legal lists were replaced by the "prudent person" rule. This allowed pension plans to hold larger percentages of equities and capture the higher returns being generated in a booming market, See, Olivia S. Mitchell, David McCarthy, Stanley C. Wisniewksi and Paul Zorn, "Developments in State and Local Pension Plans," Chapter 2 in Pension and the Public Sector, eds. Olivia S. Mitchell and Edwin C. Hustead, University of Pennsylvania Press, Philadelphia 2001, p.14.

[19] Andrew G Biggs, "The Market Value of Public Pension Deficits," Retirement Policy Outlook, No. 1, American Enterprise Institute for Public Policy Research, April 2010, p. 2.

In fact, as a result of the market downturn, some plans are taking on even more risk to make up for losses, exposing funds to greater losses when the stock market performs poorly. California's state pension plan, CalPERS lost $500 million in the financial collapse of the Stuyvesant Town-Peter Cooper Village real estate venture in 2009. In spite of this, to avoid raising the contribution rate for state agencies, CalPERS has expanded its equities holdings from 49.1 percent of 53.1 percent, exposing the portfolio to more volatility in the short-run.

Effectively, public pension accounting implies it is possible to guarantee a certain benefit with volatile investments. This lessens the likelihood there will be enough in the plan to pay benefits when they are due. The majority of a plan's obligations are payable over the next 15 years, so even if plans accurately predict market returns over a long period, they must pay out benefits over the short term when average market returns are more uncertain.[20] Thus there is a significant probability that a "fully funded" plan would be unable to meet its obligations even if the plan accurately projected average market returns. In sum, discounting pensions at the expected rate of return on investments implies that the entire return is available to pay future benefits and makes no allowances for losses. It implies that by taking on more investment risk the plan's funded status is improved.[21]

Secondly, the flawed discount rate assumption has led to the systematic underfunding of pension plans, as the higher discount rate reduces the amount needed to be set aside today to fund the plan. Even where plans are making their full contribution, they are contributing too little. And it has led governments enhance benefit formulas during boom years, since the flawed discount rate assumptions makes plans appear low-cost to the government to fund. When plans look overfunded on paper, legislators grant benefit increases which are then

[20] M. Barton Waring, "Liability-relative investing," Journal of Portfolio Management, 30 (4), 2008. Waring finds that the mid-point of a public pension's stream of benefit payments is around 15 years in the future. Thus, a lump-sum payment 15 years hence can be treated as an approximation of the annual benefit liabilities owed by a plan.
[21] Alicia Munnell, Rickard W. Kopcke, Jean-Pierre Aubry and Laura Quinby, "Valuing Liabilities in State and Local Plans," Center for Retirement Research at Boston College, Number 11, June 2010.

difficult to reverse. The discount rate assumption has also has encouraged states to defer or reduce their payments when plans appeared overfunded or when assets returns were high.

The Stanford Institute for Economic Policy Research finds that the funding policy adopted by the University of California Retirement System (UCRS) allowed contributions to the system to be suspended, "when the fund value is deemed sufficiently high relative to liabilities." The result is that since UCRS was overfunded [on paper] in 1991, contributions fell to 1 percent of covered payroll per year between 1994 and 2007. [22]

While all state and local governments suffer from the same flawed discount rate assumption there is variation in the size of pension shortfalls and the timing of when plans can expect to run out of assets necessitating a move to a pay-as-you-go system.

Two studies that estimate the budgetary impact of pension plan underfunding on individual states. Both rely on different models and assumptions. But together these studies offer some parameters as to what the worst-funded plans can expect.

It must be stressed that these scenarios can and should be generated by state and local governments and made available to the public, as economist Joshua Rauh notes, "it would be useful if states presented complete forecasts of the stream of cash flows they owe to beneficiaries under different assumptions...unfortunately, public pension plans do not present forecasts of long-horizon benefit payments. Instead they present an Accrued Actuarial Liability (AAL), a present value of the cash flows under a discount rate rule chosen to conform with GASB 25."[23]

[22] Howard Bornstien, Stan Markuze, Cameron Percy, Lisha Wang and Moritz Zander, "Going for Broke: Reforming California's Public Employee Pension Systems," Stanford Institute for Economic Policy Research, Stanford University, April 2010.
[23] Rauh, "Are State Public Pensions Sustainable?" p. 5

The most comprehensive estimate of when states can expect to run out of assets to pay pension benefits is provided by Dr. Rauh based on the data made available by state pension reports. He estimates that with 3 percent annual revenue growth and under the states' current average discount rate assumption of 8 percent, eight states will run out of assets to pay pensions by 2020.

By 2018 Illinois will run out of plan assets which will require that the state begin contributing $11 billion annually from revenues between 2019 and 2023. Currently, the state contributes $3.5 billion annually, and has often bonded its contributions. Using less generous assumptions, this scenario is much worse. Indeed, as Dr. Rauh notes this will present a "catastrophic shock" to Illinois' current revenue needs.

The situation is not much better in New Jersey. Dr. Rauh estimates New Jersey will require $10 billion annually out of its revenues to pay for pension benefits it has already made beginning in 2020, which represents one-third of the state's current budget. Other plans have a longer time horizon but face even more difficult scenarios. In 2031, Ohio will require 55 percent of its projected revenues, or roughly $13.8 billion annually to pay for existing liabilities.

A less dire scenario is offered by Alicia Munnell, Jean-Pierre Aubry and Laura Quinby of the Center for Retirement Research at Boston College. They estimate for several states, the percent of budgets that will need to be set aside to ensure pension systems can continue paying workers.[24] Accordingly by 2014, New Jersey and Illinois will have to raise their annual pension contribution to 8 percent of their budget in order

[24] Alicia Munnell, Jean-Pierre Aubry, and Laura Quinby, "The Impact of Public Pensions on State and Local Budgets," Center for Retirement Research at Boston College, Number 13, October 2010. http //crr.bc.edu/images/stories/Briefs/slp_13.pdf

to remain funded, under a generous discount rate assumption of 8 percent. However, when using a lower-risk discount rate of 5 percent, that annual amount would rise to between 12 and 13 percent of their budgets, respectively. In the case of Illinois if they were to run out of assets, this would have to rise to over 16 percent of their budget by 2027.

In the Munnell, Aubry and Quinby scenario, the pension crisis is more manageable, but will still entail difficult choices in these states. New Jersey has grown accustomed to deferring, or partially paying, its pension payment since 2003. Jumping from this year's anticipated contribution of $500 million to nearly $4 billion in three years will mean that New Jersey will have to find savings in other parts of its budget.

Illinois has often relied on bonding its contribution instead of drawing on revenues. In 2003, the state issued $10 billion in Pension Obligation Bonds (POBs).[25] In FY 2010, Illinois issued a $3.5 billion in POBs to make its pension contribution. For FY 2011, the Illinois legislature authorized new pension borrowing of up to $4.1 billion.[26]

Such annual and sustained contributions as suggested by Munnell, Aubry and Quinby will require actions these states have avoided to date. As Alicia Munnell notes, in 2008, 43 percent of state and local governments skipped their pension contribution, and a further 28 percent of governments contributed less than 80 percent of the annual payment.

[25] Alicia Munnell, Thad Calabrese, Ashby Monk and Jean-Pierre Aubry, "Pension Obligation Bonds: Financial Crisis Exposes Risks," Center for Retirement Research at Boston College, Number 9, January 2010. http //crr.bc edu/briefs/pension_obligation_bonds_financial_crisis_exposes_risks.html

[26] Institute for Illinois' Fiscal Sustainability at the Civic Federation, "Some Pension Bond Proceeds Could End up in the General Fund," January 24, 2011. http://civicfed.org/iifs/blog/some-pension-bond-proceeds-could-end-general-funds. They note a provision is attached to the borrowing that would allow the state to use the bond proceeds in the general fund rather than to fund the pension. This provision is subject to the Governor's veto.

These two studies use different methods and assumptions. In addition there are several other recent studies that have estimated when plans are likely to run out of assets to pay plan beneficiaries.[27]

Ultimately it is incumbent on State Governors, Treasurers and actuaries to stress test their pension systems[28].This should be done under a range of assumptions with the methodology and data made publicly available. Only when states generate future cash flows will policymakers have a clear sense of when they are likely to run out of assets and what they need to do today to manage their liabilities. Short of an accurate accounting and thorough forecasting state policymakers have an incentive to ignore the estimates and warnings of economists, thus delaying the very reforms that can help stabilize these systems today.

RECOMMENDATIONS

States must take responsibility for the promises they have made to their workers on behalf of taxpayers. The federal government can help alleviate the growing fiscal stress present in state budgets, largely driven by increasing health care costs, through Medicaid reform. To put states on stable footing requires public pension reform.

I have two recommendations:

1 Make accounting transparent and accurate State and local governments must accurately account for what is owed and model future cash flows to determine what will be need to be set aside annually to pay beneficiaries. While acknowledging current assumptions, states must also apply the risk-free discount rate and stress test pension plans under a range of assumptions. The data, methods and assumptions should be made public. Economists and occasionally plan actuaries have presented plan funding

[27] See Andrew G. Biggs, "An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities," AEI Working Paper 164, February 26, 2010. http://www.aei.org/docLib/Biggs-WP-164.pdf

scenarios that show a very serious picture. The effects of plan underfunding can only be mitigated when states and the public are presented with a complete picture of the tradeoffs that are going to be necessary to ensure plan funding.

2 Make pensions fiscally responsible and stable In our analysis of New Jersey's pension system, Andrew Biggs and I develop several recommendations for how the state can tackle its growing liability. To increase the probability of paying benefits to workers, states can do the following:

Freeze or reduce the Cost of Living Adjustment, increase the retirement age, increase contributions from workers, and, importantly close the defined benefit plan to new hires. This last reform will allow states to focus their resources on paying what is owed. Together, these reforms can cut the size of the liability in half while increasing the likelihood that states can ensure benefits are paid. These reforms will help minimize the impact on taxpayers and the economy. Moving younger workers to a defined contribution plan – which can be designed to fit the needs of public sector workers – allows younger workers more career flexibility, shifts the risk of plan underfunding away from taxpayers, and I would argue most importantly, ends the political and fiscal manipulation of worker benefits which has turned what was intended to be a safe investment for public sector workers into a gamble for both public employees and taxpayers.

CONCLUSION

Some state officials have begun to take steps in the right direction and are advancing some of the reforms mentioned including Governor Christie in New Jersey, Governor Scott in Florida, and State Senator Dan Liljenquist in Utah. They and others are forwarding a variety of reforms that will help states meet these promises. In some cases, public sector unions have shown a willingness to work together with states to find a solution to the funding problem. Unfortunately, in other cases, states are doing the bare minimum, all but ensuring that what is a serious problem today becomes a crisis in several states by decade's end.

With accurate pension accounting and modeling, state and local governments will be able to make better choices. Part of this however requires this accounting and data be made public for evaluation. Voters and workers must also be made aware of the sacrifices that will be necessary to pay what is owed, while at the same time undertaking retirement reform for state and local workers. Short of this, governments unfortunately, have every incentive to continue modeling their pensions based on circular logic, while taking on greater investment risks, and avoiding the kind of reforms that are needed today, to ensure retirees are paid tomorrow.

With the exception of federal spending, states have the tools they need to reform their budgets, and in some cases, it's a question of whether they want to use them. Tough choices need to be made today. Those choices will only become more difficult and economically harmful the longer governments wait. Thank you for the opportunity to testify today. I look forward to answering your questions.

Mr. MCHENRY. Mrs. Lav.

STATEMENT OF IRIS LAV

Ms. LAV. Mr. Chairman, Mr. Quigley, members of the subcommittee, thank you for the invitation to appear before you today. I believe that predictions that States throughout the country will have to bail out localities or that the Federal Government will have to bail out the States are substantially exaggerated, and I think they are producing unnecessary alarm among policymakers and the public at large.

I would like to untangle some of these claims today about cyclical issues, bonds and pensions.

First, cyclical issues. States are projecting large operating deficits as you said of about $125 billion for the 2012 fiscal year, which begins in July in most States. Unemployment remains high. Revenues remain below pre-recession levels, and there is rising demand for public services due to the weak economy and growing population. Figure one please. Moreover, the fiscal relief provided through the American Recovery and Reinvestment Act in 2009 is ending. That's not mine. That's someone else's.

It has been enormously helpful in allowing States to avert potential budget cuts and tax increases. States have used the fiscal relief to cover about one-third of their budget shortfalls through the current fiscal year, but only about $6 billion will be available for next year, covering less than 5 percent of these shortfalls.

As difficult and painful as the choices are, States and localities will balance their upcoming budgets through budget cuts, tax increases and use of reserve funds. That's what they do. And remember, it's a cyclical problem that will shrink in size as the economy continues to recover and State revenues continue to grow.

Second, bond. So there's no credible evidence of a bubble or crisis in State and local bonds.

If we could go to figure 3 please.

First interest payments on State and local bonds absorb just 4 to 5 percent of current State and local expenditures, no more than they did in the 1970's. And the historical default rates since 1970, through several recessions, has been about one-third of 1 percent.

Finally, there's no large increase in bond issuance nor are their exotic securities that hide the underlying value of the assets against which the bonds are issued, as was the case with the subprime mortgage bonds.

Third, pensions, which, of course, is a little more complicated. There are shortfalls, we all said, in pension funding for future State and local retirees. States will have to address them over the next three decades or so.

Figure 4 please.

Pensions were fully funded in 2000 before the last two recessions using standard accounting. The recessions reduced the value of assets and some jurisdictions didn't make the required deposits. So as was mentioned, the Center for Retirement Research at Boston College finds that States and localities have about $700 billion in unfunded liabilities. That implies they have to increase their contributions on average over the next 30 years from about 3.8 percent of budgets to 5 percent of budgets. Now that's on average, it's not

Illinois. But changes to pension plans could reduce that cost, and 3.8 percent to 5 percent is not a crisis.

The major controversy is over whether these traditional accounting standards are appropriate. And that $3 trillion number which comes from economists who measure future costs assuming a riskless rate of returning such as in Treasury bonds about 4 percent.

Figure 5 please.

But pension funds do invest in a diversified basket of private securities. The average historical rate of return has been about 8 percent, as you can see in that chart. It may or may not be a little lower going forward, but it's quite unlikely to be just 4 percent. So the $3 trillion numbers of construct doesn't represent the amount that pension funds have to invest to meet their obligations. The States in trouble are basically those that skipped their payments.

To summarize, cyclical problems are serious but will abate as the economy improves. The muni bond market is not in a bubble or in danger of experiencing widespread default, and pensions need attention but in most cases are not in crisis.

I see no need for Federal intervention in these areas. States do not want or need the power to declare bankruptcy. Nor is there a need, as Mr. Nunes has suggested, for Federal legislation to require States and localities to report their pensions on a riskless rate as a condition for issuing tax exempt bonds. And I should note there's a process going on in the Governmental Accounting Standards Board to reform already going on 2 years to reform the way pensions are reported and to put all States reporting on the same basis which would be a transparency improvement, so you could see what's going on and to have a reasonable actuarial method for reporting and Mr. Nunes's proposal would short-circuit that. Thank you.

Mr. McHenry. Thank you, Ms. Lav. I certainly appreciate that.

[The prepared statement of Ms. Lav follows:]

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TESTIMONY OF IRIS J. LAV
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Before the House Oversight Committee
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs
February 9, 2011

Mr. Chairman, Mr. Quigley, and members of the committee, I appreciate the invitation to appear before you today.

A spate of recent articles regarding the fiscal situation of states and localities have lumped together their ***current*** fiscal problems, stemming largely from the recession, with ***longer-term*** issues relating to debt, pension obligations, and retiree health costs, to create the mistaken impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown. That is far from true.

Operating Deficits

States are projecting large operating deficits for the upcoming 2012 fiscal year, totaling about $125 billion in aggregate These deficits, which states have to close before the fiscal year begins (on July 1 in most states), are caused largely by the weak economy. State revenues have stabilized and in some states resumed at least weak growth after record losses, but they remain 12 percent below pre-recession levels after adjustment for inflation. Localities also are experiencing diminished revenues. At the same time that revenues have declined, the need for public services has increased due to the rise in poverty and unemployment. Over the past three years, states and localities have used a combination of reserve funds and federal stimulus funds, along with budget cuts and tax increases, to close these recession-induced deficits.

As states release their proposed budgets, we find that nearly all states are proposing to spend less money than they spent in 2008 (after inflation), even though the cost of providing services will be higher. Most state spending goes toward education and health care, and in the 2012 budget year, there will be more children in public schools, more students enrolled in public colleges and universities, and more Medicaid enrollees in 2012 than there were in 2008. But among 26 states that have to date released the necessary data, 21 states plan to spend less in 2012, after inflation, than they did in 2008, and only two — Alaska and North Dakota — expect to spend significantly more. Total proposed spending would be over 10 percent below 2008 levels, after adjustment for inflation. Many of the budget cuts are reducing core services — in K-12 education, higher education, and health care.[1]

[1] http://www.cbpp.org/cms/index.cfm?fa=view&id=3389

There are three primary reasons for the deep cuts.

- **Revenues remain weak**, as noted above.

- **Costs are rising.** In the 2011-12 school year there will be about 260,000 more public school students and another 960,000 more public college and university students than in 2007-08, for example. Some 4 million more people are projected to receive subsidized health insurance through Medicaid in 2012 than were enrolled in 2008, as employers have cancelled their coverage and people have lost jobs and wages.

- **Federal aid is ending.** The fiscal relief provided through the American Recovery and Reinvestment Act of 2009 has been enormously helpful in allowing states to avert some of the most harmful potential budget cuts. States have used emergency fiscal relief from the federal government to cover about one-third of their budget shortfalls through the current (2011) fiscal year. But only about $6 billion in fiscal relief will be left for fiscal year 2012, a year in which shortfalls will total at least $125 billion. (See Figure 1.) That is, the remaining fiscal relief will cover less than five percent of state budget shortfalls next year

It is worth saying a few more words about the role of the ARRA funding. ARRA initially provided about $140 billion in fiscal relief through increased federal matching rates for state Medicaid spending and through a new State Fiscal Stabilization Fund, primarily targeted at education.

- A little less than $50 billion was delivered through the State Fiscal Stabilization Fund. Most of this (more than 80 percent) was targeted to education.

- Roughly $90 billion was delivered through enhanced FMAP, the enhanced federal match for state Medicaid expenditures to help compensate for the large increase in Medicaid enrollees the recession caused.

The August, 2010 jobs bill provided approximately another $25 billion in state fiscal relief It extended ARRA's enhanced FMAP for two more quarters until June 30, 2011 (about $15 billion), and provided support to help states retain or create education jobs (Education Jobs Fund – $10 billion)

The Government Accountability Office finds that states spent this money as intended

- GAO has studied how 16 states and DC are spending the fiscal relief provided to states under ARRA, and concluded that states spent the money as intended, to reduce spending cuts and avoid tax increases that would have further slowed the economy.

- "Overall, states reported using Recovery Act funds to stabilize state budgets and to cope with fiscal stresses," GAO concluded. "The funds helped them maintain staffing for existing programs and minimize or avoid tax increases as well as reductions in services."[2]

[2] GAO, "Recovery Act States' and Localities' Current and Planned Uses of Funds While Facing Fiscal Stresses," July 8, 2009 More recent GAO reports on ARRA fiscal relief spending in these states has reached similar conclusions

Moreover, state fiscal relief is a very effective form of stimulus.

- Mark Zandi, the chief economist at Moody's Analytics, estimates that state fiscal relief provides $1.41 in economic activity for every $1 spent.[3]

- The Congressional Budget Office finds that state fiscal relief is one of the most effective of the forms of economic stimulus it studied.[4]

ARRA's fiscal relief had an immediate impact on state spending decisions when ARRA was enacted in February 2009, when economic activity was declining rapidly. Most states were in the process of developing their budgets for the fiscal year that began in July 2009, and some were considering immediate cuts in their current-year budgets. ARRA's relief mitigated the spending cuts (and tax increases) states imposed during those crucial first months after ARRA's passage.

The difficulty of coping with the end of the ARRA funding — which is occurring before the economy has regained sufficient strength and before state revenues have recovered — will be exacerbated if the budget cuts in "non-security discretionary" spending federal policymakers are considering are enacted. These budget cuts would significantly reduce the amount of ongoing federal funding to states. About one-third of the category of the federal budget known as "non-security discretionary" spending flows through state governments in the form of funding for education, health care, human services, law enforcement, infrastructure, and other areas House leaders have proposed cutting that spending by $40 billion. That would be a 15 4 percent reduction from the level provided in the current continuing resolution for the remainder of the federal fiscal year, which ends in September. This would reduce federal support for services provided through state and local governments, forcing states to make still-deeper cuts in their budgets for next year.

While the economy-induced deficits have caused severe problems and states and localities are struggling to maintain needed services, this is a cyclical problem that ultimately will ease as the economy recovers

Unlike the projected operating deficits for fiscal year 2012, which require near-term solutions to meet states' and localities' balanced-budget requirements, longer-term issues related to bond indebtedness, pension obligations, and retiree health insurance — discussed more fully below and in the attached January 20, 2011 report, *Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm*[5] — can be addressed over the next several decades. It is not appropriate to add these longer-term costs to projected operating deficits. Nor should the size and implications of these longer-term costs be exaggerated, as some recent discussions have done. Such mistakes can lead to inappropriate policy prescriptions

[3] See http //www economy com/mark-zandi/documents/Final-House-Budget-Committee-Perspectives-on-the-US Economy-070110 pdf

[4] http //www cbo gov/ftpdocs/119xx/doc11975/11-24-ARRA pdf

[5] http //www cbpp org/cms/index cfm?fa=view&id=3372

Bond Indebtedness

Some observers claim that states and localities have run up huge bond indebtedness, in part to finance operating costs, and that there is a high risk that a number of local governments will default on their bonds. Both claims are greatly exaggerated.

- 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. (See Figure 2.) Recently, the Build America Bond provisions of the Recovery Act encouraged borrowing for infrastructure building as a way to improve employment; these bonds can only be used to finance infrastructure.

- 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. (See Figure 3, and Figures 4 and 5 for state-by-state data on debt outstanding and interest expense.)

- Municipal bond defaults have been extremely rare; the three rating agencies calculate the default rate at ***less than one-third of 1 percent.***[6] Between 1970 and 2009, only four defaults were from cities or counties. Most defaults are on non-general obligation bonds to finance the construction of housing or hospitals and reflect problems with those individual projects; they provide no indication of the fiscal health of local governments.

- The person most vociferously proclaiming the potential of defaults in the media has been shown to lack data to back up her claims. Meredith Whitney's report, which few had seen, apparently does not present evidence substantiating the potential of sizeable defaults. In a recent interview with Bloomberg News, she said "Quantifying is a guesstimate at this point."[7]

- While some have compared the state and local bond market to the mortgage market before the bubble burst, the circumstances are very different. There is no bubble in state and local bonds, nor are there exotic securities that hide the underlying value of the asset against which bonds are being issued (as was the case with subprime mortgage bonds). Most experts in state and local finance do not expect a major wave of defaults For example, a Barclays Capital December 2010 report states, "Despite frequent media speculation to the contrary, we do not expect the level of defaults in the U.S. public finance market to spiral higher or even approach those in the private sector."

[6] Chris Hoene, "Crying Wolf about Municipal Defaults," National League of Cities blog, December 22, 2010, http //citiesspeak org

[7] Max Abelson and Michael McDonald, Whitney Municipal-Bond Apocalypse Short on Specifics, Bloomberg, February 1, 2011 http //www bloomberg com/news/2011-02-01/whitney-municipal-bond-apocalypse-is-short-on-default-specifics html

Pension Obligations

Some observers claim that states and localities have $3 trillion in unfunded pension liabilities and that pension obligations are unmanageable, may cause localities to declare bankruptcy, and are a reason to enact a federal law allowing states to declare bankruptcy. Some also are calling for a federal law to force states and localities to change the way they calculate their pension liabilities (and possibly to change the way they fund those liabilities as well). Such claims overstate the fiscal problem, fail to acknowledge that severe problems are concentrated in a small number of states, and often promote extreme actions rather than more appropriate solutions.

- State and local shortfalls in funding pensions for future retirees have gradually emerged over the last decade principally because of the two most recent recessions, which reduced the value of assets in those funds and made it difficult for some jurisdictions to find sufficient revenues to make required deposits into the trust funds. Before these two recessions, state and local pensions were, in the aggregate, funded at 100 percent of future liabilities (See Figure 6.)

- A debate has begun over what assumptions public pension plans should use for the "discount rate," which is the interest rate used to translate future benefit obligations into today's dollars. The discount rate assumption affects the stated future liabilities and may affect the required annual contributions. The oft-cited $3 trillion estimate of unfunded liabilities calculates liabilities using what is known as the "riskless rate," because the pension obligations themselves are guaranteed and virtually riskless to the recipients. In contrast, standard analyses based on accepted state and local accounting rules, which calculate liabilities using the historical return on plans' assets, put the unfunded liability at about a quarter of that amount, a more manageable (although still large) $700 billion.

  (As described below, the Government Accounting Standards Board is in the process of changing the rules for pension accounting, but they are not moving to using a "riskless rate" for all liabilities.)

- Economists generally support use of the riskless rate in valuing state and local pension liabilities because the constitutions and laws of most states prevent major changes in pension promises to current employees or retirees; they argue that definite promises should be valued as if invested in financial instruments with a guaranteed rate of return. However, state and local pension funds historically have invested in a diversified market basket of private securities and have received average rates of return much higher than the riskless rate – 8 percent over the past two decades. And economists generally are not arguing that the investment practices of state and local pension funds should change. (See figure 7.)

- A key point to understand is that the two issues of how states and localities should value their pension liabilities and how much they should contribute to meet their pension obligations are not the same. The $3 trillion estimate of unfunded liabilities does not mean that states and localities should have to contribute that amount to their pension funds, since the funds very likely will earn higher rates of return over time than the Treasury bond rate, which will result in pension fund balances adequate to meet future obligations without adding the full $3 trillion to the funds. In fact, two of the leading economists who advocate valuing state pension fund assets at the riskless rate have observed, ".. the question of optimal funding levels...is entirely separate from the valuation question "[8] The required contributions to state and local pension funds should reflect not just on an assessment of liabilities based on a riskless rate of return, but also the expected rates of return on the funds' investments, as well as other practical considerations. As a result, it is mistaken to portray the current pension fund shortfall as an unfunded liability so massive that it will lead to bankruptcy or other such consequences.

- States and localities devote an average of 3.8 percent of their operating budgets to pension funding.[9] In most states, a modest increase in funding and/or sensible changes to pension eligibility and benefits should be sufficient to remedy underfunding. (The $700 billion figure implies an increase on average from 3.8 percent of budgets to 5 percent of budgets, if no other changes are made to reduce pension costs.[10]) However, in some states that have grossly underfunded their pensions in past years and/or granted retroactive benefits without funding them — such as Illinois, New Jersey, and Pennsylvania (and to a somewhat lesser extent Colorado, Kentucky, Kansas, and California) — additional measures are very likely to be necessary.

- States and localities have managed to build up their pension trust funds in the past without outside intervention They began pre-funding their pension plans in the 1970s, and between 1980 and 2007 accumulated more than $3 trillion in assets. There is reason to assume that they can and will do so again, once revenues and markets fully recover

- States and localities have the next 30 years in which to remedy any pension shortfalls. As Alicia Munnell, an expert on these matters who directs the Center for Retirement Research at Boston College, has explained, "even after the worst market crash in decades, state and local plans do not face an immediate liquidity crisis; most plans will be able to cover benefit payments for the next 15-20 years."[11] States and localities do not need to increase contributions immediately, and generally should not do so while the economy is still 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 These promises are of a substantially different nature than pensions, however, so it is inappropriate to simply add the two together.

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[8] Robert Novy-Marx and Joshua Rauh, "Public Pension Promises How Big Are They and What Are They Worth?" *Journal of Finance*, forthcoming (posted October 8, 2010 on Social Science Research Network), p 5

[9] Data are for 2008, the most recent year available from Census

[10] Alicia H Munnell, Jean-Pierre Aubry, and Laura Quinby, *The Impact of Public Pensions on State and Local Budgets*, Center for Retirement Research at Boston College, October 2010

[11] Alicia H Munnell, Jean-Pierre Aubry, and Laura Quinby, "Public Pension Funding in Practice," NBER Working Paper 16442, October 2010

- While pension promises are legally binding, backed by explicit state constitutional guarantees in some states and protected by case law in others, ***retiree health benefits generally are not.*** States and localities generally are free to change any provisions of the plans or terminate them entirely.

- States' retiree health benefit plans differ widely. For example, 14 states pay the entire premium for retirees participating in the health plan, while 14 other states require retirees to pay the entire premium. States clearly have choices in the provision of retiree health benefits.

- With health care costs projected to continue to grow faster than GDP and faster than state and local revenues, it is highly likely that current provisions for retiree health insurance will be scaled back. Many states are likely to decide that their current plans are unaffordable and move to modify them.

- This would be a good time for states and localities offering the more generous plans to decide whether they want to maintain ***and fund*** these liabilities, or whether they want to substantially reduce their liabilities by changing the provisions of their plans.

Avoid Changes that Could Harm Fiscal Conditions

Given the different origins, scope, and potential solutions to problems in each of these areas, calls for a "global" solution — such as recent proposals to allow states to declare bankruptcy or to limit their ability to issue tax-exempt bonds unless they estimate pension liabilities using a riskless discount rate — make little sense in the real world of state and local finances

For example, some people have suggested enacting federal legislation that would allow states to declare bankruptcy, potentially enabling them to default on their bonds, pay their vendors less than they are owed, and abrogate or modify union contracts.[12] Such a provision could do considerable damage, and the necessity for it has not been proven.

As discussed above, states have a strong track record of repaying their bonds. In most states, bonds are considered to have the first call on revenues; debt service will be paid ***before*** any public services are funded. (In California, education has the first call on revenues because of the provisions of a ballot initiative, but bonds are right behind.)

There are no modern instances of a state defaulting on its general obligation debt. One has to reach back to the period before and during the Civil War, when several states defaulted, or the single state that defaulted during the Great Depression (Arkansas), to find examples.

It would be unwise to encourage states to abrogate their responsibilities by enacting a bankruptcy statute. States have adequate tools and means to meet their obligations The potential for bankruptcy would just increase the political difficulty of using these other tools to balance their budgets, delaying the enactment of appropriate solutions. In addition, it could push up the cost of borrowing for all states, undermining efforts to invest in infrastructure.

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[12] See, for example, David Skeel, "Give States a Way to Go Bankrupt," *The Weekly Standard*, November 29, 2010, http //www weeklystandard com/articles/give-states-way-go-bankrupt_518378 html and Grover G Norquist and Patrick Gleason, "Let States Go Bankrupt," *Politico*, December 24, 2010

Another proposal would require states and localities to report their pensions liabilities to the federal government using the so-called "riskless rate" described above [13] Jurisdictions that did not comply would not be allowed to issue tax-exempt bonds.

As discussed above, analysis of liabilities using the riskless rate can cause confusion about the amounts states and localities actually have to deposit to meet their responsibilities. It would create a lot of paperwork, but could result in less transparency rather than more because of the potential for confusion.

Such a requirement also is not necessary. For the last couple of years, the Governmental Accounting Standards Board (GASB) has been working on a standard for state and local pension reporting that balances the need for consistent disclosure across jurisdictions and the appropriate recognition of risk with the need to accurately assess the contributions required to fund the systems The GASB process has included widespread participation of interested parties, and GASB is close to finalizing a rule. While GASB standards do not have the force of law, state and local governments generally adhere to them in their financial reports — largely because bond rating agencies look askance at governments that do not.

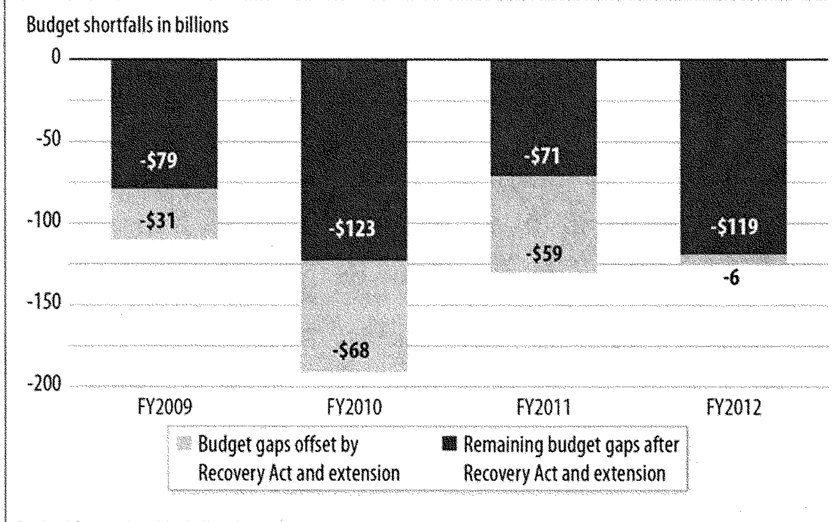
Thus state and local pension reporting will change in the near future, and will become more standardized across jurisdictions and more transparent, and will change with respect to the way risk is recognized. Federal intervention at this time is not needed, and could harm the ability of states to adopt the new GASB standards by requiring yet a different calculation for federal reporting.

Indeed, these and similar proposed solutions could ***worsen*** states' long-term fiscal picture by undermining their ability to invest in infrastructure and meet their residents' needs for education, health care, and human services What are needed are targeted solutions that are appropriate to each state and to the nature of its fiscal problems, not federal intervention.

[13] A bill proposed by House of Representative members Paul Ryan, Darrell Issa, and Devin Nunes (H R 6484 in the 111th Congress) would require states and localities to report pension liabilities to the federal government using U S Treasury Bond rates to discount liabilities as a condition of issuing tax-exempt bonds

Figure 1

ARRA Fiscal Relief Funds by Year

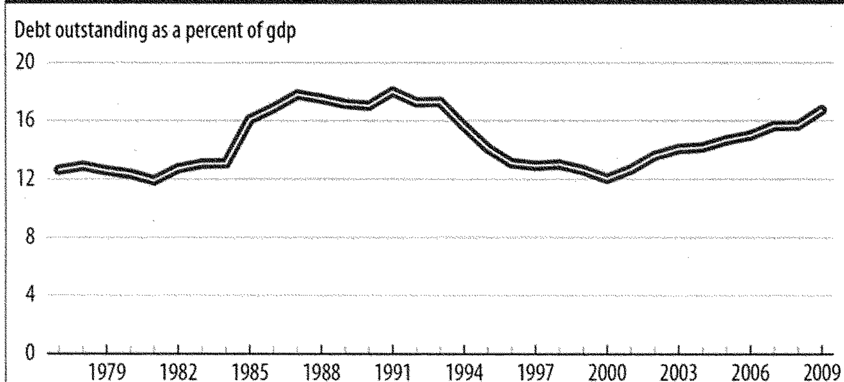


Revised September 2010, FY = fiscal year.

Source: CBPP analysis using data from U.S. Department of Health and Human Services, U.S. Department of Education, Congressional Budget Office, and state budget documents.

Figure 2

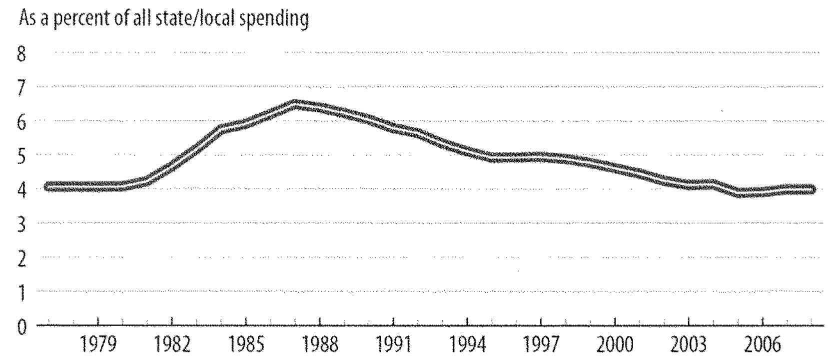
State and Local Government Debt Remains Within Historical Range



Sources: Federal Reserve Statistical Release, Flow of Funds Accounts of the United States, and Bureau of Economic Analysis.

Figure 3

Interest Payments on Debt Constitute Modest Part of State/Local Spending



Sources: CBPP calculations of Census Bureau data from the State & Local Government Finance Data Query System, The Urban Institute-Brookings Institution Tax Policy Center, and Census Bureau data.

Figure 4

State by State Interest on Debt

State	FY 2008 Interest on Debt As a Share of State and Local Expenditures
Alabama	2.8%
Alaska	3.6%
Arizona	3.7%
Arkansas	2.6%
California	3.8%
Colorado	5.1%
Connecticut	4.7%
Delaware	3.8%
DC	3.2%
Florida	3.7%
Georgia	2.5%
Hawaii	4.8%
Idaho	2.5%
Illinois	4.9%
Indiana	3.6%
Iowa	2.8%
Kansas	4.2%
Kentucky	4.8%
Louisiana	3.4%
Maine	3.2%
Maryland	3.2%
Massachusetts	6.8%
Michigan	3.9%
Minnesota	3.5%
Mississippi	2.2%
Missouri	4.3%
Montana	3.5%
Nebraska	3.2%
Nevada	4.5%
New Hampshire	5.0%
New Jersey	3.9%
New Mexico	2.9%
New York	4.5%
North Carolina	3.2%
North Dakota	4.3%
Ohio	3.3%
Oklahoma	2.8%
Oregon	3.5%
Pennsylvania	4.6%
Rhode Island	4.9%
South Carolina	4.0%
South Dakota	3.6%
Tennessee	2.9%
Texas	5.1%
Utah	3.1%
Vermont	3.7%
Virginia	3.3%
Washington	4.3%
West Virginia	3.1%
Wisconsin	3.8%
Wyoming	1.4%
United States Total	4.0%

Source: Census Bureau Data.

Figure 5

State by State Debt Outstanding

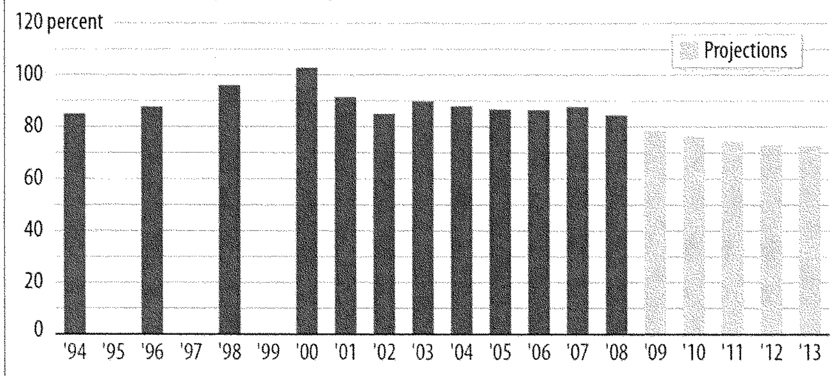
State	FY 2008 Debt Outstanding As a Share of 2007 GSP
Alabama	16.9%
Alaska	22.5%
Arizona	16.7%
Arkansas	13.3%
California	18.1%
Colorado	20.5%
Connecticut	16.5%
Delaware	13.5%
DC	10.4%
Florida	18.7%
Georgia	12.6%
Hawaii	16.2%
Idaho	10.5%
Illinois	19.7%
Indiana	17.7%
Iowa	11.5%
Kansas	17.3%
Kentucky	25.2%
Louisiana	15.7%
Maine	15.8%
Maryland	13.9%
Massachusetts	26.2%
Michigan	19.4%
Minnesota	16.3%
Mississippi	14.5%
Missouri	17.6%
Montana	18.4%
Nebraska	17.0%
Nevada	18.8%
New Hampshire	18.1%
New Jersey	18.5%
New Mexico	17.9%
New York	24.8%
North Carolina	12.9%
North Dakota	12.9%
Ohio	14.6%
Oklahoma	12.2%
Oregon	17.5%
Pennsylvania	22.2%
Rhode Island	24.1%
South Carolina	23.1%
South Dakota	14.8%
Tennessee	14.7%
Texas	18.9%
Utah	15.3%
Vermont	17.9%
Virginia	14.0%
Washington	19.8%
West Virginia	16.9%
Wisconsin	17.7%
Wyoming	7.1%
United States Total	18.2%

Source: Census Bureau Data and U.S. Bureau of Economic Analysis.

Figure 6

Public Pensions Fully Funded in 2000 But Have Since Declined

Aggregate state and local pension funding level assets as a share of trust fund liabilities

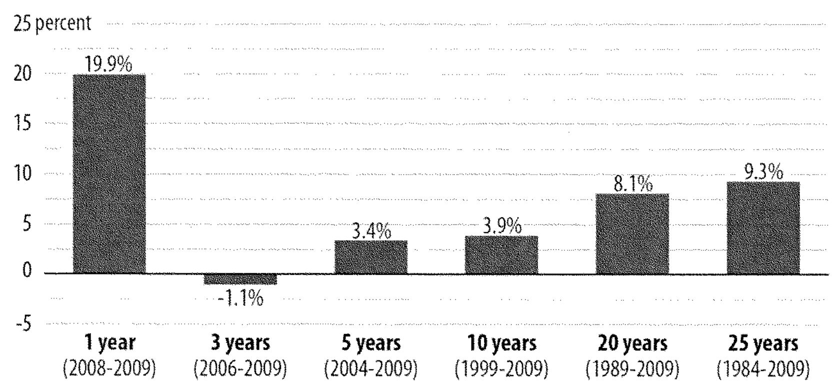


Source: Center for Retirement Research at Boston College (data not provided for 1995, 1997, and 1999).

Figure 7

Public Pension Investments Have Earned 8 Percent Annually Over Past Two Decades

Median public pension investment returns for periods ending 12/31/09

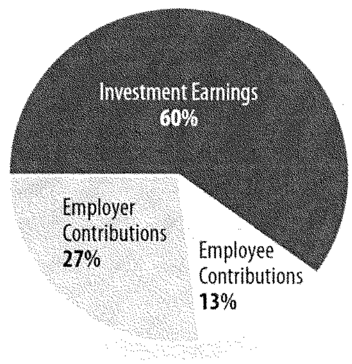


Source: NASRA, based on data from Callan Associates.

Figure 8

Trust Fund Earnings Make Up Large Share of Public Pension Revenues

State and local pension trust fund sources of revenue



Note: Cumulative percentage distribution of public pensions fund revenue sources nationwide, 1982 to 2009.
Source: NASRA, 2010 (based on U.S. Census data).

Mr. MCHENRY. And we will begin the questioning with the vice chair of the subcommittee, Mr. Guinta of New Hampshire.

Mr. GUINTA. Thank you very much, Mr. Chairman, and thank each of you for coming and testifying before us today. I have a couple questions for each of you so I'm going to try to be quick. First with Ms. Lav. You had stated that there is no impending or looming crisis at the moment. I guess the first question I would have is how would you define a crisis if what we are seeing with the States and their obligation requirements at the levels they are at? How would you define a crisis?

Ms. LAV. I would define a crisis as something States had no way of digging themselves out of. States have many, many tools in which to do this. So if you have to raise your pension contributions from 3.8 percent of expenditures to 5 percent of expenditures, that's probably, you can accommodate that within budget particularly after the economy recovers. And certainly, they are cyclical deficits. States are finding ways to close those cyclical deficits. We don't appreciate some of a lot of the budget cuts States are making which are harming low income people and residents, but that's what they do. States have balanced budget requirements and that's what they do. They manage their finances.

Mr. GUINTA. I think the concern that I and others share is that as States "manage their finances" they are spending an extraordinarily higher amount of money percentagewise of borrowed dollars to get us through these "lean or challenging" economic times.

My State of New Hampshire has done that to pay expenses, New Jersey has done that to pay expenses, which is not either good GASB accounting standard practices, or it is just not good business standards of practice. And I don't know that you had a chance to touch upon it in your verbal remarks, but I note that in your written remarks, you talked about the GASB standards. My concern is, at some point, there is this potential of States wanting to come to the Federal Government for a "bailout" because of what they define as an economic challenge that they're having.

I would argue something a little bit different. Any responsible Governor, legislature or administrator should be anticipating these challenges, and it doesn't appear that has been done in a responsible way.

So I understand your point. But can you speak to those States that are borrowing money essentially to pay for ongoing expenses? And I'm not even talking about stimulus money they have received. I'm just talking about borrowing money.

Ms. LAV. Very few States borrow for operating expenses. Illinois has borrowed a number of times, floated bonds to make its pension contributions, which is very bad practice.

By and large, States borrow money for infrastructure, and you don't see in the data any substantial run-up in borrowing as a percent of gross State product. We have a chart there that I provided some information to you behind my testimony some graphics and State-by-State information on that. You don't really see any run-up in borrowing. It isn't good practice for States to borrow to pay their operating expenses. They should borrow for infrastructure, because that is what makes sense to do economically. So we don't approve of borrowing for operating expenses usually. And in the longer paper that I refer to in my written testimony, we do have, the whole last section does suggest that States do have, as I believe Mr. Quigley referred to in Illinois, some structural deficits and mismatch between their expenditures and their revenues and part of that, and they do need to take some steps to fix those mismatches. There is no question about that. But a lot of that mismatch comes from the rate of growth of health care costs in the economy. States spend a lot of their money on health care, and health care costs are growing faster than the economy, all throughout the economy in the private sector and in the public sector and so States which have revenues that very often go somewhat slower than the economy because of the structure of their tax system have a very hard time meeting their responsibilities to provide health care to those people in the States that need it, the elderly and the disabled and the poor.

Mr. GUINTA. I would agree that States need to better manage the pie in the budgetary challenges they are having. But it sounds like you are making an argument now for bankruptcy when in your comments, you suggest that it's not necessary at this point because of the looming fiscal challenges that they're having.

Ms. LAV. They don't need bankruptcy to fix these problems.

Mr. GUINTA. I do want to ask Ms. Norcross if you would be able to comment a little bit on the testimony we just heard.

Ms. NORCROSS. I would like to explain the discount rate controversy a little more than by way of analogy and it's important because it has informed decades of policy within the pensions systems, which I believe we are seeing the results of that today. And the analogy is this, the reason you can't choose a discount rate based on what you think your assets will return to value the liability is, if you consider you have a mortgage and you have, let's say, a mutual fund, your broker says, we think, I think you're going to return 10 percent annually on your mutual fund. That doesn't enable you to slice your mortgage in half. The bank doesn't send you a different mortgage statement based on that.

So what that circular logic has produced over the years and certainly, yeah, in the 1980's and the 1990's some of these pension plans looked fine, A, they have undervalued the size of the promise so they're sort of expecting that rate of return will be taking care of the necessary contributions that they should be making to fund the system.

And No. 2, when plans look overfunded on paper, it led some States to grant these really generous benefit enhancements without even doing the math. In New Jersey, in 2001, the State granted a 9 percent benefit increase and didn't even figure out what it would cost them. And that's one of the areas the Governor is trying to address right now.

And remarkably, it violates another principle, which is you can secure a guaranteed investment with a high risk stream of investments, and in the short term, you're going to realize more volatility in your investments, and yet that promise is due within 15 years.

So they're basically trying to secure a guaranteed pay-out with a high-risk investment, and that is the flaw of logic. But Joshua Rauh, in his paper, he uses the 8 percent discount rate. And he says even that, even if we grant you that, we're looking at funds starting to run out of assets with 3 percent revenue growth by the end of the decade. New Jersey's actuaries also released a paper on their new reports on Friday using the 8.25 discount rate and they say we have 12 years in the police officer's plan. So I hope those comments help.

Mr. MCHENRY. I thank you for your testimony. The gentleman's time has expired. At the request of the subcommittee ranking member he is deferred to the full committee ranking member.

Mr. Cummings, you are recognized for 5 minutes.

Mr. CUMMINGS. Thank you very much, Mr. Chairman. I want to thank you and our ranking member, and I thank you for working in a bipartisan way to address this problem.

Ms. Lav, it is interesting after listening to the vice chairman of our subcommittee speaking just a moment ago, I find it interesting that the National Governors Association, that is, Republican and Democratic Governors through their chairmen and vice chairmen, said this on February 4, 2011: "Allowing States to declare bankruptcy is not an authority any State leader has asked for nor would they likely use. States are sovereign entities in which the public trust is granted to its elected leaders. The reported bankruptcy proposal suggests that a bankruptcy court is better able to overcome political differences, restore fiscal stability and manage the finances of a State. These assertions are false and serve only to threaten the fabric of the State and local finance."

Ms. Lav do you agree with these Governors that the State bankruptcy proposal threatens the fabric, and these are their words of State and local finance? Can you be brief please? I have several questions.

Ms. LAV. Yes, I do agree. States have all the tools they need to manage their finances. Occasionally, one State doesn't, but they have the tools they need.

Mr. CUMMINGS. And what would you recommend as to how those States might improve their fiscal situations?

Ms. LAV. I think there are many ways that States can improve their fiscal situations. They can move to taking a longer term look, many of them only look 1 year ahead or 2 years ahead. They can improve their revenue systems and be sure their revenues match with their expenditures. They can have processes in place where there are consequences of skipping a pension contribution, which has caused a lot of the problems we are talking about today.

There are many things that they can do to make it clearer to policymakers and the public about their own situations and allow some oversight. But I think that States themselves have the ability to do that, and that this recession has just been so very long and so very deep that some of the flaws have become apparent, but it's not going to be forever, and I think they will adjust their revenues and their expenditures to manage these problems.

Mr. CUMMINGS. Our House Budget Committee chair, Paul Ryan and the Republicans proposed cutting the Federal budget domestic discretionary non-military non-security spending approximately $40 billion this year and much more in the future. Wouldn't this significantly worsen the State and local governments' fiscal problems because a lot of that money flows to the State, is that right?

Ms. LAV. Yes. That's right.

Mr. CUMMINGS. And this is no gift is it? It's not a gift to the States?

Ms. LAV. No. It's not a gift. It's a penalty for the States basically. It is about a third of non-security spending that Mr. Ryan wants to cut is our grants that flow through to State and local governments, and so depending we don't have the exact number, but somewhere probably between about, don't hold me exactly to it, but $10 and $13 billion would be money that the States would have to scramble on top of their existing deficits, additional deficits they would have to close because of these cuts.

Mr. CUMMINGS. Isn't most underfunding of State pensions due to recent dramatic declines in the stock market which hurt investment portfolios of almost all American investors including hedge funds, regular working people, and probably most lawmakers and staff, reporters and attendees here today, given the recent emerging recovery market up turn and projected future gains, don't you agree with the analysis expecting future long-term gains equally over the next 30 years to smooth out today's current problems?

And the reason why I raise this, and any of you all can answer this, is that when the storm is over, I don't want to see situations where our employees, by the way a lot of them are working in this room today, may have lost their pensions and now going to the States, State pensions have been diminished, States come out of recovery, and then because some States fail to make their pension payments on time, and you got to keep in mind the employees, they pay, they have to pay, right? They have to pay.

Ms. LAV. Yes. The contributions come in on time.

Mr. CUMMINGS. So one of my concerns is when the storm is over, then these folks have been locked out of a lot of money that they were due. So I will start with you, Ms. Lav, and then maybe some of the others may have a comment on that.

Ms. LAV. Of course the improvement in the economy and the improvement in the market will have a lot to do with improving the outlook of pensions over time, and for most States, that have not provided retroactive benefits without funding them or have not seen a pension payment contributions in the past, they will be fine. So the vast majority of States will be fine when that occurs, as that occurs.

Ms. NORCROSS. I would say that the only reason why workers may lose some of the benefits that are promised is because the investments have been treated as a gamble rather than secured as they should have been secured. They've been misvalued and therefore the investment strategies have not been appropriate for the plan. I share the view that what's been promised has been promised, and that people have worked for this and they have contributed for it. I also caution, and as Ms. Lav mentioned, every State pension system and every local pension system has a little bit something different going on. We know about the worst funded plans.

But I would caution that Josh Rauh's paper is extremely important because again he is saying OK, I grant you 8 percent returns and he shows you a time table of when if there is no change to policies, these plans can expect to run out of assets.

Mr. MCHENRY. Thank you, Ms. Norcross. The gentleman's time has expired.

Mr. CUMMINGS. Thank you very much, Mr. Chairman.

Mr. MCHENRY. Thank you. I certainly appreciate that. And if I could call up slide No. 1. This is a representation of the difference between inflation, the 1950 baseline, the difference, the blue line would be private spending increases since 1950 to now versus State and local government spending increases in the red line. Private spending has increased 5 times, but local and State government spending has increased 10 times. So it's not a question of a funding shortfall, it's a spending problem. Would you concur with that Ms. Norcross?

Ms. NORCROSS. I would say that's a big part of it yes.

Mr. MCHENRY. Now in terms of the discussion about public pensions, understanding the magnitude of the problem is one thing we want to understand here today, if it is knowable. Ms. Gelinas, you mention in your testimony a funding shortfall. Is there a range, is there an agreement on what the funding shortfall is for public pensions?

Ms. GELINAS. Thank you, Chairman. There's not an agreement, a rough range would be $700 billion to $3 trillion as you can see, that's a large range. This involves predicting things that are very difficult, really impossible to predict. You have to predict the performance not only of the U.S. stock market, but of global equity and bond markets. You have to predict the course of future inflation and also predict how long people and their survivors are going to live.

Mr. MCHENRY. Ms. Norcross, do you concur with that range?

Ms. NORCROSS. Yes, well, under a range of assumptions yes.

Mr. MCHENRY. What would——

Ms. NORCROSS. Meaning the $700 billion would be under the current assumptions of the 8 percent discount rate range. That's why advocating for stress testing the pensions and granting economists how they would value the plan.

Mr. MCHENRY. What is the upward end?

Ms. NORCROSS. $3½ trillion.

Mr. MCHENRY. OK. Now, to this point, Ms. Gelinas, is there a—under current government accounting standards, is it sufficient? Do we have enough transparency in understanding the unfunded liabilities of these State and local government pensions?

Ms. GELINAS. No, it's not sufficient. I would advocate asking the States and large municipalities to report the assumptions—report the liabilities under a range of assumptions. Report it under a lower what used to be called a risk free rate, maybe 3 percent annual return, report it under the 8 percent return if they like to continue to do that and allow investors to make up their mind.

I don't think there's a big—there's a problem with disclosure, but it is not the biggest problem because investors can do their own calculations on these liabilities. We've seen Dr. Rauh and others do it on their own. If the investors do not like what is reported, they can simply not invest in the debt.

So again, we should have more disclosure. But the problem is not that we don't understand the magnitude of the issue. It is getting the political will within States to change State constitutions which govern pension benefits for future workers, people who have not been hired, change State laws governing collective bargaining, wages, health care and so forth.

Mr. MCHENRY. Would you concur with that Ms. Norcross?

Ms. NORCROSS. I agree.

Mr. MCHENRY. That's simple enough. That's reasonable.

Are the government accounting standards for pensions similar or dissimilar to what public companies are required to disclose? Ms. Norcross.

Ms. NORCROSS. They're a little bit different in private sector defined benefit plans, they do use something closer to a risk free rate, and they're valuable but different than the public sector plans.

Mr. MCHENRY. Ms. Gelinas, would you like to add anything to that?

Ms. GELINAS. No.

Mr. MCHENRY. Wow. Going pretty smoothly. So in terms of, Ms. Norcross, in your testimony, you discuss that State spending grew faster than States' own revenue sources in 47 States from 1977 to 2007. And to this point, can you explain the danger of States reporting budgetary imbalances when they are actually using Federal funds and debt to fund these expenditures?

Ms. NORCROSS. I think that just highlights the pie and what's in the pie, so you have States' own source revenue, you have Federal funds debt and other, and a deficit if you're just considering what a State can support on its own, that can be papered over if you then sort of discount that they're getting Federal funds which can stimulate sometimes greater spending or cause a State to need to raise taxes to support that spending and also the rising use of debt.

And I agree that debt is not a very large portion of budgets, we've seen some techniques recently where States will bond, they'll dump a trust fund bond to replace it and use that to balance the budget. So maybe they're not bonding directly for operating expenses, but they are.

Mr. MCHENRY. To that point, have States changed the nature of what they use bonds for? The nature of rather than building a road, are they changing it to plug a pension fund promise, has that changed?

Ms. NORCROSS. We've seen more bonding for stuff like that. Also the definition of capital can be pretty flexible.

Mr. MCHENRY. Thank you for your testimony. My time has expired. And now Mr. Quigley, the ranking member, is recognized for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

So far the problems that we have seen with these States, these 8 or 10 States that are in particular trouble, seem to be self-contained. I would like to ask any one of you, if you can, what the potential systemic risk are. I guess if the last economic crisis taught us anything is that everything is interconnected. In terms of the market or what have you, if there is a big hiccup, and there certainly are threats with some of these States, defaulting or having some other problem, missing payments and so forth, the impact on other States, the impact on bond ratings, but also the bond market itself. So while there may be only 8 to 10 States, that is 25 percent of the country's population. What are the impacts on the rest of the States?

Mr. SKEEL. I will jump in on that really quickly. I think the risk of contagion is much less severe than it was in 2008 with the financial institutions. I think the bond markets know the difference between the States that are in real trouble and the States that are not.

Mr. QUIGLEY. Do you think their investors do?

Mr. SKEEL. I do. I do.

I think we have to have some confidence in the ability of the markets to make those distinctions. That is my first point.

My second point would be that a lot of the problems with the financial institutions was hot money. It was that they depended really heavily on short term financing which was subject to immediate withdrawal. States are not subject to financing that is going to disappear instantly. They have tax revenues coming in. They are likely to be able to continue borrowing. So I think it is a very different kind of crisis.

Ms. LAV. It is possible to panic markets in the short term. Meredith Whitney has succeeded in doing that in the municipal bond markets by claiming——

Mr. QUIGLEY. That is the first time the name was mentioned today.

Mr. SKEEL. You violated our rule.

Ms. LAV. Sorry about that. But in the long run, people realize what the fundamentals are and you can see that there is beginning to be some improvements in that markets now that her comments have been put to rest.

So I think that there are distinctions among States. You know, the last time a State defaulted was in the Great Depression, and even in the Great Depression, only one State, Arkansas, defaulted. Only four cities or counties have actually defaulted since 1970. We are talking, you know, I don't think we are going to have a major default crisis. I think that there will be ways. You are going to have some sewer districts and some revenues bonds that were tied to the housing bubble and so forth that are going to have trouble paying, and those districts are going to have some problems, and the States will probably step in, as Pennsylvania stepped in in Harrisburg, and sort that out in a reasonable way. I just cannot see a scenario of major default and contagion.

Ms. GELINAS. If I may add to that, I would say one issue that risks courting a bond market crisis would be changing the statute to allow for Federal bankruptcy because if I am a bond holder, and for example, take New York's Metropolitan Transportation Authority, an entity with $30 billion worth of debt, I have lent money to this entity based on a long list of covenants, including a State law that says that for as long as these bonds are outstanding, this entity will not declare bankruptcy.

That is what New York lawmakers have determined under the democratic process. If there is any question that you have a new Federal statute that would somehow supersede that, or this idea that you could take away promises made to these bondholders to give to bondholders or unions at another State entity, this risk would take many months to sort out.

I would also add maybe not the potential for an acute crisis that we saw in September 2008, but the potential for the risk of losses at banks where you don't need a default for the market value of these securities to decline. You've got more than $200 billion of municipal debt in banks, similar amounts in money markets and insurance funds. If banks worry that the value of these securities have declined, they may pull back on lending to the rest of the economy, again, not a crisis or panic, but makes the recovery more difficult. The question is what are you getting for making it more difficult. You are not getting much benefit because States have the tools to fix these problems.

Mr. SKEEL. I would just add one brief response, and that is, this is all assuming that the States wouldn't default on these bonds. I think the question we have to ask is what are the possibilities? One possibility is no bankruptcy, they simply default completely.

Mr. QUIGLEY. Let me ask one other question to Ms. Norcross. You talk about the rate of return and you advocate to reducing it to what you judge is a much more realistic figure. The same sort of question, a quick shift from perhaps 8.25 to 8.4 would have to have some sort of impact, pretty traumatic obviously from a fiscal point of view and how much the contributions would have to be increased, but also within, again, the market that looks at this, would you see this being done through a slower period of time, an adjustment period, or how would you see that work?

Ms. NORCROSS. Well, I agree with what Ms. Gelinas said, you should probably grant a range of assumptions. But the liability is the liability. So simply targeting a rate that makes it look a little bit better, it only masks over the underlying reality of what is owed. Also, if you're going to pay this out over 15 years, my concern is that in cases like Illinois where they are going to take on more risk in their investment strategy to make up for what was lost. So that is why I would caution you.

Mr. MCHENRY. I thank the ranking member.

Mrs. Maloney of New York is recognized for 5 minutes.

Mrs. MALONEY. I thank the chairman and ranking member for organizing this important hearing and all of the panelists for their thoughtful testimony.

I would like to gain a deeper understanding of the magnitude of the challenge. I would first like to ask Ms. Norcross and Ms. Lav to qualify and expand on a statement in Ms. Lav's testimony where you stated that States and localities devote 3.8 percent of their operating budgets to pension funding. First, I would like to know where you got this number from, and is this an accepted number universally. And if that, in fact, is the correct number, based on this number, how can you suggest that public pension costs are the large costs of the State and local financial problems. As we know, we are just digging our way out from the great recession that has impacted our entire country and there are many costs there. Could you comment first, Ms. Norcross, and then Ms. Lav.

Ms. NORCROSS. I believe Ms. Lav gets that figure from the Alicia Munnell paper, and that is what her estimate is on what States have been contributing on average. So that would be all plans. She estimates if you use the 8 percent discount rate, you would have to raise that to 5 percent of budget on average.

Ms. LAV. That is correct, we worked with the Boston College people, Alicia Munnell, using our expertise on State and local finance to help them come up with that figure.

Mrs. MALONEY. So how can you suggest that this is the cause of the local and State financial problems if the contribution is just 3.8 percent?

Ms. LAV. It isn't. It isn't the cause. Pension contributions come from general funds. And the big deficit number is $125 billion that you are hearing about, is a general fund number. But pension contributions, neither pension contributions nor interest on bonds are the major component of that. The major component of the deficits is the expenditure States have—Medicaid, health care and education and so forth. So that is why I said it is not a crisis to raise from 3.8 percent to 5 percent in the way that the State budgets, the State and local budgets are put together. You can do that over time. It is not a big crisis.

You know, all of this talk about the riskless rate, that is one way to look at it. The Munnell paper says you have to go to 9 percent which would be a big problem if you use the riskless rate. But there is a distinction between valuing the liabilities and how much you have to deposit to make the pension whole. I would say that those are two different things.

Mrs. MALONEY. Well, on the riskless rate that a number of you testified on, I would like some clarification from it. Is it true that this rate is different from what the private sector pension plans use? Is it different?

Ms. NORCROSS. Private sector pension plans admit they have a little more risk because the company can go bankrupt. They use the corporate bond rate to reflect the risk.

Ms. LAV. It is higher than the riskless rate. The corporate bond rate is, I don't know, 5½ percent, 6 percent, that they use.

Mrs. MALONEY. Why should there be a different rate for public pensions and private pensions?

Ms. LAV. Well, because private pensions have to be a little more conservative because a private company can go out of business and then they dump their liabilities for their pensions on the Public Benefit Guaranty Corp. So ERISA, so the Federal Government, doesn't have to bail out the private corporation and pay those pension liabilities, insists that it uses a more conservative rate. But a public entity is not going out of business, and the public entity has taxing power and can adjust its taxes and expenditures. It is going to be an ongoing entity. You know, there have been GAO reports and other observers, most people who look at this say you do not need as stringent standards for a public entity as you do for a private.

Mrs. MALONEY. So would the riskless rate increase the perceived pension shortfall?

Ms. LAV. Yes, substantially.

Mrs. MALONEY. How does it increase it?

Ms. LAV. Well, 60 percent of pension assets come from return on assets, from investment income. So if you are going to say you only are going to get 4 percent on that investment income, and you are projecting that 30 years into the future, you make up a much larger hole that you have to fill. But if you say you are going to get

4 percent and you continue to invest in equities, you are saying something that is not true. And you are sort of saying you have to overfund the pension in the front end because you are saying it is only going to be 4 percent, but if you get 7 or 8 percent, you are actually going to have more in it. That will be, I hate to say it, but it could end up with even more temptation for an overfilled pension fund to not have consistent contributions every year.

It is much more realistic to say what you are going to gain and consistently contribute the amount you need rather than having the feast or famine.

Mrs. MALONEY. My time has expired, but would anyone else like to comment?

Ms. NORCROSS. I would just like to add, if I may, the logic behind that discount rate has again to do with the safety or risk of what you are valuing. And so a private sector plan reflects some of the risk involved that a company can go out of business; whereas the government is guaranteeing 100 percent saying you are going to get paid.

Again, the long time horizon gets back to the idea you have 15 years in which the majority of your obligations come due, and you are securing that with high volatile investments where you are lessening the likelihood that the money will be available to pay it out.

Ms. GELINAS. If I can comment as to the magnitude of pension liabilities, the reason they don't show up as much at the State level is because these are the responsibility often of the local governments. They are set by State law but paid by the locality. For example, New York City will pay about $8½ billion in pension obligations this year. That is more than 10 percent of the entire budget, including Federal funding for the city. So it is a much bigger problem at the local level than the State level.

Ms. LAV. My figures were State and local.

Mr. MCHENRY. Thank you.

Mr. Quigley is recognized for a unanimous consent request.

Mr. QUIGLEY. Mr. Chairman, I ask unanimous consent to enter into the record a statement from the Governor of the State of Massachusetts.

Mr. MCHENRY. Without objection, so ordered.

Mr. Cooper is recognized for 5 minutes.

Mr. COOPER. Mr. Chairman, I would like to ask unanimous consent to insert into the record an article by Jeb Bush and Newt Gingrich in the Los Angeles Times entitled "Better Off Bankrupt."

Mr. MCHENRY. Without objection.

Mr. COOPER. I think in finance hearings, it is really important to keep things simple. To my understanding, almost 80 percent of municipal bonds are owned by individuals in some form; is that your understanding? These are more widely held?

Ms. LAV. The tax exempt bonds, yes. I'm not sure about the others.

Mr. COOPER. Yes, the tax-exempt bonds.

And what most investors hate is a nasty surprise, a down side surprise. So in markets that function well and you have transparency, you have a heads-up on oncoming bad news, people are usually less alarmed. I want to ask a couple of questions about the transparency of these markets.

What are we missing today comparing these obligations between States that would enable an investor, an individual investor, to better evaluate these investments? It is my understanding that some of these get packaged up in bond funds and they just want a tax break. That is the way they diversify their risk, but you don't want that bond fund to be harmed either. What are we missing in terms of transparency between the States?

Ms. LAV. With respect to bonds, I don't think there is anything missing. I think the bond raters have a great deal of information about the States and the financial analysts, and follow them very closely. So I'm not aware of anybody complaining about the transparency of bonds among the States. Moody's just put out a new kind of analysis where they added together the outstanding bond debt and the pension obligations so you could look at it in one place. I think that is a good thing.

With respect to pension obligations, I think there is a problem of not being able to look at State-by-State pensions on the same basis.

Mr. COOPER. Exactly what are those problems?

Ms. LAV. They use different standards. There are a range of actuarial standards and it is pretty arcane as to how you measure future liabilities and so forth. And States can choose which ones they want.

I mentioned at the beginning of this hearing that the Governmental Accounting Standards Board is very close to issuing a new standard that no longer will allow that and that will require——

Mr. COOPER. Then after GASB has a new standard, we will have an apples-to-apples comparison between the States?

Ms. LAV. I believe so, yes.

Mr. COOPER. On pension obligations?

Ms. LAV. Yes.

Mr. COOPER. Do all the panelists agree with that?

Ms. NORCROSS. I believe that is so.

Mr. COOPER. So this is pending, it is about to happen, it doesn't require legislation?

Ms. NORCROSS. If I might clarify, is that a rule that is going to require them to use the ABO versus the PBO, or are you referring to GASB 25? Because GASB is also working on the discount rate rule, but I don't think that they have solved that problem.

Ms. LAV. Yes, they are looking both together.

Mr. COOPER. So in the next few months, we will have greater comparability between the States so an investor, an individual investor, can evaluate the risk involved in the most complex aspect of this which is valuing pension obligations?

Ms. LAV. That is my understanding. Of course, they haven't put out the final rule yet; but they are working on it.

Mr. COOPER. Are all of the panelists equally hopeful that GASB is about to do this positive step?

Ms. NORCROSS. I know they are looking at it, so I am hopeful.

Ms. LAV. They have taken all the comments. They had a draft rule in September, and they are very far down the line.

I think it is appropriate because all of the stakeholders have had a chance to comment. It is not something that is being imposed by fiat. Various people object to various parts of the rule, but it is going to be a standard rule, and better than the one we have.

Mr. COOPER. So does the Manhattan Institute and the University of Pennsylvania Law School concur in this?

Mr. SKEEL. I'm not following this that closely, so I will be agnostic on this.

Ms. GELINAS. I will be as well. I have no prediction on how they will come out.

Mr. COOPER. You mentioned earlier rating agency analyses. The rating agencies don't have the credibility that perhaps they once had prior to the housing crisis. Are the rating agencies on top of these developments between and among the States and municipalities?

Ms. LAV. I think they are. There are rating agencies, and then there are a whole host of other financial analysts out there that specialize in looking which are not the rating agencies, which I agree have lost some credibility, who look at this and who have specialists who spend all of their time looking at State and local finance. I mean, I think they have a pretty good handle on what is going on.

And to the one, which I cite in my report, they are saying there is no major chance of a contagious default. If there are a couple extra defaults, they are likely to be in small things, like sewer districts and not in major areas.

Mr. COOPER. I see that my time has expired. Mr. Chairman, I thank you.

Mr. MCHENRY. I thank the gentleman.

If it is OK with the panel, we have an opportunity to go for a second round of questions if there are no pressing concerns this morning. So with that, I recognize myself for 5 minutes.

So the definition of default is to fail to fulfill a contract, agreement or duty. To fail to perform, paying or make good. So if we look at default in the bond market, does the bond market define that narrowly which is to make good on your payment to me, or can we as policymakers define it more broadly, which is failure to fulfill an obligation to the people you are serving, to pension holders, for instance, and not being able to pay pension holders? Or could it be not making good so you have to sell a city or State asset in order to pay bondholders, which is an interesting piece here. But beyond that, as Federal policymakers, are we making the matter worse through our transfer payments to the States? There has been some point of reference in testimony here today that is, in fact, the case. Ms. Norcross, your written testimony includes some discussion of this. But to the tune of hundreds of billions of dollars a year, there are Federal transfers to States. There are also Federal mandates on the States that are cost drivers to government. Can you touch on this and the implications it has obviously for the bond market and indebtedness of the taxpayers.

Ms. NORCROSS. Well, of course the most well-known maintenance of effort would be currently with the Medicaid requirements on the States. And there are many other grants and aid that are handed out to the States that occasionally come with maintenance of effort requirements or may encourage that municipality or government to need to raise taxes to support the spending.

I don't know if I answered your question.

Mr. MCHENRY. You did.

Now, there are certain States that are in difficult fiscal situations. I know some research has been done on this. So does that, the difficulty of policymakers to balance the budget, does that have a bearing on their credit rating? Certainly it does, one would believe.

Ms. Gelinas, in terms of your discussion of various sub-groupings of the State, not the general obligation bonds, but obviously the dormitory authority or a road authority, does that have a bearing, the State revenue sources, whether or not they are sustainable? Can you touch on that?

Ms. GELINAS. Sure it does. Without saying whether or not the ratings agencies are right or wrong, either on the broad issues or narrow credits, the ratings agencies do have a good understanding that each bond is different even at the State level.

So California, for instance, they have said very clearly paying debt service on general obligation bonds, this is one of two top priorities for the State. That even if California has massive budget deficit, they pay these bonds first before they pay anything else. So ratings agencies look at that, see the structure of the law and precedents, and that goes into the analysis.

Other States it may not be as high a priority, but it is a very high priority in every State. And then when you look at things like bonds that are tax secured where the State has said we pledge this sales tax to pay bonds before we use the sales tax for anything else. That is actually higher than a general obligation bond. That gets AAA ratings in a lot of cases because of that.

So you have to look at each of the payment streams, the character of the State, the willingness of the State to pay the debt. And sometimes, frankly, the willingness of the State to make bad decisions.

We saw in Illinois, the State raised taxes to give comfort to the bondholders. So trying to get more market discipline in getting the bondholders to care more about the fundamentals, it doesn't necessarily get you the good, long-term decision for the State. If the response of the State is to raise taxes, it may make the long-term situation worse, not better.

Mr. MCHENRY. I certainly appreciate that. And in today's Wall Street Journal, there is a story about this hearing, and they reference that California borrows billions of dollars each year to cover seasonal shortfalls in its cash-flows. Illinois is proposing to issue an $8.7 billion debt restructuring bond to pay past due bills, and a $3.7 billion bond to make required pension contributions to its pension system.

There is a larger discussion here about whether these States will be able to afford higher interest rates on these bonds following the end of quantitative easing and the impacts that will have on their pension fund gap. So I can just ask the panel to make comments on that briefly, and we would certainly like to hear your testimony.

Ms. GELINAS. Right. Higher interest rates are certainly a risk not having to do with the fundamentals of the municipal bond market, but also how do global investors feel about the prospects of inflation in the United States? If Treasury bond rates go up, it is likely that municipal bond rates will go up at the same time.

Mr. SKEEL. I will just add those effects are likely and already are disproportionately borne by the States that are in big trouble. So California's interest rate is much higher than other States' interest rates. That is what we would expect. And I think in the long run, that is what we want. That is what we want the bond markets to be doing.

Ms. NORCROSS. I concur with what Professor Skeel said.

Ms. LAV. I would distinguish those different things. California issues revenue, and a few other States issue anticipation notes. They pay them back within the same year. That is not borrowing for operating expenses, it is just changing the timing of their borrowing; whereas the Illinois bonds are actually borrowing for operating expenses, which is a big distinction.

Of course, the expenses will go up if interest rates go up. And as I showed, that total interest on bonds are, depending on the source used to calculate, only 4 or 5 percent of total State and local expenditures. So again, this is not something that is going to break the bank if it goes up from 4 percent to 5 percent to 6 percent of expenditures. It is on the margin. They will have to accommodate it, but it is not going to break the bank.

Mr. MCHENRY. Thank you.

Mr. Quigley is recognized for 5 minutes.

Mr. QUIGLEY. Again, thanks to our panelists and the chairman for participating in this. It is a very good first step by the chairman and the committee on an important issue.

Before I ask you my last question, the thoughts for local governments, State and local governments, is, from my point of view, the mission matters. We often hear so much that people don't like government. But when it comes to local government, when they call 911, they want a fireman or an ambulance or a police officer to respond, and they want to know that when they cross a bridge, it is safe.

So much of local government strikes so close to home. It is where the wheels hit the streets. So what we are talking about today is so important because poor financial management can put all of those things at risk. So beyond the financial management dealing with pensions and so forth, it is really the notion that governments need to look at themselves and reinvent themselves. And I am not just speaking as a Congressman, but I was a Cook County commissioner for 10 years. All local governments need to reinvent themselves, streamline and consolidate, not because they don't matter, but because they matter very, very much. So there is a lot at stake here.

I want to commend the panelists. With one exemption, you kept your bond that you weren't going to mention the name, and shall not be mentioned. But it is still a big question. The public wants to know to what extent could there be significant defaults or significant bond defaults in the year 2011 or 2012?

Ms. LAV. I don't think there will be a city or a county that defaults. I think there will be some defaults in special districts and on revenue bonds. So, for example, in Florida, there were bonds issued for sewers in a development that never got built because the housing bubble burst. Well, there is no way—you can't pay back those bonds because there is no sewer revenue coming in. There are those kinds of things around the country that are going to be a bit of a problem and there could be defaults or restructuring.

As the chairman said, the term "default" is being used in a number of different ways. I use it as you don't make the interest payment on the bond, not that you find some other way to provide it. Again, there are always some projects that go back in a bad economy. But I don't think there will be any major, large city or county that defaults. And I think by and large, that even for smaller ones that the States will step in. And, you know, we have a control board now in Nassau County, New York. We will see quite a number of control boards, I think, where States come in and impose control boards on localities that are trouble and make them figure out a plan for working their finances out.

Mr. SKEEL. I also don't think there will be 50 to 100 defaults. But I think it is really important to keep in mind we don't know. Probably 50 States will survive, but if only 48 States survive the current crisis, we are in trouble. And I think we really need to plan for that. We need to plan for surprises in a way that 2008 we had not planned for surprises.

Ms. GELINAS. As a democratic people in each State, we don't have to wait for the bond market to make commonsense decisions today. We know State by State and for the Nation as a whole, we have to control our health care costs for public employees, as well as other people as well; retiree pension liabilities. These are all things that if we do not get a handle on them, we will not be building or repairing roads, bridges, transit because we are paying these growing retiree costs. These are things we can fix today. We shouldn't and don't have to wait for bond markets to tell us what we should be doing already.

Ms. NORCROSS. I would concur with what Ms. Gelinas said.

Mr. QUIGLEY. Thank you. I yield back the balance of my time.

Mr. MCHENRY. Mr. Cooper is recognized for 5 minutes.

Mr. COOPER. Thank you, Mr. Chairman. I would like to thank you again and the ranking member for this excellent hearing.

Back to the question of individual investors. If I am an individual bondholder today or a local taxpayer who is thinking about maybe buying some of these bonds, what is the easiest way for me to find, on the Web or another source, the credit status, credit rating, financial soundness of the entity in which I am investing or am living?

Ms. LAV. Bond prospectus have a whole lot of information about the finances of a State or locality. It depends.

Mr. COOPER. A prospectus is a big, long, legal document, sometimes hundreds of pages. It is very different for the average person. What is the best way for a consumer who is maybe at the broker's office saying I want a tax-free bond, tell me what I should buy? How do you find out that information? How do you tell whether you are living in a creditworthy jurisdiction or not? This is the information age. Is there a Web site that you can go to and find out with relative ease, small town U.S.A., is it worthy or not?

Mr. SKEEL. I think it is fairly difficult. You have to piece together information. But all of the brokerages publish reports or put out reports on individual bonds. Certainly if you go to a broker, you can get that kind of information. But to assemble it together yourself, I think, it is difficult.

Ms. LAV. That is why most people do rely on financial advisers and on brokers rather than make their own decisions. Or at least for information.

As Ms. Gelinas said, it depends on what kind of a bond it is. You may be wanting to know about the possibility of are the tolls going to pay back the bond on this highway. Or it may be full credit, in which case you need to have some sense about the budget of the entity and its long-term prospects.

Mr. COOPER. When Ms. Gelinas said earlier that individual citizens should take it upon themselves to get ahead of the bond markets and anticipate bad practices, it is very difficult to do that. You really have to be a student of this to understand what is going on.

Ms. LAV. Right. And I think people, just like I go to a lawyer or I go to a doctor. I mean, I am a public finance person, but everybody isn't and they need to go to an adviser.

Mr. COOPER. But for the individual investor, it should be made relatively easy. And it is my understanding that some of the brokerage houses may be affiliated with investment banks that help underwrite the bonds, and they have an interest in making those bonds look good.

Ms. LAV. Yes, that may be the case. You know, there is not a lot of ways that an individual can investigate. Most towns have their budgets on the Web site. I can find them, but it may not tell you everything you want to know.

Mr. COOPER. We can compare almost everything else in life through easily accessible Web sites. These important financial instruments, why can't we get an easy handle on these?

Ms. LAV. There are 80,000 jurisdictions in the United States—some people say 90,000—that issue bonds. It is quite a large undertaking and one that maybe somebody would want to undertake. But it would be a big deal.

Mr. COOPER. Perhaps a more relevant question is so many people buy a bond fund, which may have a few bad apples in it. How do you tell what is in your bond fund? It is my understanding that with the housing crisis, they bundled subprime credits and when a few more went under than expected, that tainted the whole package.

Ms. LAV. That was a different kind. Those were kind of what people call sliced and diced securities where people couldn't know what the origin is.

Mr. COOPER. That is not done with muni bonds?

Ms. LAV. No. Never. It is not done ever.

Ms. GELINAS. The bond funds, without endorsing or not endorsing them, there is at least something there, unlike with something like a collateralized debt obligation built on mortgage bonds built on more mortgage bonds. Some of these things were rated AAA. They ended up being worth literally nothing. I don't see how that would be the case here, even if we did see small scale municipal and project defaults. It is hard to conceive waking up and having a AAA rated municipal bond fund being worth nothing.

However, I think your other point is very important, that individuals own these bonds, but they don't own them directly. They own them through money markets, $300 billion worth of State and local debt in money market funds, and there is an issue here of financial intermediation and the dealers responsibility, that these are the large investment banks. They run these funds, they hold many holdings on their own books. And if we haven't succeeded in getting financial discipline into these firms that still believe, in many cases, that they are too big to fail, they are not going to be worried about State and local debt because they think Congress will bail them out, not the States.

Mr. COOPER. Would any of you invest today in a bond fund in the hunt for yield with higher tax-free interest rates of project funds in Nevada, southern California, Florida? Would you put your lifesavings or your pension fund in a fund like that, especially since it is apparently quite difficult to find out about the merits of each individual project?

Mr. SKEEL. I would be careful, but I certainly wouldn't steer away from the muni market.

Mr. COOPER. I asked about project funds because those would be most likely to have problems.

Mr. SKEEL. You would have to look at the project.

Mr. COOPER. But apparently, that is almost impossible to do unless you are a bond lawyer and are willing to read 200 pages per project.

Mr. SKEEL. Well, I mean, if you are going to invest in a particular project——

Mr. COOPER. But this would be a bond fund with lots of these projects. It just seems to me that we are not giving consumers, individual investors, enough information here. At least that is easily accessible. But I see that my time has expired. I appreciate the chairman's patience.

Mr. MCHENRY. I certainly appreciate the gentleman's line of questioning. If the panel wants to go through, the question was: Would you invest in State municipal bond funds; you, yourself? Yes or no; maybe, if you all want to answer, that would be great.

Ms. GELINAS. I think there is a very real problem with trust, people's trust in the financial industry and in trusting their financial advisers and trusting the managers of these bond funds, and that issue is not going away any time soon.

Mr. MCHENRY. Ms. Norcross.

Ms. NORCROSS. I would probably ask my financial planner.

Ms. LAV. I have never actually invested in municipal bonds. It is just not my style of investing.

Mr. MCHENRY. I thank the gentleman from Tennessee for his line of questioning.

With that, we will go to Mr. Walsh of Illinois.

Mr. WALSH. Thank you, Mr. Chairman. And thank you for holding such an important hearing. Like the ranking member, I am from Illinois as well. Illinois is a mess. We all know that. No way is the Federal Government going to bail out my State. My voters, our constituents won't allow it. I feel like I left the movie right before the good part, and I am sure the case was being made that bankruptcy is not feasible. So no bailout. Bankruptcy isn't feasible.

Let me start out with a quick round-robin question. Give me your 20-second solution just so I can walk out of here with that take away. We are not going to bail you out. Bankruptcy is probably not feasible, so what are the States going to do? Give a quick one to that.

Ms. GELINAS. Well, I think voters in many States are already doing the right thing. We have new Governors from both parties that are starting to address what do we do about pensions for future employees? What do we do about Medicaid costs? Something Congress can certainly help with. These are questions for voters in the individual States pressuring their own lawmakers to change State laws and, in some cases, State constitutions, not something that the Federal Government can or should do for them. So in some ways the system is working, if imperfectly.

Mr. WALSH. I guess my question is if there is going to be no bailout from us and a bankruptcy is not feasible, a State is falling off the cliff, let's imagine that one in the next 3 or 4 months literally is going to fall off the cliff. We can change laws that will impact things in the future, but what do you do for that State that has just fallen off the cliff?

Mr. SKEEL. My answer is going to be I really think we need to put a bankruptcy regime in place to deal with precisely that problem. That is the only problem we absolutely need bankruptcy for. I would add one thing to that: I agree that States are doing the right thing. I hope the optimism that we have heard today is correct, that most of them can muddle their way through. But some measures are a lot tougher than others. For instance, pension reform in a State, while there is a lot of debate in Illinois about what can and can't be done right now, but in many States it does require a constitutional change. I think that is pretty unrealistic. So some of the options are more feasible than others.

Mr. WALSH. Ms. Norcross, your State is falling off a cliff; what are you going to do?

Ms. NORCROSS. I would say close the defined benefit plan and figure out how you are going to pay out what has been accumulated.

Mr. WALSH. Ms. Lav.

Ms. LAV. I think States can use their normal processes of dealing with their taxes and their expenditures to set themselves on a right path. Illinois has a particularly deep hole. I have been writing and talking about Illinois' problems for the last 25 years of its fiscal mismanagement. I am a native Chicagoan. But it just needs to do those things it needs to do to get out of it and to bring itself back to balance. It has the tools. It just needs to use them.

Mr. WALSH. Thank you. In my remaining time, let me quickly ask one quick question about market risk. Bill Gross who manages PIMCO, one of the largest mutual funds in the country, he stated that a low or negative real interest rate for an extended period of time is the most devilish of all policy tools. It is interpreted to mean, what he is saying is that the Fed's action to lower interest rates helps our debtors, such as States and municipalities, while harming all those who worked hard and saved money.

Ms. Norcross, Ms. Gelinas, quickly, in effect, the Fed is enabling debtors to reduce their debt on the backs of those that saved money; is that right?

Ms. NORCROSS. I would hesitate to say that right now.

Mr. WALSH. Ms. Gelinas.

Ms. GELINAS. There is complacency. States and cities have borrowed at very low rates not just for the past couple of years in extreme conditions, but really for two decades now. If rates go up, including possibly way up, they will have to get used to a very different environment very quickly.

Mr. WALSH. Could you argue that the Fed's quantitative easing program is in effect, has in effect been a bailout for States and municipalities?

Ms. GELINAS. Sure this is a bailout for anyone who owes money. States and municipalities may not be the biggest proportionate benefitter from this, but it certainly helps them.

Mr. WALSH. Ms. Norcross, you concur?

Ms. NORCROSS. I concur.

Mr. WALSH. Thank you.

Mr. Chairman, I yield back. Thank you.

Mr. MCHENRY. Ms. Buerkle from New York is recognized for 5 minutes.

Ms. BUERKLE. Thank you, Mr. Chairman, for hosting this very important meeting. Coming from New York State, as you can imagine, this is a concern on many of our minds. I apologize, we've had a number of hearings today for being in and out. I appreciate your time this morning.

The first question I want to ask is regarding actually the stimulus money and the fact that so much of it was paid to the States. Do you think that was a way the States were sort of—it put the States off, they didn't have to really face these issues head on, and so it actually delayed and now the States have to reckon with the situation? That is a question for any one of you.

Ms. LAV. I am happy to respond to that. When that money first came out in 2009, we would have seen it covered about a third of the State's deficits. In that year, we would have seen very sharp cuts in education and health care. We would have seen millions of people losing their health insurance, and the States were poised to cut people. We would have seen many, many more layoffs of teachers and other public employees, which would, in fact, have potentially delayed recovery because you take that demand out of the economy, and the stimulus actually provided a boost to the economy that was very important.

So now, as the stimulus is ending, at least State revenues are beginning to grow again. They are still below 2008 levels, but they are beginning to grow again. So States have a little more ability to absorb the end of the stimulus. They are proposing very major cuts in budgets this year. But it is probably better that they are doing it now as the economy is at least on something of a growth path than if they did it in the depths of the recession which could have been very damaging to the economy.

Ms. BUERKLE. But it seems to me those decisions they are making now, they should have made a year ago and actually got their fiscal houses in order. It appears the stimulus just delayed reckoning with the reality of the situation. Mr. Skeel.

Mr. SKEEL. I agree. There is some case for some of the stimulus money going to the States, but there is no question in my mind that it has delayed the restructuring.

Ms. GELINAS. Yes, I would agree with that. There was a missed opportunity in that Congress might have considered saying to the States: we will give you a dollar today in 2009 if you take steps to cut your future liabilities by a dollar 10 years from now. So fix the pensions, fix the health care and Medicaid costs, give them operating aid now, but use it as leverage to work on the long-term problems. That was something that was not done.

Ms. NORCROSS. I would add to that some of the stimulus expanded some spending and is leading to cuts that need to be taken today. States, Virginia, New Jersey, deferred their pension payments. They were not making the tough choices.

Ms. BUERKLE. Thank you. While I still have some time, if I could ask another question.

Mr. Skeel, regarding the possibility of bankruptcies in some of the States that are so financially strapped, if, in fact, they did declare bankruptcy, would that affect the borrowing abilities of healthier States? Does that impact a State that kept its fiscal house in order, and now they are going to be impacted by some of the States that did not?

Mr. SKEEL. I think the impact would be very limited. As I was saying a few minutes ago, the bond markets have the ability to distinguish between States that are in good fiscal shape and States that are not. It is really not like the big banks in 2008 which were really connected to each other, had the same kinds of assets, the same kinds of problems. The States really are independent. So I think a State that is in good fiscal health would continue to be able to borrow just fine.

Ms. BUERKLE. Thank you.

Ms. Gelinas, I think in your opening statement you addressed that. Would you like to address that issue as well?

Ms. GELINAS. Sure. I would respectfully disagree. Markets can distinguish among States, but they cannot do it instantaneously or even in a few weeks or even months. So changing the law in this way, really sweeping away half a century's worth of precedents, it would take a long time for markets to adjust to that and healthier States would suffer during that timeframe as well.

Mr. SKEEL. If I may add one last remark on that, when you look at countries that have run into trouble, Argentina, for instance, which is about as profligate as you can get, it is remarkable how quickly they can go back to the markets. I really believe markets respond a lot more quickly than people tend to think.

Ms. BUERKLE. Thank you. I yield back.

Mr. MCHENRY. Thank you so much for your line of questioning. I have just three more questions that I wanted to pose to the panel, if that is all right with you all.

If you look at the public sector employee unions versus private sector employee unions, the public sector unions now account for more than private sector unions. It is an interesting crossover we have had just in the last 2 years. On average, public sector workers make $14 more per hour in total compensation, wages and benefits, than their private sector counterparts.

Ms. Gelinas, you have written about this, I know, but if you can testify and say here today, it seems to me that public sector employees and private sector employees are living in two separate economies. What are the ramifications of that, and what is really the root cause of that disparity?

Ms. GELINAS. Yes, and I should be clear that it differs from State to State. Some States, particularly the northeastern States, Illinois, California, offer much greater power to employees to collectively bargain. Their benefits are commensurately much higher. Generalizing the problem, it would not be so much the wages as it is the benefits because these are open-ended liabilities that States and localities are taking on. Right now they are uncontrolled.

So one aspect of getting these under control is to start to switch new civilian employees, a good first start, into 401(k)-style pension plans, just as the private sector has. So you are getting rid of an open-ended liability for the State in the future.

The same thing with health care benefits. In many municipalities, certainly not all of them, workers do not pay a share or anywhere near the share of their own health care benefits that private sector workers pay. Asking workers to pay more for their own health care do much to help States and cities with these liabilities.

Mr. MCHENRY. So you mention switching from a defined benefit plan to a 401(k) style which most Federal employees have, for instance, just as a for instance. That is one policy change that we could—that the States could enact. What are the prescriptions that the Federal Government can take action over to help stem the tide that we see coming? Ms. Lav talked about the loss of revenue, and the fact that stimulus funds sort of relieved the States of that burden of having to lay off workers. But if you look at local school boards right now, with the loss of stimulus funds, you are having hundreds of people show up at school board meetings because they are talking about layoffs.

What I believe I saw and I believe a lot of folks saw was that the day is coming, the day of reckoning is coming when those stimulus funds run out. And rather than realizing it 2 years ago and making changes, they are having to do it now. What are the things that we here in Congress, what policy changes can we make to help stem this crisis? I will pose that for everyone. We will start with Ms. Gelinas.

Ms. GELINAS. One area where it may be most straightforward for Congress to help States is in Medicaid because this is not an issue where Congress would be telling States you have to change your pension plan; you have to change the way you govern yourself. Medicaid is currently a program that encourages States to spend more, because when a State spends a dollar more, sometimes it gets more than a dollar back from Washington. Gradually changing Medicaid into a block grant program where you offer a set amount of money, increases on the set formula, and the States are encouraged to innovate and cut costs within that, reward them for cutting costs rather than raising costs. This would approach another big chunk of their costs, current and future.

Mr. MCHENRY. Mr. Skeel.

Mr. SKEEL. I agree that Medicaid is the most obvious place to do things. There are real limits on what you all can do say with pensions and things of that sort simply for State sovereignty reasons. So places where there is already Federal funding are the places where I think you look first.

Mr. MCHENRY. Ms. Norcross.

Ms. NORCROSS. I concur that Medicaid and other areas, K through 12 education and where there are mandates that increase fiscal pressure on States.

Ms. LAV. I don't think on the areas we are talking about today that there is any need, as I said, for Federal intervention.

Mr. MCHENRY. Other than money?

Ms. LAV. Well, I am not asking for the extension of the stimulus. I mean, it was unfortunate that it was designed so that the economy be recovered when the stimulus ended. Revenues are still below their 2008 levels, so of course, at the end of the stimulus, States were not able to get back to where they were. So helping the economy, there is not much you can do to help the economy right now either, necessarily.

But with respect to Medicaid, I think you can easily talk about a block grant, but Medicaid is actually more efficient in many ways than private insurance per individual matched for health conditions. So I think that the best thing would be to figure out how to control the rate of growth of health care costs in the economy wide.

Those scary GAO numbers that Ms. Norcross mentioned are entirely driven by the rate of growth of health care costs. If health care costs continue to grow faster than GDP, States are going to have trouble coping with that. So will the Federal Government. It is a major driver of the Federal deficit, and figuring out how to bring them under control is the best thing to do.

Mr. MCHENRY. The final question of the day, and this is something that I intend to ask future panels as well. We are going to have a series of hearings about this fiscal crisis at the State level and the ramifications of not addressing it, and this is the opening of it. We wanted to hear from informed individuals to start this process. But I would like for you all, if you could, I'm asking you on the spot, but in the future as well, tell us who we should hear from next: bond market participants, credit rating agencies, pension holders, unions? If you could, tell me one, two, three people or entities we should hear from. Ms. Lav? We will go right down the line.

Ms. LAV. Yes, that was a pretty good list. Financial analysts. There are several who have a very good handle on this. I can suggest a few and send them to you. And of course, unions have a major stake in this. You should hear from them. I mean, I think you also should listen to the Governors and the mayors.

Mr. MCHENRY. Ms. Norcross.

Ms. NORCROSS. I concur, that is a good list to start with. And also consider calling those who are involved in education finance and financing other policy areas.

Mr. SKEEL. I would just add, I think you all should talk to pension lawyers because these issues are both economic and legal. I think you need to see the whole picture.

Ms. GELINAS. All of those people, and I would also suggest speaking with infrastructure people, because the other side of this is that States have to grow. The private sector can't create jobs when we have infrastructure that is decaying, and so how can States spend Congress' money and their own money, get the biggest bang for their buck in infrastructure and help grow States so these liabilities can be better controlled from that end as well.

Mr. MCHENRY. Thank you. And I certainly appreciate your testimony, and I appreciate the opportunity to hear from you. Thank you for your time. Thank you for spending the morning with us. Thank you so much. And this meeting is adjourned.

[Whereupon, at 11:25 a.m., the subcommittee was adjourned.]

[The prepared statement of Hon. Elijah E. Cummings follows:]

Congressman Elijah E. Cummings (MD-07), Ranking Member

Opening Statement

Hearing on: State and Municipal Debt: The Coming Crisis?
House Committee on Oversight and Government Reform
Subcommittee on TARP, Financial Services and Bailouts of Public and Private Programs

Capitol Visitors Center House Room 210
Wednesday, February 9, 2011 at 9:30 a.m

I thank the Subcommittee Chairman for calling this hearing to examine the important and timely issue of state and municipal debt.

Today, we have the opportunity to get to the root of the states' fiscal problems, and to discuss how best to find serious and effective solutions.

I hope that our focus can be about how to support our states with serious solutions that they want and need, and not the alarmist and drastic proposal that has been raised by former Speaker Newt Gingrich and former Governor Jeb Bush to push states to into bankruptcy.

This is an area where we need to listen to our state leaders and hear from them about what they want and need. The bipartisan National Governors Association, has issued a statement opposing proposals for state bankruptcy.

They said that: "The reported bankruptcy proposals suggest that a bankruptcy court is better able to overcome political differences, restore financial stability and manage the finances of a state. These assertions are false and serve only to threaten the fabric of state and local finance."

Barclays Capital has confirmed that drastic interventions in the state municipal bond market is unwarranted, stating that: "Despite frequent media speculation to the contrary, we do not expect the level of defaults in the U.S. public finance market to spiral higher or even approach those in the private sector. We hold this view in large part because of the steps taken [by municipalities] thus far and the control that public entities can exert over the expensive and revenue portions of their balance sheets."

We must examine our solutions and ensure that they do not do more harm than good. This bankruptcy proposal sparks unwarranted fear that the state budgets will collapse, which then results in higher borrowing costs and further limitations on states' abilities to finance projects and meet local needs.

I also think we need to be careful not to blame the financial situation of states on employee pensions. According to the Center for Retirement Research at Boston College, state and local pension contributions constitute a tiny portion of the state and local operating budgets -- only 3.8 percent.

Furthermore, the underfunding issues that states are facing are largely attributable to the two recessions that have occurred over the past decade, not because of overly generous employee pensions. This is evidenced by the fact that in the year 2000, state and local pensions were, on average, fully funded. Furthermore, most states have already taken significant steps to address their pension funding challenges.

Rather than distort the true causes of the states' budgetary problems, let's use this opportunity to explore appropriate ways that Congress can support the states' efforts to become fiscally sound. In the absence of providing additional Federal aid, Congress can help the states overcome the current budget crisis by focusing on job creation and addressing the ongoing foreclosure crisis, which continues to wreak havoc on the housing market and state and local budgets.

On that point, I hope that we will use this hearing to explore appropriate ways that Congress can support the states' efforts, while abandoning proposals, like bankruptcy, that may inflict greater harm by increasing market instability and borrowing costs, further hindering the states' ability to achieve fiscal stability.