

ROLE OF PUBLIC EMPLOYEE PENSIONS IN CONTRIBUTING TO STATE INSOLVENCY AND THE POSSIBILITY OF A STATE BANKRUPTCY CHAPTER

HEARING

BEFORE THE

SUBCOMMITTEE ON COURTS, COMMERCIAL
AND ADMINISTRATIVE LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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**ROLE OF PUBLIC EMPLOYEE PENSIONS IN
CONTRIBUTING TO STATE INSOLVENCY
AND THE POSSIBILITY OF A STATE BANK-
RUPTCY CHAPTER**

MONDAY, FEBRUARY 14, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COURTS,
COMMERCIAL AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to notice, at 4:02 p.m., in room 2141, Rayburn House Office Building, the Honorable Howard Coble (Chairman of the Subcommittee) presiding.

Present: Representatives Coble, Smith, Gowdy, Gallegly, Reed, Ross, Johnson, Quigley, and Conyers.

Staff Present: (Majority) Daniel Flores, Subcommittee Chief Counsel; Travis Norton, Counsel; Allison Rose, Professional Staff Member; and Ashley Lewis, Clerk.

Mr. COBLE. Good afternoon, ladies and gentlemen. The Subcommittee will come to order.

And before we give our opening statements, I have some unanimous consent requests to have introduced in and made part of the record: a Bureau of Labor Statistics from the U.S. Department of Labor news release, dated December 8; a San Francisco Chronicle op-ed, dated February 13; the National Governors Association, January 24 of this year; a second National Governors Association letter, dated February the 4th of 2011. And I would like to have these made part of the record, without objection.

[The information referred to follows:]



NEWS RELEASE



For release 10:00 a.m. (EST) Wednesday, December 8, 2010

USDL-10-1687

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EMPLOYER COSTS FOR EMPLOYEE COMPENSATION – SEPTEMBER 2010

State and local government employers spent an average of \$26.25 per hour worked for employee wages and salaries in September 2010, the U.S. Bureau of Labor Statistics reported today. Wages and salaries accounted for 65.5 percent of compensation costs while benefits averaged \$13.85 per hour worked and accounted for the remaining 34.5 percent. (See chart 1.) Wages and salaries for management, professional, and related occupations, which represent approximately half of all state and local government employment, averaged \$33.17 per hour worked.

Employer Costs for Employee Compensation (ECEC), a product of the National Compensation Survey, measures employer costs for wages, salaries, and employee benefits for nonfarm private and state and local government workers.

Chart 1. Employer costs per hour worked: civilian, private industry, and state and local government workers, September 2010

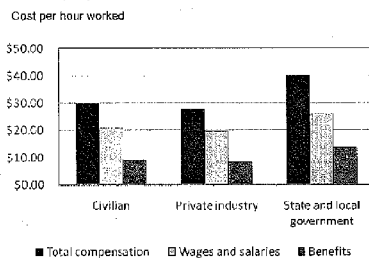
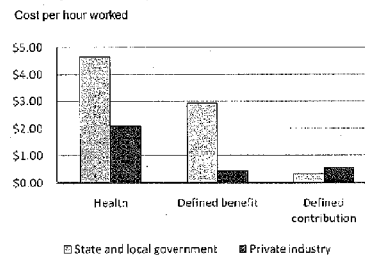


Chart 2. Employer costs per hour worked: selected benefits, state and local government and private industry workers, September 2010



Health benefit employer costs in September 2010 were \$4.65 per hour worked for state and local government and \$2.10 in private industry. **Defined benefit** retirement plan costs for state and local government employers were \$2.94 per hour worked, significantly higher than 44 cents for private industry employers. (See chart 2.) **Defined contribution** retirement costs were 32 cents per hour worked for state and local government and 55 cents for private industry.

Civilian

Civilian employer costs averaged \$2.63 per hour worked for **insurance** benefits (life, health, and disability insurance) or 8.8 percent of total compensation. In addition to insurance, the other benefit categories were: **paid leave** (vacation, holiday, sick leave, and personal leave), which averaged \$2.05 (6.9 percent of total compensation); **supplemental pay** (overtime and premium, shift differentials, and nonproduction bonuses), which averaged 71 cents per hour worked (2.4 percent); **retirement and savings** (defined benefit and defined contribution), which averaged \$1.34 per hour (4.5 percent of total compensation); and **legally required benefits** (Social Security, Medicare, unemployment insurance, and workers' compensation), which averaged \$2.32 per hour worked (7.8 percent). (See table A and table 1.)

Private industry

Private industry employer compensation costs averaged \$27.88 per hour worked. Private industry employer wages and salaries averaged \$19.68 per hour (70.6 percent of total compensation), while benefits averaged \$8.20 (29.4 percent). Employer costs for **paid leave** averaged \$1.88 per hour worked (6.7 percent), **supplemental pay** averaged 78 cents (2.8 percent), **insurance** benefits averaged \$2.24 (8.0 percent), **retirement and savings** averaged 99 cents (3.6 percent), and **legally required benefits** averaged \$2.31 (8.3 percent) per hour worked. (See table 5.)

Compensation costs in state and local government

State and local government compensation costs averaged \$40.10 per hour worked. Wages and salaries averaged \$26.25 per hour (65.5 percent of total compensation), while benefits averaged \$13.85 (34.5 percent). Among state and local government employees, average hourly compensation costs were higher for management, professional, and related occupations (\$48.73) than for service occupations (\$30.17) and sales and office occupations (\$27.87). (See table 3.)

For state and local government employees, employer costs for **insurance** benefits were \$4.80 per hour, or 12.0 percent of total compensation. The largest component of insurance costs was health insurance, which averaged \$4.65, or 11.6 percent of total compensation.

In September 2010, the average cost for **retirement and savings** benefits was \$3.26 per hour worked in state and local government (8.1 percent of total compensation). Included in this amount were employer costs for defined benefit plans, which averaged \$2.94 per hour (7.3 percent), and defined contribution plans, which averaged 32 cents (0.8 percent). Defined benefit plans specify a formula for determining future benefits, while defined contribution plans specify employer contributions but do not guarantee the amount of future benefits.

Two major components of benefit costs are paid leave and legally required benefits. **Paid leave** benefit costs include vacation, holiday, sick leave, and personal leave. The average cost for paid leave was \$3.03 per hour worked for state and local government employees. Costs for **legally required benefits**, including Social Security, Medicare, unemployment insurance (both state and federal), and workers' compensation, averaged \$2.42 per hour worked.

The National Compensation Survey produces data on the percentage of state and local government workers with access to and participation in employee benefit plans, including health and retirement and savings plans. Detailed data on health and retirement plan provisions are available at <http://www.bls.gov/ncs/cbs/>.

Table A. Relative importance of employer costs for employee compensation, September 2010

Compensation component	Civilian workers	Private industry	State and local government
Wages and salaries	69.5%	70.6%	65.5%
Benefits	30.5	29.4	34.5
Paid leave	6.9	6.7	7.6
Supplemental pay	2.4	2.8	0.8
Insurance	8.8	8.0	12.0
Health	8.4	7.5	11.6
Retirement and savings	4.5	3.6	8.1
Defined benefit	2.8	1.6	7.3
Defined contribution	1.7	2.0	0.8
Legally required	7.8	8.3	6.0

Employer Costs for Employee Compensation data for December 2010 is scheduled to be released on Wednesday, March 9, 2011, at 10:00 a.m. (EST).

Employer Costs for Employee Compensation data on total compensation, wages and salaries, and benefits in private industry are produced annually for 15 metropolitan areas. Metropolitan area data will be included in the March 2011 news release to be published in June 2011. For further information about metropolitan area ECEC estimates see: "BLS Introduces New Employer Costs for Employee Compensation Data for Private Industry Workers in 15 Metropolitan Areas," at <http://www.bls.gov/opub/cwc/cm20090921ar01p1.htm>.

Supplemental tables with occupational, establishment size, and bargaining status series for detailed industries are available at <http://www.bls.gov/ncs/ect/sp/ecsupht.pdf> and <http://www.bls.gov/ncs/ect/sp/ecsuptc16.pdf>.

Relative standard errors for all cost estimates in the most recent news release and supplementary tables are available at <ftp://ftp.bls.gov/pub/special.requests/ocwc/ect/ececrse.pdf> and <http://www.bls.gov/ncs/ect/sp/ecsupsrse.pdf>.

Historical ECEC data are available in three listings, all available at <http://www.bls.gov/ect/#tables>. The first historical listing covers data for the March reference periods from 1986 to 2001. These data use the Standard Industrial Classification (SIC) and Census of Population occupational classification systems. The second listing contains data for the March, June, September, and December reference periods from March 2002 to December 2003. These data are also based on the SIC and Census of Population occupational classification systems. The final listing includes data from March 2004 to the current reference period. These are based on the North American Industry Classification System (NAICS) and the Standard Occupational Classification (SOC) system.

Information in this release will be made available to sensory impaired individuals upon request—Telephone: (202) 691-5200; Federal Relay Service: (800) 877-8339.

BLS news releases, including the ECEC, are available through an e-mail subscription service at: www.bls.gov/bls/list.htm.

TECHNICAL NOTE

Employer Costs for Employee Compensation (ECEC) measures the average cost to employers for wages and salaries and benefits per employee hour worked.

ECEC covers the civilian economy, which includes data from both private industry and state and local government. Excluded from private industry are the self-employed and farm and private household workers. Federal government workers are excluded from the public sector. The private industry series and the state and local government series provide data for the two sectors separately.

The cost levels for this quarter were collected from a probability sample of approximately 62,400 occupations selected from a sample of about 13,100 establishments in private industry and approximately 11,600 occupations from a sample of about 1,800 establishments in state and local governments. The private industry sample is rotated over approximately 5 years, which makes the sample more representative of the economy and reduces respondent burden. The state and local government sample, which is replaced less frequently than the private industry sample, was replaced in its entirety in September 2007. The sample is replaced on a cross-area, cross-industry basis. Data are collected for the pay period including the 12th day of the survey months of March, June, September, and December.

Comparing private and public sector data

Compensation cost levels in state and local government should not be directly compared with levels in private industry. Differences between these sectors stem from factors such as variation in work activities and occupational structures. Manufacturing and sales, for example, make up a large part of private industry work activities but are rare in state and local government. Management, professional, and administrative support occupations (including teachers) account for two-thirds of the state and local government workforce, compared with two-fifths of private industry.

ECEC quarterly publication focus

ECEC news releases are published quarterly, providing civilian, private industry, and state and local government cost per hour estimates as well as additional detail on a specific compensation cost topic of interest. This quarter focuses on compensation costs in state and local government. Topics of news releases for the upcoming reference periods are as follows:

- December 2010—Legally required and paid leave benefit costs in private industry
- March 2011—Health benefit costs in private industry
- June 2011—Retirement and savings benefit costs in private industry

ECEC detailed information and measures

For detailed information on the Employer Costs for Employee Compensation series, see National Compensation Measures, Chapter 8, of the *BLS Handbook of Methods* at: www.bls.gov/opub/hom/pdf/homch8.pdf.

Table 1. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Civilian workers, by major occupational and industry group, September 2010

Compensation component	Occupational group							
	All workers ¹		Management, professional, and related		Sales and office		Service	
	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$29.75	100.0	\$49.14	100.0	\$22.51	100.0	\$16.28	100.0
Wages and salaries	20.69	69.5	24.40	70.0	15.88	70.5	11.57	71.0
Total benefits	9.06	30.5	14.74	30.0	6.63	29.5	4.72	29.0
Paid leave	2.05	6.9	3.90	7.9	1.43	6.3	0.99	5.5
Vacation	0.99	3.3	1.94	3.7	0.72	3.2	0.42	2.6
Holiday	0.64	2.2	1.18	2.4	0.45	2.1	0.28	1.7
Sick	0.32	1.1	0.67	1.4	0.21	0.9	0.14	0.9
Personal	0.11	0.4	0.22	0.5	0.07	0.3	0.04	0.3
Supplemental pay	0.71	2.4	1.19	2.4	0.44	2.0	0.28	1.7
Overtime and premium ⁴	0.25	0.8	0.15	0.3	0.14	0.6	0.17	1.0
Shift differentials	0.06	0.2	0.11	0.2	0.02	0.1	0.05	0.3
Nonproduction bonuses	0.40	1.3	0.94	1.9	0.29	1.2	0.07	0.4
Insurance	2.63	8.8	3.91	8.0	2.18	9.7	1.41	8.7
Life	0.05	0.2	0.09	0.2	0.03	0.2	0.02	0.1
Health	2.49	8.4	3.68	7.4	2.09	9.3	1.17	7.4
Short-term disability	0.05	0.2	0.07	0.1	0.03	0.2	0.02	0.1
Long-term disability	0.04	0.1	0.08	0.2	0.03	0.1	(⁵)	(⁵)
Retirement and savings	1.34	4.5	2.50	5.1	0.76	3.4	0.63	3.8
Defined benefit	0.83	2.8	1.60	3.1	0.35	1.6	0.46	3.0
Defined contribution	0.51	1.7	1.00	2.0	0.40	1.8	0.14	0.8
Legally required benefits	2.52	7.0	3.24	6.6	1.76	7.8	1.50	9.2
Social Security and Medicare	1.68	5.7	2.69	5.5	1.33	5.9	0.97	6.0
Social Security ⁷	1.34	4.5	2.12	4.3	1.07	4.7	0.78	4.8
Medicare	0.34	1.1	0.57	1.2	0.26	1.1	0.16	1.2
Federal unemployment insurance	0.03	0.1	0.02	(⁶)	0.03	0.1	0.03	0.2
State unemployment insurance	0.17	0.6	0.15	0.3	0.15	0.7	0.14	0.9
Workers' compensation	0.44	1.5	0.37	0.7	0.24	1.1	0.36	2.2

See footnotes at end of table.

Table 1. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Civilian workers, by major occupational and industry group, September 2010 — Continued

Compensation component	Occupational group				Industry group			
	Natural resources, construction, and maintenance		Production, transportation, and material moving		Goods-producing ²		Service-providing ³	
	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$31.54	100.0	\$24.30	100.0	\$32.86	100.0	\$29.19	100.0
Wages and salaries	21.20	67.2	16.12	66.4	21.87	68.5	20.48	70.1
Total benefits	10.35	32.8	8.17	33.6	10.99	33.5	8.72	29.9
Paid leave	1.69	5.4	1.47	6.0	2.11	6.4	2.04	7.0
Vacation	0.89	2.8	0.74	3.1	1.12	3.4	0.97	3.3
Holiday	0.55	1.7	0.51	2.1	0.75	2.3	0.62	2.1
Sick	0.18	0.6	0.16	0.7	0.18	0.5	0.34	1.2
Personal	0.08	0.3	0.06	0.2	0.06	0.2	0.11	0.4
Supplemental pay	0.94	3.0	0.79	3.2	1.18	3.6	0.63	2.2
Overtime and premium ⁴	0.65	2.1	0.52	2.1	0.58	1.8	0.10	0.7
Shift differentials	0.05	0.1	0.09	0.4	0.08	0.3	0.06	0.2
Nonproduction bonuses	0.24	0.8	0.18	0.7	0.52	1.6	0.38	1.3
Insurance	2.84	9.0	2.64	10.9	3.13	9.5	2.54	8.7
Life	0.05	0.2	0.05	0.2	0.07	0.2	0.05	0.2
Health	2.68	8.5	2.49	10.3	2.93	8.9	2.41	8.3
Short-term disability	0.08	0.3	0.06	0.3	0.03	0.3	0.04	0.1
Long-term disability	0.03	0.1	0.04	0.2	0.04	0.1	0.04	0.1
Retirement and savings	1.73	5.5	0.97	4.0	1.60	4.9	1.30	4.4
Defined benefit	1.24	3.9	0.61	2.5	0.93	2.8	0.80	2.7
Defined contribution	0.49	1.6	0.36	1.5	0.67	2.0	0.50	1.7
Legally required benefits	3.14	10.0	2.30	9.5	2.97	9.0	2.21	7.6
Social Security and Medicare	1.78	5.6	1.37	5.7	1.88	5.7	1.65	5.6
Social Security ⁵	1.44	4.6	1.11	4.6	1.50	4.6	1.31	4.6
Medicare	0.34	1.1	0.27	1.1	0.38	1.1	0.34	1.1
Federal unemployment insurance	0.03	0.1	0.03	0.1	0.03	0.1	0.03	0.1
State unemployment insurance	0.22	0.7	0.21	0.9	0.25	0.8	0.15	0.5
Workers' compensation	1.11	3.5	0.69	2.8	0.92	2.8	0.38	1.3

¹ Includes workers in the private nonfarm economy excluding households and the public sector excluding the Federal government.

² Includes mining, construction, and manufacturing. The agriculture, forestry, farming, and hunting sector is excluded.

³ Includes utilities; wholesale trade; retail trade; transportation and warehousing; information, finance and insurance; real estate and rental and leasing; professional and technical services; management of companies and enterprises; administrative and waste services; educational services; health care and social assistance; arts, entertainment and recreation; accommodation and food services; other services, except public administration; and public administration.

⁴ Includes premium pay for work in addition to the regular work schedule (such as overtime, weekends, and holidays).

⁵ Cost per hour worked is \$0.01 or less.

⁶ Less than .05 percent.

⁷ Comprises the Old-Age, Survivors, and Disability Insurance (OASDI) program.

Note: The sum of individual items may not equal totals due to rounding.

Table 2. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Civilian workers, by occupational and industry group, September 2010

Series	Total compensation	Wages and salaries	Benefit costs					Legally required benefits
			Total	Paid leave	Supplemental pay	Insurance	Retirement and savings	
Cost per hour worked								
Civilian workers ¹	\$29.75	\$20.65	\$5.06	\$2.05	\$0.71	\$2.63	\$1.34	\$2.32
Occupational group								
Management, professional, and related	49.14	34.40	14.74	3.90	1.19	3.81	2.50	3.24
Management, business, and financial	55.48	39.34	17.12	5.06	1.65	3.96	2.63	3.81
Professional and related	46.82	32.85	13.87	3.47	0.56	3.89	2.46	3.13
Teachers ²	22.89	37.87	15.01	2.72	0.13	5.20	3.88	3.07
Primary, secondary, and special education school teachers	52.65	37.31	15.23	2.50	0.15	6.64	3.89	2.85
Registered nurses	48.24	33.74	14.52	4.01	1.83	3.61	1.80	3.65
Sales and office	22.51	15.86	6.53	1.48	0.44	2.18	0.76	1.76
Sales and related	20.69	18.65	5.34	1.15	0.49	1.42	0.53	1.75
Office and administrative support	23.41	16.02	7.33	1.57	0.41	2.63	0.60	1.77
Service	18.28	11.57	4.72	0.89	0.28	1.41	0.63	1.50
Natural resources, construction, and maintenance	31.54	21.20	10.35	1.69	0.94	2.84	0.79	3.14
Construction, extraction, farming, fishing, and forestry ³	31.59	21.03	10.55	1.57	1.01	2.72	2.04	3.51
Installation, maintenance, and repair	31.50	21.38	10.13	2.15	0.66	2.58	1.59	2.75
Production, transportation, and material moving	24.50	16.12	8.17	1.47	0.79	2.64	0.67	2.30
Production	24.03	16.27	8.35	1.59	0.52	2.74	0.63	2.27
Transportation and material moving	23.98	15.89	8.00	1.35	0.88	2.58	1.11	2.33
Industry group								
Education and health services	34.60	24.13	10.38	2.42	0.43	3.37	1.80	2.34
Educational services	42.50	29.48	13.02	2.66	0.14	4.68	3.05	2.50
Elementary and secondary schools	42.41	29.27	13.14	2.27	0.15	5.09	3.25	2.38
Junior colleges, colleges, and universities	45.36	31.41	13.07	3.75	0.14	4.29	2.97	2.81
Health care and social assistance	29.12	20.54	8.88	2.27	0.63	2.40	0.96	2.23
Hospitals	36.71	24.00	12.05	3.17	1.05	3.67	1.50	2.02
Percent of total compensation								
Civilian workers ¹	100.0	69.5	30.5	6.9	2.4	8.8	4.5	7.8
Occupational group								
Management, professional, and related	100.0	70.0	30.0	7.9	2.4	8.0	5.1	6.9
Management, business, and financial	100.0	69.1	30.9	9.1	3.2	7.1	4.7	6.5
Professional and related	100.0	70.4	29.6	7.4	2.0	8.3	5.2	6.6
Teachers ²	100.0	71.7	28.3	5.1	0.3	9.8	7.3	5.8
Primary, secondary, and special education school teachers	100.0	71.0	26.0	4.8	0.3	11.1	7.4	5.4
Registered nurses	100.0	69.9	30.1	8.3	3.2	7.3	3.8	7.4
Sales and office	100.0	70.5	28.5	6.6	2.0	9.7	3.4	7.8
Sales and related	100.0	74.6	25.4	6.5	2.3	6.8	2.6	8.4
Office and administrative support	100.0	68.4	31.6	7.1	1.8	11.2	3.5	7.6
Service	100.0	71.0	28.0	5.5	1.7	8.7	3.8	9.2
Natural resources, construction, and maintenance	100.0	67.2	32.8	5.4	3.0	9.0	5.5	10.0
Construction, extraction, farming, fishing, and forestry ³	100.0	65.6	35.4	4.0	3.2	8.5	6.5	11.1
Installation, maintenance, and repair	100.0	67.9	32.1	8.8	2.7	9.5	4.4	8.7
Production, transportation, and material moving	100.0	66.4	35.6	6.0	3.2	10.9	4.0	9.5
Production	100.0	66.1	35.9	6.5	3.7	11.1	3.4	9.2
Transportation and material moving	100.0	66.7	35.3	5.6	2.7	10.7	4.6	9.7
Industry group								
Education and health services	100.0	70.0	30.0	7.0	1.3	8.8	5.2	6.8
Educational services	100.0	69.4	30.6	6.3	0.3	11.0	7.2	6.0
Elementary and secondary schools	100.0	69.0	31.0	5.4	0.3	12.0	7.7	5.3
Junior colleges, colleges, and universities	100.0	69.2	30.8	8.3	0.3	9.4	6.5	6.2
Health care and social assistance	100.0	70.5	29.5	7.8	2.2	8.6	3.3	7.7
Hospitals	100.0	67.2	32.8	8.0	2.9	10.0	4.1	7.1

¹ Includes workers in the private nonfarm economy excluding households and the public sector excluding the Federal government.
² Includes postsecondary teachers, primary, secondary, and special education teachers, and other teachers and instructors.
³ Farming, fishing, and forestry occupations were combined with construction and extraction occupational groups as of December 2008.
 Note: The sum of individual items may not equal totals due to rounding.

Table 3. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: State and local government workers, by major occupational and industry group, September 2010

Compensation component	Occupational group ¹								Industry group	
	All workers		Management, professional, and related		Sales and office		Service		Service-providing ²	
	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$40.10	100.0	\$48.73	100.0	\$27.87	100.0	\$30.17	100.0	\$40.15	100.0
Wages and salaries	26.25	65.5	33.17	68.1	16.88	60.9	18.06	59.9	26.30	65.5
Total benefits	13.85	34.5	15.56	31.9	10.99	39.1	12.11	40.1	13.85	34.5
Paid leave	3.03	7.6	3.38	6.9	2.49	8.9	2.66	8.8	3.03	7.6
Vacation	1.15	2.8	1.15	2.4	1.12	4.0	1.18	3.8	1.14	2.9
Holiday	0.90	2.2	0.85	1.9	0.79	2.8	0.86	2.8	0.88	2.2
Sick	0.77	1.9	0.96	2.0	0.48	1.7	0.53	1.7	0.78	1.9
Personal	0.22	0.5	0.30	0.6	0.11	0.4	0.13	0.4	0.22	0.5
Supplemental pay	0.33	0.8	0.24	0.5	0.20	0.7	0.56	1.9	0.33	0.8
Overtime and premium ³	0.17	0.4	0.07	0.1	0.11	0.4	0.37	1.2	0.17	0.4
Shift differentials	0.05	0.1	0.03	0.1	0.02	0.1	0.09	0.3	0.05	0.1
Nonproduction bonuses	0.11	0.3	0.13	0.3	0.07	0.2	0.11	0.4	0.11	0.3
Insurance	4.80	12.0	5.34	11.0	4.36	15.6	3.89	12.9	4.80	12.0
Life	0.09	0.2	0.12	0.3	0.05	0.2	0.04	0.1	0.09	0.2
Health	4.05	11.5	5.13	10.5	4.26	15.3	3.80	12.6	4.85	11.8
Short-term disability	0.02	0.1	0.03	0.1	0.02	0.1	0.02	0.1	0.02	0.1
Long-term disability	0.04	0.1	0.06	0.1	0.03	0.1	0.02	0.1	0.04	0.1
Retirement and savings	3.28	8.1	3.83	7.9	2.05	7.5	2.96	9.8	3.26	8.1
Defined benefit	2.94	7.3	3.42	7.0	1.85	6.8	2.73	9.1	2.94	7.3
Defined contribution	0.32	0.8	0.41	0.8	0.23	0.8	0.21	0.7	0.32	0.8
Legally required benefits	2.42	6.0	2.77	5.7	1.76	6.3	2.03	6.7	2.42	6.0
Social Security and Medicare	1.87	4.7	2.28	4.7	1.35	4.8	1.33	4.4	1.97	4.8
Social Security ⁴	1.45	3.6	1.76	3.6	1.08	3.8	1.03	3.4	1.45	3.6
Medicare	0.42	1.0	0.52	1.1	0.28	1.0	0.50	1.0	0.42	1.0
Federal unemployment insurance	(5)	(6)	(5)	(6)	(5)	(6)	(5)	(6)	(5)	(6)
State unemployment insurance	0.09	0.2	0.09	0.2	0.08	0.3	0.09	0.3	0.09	0.2
Workers' compensation	0.46	1.2	0.40	0.8	0.33	1.2	0.61	2.0	0.48	1.1

¹ This table presents data for the three major occupational groups in State and local government: management, professional, and related occupations, including teachers; sales and office occupations, including clerical workers; and service occupations, including police and firefighters.
² Service-providing industries, which include health and educational services, employ a large part of the State and local government workforce.
³ Includes premium pay for work in addition to the regular work schedule

(such as overtime, weekends, and holidays).
⁴ Comprises the Old-Age, Survivors, and Disability Insurance (OASDI) program.
⁵ Cost per hour worked is \$0.01 or less.
⁶ Less than .05 percent.

Note: The sum of individual items may not equal totals due to rounding.

Table 4. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: State and local government workers, by occupational and industry group, September 2010

Series	Total compensation	Wages and salaries	Benefit costs					Retirement and savings	Legally required benefits
			Total	Paid leave	Supplemental pay	Insurance			
Cost per hour worked									
State and local government workers	\$40.10	\$26.25	\$13.85	\$3.03	\$0.33	\$4.80	\$3.20	\$2.42	
Occupational group									
Management, professional, and related	48.73	33.17	15.55	3.38	0.24	5.34	3.83	2.77	
Professional and related	47.90	32.76	15.13	3.06	0.23	5.35	3.79	2.70	
Teachers ¹	55.84	39.22	16.32	2.85	0.14	5.87	4.44	3.02	
Primary, secondary, and special education school teachers	55.38	39.05	16.33	2.82	0.15	5.37	4.32	2.87	
Sales and office	27.87	16.58	10.89	2.49	0.20	4.36	2.08	1.76	
Office and administrative support	28.06	17.55	11.01	2.52	0.20	4.43	2.11	1.76	
Service	30.17	18.06	12.11	2.65	0.56	3.98	2.96	2.03	
Industry group									
Education and health services	42.24	28.63	13.51	2.74	0.21	5.04	3.22	2.40	
Educational services	43.35	29.64	13.74	2.65	0.15	5.14	3.35	2.41	
Elementary and secondary schools	43.09	29.50	13.55	2.31	0.15	5.31	3.44	2.35	
Junior colleges, colleges, and universities	44.71	30.29	14.43	3.80	0.12	4.63	3.24	2.63	
Health care and social assistance	34.98	22.24	12.74	3.23	0.60	4.40	2.22	2.29	
Hospitals	37.10	23.53	13.47	3.45	0.73	4.67	2.24	2.38	
Public administration	38.13	23.31	14.82	3.64	0.54	4.50	3.59	2.46	
Percent of total compensation									
State and local government workers	100.0	65.5	34.5	7.6	0.8	12.0	8.1	6.0	
Occupational group									
Management, professional, and related	100.0	68.1	31.9	6.9	0.5	11.0	7.9	5.7	
Professional and related	100.0	66.4	31.6	6.4	0.5	11.2	7.9	5.6	
Teachers ¹	100.0	70.6	29.4	5.1	0.2	10.6	8.0	5.4	
Primary, secondary, and special education school teachers	100.0	70.5	29.5	4.7	0.3	11.5	7.8	5.2	
Sales and office	100.0	60.9	30.1	8.9	0.7	15.6	7.5	6.3	
Office and administrative support	100.0	60.7	30.3	9.0	0.7	15.8	7.5	6.3	
Service	100.0	59.9	40.1	8.5	1.9	12.9	9.3	6.7	
Industry group									
Education and health services	100.0	67.8	32.2	6.5	0.5	11.9	7.6	5.7	
Educational services	100.0	69.3	31.7	6.1	0.3	11.9	7.8	5.6	
Elementary and secondary schools	100.0	68.5	31.5	5.4	0.4	12.3	8.0	5.5	
Junior colleges, colleges, and universities	100.0	67.7	32.3	8.5	0.3	10.3	7.3	5.9	
Health care and social assistance	100.0	63.6	36.4	9.2	1.7	12.6	6.4	6.5	
Hospitals	100.0	63.7	35.3	9.3	2.0	12.6	5.0	6.4	
Public administration	100.0	61.1	38.9	9.5	1.4	12.0	9.4	6.5	

¹ Includes postsecondary teachers; primary, secondary, and special education teachers; and other teachers and instructors.

Note: The sum of individual items may not equal totals due to rounding.

Table 5. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by major occupational group and bargaining unit status, September 2010

Compensation component	Occupational group							
	All workers		Management, professional, and related		Sales and office		Service	
	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$27.98	100.0	\$49.31	100.0	\$22.00	100.0	\$13.80	100.0
Wages and salaries	19.58	70.0	34.91	70.8	15.77	71.7	10.41	75.4
Total benefits	8.20	29.4	14.41	29.2	6.23	28.3	3.40	24.6
Paid leave	1.88	6.7	4.12	8.3	1.98	9.0	0.57	4.2
Vacation	0.99	3.4	2.12	4.3	0.99	4.5	0.29	2.1
Holiday	0.60	2.1	1.27	2.6	0.45	2.0	0.18	1.3
Sick	0.23	0.8	0.53	1.1	0.18	0.8	0.08	0.6
Personal	0.09	0.3	0.19	0.4	0.07	0.3	0.03	0.2
Supplemental pay	0.78	2.8	1.59	3.2	0.46	2.1	0.24	1.7
Overtime and premium ¹	0.26	0.9	0.18	0.4	0.14	0.7	0.13	1.0
Shift differentials	0.07	0.2	0.14	0.3	0.02	0.1	0.04	0.3
Nonproduction bonuses	0.45	1.6	1.27	2.6	0.90	4.1	0.36	2.6
Insurance	2.24	8.0	3.32	6.7	1.66	7.5	0.97	7.0
Life	0.04	0.2	0.08	0.2	0.03	0.2	(²)	(³)
Health	2.10	7.5	3.06	6.2	1.68	7.6	0.90	6.6
Short-term disability	0.05	0.2	0.09	0.2	0.04	0.2	0.02	0.1
Long-term disability	0.04	0.1	0.08	0.2	0.03	0.1	(²)	(³)
Retirement and savings	0.99	3.6	1.96	4.0	0.64	2.9	0.21	1.5
Defined benefit	0.44	1.6	0.71	1.4	0.22	1.0	0.09	0.6
Defined contribution	0.55	2.0	1.24	2.5	0.42	1.9	0.12	0.9
Legally required benefits	2.31	8.3	3.43	7.0	1.76	8.0	1.41	10.2
Social Security and Medicare	1.65	5.9	2.86	5.8	1.32	6.0	0.81	5.9
Social Security ⁴	1.32	4.7	2.27	4.6	1.07	4.9	0.74	5.3
Medicare	0.32	1.2	0.59	1.2	0.25	1.2	0.17	1.2
Federal unemployment insurance	0.03	0.1	0.03	0.1	0.03	0.2	0.04	0.3
State unemployment insurance	0.18	0.7	0.19	0.4	0.17	0.8	0.15	1.1
Workers' compensation	0.44	1.6	0.35	0.7	0.24	1.1	0.31	2.3

See footnotes at end of table.

Table 5. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private Industry workers, by major occupational group and bargaining unit status, September 2010 — Continued

Compensation component	Occupational group				Bargaining unit status			
	Natural resources, construction, and maintenance		Production, transportation, and material moving		Union		Nonunion	
	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$31.29	100.0	\$24.04	100.0	\$37.85	100.0	\$26.74	100.0
Wages and salaries	21.23	67.9	16.03	66.7	23.19	61.3	19.28	72.1
Total benefits	10.06	32.1	8.01	33.3	14.66	38.7	7.46	27.9
Paid leave	1.55	5.0	1.43	6.0	2.77	7.3	1.78	6.6
Vacation	0.83	2.7	0.73	3.1	1.43	3.8	0.91	3.4
Holiday	0.50	1.6	0.50	2.1	0.81	2.1	0.57	2.1
Sick	0.14	0.4	0.16	0.6	0.38	1.0	0.22	0.8
Personal	0.06	0.3	0.05	0.2	0.15	0.4	0.09	0.3
Supplemental pay	0.98	3.1	0.90	3.3	1.09	2.9	0.75	2.8
Overtime and premium ¹	0.88	2.2	0.52	2.2	0.74	2.0	0.21	0.8
Shift differentials	0.04	0.1	0.29	0.4	0.17	0.4	0.05	0.2
Nonproduction bonuses	0.26	0.8	0.18	0.8	0.18	0.5	0.48	1.8
Insurance	2.88	8.8	2.58	10.6	4.84	12.8	1.84	7.3
Life	0.05	0.2	0.05	0.2	0.08	0.2	0.04	0.2
Health	2.51	8.0	2.40	10.0	4.54	12.0	1.82	6.8
Short-term disability	0.09	0.3	0.05	0.3	0.15	0.4	0.04	0.2
Long-term disability	0.03	0.1	0.04	0.2	0.07	0.2	0.04	0.1
Retirement and savings	1.63	5.2	0.92	3.8	2.75	7.3	0.79	3.0
Defined benefit	1.11	3.5	0.54	2.3	2.03	5.4	0.26	1.0
Defined contribution	0.52	1.7	0.37	1.6	0.72	1.9	0.53	2.0
Legally required benefits	3.22	10.3	2.31	9.5	3.21	8.5	2.20	8.2
Social Security and Medicare	1.60	5.7	1.37	5.7	2.02	5.3	1.90	6.9
Social Security ²	1.46	4.7	1.11	4.6	1.83	4.3	1.29	4.8
Medicare	0.34	1.1	0.26	1.1	0.38	1.0	0.32	1.2
Federal unemployment insurance	0.03	0.1	0.03	0.1	0.03	0.1	0.03	0.1
State unemployment insurance	0.24	0.8	0.21	0.9	0.25	0.7	0.19	0.7
Workers' compensation	1.15	3.7	0.68	2.9	0.91	2.4	0.59	2.4

¹ Includes premium pay for work in addition to the regular work schedule (such as overtime, weekends, and holidays).
² Cost per hour worked is \$0.01 or less.
³ Less than 0.5 percent.
⁴ Comprises the Old-Age, Survivors, and Disability

Insurance (OASDI) program.

Note: The sum of individual items may not equal totals due to rounding.

Table 6. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by major industry group, September 2010

Compensation component	Goods-producing ¹						Service-providing ²					
	All goods-producing ¹		Construction		Manufacturing		All service-providing ³		Trade, transportation, and utilities		Information	
	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$32.63	100.0	\$31.68	100.0	\$32.68	100.0	\$26.81	100.0	\$23.87	100.0	\$42.03	100.0
Wages and salaries	21.87	66.6	21.81	69.1	21.48	65.8	19.21	71.8	18.82	70.5	23.82	56.5
Total benefits	10.96	33.4	9.77	30.9	11.19	34.2	7.60	28.4	7.05	29.5	13.25	31.5
Paid leave	2.10	6.4	1.13	3.6	2.48	7.8	1.83	6.8	1.45	6.1	3.91	9.3
Vacation	1.12	3.4	0.64	2.0	1.50	4.0	0.99	3.5	0.74	3.1	2.03	4.8
Holiday	0.75	2.3	0.29	1.2	0.88	2.7	0.57	2.1	0.45	1.9	1.00	2.5
Sick	0.19	0.5	0.08	0.2	0.22	0.7	0.34	0.9	0.20	0.8	0.47	1.1
Personal	0.06	0.2	0.03	0.1	0.07	0.2	0.06	0.3	0.00	0.3	0.38	0.9
Supplemental pay	1.19	3.6	1.05	3.3	1.19	3.6	0.70	2.6	0.53	2.2	0.96	2.4
Overtime and premium ⁴	0.58	1.8	0.63	2.0	0.54	1.6	0.20	0.7	0.26	1.1	0.36	0.9
Shift differentials	0.09	0.3	(⁵)	(⁶)	0.12	0.4	0.06	0.2	0.02	0.1	0.06	0.1
Nonproduction bonuses	0.52	1.6	0.41	1.3	0.53	1.6	0.44	1.6	0.25	1.0	0.57	1.4
Insurance	3.11	9.5	2.34	7.4	3.40	10.4	2.05	7.6	2.09	8.7	3.79	9.0
Life	0.07	0.2	0.05	0.2	0.07	0.2	0.04	0.1	0.04	0.1	0.35	0.1
Health	2.91	8.9	2.22	7.0	3.18	9.7	1.92	7.2	1.90	8.0	3.50	8.3
Short-term disability	0.09	0.3	0.05	0.2	0.10	0.3	0.05	0.2	0.04	0.2	0.17	0.4
Long-term disability	0.04	0.1	0.02	0.1	0.05	0.2	0.04	0.2	0.04	0.1	0.07	0.2
Rational and savings	1.68	4.9	1.70	5.4	1.42	4.4	0.87	3.2	0.89	3.7	1.24	3.0
Defined benefit	0.95	2.9	1.13	3.6	0.80	2.4	0.33	1.2	0.43	1.8	0.70	1.7
Defined contribution	0.63	1.9	0.57	1.8	0.63	1.9	0.53	2.0	0.46	1.9	0.84	2.2
Legally required benefits	2.97	9.1	3.55	11.2	2.70	8.3	2.16	8.1	2.09	8.8	2.51	6.0
Social Security and Medicare	1.86	5.7	1.81	5.7	1.86	5.7	1.00	6.0	1.40	5.8	2.43	5.8
Social Security ⁷	1.30	4.6	1.45	4.6	1.50	4.6	1.28	4.8	1.13	4.7	1.55	4.5
Medicare	0.36	1.1	0.35	1.1	0.35	1.1	0.22	1.2	0.27	1.1	0.45	1.2
Federal unemployment insurance	0.03	0.1	0.03	0.1	0.03	0.1	0.03	0.1	0.04	0.2	0.05	0.1
State unemployment insurance	0.26	0.8	0.31	1.0	0.24	0.7	0.17	0.6	0.17	0.7	0.19	0.4
Workers' compensation	0.87	2.5	1.40	4.4	0.58	1.8	0.36	1.3	0.49	2.0	0.26	0.6

See footnotes at end of table.

Table 6. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by major industry group, September 2010 — Continued

Compensation component	Service-providing ²									
	Financial activities		Professional and business services		Education and health services		Leisure and hospitality		Other services	
	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$36.88	100.0	\$33.38	100.0	\$29.94	100.0	\$12.14	100.0	\$24.78	100.0
Wages and salaries	25.03	67.9	24.26	72.7	21.46	71.8	9.58	78.9	18.26	73.7
Total benefits	11.86	32.1	9.12	27.3	8.46	28.2	2.55	21.1	6.50	25.3
Paid leave	3.04	8.2	2.32	7.0	2.24	7.5	0.38	3.1	1.56	6.3
Vacation	1.54	4.2	1.20	3.6	1.09	3.7	0.22	1.9	0.79	2.9
Holiday	0.93	2.5	0.77	2.3	0.87	2.9	0.11	0.9	0.56	2.3
Sick	0.43	1.2	0.27	0.8	0.35	1.2	0.05	0.3	0.20	0.8
Personal	0.15	0.4	0.09	0.3	0.15	0.4	0.02	0.2	0.05	0.2
Supplemental pay	1.66	4.5	1.15	3.4	0.57	1.9	0.12	1.0	0.57	2.3
Overtime and premium	0.15	0.4	0.20	0.6	0.21	0.7	0.07	0.5	0.15	0.6
Shift differentials	(⁵)	(⁵)	0.03	0.1	0.20	0.7	(⁵)	(⁶)	(⁶)	(⁶)
Nonproduction bonuses	1.80	4.1	0.90	2.7	0.15	0.5	0.05	0.4	0.41	1.7
Insurance	3.06	8.3	2.12	6.4	2.39	8.0	0.67	5.5	1.57	6.3
Life	0.06	0.2	0.06	0.2	0.03	0.1	(⁵)	(⁶)	0.06	0.2
Health	2.84	7.7	1.98	5.9	2.26	7.6	0.84	6.9	1.45	5.8
Short-term disability	0.09	0.3	0.06	0.2	0.04	0.1	(⁵)	(⁷)	0.03	0.1
Long-term disability	0.06	0.2	0.05	0.2	0.06	0.2	(⁵)	(⁵)	0.03	0.1
Retirement and savings	1.62	4.4	0.95	2.9	0.95	3.2	0.11	0.9	0.67	2.7
Defined benefit	0.65	1.8	0.31	0.9	0.30	1.0	0.03	0.2	0.27	1.1
Defined contribution	0.99	2.6	0.65	1.9	0.66	2.2	0.08	0.7	0.40	1.6
Legally required benefits	2.47	6.7	2.59	7.7	2.31	7.7	1.29	10.6	2.13	8.5
Social Security and Medicare	2.07	5.6	1.98	5.9	1.78	6.0	0.66	5.4	1.53	6.2
Social Security ³	1.65	4.5	1.68	4.7	1.43	4.8	0.69	5.7	1.23	5.0
Medicare	0.43	1.2	0.40	1.2	0.35	1.2	0.16	1.3	0.30	1.2
Federal unemployment insurance	0.03	0.1	0.03	0.1	0.03	0.1	0.04	0.3	0.03	0.1
State unemployment insurance	0.17	0.5	0.21	0.6	0.15	0.5	0.14	1.2	0.16	0.7
Workers' compensation	0.19	0.5	0.35	1.1	0.34	1.1	0.24	2.0	0.41	1.7

¹ Includes mining, construction, and manufacturing. The agriculture, forestry, fishing, and hunting sector is excluded.
² Includes utilities; wholesale trade; retail trade; transportation and warehousing; information; finance and insurance; real estate and rental and leasing; professional and technical services; management of companies and enterprises; administrative and waste services; educational services; health care and social assistance; arts, entertainment and recreation; accommodation and food services; and other services, except public administration.
³ Includes utilities; wholesale trade; retail trade; transportation and warehousing; information; finance and insurance; real estate and rental and leasing; professional and technical services; management of

companies and enterprises; administrative and waste services; educational services; health care and social assistance; arts, entertainment and recreation; accommodation and food services; and other services, except public administration.
⁴ Includes premium pay for work in addition to the regular work schedule (such as overtime, weekends, and holidays).
⁵ Cost per hour worked is 50¢ or less.
⁶ Less than .05 percent.
⁷ Comprises the Old-Age, Survivors, and Disability Insurance (OASDI) program.
 Note: The sum of individual items may not equal totals due to rounding.

Table 7. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by census region and division, September 2010

Compensation component	Census region and division ¹									
	Northeast		Northeast divisions				South		South divisions	
	Cost	Percent	New England		Middle Atlantic		Cost	Percent	South Atlantic	
			Cost	Percent	Cost	Percent			Cost	Percent
Total compensation	\$32.26	100.0	\$34.18	100.0	\$31.51	100.0	\$24.87	100.0	\$25.88	100.0
Wages and salaries	22.27	69.0	23.53	68.6	21.78	69.1	17.88	71.9	18.50	72.0
Total benefits	9.99	31.0	10.65	31.2	9.73	30.9	6.99	28.1	7.19	28.0
Paid leave	2.35	7.3	2.60	7.3	2.30	7.3	1.61	6.5	1.70	6.5
Vacation	1.17	3.6	1.26	3.7	1.13	3.6	0.82	3.3	0.85	3.3
Holiday	0.74	2.3	0.80	2.4	0.72	2.3	0.52	2.1	0.55	2.1
Sick	0.31	1.0	0.30	0.9	0.31	1.0	0.20	0.8	0.21	0.8
Personal	0.13	0.4	0.13	0.4	0.13	0.4	0.08	0.3	0.09	0.3
Supplemental pay	1.21	3.8	1.67	4.8	1.04	3.3	0.64	2.6	0.60	2.4
Overtime and premium ²	0.27	0.8	0.26	0.8	0.27	0.8	0.25	1.0	0.24	0.9
Shift differentials	0.07	0.2	0.08	0.2	0.07	0.2	0.06	0.3	0.07	0.3
Nonproduction bonuses	0.88	2.7	1.34	3.9	0.70	2.2	0.32	1.3	0.30	1.2
Insurance	2.59	8.0	2.59	7.6	2.59	8.2	1.92	7.7	1.96	7.6
Life	0.05	0.2	0.05	0.2	0.04	0.1	0.05	0.2	0.04	0.2
Health	2.41	7.5	2.41	7.0	2.41	7.7	1.79	7.2	1.83	7.1
Short-term disability	0.08	0.3	0.07	0.2	0.09	0.3	0.04	0.2	0.05	0.2
Long-term disability	0.05	0.1	0.09	0.2	0.04	0.1	0.04	0.2	0.04	0.2
Retirement and savings	1.21	3.7	1.28	3.5	1.21	3.9	0.82	3.3	0.85	3.3
Defined benefit	0.52	1.6	0.48	1.4	0.54	1.7	0.32	1.3	0.31	1.2
Defined contribution	0.68	2.1	0.72	2.1	0.67	2.1	0.50	2.0	0.53	2.1
Legally required benefits	2.63	8.1	2.70	7.9	2.69	8.2	2.00	8.0	2.08	8.1
Social Security and Medicare	1.97	6.1	1.96	5.8	1.92	6.1	1.50	6.0	1.52	6.0
Social Security ³	1.50	4.6	1.50	4.5	1.46	4.6	1.21	4.8	1.24	4.8
Medicare	0.37	1.2	0.40	1.2	0.39	1.2	0.29	1.2	0.30	1.2
Federal unemployment insurance	0.35	1.1	0.33	1.0	0.33	1.1	0.25	1.0	0.26	1.0
State unemployment insurance	0.27	0.8	0.28	0.8	0.25	0.8	0.12	0.5	0.12	0.5
Workers' compensation	0.46	1.4	0.40	1.2	0.48	1.5	0.35	1.4	0.37	1.5

See footnotes at end of table.

Table 7. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by census region and division, September 2010 — Continued

Compensation component	Census region and division ¹									
	South divisions				Midwest		Midwest divisions			
	East South Central		West South Central		Cost	Percent	East North Central		West North Central	
	Cost	Percent	Cost	Percent			Cost	Percent	Cost	Percent
Total compensation	\$21.93	100.0	\$25.08	100.0	\$26.89	100.0	\$27.30	100.0	\$26.08	100.0
Wages and salaries	15.31	70.8	18.09	72.1	13.80	69.9	13.92	69.3	13.57	71.2
Total benefits	6.32	29.2	6.99	27.9	9.09	30.1	8.38	30.7	7.61	28.8
Paid leave	1.33	6.1	1.60	6.4	1.76	6.5	1.33	6.7	1.64	6.3
Vacation	0.70	3.2	0.81	3.2	0.93	3.5	0.94	3.5	0.90	3.5
Holiday	0.42	2.0	0.52	2.1	0.56	2.1	0.69	2.2	0.50	1.9
Sick	0.14	0.7	0.20	0.8	0.19	0.7	0.19	0.7	0.19	0.7
Personal	0.06	0.3	0.07	0.3	0.08	0.3	0.09	0.3	0.05	0.2
Supplemental pay	0.61	2.4	0.76	3.0	0.99	2.8	0.72	2.7	0.61	2.4
Overtime and premiums ²	0.24	1.1	0.29	1.1	0.28	1.0	0.29	1.1	0.25	0.9
Shift differentials	0.07	0.3	0.05	0.2	0.08	0.3	0.09	0.3	0.05	0.2
Nonproduction bonuses	0.20	0.9	0.43	1.7	0.33	1.2	0.35	1.3	0.30	1.2
Insurance	1.09	9.2	1.82	7.3	2.88	9.9	2.50	9.2	2.14	8.2
Life	0.05	0.2	0.05	0.2	0.05	0.2	0.05	0.2	0.04	0.2
Health	1.65	8.6	1.70	6.8	2.24	8.3	2.35	8.6	2.01	7.7
Short-term disability	0.04	0.2	0.04	0.2	0.05	0.2	0.07	0.2	0.04	0.1
Long-term disability	0.03	0.2	0.03	0.1	0.04	0.2	0.04	0.1	0.05	0.2
Retirement and savings	0.66	3.1	0.85	3.4	1.03	3.8	1.05	3.9	0.98	3.8
Defined benefit	0.29	1.3	0.35	1.4	0.50	1.9	0.56	2.0	0.41	1.5
Defined contribution	0.36	1.7	0.48	2.0	0.53	2.0	0.51	1.9	0.56	2.2
Legally required benefits	1.63	8.5	1.95	7.9	2.22	8.3	2.27	8.3	2.19	8.2
Social Security and Medicare	1.34	6.2	1.60	6.0	1.56	5.9	1.61	5.9	1.52	5.9
Social Security ³	1.09	5.0	1.20	4.8	1.27	4.7	1.20	4.7	1.22	4.7
Medicare	0.26	1.2	0.30	1.2	0.31	1.1	0.31	1.1	0.30	1.2
Federal unemployment insurance	0.03	0.2	0.03	0.1	0.03	0.1	0.03	0.1	0.03	0.1
State unemployment insurance	0.12	0.6	0.12	0.5	0.19	0.7	0.20	0.7	0.18	0.7
Workers' compensation	0.34	1.6	0.31	1.2	0.42	1.6	0.43	1.6	0.39	1.5

See footnotes at end of table.

Table 7. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by census region and division, September 2010 — Continued

Compensation component	Census region and division ¹					
	West		West divisions			
	Cost	Percent	Mountain		Pacific	
	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$28.66	100.0	\$28.66	100.0	\$30.66	100.0
Wages and salaries	21.10	71.1	19.49	72.5	21.79	70.6
Total benefits	8.56	28.9	7.38	27.5	9.07	29.4
Paid leave	1.93	6.7	1.72	6.4	2.09	6.8
Vacation	1.02	3.5	0.88	3.3	1.08	3.5
Holiday	0.62	2.1	0.55	2.1	0.65	2.1
Sick	0.27	0.9	0.22	0.8	0.29	0.9
Personal	0.07	0.2	0.07	0.3	0.07	0.2
Supplemental pay	0.72	2.4	0.64	2.4	0.75	2.4
Overtime and premium ²	0.27	0.9	0.22	0.8	0.29	0.9
Shift differentials	0.03	0.2	0.05	0.2	0.06	0.2
Nonproduction bonuses	0.40	1.3	0.38	1.4	0.41	1.3
Insurance	2.24	7.5	1.98	7.4	2.35	7.6
Life	0.04	0.1	0.05	0.2	0.04	0.1
Health	2.12	7.2	1.87	7.0	2.23	7.2
Short-term disability	0.04	0.1	0.03	0.1	0.04	0.1
Long-term disability	0.04	0.1	0.04	0.1	0.04	0.1
Retirement and savings	1.08	3.5	0.83	3.1	1.12	3.6
Defined benefit	0.50	1.7	0.31	1.2	0.58	1.9
Defined contribution	0.53	1.8	0.51	1.9	0.54	1.7
Legally required benefits	2.59	8.7	2.20	8.2	2.75	8.9
Social Security and Medicare	1.75	5.9	1.59	5.9	1.82	5.9
Social Security ³	1.41	4.7	1.28	4.8	1.46	4.7
Medicare	0.35	1.2	0.32	1.2	0.36	1.2
Federal unemployment insurance	0.23	0.1	0.19	0.1	0.23	0.1
State unemployment insurance	0.20	0.7	0.14	0.5	0.23	0.7
Workers' compensation	0.50	2.0	0.43	1.6	0.67	2.2

¹ The States that comprise the census divisions are: New England: Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont; Middle Atlantic: New Jersey, New York, and Pennsylvania; South Atlantic: Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, and West Virginia; East South Central: Alabama, Kentucky, Mississippi, and Tennessee; West South Central: Arkansas, Louisiana, Oklahoma, and Texas; East North Central: Illinois, Indiana, Michigan, Ohio, and Wisconsin; West North Central: Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, and South

Dakota; Mountain: Arizona, Colorado, Idaho, Montana, Nevada, New Mexico, Utah, and Wyoming; and Pacific: Alaska, California, Hawaii, Oregon, and Washington.

² Includes premium pay for work in addition to the regular work schedule (such as overtime, weekends, and holidays).

³ Comprises the Old-Age, Survivors, and Disability Insurance (OASDI) program.

Note: The sum of individual items may not equal totals due to rounding.

Table 8. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private Industry workers, by establishment employment size, September 2010

Compensation component	1-99 workers						100 workers or more					
	1-99 workers		1-49 workers		50-99 workers		100 workers or more		100-499 workers		500 workers or more	
	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent	Cost	Percent
Total compensation	\$22.96	100.0	\$22.20	100.0	\$25.36	100.0	\$33.47	100.0	\$23.71	100.0	\$39.96	100.0
Wages and salaries	16.69	73.0	16.47	74.2	18.20	71.9	22.85	68.3	20.14	70.2	28.55	66.4
Total benefits	6.07	26.4	5.72	25.8	7.16	28.2	10.62	31.7	8.57	29.8	13.41	33.8
Paid leave	1.26	5.5	1.16	5.3	1.50	5.9	2.58	7.7	1.95	8.8	3.43	8.6
Vacation	0.63	2.7	0.59	2.7	0.74	2.9	1.34	4.0	1.00	3.5	1.80	4.5
Holiday	0.43	1.9	0.41	1.8	0.50	2.0	0.79	2.4	0.93	2.2	1.01	2.5
Sick	0.15	0.7	0.14	0.6	0.19	0.7	0.33	1.0	0.24	0.8	0.45	1.1
Personal	0.06	0.2	0.05	0.2	0.07	0.3	0.12	0.4	0.09	0.3	0.17	0.4
Supplemental pay	0.60	2.6	0.58	2.6	0.87	3.4	0.99	3.0	0.74	2.6	1.33	3.3
Overtime and premium ¹	0.20	0.8	0.17	0.8	0.26	1.0	0.34	1.0	0.31	1.1	0.39	1.0
Shift differentials	0.02	0.1	(²)	(²)	0.03	0.1	0.12	0.4	0.07	0.2	0.23	0.5
Nonproduction bonuses	0.38	1.7	0.40	1.8	0.38	1.5	0.52	1.6	0.36	1.2	0.75	1.9
Insurance	1.55	6.7	1.41	6.4	1.97	7.8	3.02	9.0	2.52	8.8	3.71	9.3
Life	0.03	0.1	0.03	0.1	0.04	0.2	0.05	0.2	0.05	0.2	0.07	0.2
Health	1.46	6.4	1.33	6.0	1.85	7.3	2.82	8.4	2.38	8.2	3.45	8.6
Short-term disability	0.03	0.1	0.03	0.1	0.04	0.2	0.08	0.2	0.06	0.2	0.13	0.3
Long-term disability	0.02	0.1	0.02	0.1	0.03	0.1	0.08	0.2	0.04	0.1	0.09	0.2
Retirement and savings	0.59	2.6	0.53	2.4	0.77	3.0	1.46	4.4	1.01	3.5	2.07	5.2
Defined benefit	0.23	1.0	0.20	0.9	0.33	1.3	0.69	2.1	0.43	1.5	1.04	2.6
Defined contribution	0.36	1.6	0.33	1.5	0.45	1.8	0.77	2.3	0.58	2.0	1.03	2.6
Legally required benefits	2.07	9.0	2.02	9.1	2.25	8.9	2.57	7.7	2.36	8.2	2.87	7.2
Social Security and Medicare	1.40	6.1	1.37	6.2	1.52	6.0	1.92	5.7	1.98	8.8	2.29	5.7
Social Security ⁴	1.13	4.9	1.10	5.0	1.23	4.8	1.54	4.6	1.33	4.5	1.32	4.8
Medicare	0.27	1.2	0.27	1.2	0.30	1.2	0.38	1.1	0.33	1.2	0.46	1.1
Federal unemployment insurance	0.04	0.2	0.04	0.2	0.03	0.1	0.03	0.1	0.03	0.1	0.03	0.1
State unemployment insurance	0.19	0.8	0.18	0.8	0.19	0.8	0.18	0.5	0.20	0.7	0.17	0.4
Workers' compensation	0.45	1.9	0.43	1.9	0.50	2.0	0.44	1.3	0.46	1.6	0.40	1.0

¹ Includes premium pay for work in addition to the regular work schedule (such as overtime, weekends, and holidays).

² Cost per hour worked is \$0.01 or less.

³ Less than .05 percent.

⁴ Comprises the Old-Age, Survivors, and Disability Insurance (OASDI) program.

Note: The sum of individual items may not equal totals due to rounding.

Table 9. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, goods-producing and service-providing industries, by occupational group, September 2010

Sector	Total compensation	Wages and salaries	Benefit costs					Legally required benefits
			Total	Paid leave	Supplemental pay	Insurance	Retirement and savings	
Cost per hour worked								
All workers in private industry	\$27.88	\$19.85	\$8.20	\$1.88	\$0.78	\$2.24	\$0.99	\$2.31
Management, professional, and related	49.51	34.91	14.41	4.12	1.59	3.32	1.99	3.43
Management, business, and financial	55.31	39.95	16.66	5.05	2.17	3.88	2.34	3.71
Professional and related	46.27	33.04	13.23	3.58	1.32	3.15	1.78	3.20
Sales and office	22.00	16.77	6.23	1.38	0.45	1.88	0.64	1.76
Sales and related	20.94	15.64	5.29	1.14	0.49	1.40	0.51	1.76
Office and administrative support	22.72	15.85	6.85	1.54	0.45	2.37	0.72	1.77
Service	13.80	10.41	3.40	0.57	0.24	0.97	0.21	1.41
Natural resources, construction, and maintenance	31.29	21.23	10.09	1.55	0.98	2.68	1.55	3.22
Construction, extraction, farming, fishing, and forestry ¹	31.46	21.14	10.30	1.10	1.05	2.55	1.26	3.62
Installation, maintenance, and repair	31.15	21.33	9.60	2.04	0.93	2.82	1.27	2.79
Production, transportation, and material moving	24.04	16.03	8.01	1.43	0.80	2.56	0.92	2.31
Production	24.44	16.18	8.25	1.66	0.92	2.70	0.90	2.27
Transportation and material moving	23.64	15.88	7.75	1.30	0.67	2.42	1.03	2.34
All workers, goods-producing industries ²	32.83	21.87	10.98	2.10	1.19	3.11	1.59	2.97
Management, professional, and related	57.81	39.23	18.58	5.15	2.07	4.27	3.14	3.85
Sales and office	28.00	19.56	8.44	1.50	0.70	2.65	0.93	2.28
Natural resources, construction, and maintenance	32.03	21.46	10.57	1.24	1.10	2.71	1.94	3.57
Production, transportation, and material moving	25.00	16.78	9.22	1.68	1.05	3.11	0.95	2.41
All workers, service-providing industries ³	26.81	19.21	7.60	1.83	0.70	2.05	0.97	2.18
Management, professional, and related	48.23	34.35	13.87	3.58	1.53	3.19	1.80	3.38
Sales and office	21.59	15.52	6.08	1.35	0.45	1.93	0.62	1.73
Service	13.71	10.39	3.35	0.57	0.23	0.95	0.20	1.40
Natural resources, construction, and maintenance	30.31	20.93	9.38	1.59	0.81	2.65	1.21	2.75
Production, transportation, and material moving	22.40	15.41	6.95	1.22	0.58	2.10	0.68	2.22
Percent of total compensation								
All workers in private industry	100.0	70.8	29.4	6.7	2.8	6.0	3.5	8.3
Management, professional, and related	100.0	70.8	29.2	8.3	3.2	6.7	4.0	7.0
Management, business, and financial	100.0	69.7	30.3	9.0	3.9	6.6	4.2	6.6
Professional and related	100.0	71.4	28.6	8.0	2.8	6.8	3.6	7.1
Sales and office	100.0	71.7	28.3	6.3	2.1	8.0	2.9	8.0
Sales and related	100.0	74.7	25.3	5.4	2.3	6.7	2.4	8.4
Office and administrative support	100.0	69.3	30.2	6.8	2.0	10.4	3.2	7.5
Service	100.0	75.4	24.6	4.2	1.7	7.0	1.5	10.2
Natural resources, construction, and maintenance	100.0	67.9	32.1	5.0	3.1	6.6	3.2	10.3
Construction, extraction, farming, fishing, and forestry ¹	100.0	67.2	32.8	3.5	3.4	8.1	6.2	11.5
Installation, maintenance, and repair	100.0	68.5	31.5	6.5	2.8	9.1	4.1	9.0
Production, transportation, and material moving	100.0	66.7	33.3	6.0	3.3	10.6	3.8	9.6
Production	100.0	65.2	33.8	6.4	3.8	11.0	3.3	9.3
Transportation and material moving	100.0	67.2	32.8	5.5	2.8	10.2	4.3	9.9
All workers, goods-producing industries ²	100.0	66.8	33.4	6.4	3.8	9.5	4.8	9.1
Management, professional, and related	100.0	67.9	32.1	8.9	3.6	7.4	5.4	6.8
Sales and office	100.0	69.8	30.2	6.8	2.5	9.5	3.3	8.1
Natural resources, construction, and maintenance	100.0	67.0	33.0	3.9	3.4	8.4	6.1	11.2
Production, transportation, and material moving	100.0	64.6	35.5	6.5	4.1	12.0	3.7	9.3
All workers, service-providing industries ³	100.0	71.6	28.4	6.8	2.8	7.6	3.2	8.1
Management, professional, and related	100.0	71.2	28.8	8.3	3.2	6.6	3.7	7.0
Sales and office	100.0	71.0	28.1	6.2	2.1	8.9	2.9	8.0
Service	100.0	75.6	24.4	4.1	1.7	7.0	1.5	10.2
Natural resources, construction, and maintenance	100.0	69.0	31.0	6.5	2.7	8.7	4.0	9.1
Production, transportation, and material moving	100.0	68.2	31.2	5.5	2.6	9.4	3.9	9.9

¹ Farming, fishing, and forestry occupations were combined with construction and extraction occupational groups as of December 2008.
² Includes mining, construction, and manufacturing. The agriculture, forestry, farming, and hunting sector is excluded.
³ Includes utilities, wholesale trade, retail trade, transportation and warehousing, information, finance and insurance, real estate and rental and leasing, professional and technical services, management of companies and enterprises, administrative and waste services, educational services, health care and social assistance, arts, entertainment and recreation, accommodation and food services, and other services, except public administration.
 Note: The sum of individual items may not equal totals due to rounding.

Table 10. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by industry group, September 2010

Series	Total compensation	Wages and salaries	Benefit costs					Legally required benefits
			Total	Paid leave	Supplemental pay	Insurance	Retirement and savings	
Cost per hour worked								
All workers, goods-producing industries ¹	\$32.83	\$21.87	\$10.98	\$2.10	\$1.19	\$3.11	\$1.59	\$2.97
Construction	31.58	21.81	9.77	1.13	1.05	2.34	1.70	3.55
Manufacturing	32.68	21.49	11.19	2.48	1.15	3.40	1.42	2.70
Aircraft manufacturing ²	63.02	38.70	24.32	5.86	2.37	5.88	6.18	4.06
All workers, service-providing industries ³	26.81	19.21	7.80	1.83	0.70	2.05	0.87	2.16
Trade, transportation, and utilities	23.87	16.82	7.05	1.45	0.53	2.09	0.89	2.09
Wholesale trade	30.16	20.86	9.20	2.02	0.82	2.68	1.08	2.52
Retail trade	17.43	13.11	4.32	0.61	0.28	1.25	0.35	1.51
Transportation and warehousing	33.85	22.19	11.76	2.42	0.74	3.87	1.74	3.89
Utilities	55.51	33.84	21.57	4.98	1.81	5.08	5.87	3.84
Information	42.05	28.82	13.25	3.91	0.89	3.79	1.84	2.91
Financial activities	36.88	25.03	11.36	3.04	1.65	3.06	1.52	2.47
Finance and insurance	35.69	24.58	13.10	3.37	1.94	3.35	1.91	2.53
Credit intermediation and related activities	34.35	23.15	11.21	2.94	1.30	3.04	1.70	2.23
Insurance carriers and related activities	38.34	26.12	12.22	3.22	1.02	3.49	1.92	2.59
Real estate and rental and leasing	23.35	19.17	7.19	1.81	0.51	2.00	0.56	2.21
Professional and business services	33.39	24.26	9.12	2.32	1.13	2.12	0.95	2.59
Professional and technical services	44.00	31.60	12.40	3.40	1.87	2.78	1.29	3.05
Administrative and waste services	21.89	16.35	5.24	1.01	0.47	1.24	0.47	2.05
Education and health services	29.94	21.48	8.48	2.24	0.57	2.39	0.80	2.31
Educational services	39.07	28.88	10.19	2.65	0.12	2.87	1.73	2.83
Junior colleges, colleges, and universities	48.50	33.48	13.12	3.68	0.17	3.65	2.46	3.15
Health care and social assistance	29.58	20.58	8.20	2.18	0.53	2.32	0.84	2.23
Leisure and hospitality	12.14	9.58	2.58	0.38	0.12	0.67	0.11	1.20
Accommodation and food services	11.32	8.96	2.35	0.32	0.10	0.61	0.09	1.23
Other services	24.76	18.20	6.50	1.58	0.57	1.57	0.67	2.13
Percent of total compensation								
All workers, goods-producing industries ¹	100.0	66.6	33.4	6.4	3.6	9.5	4.8	9.1
Construction	100.0	69.1	30.9	3.6	3.3	7.4	5.4	11.2
Manufacturing	100.0	65.8	34.2	7.6	3.6	10.4	4.4	8.3
Aircraft manufacturing ²	100.0	51.4	38.8	9.3	3.8	9.3	9.6	6.4
All workers, service-providing industries ³	100.0	71.6	28.4	6.8	2.6	7.6	3.2	8.1
Trade, transportation, and utilities	100.0	70.5	29.5	6.1	2.2	8.7	3.7	8.8
Wholesale trade	100.0	69.0	30.5	6.7	3.0	8.8	3.6	8.4
Retail trade	100.0	75.2	24.8	4.7	1.6	7.2	2.1	9.3
Transportation and warehousing	100.0	65.4	34.6	7.1	2.2	11.4	5.1	8.8
Utilities	100.0	61.0	39.0	9.0	3.4	9.1	10.6	6.9
Information	100.0	68.5	31.5	9.3	2.4	9.0	3.9	6.9
Financial activities	100.0	67.9	32.1	8.2	4.5	8.3	4.4	6.7
Finance and insurance	100.0	67.0	33.0	8.5	4.9	8.4	4.6	6.4
Credit intermediation and related activities	100.0	67.4	32.5	8.6	3.9	8.8	4.0	6.5
Insurance carriers and related activities	100.0	68.1	31.9	8.4	2.7	9.1	5.0	6.7
Real estate and rental and leasing	100.0	72.7	27.3	6.9	2.3	7.6	2.1	8.4
Professional and business services	100.0	72.7	27.3	7.0	5.4	5.4	2.9	7.7
Professional and technical services	100.0	71.8	28.2	7.7	4.2	6.3	2.9	6.9
Administrative and waste services	100.0	75.7	24.3	4.7	2.2	5.7	2.2	9.5
Education and health services	100.0	71.8	28.2	7.5	1.9	8.0	3.2	7.7
Educational services	100.0	73.9	26.1	6.8	0.3	7.3	4.4	7.2
Junior colleges, colleges, and universities	100.0	71.8	28.2	7.9	0.4	7.9	5.3	6.8
Health care and social assistance	100.0	71.3	28.7	7.6	2.2	8.1	2.9	7.8
Leisure and hospitality	100.0	78.9	21.1	3.1	1.0	5.5	0.9	10.8
Accommodation and food services	100.0	79.2	20.8	2.9	0.9	5.4	0.8	10.8
Other services	100.0	73.7	26.3	6.3	2.3	6.3	2.7	8.6

¹ Includes mining, construction, and manufacturing. The agriculture, forestry, farming, and hunting sector is excluded.

² Data are available beginning with December 2005.

³ Includes utilities; wholesale trade; retail trade; transportation and warehousing; information; finance and insurance; real estate and rental and leasing; professional and technical services; management of companies

and enterprises; administrative and waste services; educational services; health care and social assistance; arts, entertainment and recreation; accommodation and food services; and other services, except public administration.

Note: The sum of individual items may not equal totals due to rounding.

Table 11. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by occupational group and full-time and part-time status, September 2010

Series	Total compensation	Wages and salaries	Benefit costs					
			Total	Paid leave	Supplemental pay	Insurance	Retirement and savings	Legally required benefits
Cost per hour worked								
All full-time workers in private industry	\$31.93	\$22.14	\$9.70	\$2.34	\$0.86	\$2.72	\$1.24	\$2.53
Management, professional, and related	50.92	36.99	15.24	4.44	1.67	3.55	2.12	3.46
Management, business, and financial	39.49	29.25	17.24	5.15	2.22	3.75	2.38	3.73
Professional and related	47.89	33.74	14.15	4.05	1.38	3.43	1.97	3.32
Sales and office	25.34	17.81	7.53	1.78	0.60	2.44	0.80	1.92
Sales and related	27.39	20.03	7.36	1.77	0.76	1.98	0.75	2.10
Office and administrative support	24.34	16.72	7.51	1.78	0.52	2.03	0.62	1.84
Service	16.57	11.85	4.72	0.84	0.37	1.55	0.33	1.54
Natural resources, construction, and maintenance	31.73	21.41	10.31	1.62	1.00	2.77	1.70	3.21
Construction, extraction, farming, fishing, and forestry ¹	31.74	21.26	10.48	1.4	1.07	2.92	2.05	3.59
Installation, maintenance, and repair	31.71	21.58	10.13	2.15	0.93	2.94	1.31	2.70
Production, transportation, and material moving	25.80	17.05	8.75	1.84	0.89	2.79	1.03	2.40
Production	25.32	16.62	8.70	1.86	0.98	2.86	0.86	2.32
Transportation and material moving	29.40	17.60	8.51	1.61	0.76	2.67	1.23	2.51
All part-time workers in private industry	15.67	12.28	3.39	0.47	0.24	0.73	0.25	1.63
Management, professional, and related	38.03	29.49	8.54	1.94	1.00	1.60	0.82	3.10
Professional and related	38.34	29.64	8.70	1.87	1.03	1.75	0.83	3.21
Sales and office	13.61	10.59	2.91	0.39	0.12	0.81	0.24	1.26
Sales and related	11.75	9.40	2.35	0.24	0.10	0.57	0.16	1.27
Office and administrative support	16.00	12.29	3.71	0.59	0.14	1.16	0.39	1.48
Service	10.90	8.90	2.00	0.19	0.08	0.36	0.09	1.27
Production, transportation, and material moving	15.19	10.90	4.29	0.39	0.34	1.41	0.34	1.81
Transportation and material moving	15.67	10.94	4.72	0.40	0.36	1.56	0.43	1.96
Percent of total compensation								
All full-time workers in private industry	100.0	69.3	30.7	7.3	3.0	8.5	3.9	7.9
Management, professional, and related	100.0	70.1	29.9	8.7	3.3	7.0	4.2	6.8
Management, business, and financial	100.0	69.5	30.5	8.1	3.3	6.7	4.2	6.6
Professional and related	100.0	70.5	29.5	8.5	2.9	7.2	4.1	6.9
Sales and office	100.0	70.3	26.7	7.0	2.4	9.6	3.1	7.6
Sales and related	100.0	75.1	26.9	6.5	2.8	7.2	2.8	7.7
Office and administrative support	100.0	68.7	31.3	7.3	2.1	10.9	3.4	7.6
Service	100.0	71.5	25.5	5.7	2.2	9.4	2.0	9.3
Natural resources, construction, and maintenance	100.0	67.5	32.5	5.1	3.2	8.7	5.4	10.1
Construction, extraction, farming, fishing, and forestry ¹	100.0	67.0	33.0	3.9	3.4	8.3	6.5	11.3
Installation, maintenance, and repair	100.0	69.0	32.0	6.8	2.9	9.3	4.1	8.8
Production, transportation, and material moving	100.0	66.1	33.9	8.4	3.4	10.8	4.0	9.3
Production	100.0	65.0	34.4	8.6	3.8	11.4	3.4	9.1
Transportation and material moving	100.0	66.6	33.4	6.1	2.9	10.1	4.7	9.5
All part-time workers in private industry	100.0	78.4	21.6	3.0	1.6	5.1	1.6	10.4
Management, professional, and related	100.0	77.5	22.5	4.8	2.6	4.5	2.1	8.4
Professional and related	100.0	77.3	22.7	4.9	2.7	4.6	2.2	8.4
Sales and office	100.0	78.4	21.6	2.8	0.8	6.0	1.8	10.1
Sales and related	100.0	80.0	20.0	2.0	0.8	4.8	1.4	10.9
Office and administrative support	100.0	76.8	23.2	3.7	0.9	7.3	2.2	9.3
Service	100.0	81.6	18.4	1.8	0.9	3.3	0.8	11.7
Production, transportation, and material moving	100.0	71.7	28.3	2.9	2.2	8.3	2.3	11.9
Transportation and material moving	100.0	69.8	30.2	2.5	2.3	10.8	2.7	11.8

¹ Farming, fishing, and forestry occupations were combined with construction and extraction occupational group as of December 2006.

Note: The sum of individual items may not equal totals due to rounding.

Table 12. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by industry group and full-time and part-time status, September 2010

Series	Total compensation	Wages and salaries	Benefit costs					Legally required benefits
			Total	Paid leave	Supplemental pay	Insurance	Retirement and savings	
Cost per hour worked								
All full-time workers in private industry	\$31.93	\$22.14	\$9.79	\$2.34	\$0.96	\$2.72	\$1.24	\$2.63
Goods-producing ¹	30.21	22.04	11.17	2.15	1.22	3.19	1.63	2.98
Construction	31.90	21.89	10.01	1.18	1.09	2.44	1.77	3.54
Manufacturing	33.07	21.69	11.58	2.93	1.21	3.47	1.45	2.72
Service-providing ²	31.55	22.16	9.39	2.40	0.89	2.57	1.12	2.40
Trade, transportation, and utilities	26.61	19.89	8.73	1.95	0.69	2.54	1.17	2.37
Information	44.84	30.56	14.30	4.24	1.08	4.12	1.79	3.06
Financial activities	38.54	25.95	12.89	3.95	1.84	3.31	1.79	2.59
Professional and business services	37.11	23.55	10.46	2.90	1.27	2.49	1.15	2.75
Education and health services	31.29	22.11	9.29	2.57	0.61	2.71	1.07	2.32
Leisure and hospitality	18.51	11.98	3.94	0.77	0.23	1.50	0.20	1.46
Other services	26.56	20.30	8.28	2.05	0.78	2.16	0.93	2.34
All part-time workers in private industry	15.67	12.28	3.39	0.47	0.24	0.79	0.26	1.63
Service-providing ²	15.55	12.19	3.37	0.47	0.24	0.80	0.26	1.60
Trade, transportation, and utilities	13.60	10.32	3.49	0.36	0.20	1.12	0.30	1.51
Professional and business services	18.12	14.48	3.64	0.35	0.59	0.63	0.17	1.89
Education and health services	25.66	19.65	6.03	1.28	0.43	1.44	0.62	2.25
Leisure and hospitality	9.50	6.03	1.47	0.05	0.33	0.17	0.03	1.15
Percent of total compensation								
All full-time workers in private industry	100.0	69.3	30.7	7.3	3.0	8.5	3.9	7.9
Goods-producing ¹	100.0	65.4	33.6	6.5	3.7	9.6	4.9	9.0
Construction	100.0	68.6	31.4	3.7	3.4	7.6	5.6	11.1
Manufacturing	100.0	65.6	34.4	7.7	3.7	10.5	4.4	8.2
Service-providing ²	100.0	70.3	29.7	7.9	2.8	8.2	3.6	7.6
Trade, transportation, and utilities	100.0	69.5	30.5	6.3	2.4	8.3	4.1	8.3
Information	100.0	68.1	31.9	9.5	2.4	9.2	4.0	6.8
Financial activities	100.0	67.4	32.6	8.5	4.7	8.4	4.5	6.5
Professional and business services	100.0	71.8	28.2	7.9	3.4	6.7	3.1	7.4
Education and health services	100.0	70.4	29.6	8.2	2.0	8.5	3.4	7.4
Leisure and hospitality	100.0	74.5	25.4	4.9	1.5	8.4	1.3	9.4
Other services	100.0	71.1	28.9	7.2	2.7	7.9	3.3	8.2
All part-time workers in private industry	100.0	79.4	21.6	3.0	1.6	5.1	1.6	10.4
Service-providing ²	100.0	79.3	21.7	3.0	1.6	5.1	1.6	10.3
Trade, transportation, and utilities	100.0	74.7	25.3	2.6	1.5	8.1	2.1	10.9
Professional and business services	100.0	75.0	25.1	2.0	3.3	3.5	0.9	10.5
Education and health services	100.0	75.5	23.5	5.0	1.7	5.8	2.4	8.8
Leisure and hospitality	100.0	84.6	15.6	0.9	0.4	1.8	0.4	12.1

¹ Includes mining, construction, and manufacturing. The agriculture, forestry, farming, and hunting sector is excluded.
² Includes utilities; wholesale trade; retail trade; transportation and warehousing; information; finance and insurance; real estate and rental and leasing; professional and technical services; management of companies and enterprises; administrative and

waste services; educational services; health care and social assistance; arts, entertainment and recreation; accommodation and food services; and other services, except public administration.
 Note: The sum of individual items may not equal totals due to rounding.

Table 13. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry workers, by major industry group and establishment employment size and bargaining unit status, September 2010

Series	Total compensation	Wages and salaries	Benefit costs					Legally required benefits
			Total	Paid leave	Supplemental pay	Insurance	Retirement and savings	
Cost per hour worked								
All workers, goods-producing industries ¹	\$32.83	\$21.87	\$10.96	\$2.10	\$1.19	\$3.11	\$1.59	\$2.97
1-99 workers	27.54	19.41	8.13	1.26	0.81	2.17	0.98	2.50
1-49 workers	26.72	19.05	7.87	1.17	0.76	1.95	0.89	2.50
50-99 workers	29.48	20.27	9.22	1.49	0.82	2.70	1.21	2.89
100 workers or more	37.48	24.03	13.45	2.84	1.52	3.94	2.12	3.64
100-499 workers	32.33	21.11	11.22	2.10	1.20	3.32	1.55	2.65
500 workers or more	44.87	28.23	16.70	3.91	1.98	4.55	2.94	3.32
Union	40.33	23.56	16.77	2.41	1.49	5.33	3.78	3.77
Nonunion	31.01	21.40	9.55	2.03	1.12	2.55	1.08	2.78
All workers, service-providing industries ² ..	26.81	19.21	7.60	1.93	0.70	2.05	0.87	2.16
1-99 workers	22.12	16.43	5.69	1.26	0.56	1.43	0.51	1.92
1-49 workers	21.43	16.04	5.40	1.19	0.55	1.32	0.47	1.87
50-99 workers	24.39	17.71	6.68	1.51	0.61	1.79	0.67	2.10
100 workers or more	32.48	22.58	9.50	2.51	0.86	2.78	1.29	2.40
100-499 workers	27.76	19.89	7.87	1.91	0.62	2.26	0.86	2.23
500 workers or more	38.78	25.14	12.62	3.31	1.18	3.51	1.87	2.76
Union	36.60	23.01	13.59	2.85	0.89	4.58	2.23	2.83
Nonunion	25.93	19.87	7.07	1.73	0.68	1.82	0.74	2.09
Percent of total compensation								
All workers, goods-producing industries ¹ ..	100.0	66.6	33.4	6.4	3.6	9.5	4.8	9.1
1-99 workers	100.0	70.5	29.5	4.6	2.9	7.9	3.6	10.5
1-49 workers	100.0	71.3	28.7	4.4	2.9	7.3	3.3	10.9
50-99 workers	100.0	68.7	31.3	5.0	3.1	8.2	4.1	9.8
100 workers or more	100.0	64.1	35.9	7.6	4.1	10.5	5.6	8.1
100-499 workers	100.0	65.0	34.7	6.5	3.7	10.9	4.8	8.3
500 workers or more	100.0	62.9	37.1	8.7	4.4	10.1	5.5	7.4
Union	100.0	68.4	41.6	8.0	3.7	13.2	9.4	9.3
Nonunion	100.0	68.2	30.8	6.5	3.6	8.3	3.4	9.0
All workers, service-providing industries ² ..	100.0	71.6	28.4	6.8	2.6	7.6	3.2	8.1
1-99 workers	100.0	74.3	25.7	5.7	2.6	6.5	2.3	8.7
1-49 workers	100.0	74.8	25.2	5.6	2.6	6.2	2.2	8.7
50-99 workers	100.0	72.6	27.4	6.2	2.6	7.4	2.7	8.6
100 workers or more	100.0	69.5	30.5	7.7	2.0	8.6	4.0	7.6
100-499 workers	100.0	71.6	28.4	6.9	2.2	8.1	3.1	8.0
500 workers or more	100.0	67.4	32.6	8.5	3.0	9.0	4.8	7.1
Union	100.0	62.9	37.1	8.1	2.4	12.5	6.1	8.0
Nonunion	100.0	72.8	27.2	6.7	2.6	7.0	2.8	8.1

¹ Includes mining, construction, and manufacturing. The agriculture, forestry, fishing, and hunting sector is excluded.
² Includes utilities; wholesale trade; retail trade; transportation and warehousing; information; finance and insurance; real estate and rental and leasing; professional and technical services; management of companies and enterprises; administrative and

waste services; educational services; health care and social assistance; arts, entertainment and recreation; accommodation and food services; and other services, except public administration.
 Note: The sum of individual items may not equal totals due to rounding.

Table 14. Employer costs per hour worked for employee compensation and costs as a percent of total compensation: Private industry health care and social assistance workers, by industry and occupational group, September 2010

Series	Total compensation	Wages and salaries	Benefit costs					Legally required benefits
			Total	Paid leave	Supplemental pay	Insurance	Retirement and savings	
Cost per hour worked								
Health care and social assistance	\$28.58	\$20.38	\$6.20	\$2.18	\$0.83	\$2.32	\$0.84	\$2.23
Management, professional, and related	41.19	28.53	11.95	3.39	0.98	2.94	1.32	3.95
Registered nurses	48.34	33.88	14.46	4.13	1.63	3.33	1.76	3.50
Sales and office	22.23	15.51	6.72	1.59	0.38	2.35	0.69	1.71
Service	16.20	11.52	4.68	0.97	0.37	1.54	0.32	1.48
Hospitals	36.53	24.87	11.76	3.11	1.15	3.47	1.35	2.57
Management, professional, and related	44.97	31.01	13.96	3.95	1.46	3.65	1.65	3.24
Registered nurses	48.88	33.33	15.35	4.29	1.63	3.76	1.84	3.55
Service	26.65	13.16	7.49	1.43	0.71	2.98	0.75	1.92
Nursing and residential care facilities	20.10	14.89	5.41	1.33	0.43	1.52	0.28	1.85
Management, professional, and related	31.19	23.09	8.10	2.25	0.67	2.02	0.50	2.65
Service	15.04	10.87	4.17	0.88	0.35	1.27	0.18	1.49
Nursing care facilities ¹	21.80	15.97	5.83	1.48	0.52	1.57	0.29	1.57
Management, professional, and related	34.11	25.56	8.55	2.44	0.82	1.94	0.48	2.67
Service	15.90	11.41	4.55	1.00	0.43	1.38	0.19	1.55
Percent of total compensation								
Health care and social assistance	100.0	71.3	28.7	7.6	2.2	8.1	2.9	7.8
Management, professional, and related	100.0	71.7	28.3	8.2	2.3	7.1	3.2	7.3
Registered nurses	100.0	70.1	29.9	8.5	3.4	6.9	3.6	7.5
Sales and office	103.0	69.8	30.2	7.1	1.7	10.6	3.1	7.7
Service	103.0	71.1	28.9	6.0	2.3	9.5	2.0	9.1
Hospitals	100.0	67.9	32.1	8.5	3.1	9.5	3.7	7.3
Management, professional, and related	100.0	69.0	31.0	8.8	3.2	8.1	3.7	7.2
Registered nurses	100.0	68.5	31.5	8.8	4.0	7.7	3.8	7.3
Service	100.0	63.7	36.3	8.9	3.4	14.4	3.6	7.8
Nursing and residential care facilities	100.0	73.1	28.9	6.6	2.1	7.6	1.4	9.2
Management, professional, and related	100.0	74.0	26.0	7.2	2.2	6.5	1.6	8.5
Service	100.0	72.3	27.7	5.9	2.3	8.4	1.2	8.9
Nursing care facilities ¹	100.0	73.2	28.8	6.8	2.4	7.2	1.3	9.0
Management, professional, and related	100.0	74.9	25.1	7.2	2.4	6.7	1.4	8.4
Service	100.0	71.5	28.5	6.2	2.7	8.7	1.2	9.7

¹ Data are available beginning with December 2008.

Note: The sum of individual items may not equal totals due to rounding.

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Sunday, February 13, 2011

Since the 2008 financial crisis, individual states all over the Union have been plunged into financial despair. As tax receipts plunged and the need for services skyrocketed, even financially healthy states have found themselves awash in red ink. States with structural deficits - like California - have had it even worse. California is still facing an eye-popping \$25 billion deficit this year, and the planned cuts will go deep and have reverberations for decades.

Despite the states' impossible predicament, none of them has any interest in a Republican idea that's been floating around Capitol Hill: Let the states go bankrupt. The proposal, which is being drafted into legislation in the Senate, has been met with a resounding no from the National Governors Association.

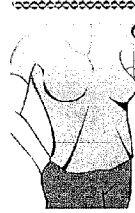
"The nation's governors and legislators do not support proposals to provide states with bankruptcy protection," begins a letter from the National Governors Association and the National Conference of State Legislatures to the leaders of both the House and the Senate. The letter, which is dated Feb. 4, goes on to explain: "Allowing states to declare bankruptcy is not an authority any state leader has asked for nor would they likely use."

Wall Street hates the idea, too. The \$3 trillion municipal bond market took a nosedive last month on threats of the state bankruptcy proposal and on a controversial analyst's prediction that 50 to 100 city and county governments could default on their loans this year. Investors are hopping mad about the proposal, and they're furious that bankruptcy could help states unwind their pension funds - where many of them have invested, too.

So if none of the stakeholders is interested in allowing states to declare bankruptcy, what's in it for congressional Republicans? And why do they think it would be good for the country?

At first blush, there are some attractive aspects to allowing states to declare bankruptcy. Many state legislatures have been paralyzed by the financial crisis - seemingly unable to either raise taxes or impose devastating cuts. They've exhausted all the usual accounting tricks, and a newly conservative Congress is unlikely to offer them any additional aid. Those with structural deficits, like California, have also found themselves groaning under the burden of the pension and benefit promises that legislators made to state workers during better times.

Theoretically, bankruptcy would allow states to wipe out all of those obligations and start over. Some - not all - cities and counties have the rights to declare bankruptcy, and a few of them have in recent years. In a well-publicized case, Vallejo used Chapter 9 bankruptcy proceedings to unwind unsustainable labor contracts.

1 Tip for a tiny belly :

Cut down a bit
of your belly
everyday by
following this
1 weird old tip

Tip ►

But Vallejo is also using the proceedings to suggest paying some creditors as little as 5 cents on the dollar, which is why investors are furious about the idea of state bankruptcy.

If states are allowed to declare bankruptcy - even if none of them does so - the interest rates on municipal bonds will definitely increase. For some states, the additional costs could make or break their ability to raise funds for infrastructure and other public services.

The proposal would also have to clear high constitutional hurdles, because states are considered sovereign entities. Why would they want to give up control over their own destinies to a Bankruptcy Court?

Furthermore, states are not businesses. One of the ways in which they have sovereignty is their power to raise capital through taxes. Just because some legislators don't wish to raise taxes doesn't mean that the states no longer have the power to do so. If times are tough enough for a state to contemplate bankruptcy, its leaders should be brave enough to contemplate less extreme measures, like a tax increase.

It says something about the principles of some congressional Republicans that they consider a tax increase to be more extreme than bankruptcy. For them, state bankruptcy would also have the benefit of disempowering and defunding a key Democratic interest group - government labor unions - but that's hardly a good reason to approve this drastic and destabilizing proposal.

The states have the power to solve their budget problems, painful though it may be. Congress shouldn't make it any harder by floating ideas that damage the bond market and undermine state sovereignty.

<http://sfgate.com/cgi-bin/article.cgi?f=/c/a/2011/02/13/EDTC1HKJ8R.DTL>

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Christine O. Gregoire
Governor of Washington
Chair

Dave Heineman
Governor of Nebraska
Vice Chair

Raymond C. Scheppach
Executive Director

January 24, 2011

The Honorable Harry Reid
Majority Leader
U.S. Senate
Washington, D.C. 20510

The Honorable Mitch McConnell
Minority Leader
U.S. Senate
Washington, D.C. 20510

The Honorable John Boehner
Speaker of the House
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Nancy Pelosi
Minority Leader
U.S. House of Representatives
Washington, D.C. 20515

Dear Majority Leader Reid, Senator McConnell, Speaker Boehner, and Representative Pelosi:

As a new Congress convenes and a new year begins, the nation's governors call on the federal government to work cooperatively with us to reduce deficits, restore fiscal discipline and promote economic growth and long-term prosperity.

This month 29 new governors—the largest class in history—assumed office with most facing collective budget deficits of \$175 billion through 2013. This amount is on top of \$230 billion in budget gaps states filled between fiscal years 2009 and 2011. As you know, unlike the federal government, states have to balance their budgets. This means that the \$175 billion shortfall will have to be filled through spending cuts or increased fees and taxes.

Over the last two years the federal government put more than \$151 billion into state coffers to help offset catastrophic declines in revenues. States also did their part cutting spending by more than 10.7 percent (\$75 billion), tapping rainy day funds, shrinking the size of government and streamlining state services. More cuts will be necessary, but with all easy cuts exhausted, the next round will require more layoffs, fewer state services and potential cuts to core programs like K-12 education and public safety.

Despite states' difficult fiscal situation, governors are not calling for new one-time help from the federal treasury. In fact, we encourage the federal government to follow the lead of states and make the tough decisions necessary to get its fiscal house in order; federal fiscal stability is critical to the long-term strength of states and the country.

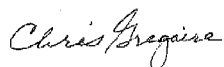
As federal lawmakers work to reduce deficits, reform programs and restore long-term stability, governors call on the Administration and Congress to adhere to the following principles for state-federal deficit reduction:

Page 2

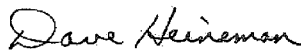
- **Federal reforms should be designed to produce savings for both the federal government and states.** The shared responsibility for implementing and running state-federal programs should also mean shared savings when reductions or reforms are made at the federal level.
- **Deficit reduction should not be accomplished by merely shifting costs to states or imposing unfunded mandates.** The structural deficit facing federal lawmakers cannot be solved by the states. Good fiscal policy must take into account the effects of federal action on state government to avoid actions that harm the ability of governors to manage state budgets.
- **States should be given increased flexibility to create efficiencies and achieve results.** Decreases in funding should be accompanied by an increase in state authority to manage programs and find savings. For example, states must be allowed to consolidate funds from similar programs to produce better results. Federal mandates, even those that are paid for, fail to encourage state innovation or cost savings that can benefit both states and the federal government.
- **Congress should not impose maintenance of effort (MOE) provisions on states as a condition of funding.** MOE's curtail state authority to control their own budgets and fiscal systems and over time discourage investment in state-federal programs (see attached).

Governors have a duty to be good fiscal stewards of taxpayer dollars. The recession forced many states to take difficult short-term actions to balance budgets and to find innovative ways to make government a more efficient and productive instrument that can do more with less. The federal government must now do the same.

Sincerely,



Governor Christine O. Gregoire
Chair



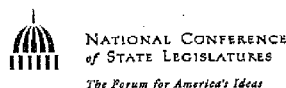
Governor Dave Heineman
Vice Chair

Enclosure

STATE PROGRAMS WITH MOE REQUIREMENTS

Grant Name:	State Match	MOE	Description of Requirements
Environment			
Clean Air Act - Section 105	X	X	40% match requirement
Non-Point Source Grants - Section 319 Grants	X	X	40% of total cost
Hazardous Waste Management State Program Support	X	X	25% of approved cost
Pipeline Safety	X	X	MOE was waived for 2009 and 2010. States currently providing 35% of funding.
Transportation			
FTA - Section 5307 Urban Areas Formula Grants	X	X	50% of operating expenses; 20% of capital costs; 10% if related to Clean Air Act or Americans with Disabilities Act; 10% for bicycle-related projects
FTA - Section 5311 Non-Urban Areas Formula Grants	X	X	20% of capital costs; 10% if related to Clean Air Act or Americans with Disabilities Act; 50% of administrative costs; 10% for bicycle-related projects
Airport Improvement Program		X	
Community and Regional Development			
Appalachian Development Highway System	X	X	20% of total cost
Education			
Adult Education Basic Grant	X	X	25% of total funds spent; MOE not less than 90% of prior year level
Education Jobs		X	For FY11 states must maintain spending in K-12 and higher education at: (1) FY09 levels; (2) the same percentage share as total revenues available in FY10; or (3) for states with receipts below FY06 levels in FY09, the FY06 spending level or percentage share.
Title I - Grants to Local Education Agencies		X	
Special Education Grants to States		X	MOE based on expenditures from previous year.
Vocational Education - Basic State Grant	X	X	50% of admin. cost
Indian Education - Grants to Local Education Agencies		X	
Rehab. Services - Basic State Grant	X	X	21.3% of total cost; MOE based on previous two year spending
Special Education - Preschool Grants		X	
Special Education - Infants and Families		X	
Safe and Drug Free Schools & Communities State Grants		X	
Tech-Prep Education		X	
21st Century Community Learning Centers		X	
Higher Education			
Leveraging Educational Assistance Partnership	X	X	Match based on MOE level but not less than one-to-one basis. MOE based on expenditures from previous three years.
College Access Grant Program	X	X	One-third of program activities and services; in-kind allowed; Must maintain funding at previous five year average.
Employment and Training			
Senior Community Service Employment Program	X	X	10% of total cost; in-kind allowed
WIA Adult Activities		X	
WIA Youth		X	
WIA Dislocated Workers		X	
Social Services			
Prevention of Elder Abuse, Neglect and Exploitation		X	
Long-Term Care Ombudsman		X	
Support Services	X	X	15% of grant amount; 25% of administrative cost; in-kind allowed
Health			
Affordable Care Act		X	States may not change their Medicaid or CHIP eligibility policies or procedures that are more restrictive than they were on July 1, 2008. The MOE for adults is in effect until January 1, 2014, and for children until October 1, 2019.

Public Health Emergency Preparedness	X	X	5% of federal funds in 2009, 10% in 2010; in-kind allowed; must maintain spending at the average of the amount provided annually during the previous two years
Consolidated Health Centers Ryan White Formula Grants	X	X	States with more than 1% of total HIV/AIDS cases reported during the previous two years must provide matching funds, amount varies based on the number of years a state meets the threshold; separate 20% of total cost matching requirement for ADAP supplemental; must maintain spending at previous year level
Community Mental Health Services Block Grant		X	Must maintain spending at the average of the amount provided annually during the previous two years.
Substance Abuse Prevention and Treatment Block Grant		X	Must maintain spending at the average of the amount provided annually during the previous two years.
Maternal and Child Health Block Grant	X	X	45% of total cost; maintain spending at 1989 level
Income Security			
Temporary Assistance for Needy Families (TANF)		X	
Child Care Mandatory Matching Funds	X	X	Varies based on FMAP; MOE equal to the state's share of expenditures for FY 1994 or 1995, whichever is greater
Child Nutrition - State Administrative Expenses		X	
Public and Indian Housing			
Homeland Security			
Blasting Safety Assistance	X	X	Generally 50% of total cost
Emergency Management Performance Grants	X	X	50% of total cost; in-kind allowed
Assistance to Firefighters Grant	X	X	varies based on award



February 4, 2011

The Honorable John Boehner
Speaker of the House
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Harry Reid
Majority Leader
United States Senate
Washington, D.C. 20501

The Honorable Nancy Pelosi
Minority Leader
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Mitch McConnell
Minority Leader
United States Senate
Washington, D.C. 20510

Dear Mr. Speaker, Ms. Pelosi, Senator Reid and Senator McConnell:

The nation's governors and legislators do not support proposals to provide states with bankruptcy protection.

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 proposals suggest 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 state and local finance.

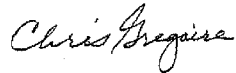
For the last three years, states have faced growing budget deficits and in each of those years, we have closed those deficits by spending cuts and when necessary increasing taxes. Governors and legislators have had to make tough and politically unfavorable decisions to be fiscally responsible and balance our budgets. Throughout this process, our colleagues never contemplated walking away from our obligations to our constituents or to the bond markets by requesting that the federal government allow states to receive bankruptcy protection. While a number of states continue to face budget deficits over the next few years, we will continue to use our sovereign authority to balance our budgets and meet our obligations.

State and local bonds and fiscal instruments remain some of the safest investments in the world. State leaders are keenly aware of their responsibility to manage their finances and repay their obligations. In contrast, the mere discussion of legislation, let alone the existence of a law allowing states to declare bankruptcy would only serve to increase interest rates and create more volatility in bond markets.

State and local leaders are interested in working with their federal partners to improve the fiscal stability of government at all levels. We call on Congress and the Administration to work with our members to eliminate unfunded mandates, provide greater flexibility to use federal funds more efficiently and avoid federal restrictions such as maintenance-of-effort provisions that hinder state and local authority to control their own finances.

These are difficult times in which to govern, but the challenges also provide us with the opportunity to work more closely together to find common solutions. We look forward to working with you to address the financial needs of the country and ensure our prosperity for the future.

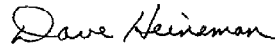
Sincerely,



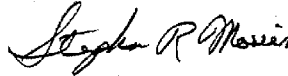
Governor Christine O. Gregoire
Chair, National Governors Association



Senator Richard T. Moore
Massachusetts Senate
President, National Conference of State
Legislatures



Governor Dave Heineman
Vice Chair, National Governors Association



Senator Stephen R. Morris
Senate President, Kansas
President-Elect, National Conference of State
Legislatures

Mr. COBLE. Folks, to begin with, I want to apologize for my raspy voice. I have been nursing this cold for about a week that seems like a month. So it doesn't sound very pleasant, so bear with me.

And I am going to try to be as objective in my opening statement as I can, but if we, in fact, create a bankruptcy—strike that—a State bankruptcy chapter, I see all sorts of snakes coming out of that pit. But I will have an open mind as we go along.

Many States are currently suffering a severe budget crisis, as we all know. High unemployment and depressed property values have

resulted in less tax revenue for States. But despite taking in less revenue, many States continue to spend as if the recession never occurred.

In particular, States continue to offer defined benefit pension plans to their public employees. Defined benefit, as we all know, means that the employee is entitled to the pension without contributing or contributing a very small amount. Making their budget problems worse, States are underfunding their pension obligations to the tune of \$3 trillion. And we will hear that from one of the witnesses today.

Public employee unions need to realize that they should not be entitled to be recession-proof. American workers in the private sector have had their wages frozen during the recession. The 401(k) retirement plans to which they have contributed hard-earned dollars have lost significant value.

Some people fear the States will eventually go broke and ask Congress for a bailout. We all know that bailouts have consequences. Oftentimes, a bailout merely kicks the current problem down the road even farther, and they generally don't encourage fiscal discipline.

Neither should Congress permit States to file bankruptcy, in my opinion. Though States would have powerful tools in bankruptcy, like the power to break pension contracts with unions, States are sovereign entities that must handle their financial problems themselves, it seems to me.

Bankruptcy for States would cripple the bond markets. States, as we all know, issue bonds for capital projects like building roads and universities. Permitting States to break their promises to bondholders would decrease investor confidence and damage States' ability to invest in much-needed infrastructure.

Instead, Congress should encourage States to use the tools they already have to bring public employee unions to the negotiating table and restructure pension contracts. My home State of North Carolina is a right-to-work State. Public employees are not unionized. Rather than demand defined benefit pension plans, North Carolina's public employees contribute to a 401(k) administered by the State treasurer.

I am eager to learn more from our witnesses about how underfunded public employee pension liabilities are contributing to various State insolvencies. I am also interested in how bankruptcy for States would impact States' ability to borrow for capital projects in the bond market. While I disfavor the approach that lets States go into bankruptcy, I will be open to suggestions from the witnesses on alternatives that help States get their fiscal houses in order.

I am now pleased to recognize the distinguished gentleman from Georgia, Mr. Johnson, for his opening statement.

Mr. JOHNSON. I thank the Ranking Member. And this is my first hearing serving with you as Chairman, and I look forward to our service together on this Committee in the future.

Mr. COBLE. Thank you, Mr. Johnson. I appreciate that.

Mr. JOHNSON. Now, with all due respect to my friends on the other side of the aisle, I must wonder aloud, why is it that we are holding this hearing today? Ostensibly, it is about whether States should be permitted to file bankruptcy. But, from what I can tell,

none of the witnesses claims that bankruptcy is a panacea for a State's financial troubles.

We seem to agree that allowing States to file for bankruptcy would result in increased interest rates, making it more expensive for States to address their financial needs. Moreover, a State bankruptcy option would create greater instability in the financial market. There also seems to be some shared concern about respect for State sovereignty, in that Federal bankruptcy law could be used to override State constitutions and laws prohibiting an impairment of contractual obligations.

Finally, States already have the tools at their disposal to address any financial troubles they face, as Majority Leader Eric Cantor has noted. States have the ability to adjust revenues and spending and to renegotiate their financial obligations with creditors.

Indeed, I get the strong sense that State bankruptcy may be a solution in search of a problem. Why are we wasting time on what promises to be something of an esoteric discussion about a proposal that few, if anyone, in Congress, including those on this Committee, appear to accept?

Instead, we should be talking about what Congress will do to accelerate economic recovery and create jobs, which, in turn, will help States recover financially. We should be talking about the continuing mortgage foreclosure crisis and how Congress will help hard-working American families stay in their homes. We should be talking about crushing private student loan debt that threatens to stifle educational opportunities for people of modest means. We should be talking about how to improve the bankruptcy process so that it can better help honest but unfortunate debtors who have fallen upon hard times because of the lingering effects of the 2008 financial crisis, a crisis brought about by Wall Street's reckless behavior.

Unfortunately, I suspect we are here talking about State bankruptcy because of a cynical attempt by the likes of a future President Jeb Bush or future President Newt Gingrich, actually, with Jeb Bush being the Vice President, or Jeb Bush being President, Newt Gingrich being Vice President. I don't know how they are going to work it out. But they, along with the infamous Dick Morris and Grover Norquist, they are in an unholy combination to demonize public employees for political reasons.

Let's call this what it is. It is an attack on a group of workers including State troopers, police officers, firemen, prosecutors, and teachers. And these proponents of State bankruptcy simply don't like those groups, and they want to do whatever they can to help them, so they figure that allowing States to go into a bankruptcy court and then avoid contracts that they have signed through collective bargaining, a fair process, that protect their employees, they want to be able to get out of those. And they also want to be able to avoid their obligations to innocent pensioners, elderly people on pensions, who have worked all their lives and expected to be able to retire in comfort with health benefits. And they want to abrogate the terms of those agreements and leave those people up the road, or up the lake with no paddle in a boat, subject to the harsh waves of Wall Street.

That is what they want to do, because they want to also protect bond holders, State bond holders. They want to protect them in that chapter, or in that bankruptcy process. Can you imagine that? Trying to balance the budget on the backs of working men and women, trying to protect Wall Street. This is unconscionable.

And we are talking about public pensions that barely have an impact on a State's financial health. Less than 3 percent of all State and local government funding is spent on pension benefits, as most such benefits are paid out of trusts funded by employees and their employers. But why let the facts get in the way of political opportunism?

The proponents of State bankruptcy don't even bother to hide their true intent. For instance, in a Los Angeles Times op-ed piece published last month, Mr. Gingrich and Mr. Bush, Bush III, pointed to the "stranglehold government employee unions have on State and Federal budgets," end quote, rather than the severe economic recession of the last few years as the reasons for the States' fiscal problems.

Even more crassly, Mr. Morris wrote a piece in The Hill arguing in favor of State bankruptcy because it would, quote, "break the political power of public employee unions and undermine the labor-Democratic Party coalition."

Hopefully, sensible minds on both sides of the aisle, including Majority Leader Cantor, Judiciary Committee Chairman Lamar Smith, and Subcommittee Chairman Howard Coble, will carry the day on the issue of State bankruptcy and not allow naked political calculations to answer serious constitutional and policy questions.

And, with that, I will yield back.

Mr. COBLE. I thank the gentleman.

The Chair recognizes the distinguish Chairman of the Judiciary Committee, Mr. Smith.

Mr. SMITH. Thank you, Mr. Chairman.

A famous tale by Hans Christian Andersen depicts an emperor who cares only about his wardrobe. His weavers fashioned him a garment made from fine fabric they say is invisible only to those who are unfit to see it. The emperor cannot see the suit, but he fears being deemed unfit to being king. So he dons his invisible garment and parades around town. Finally, a small child calls out from the crowd, "The emperor has no clothes."

Much like the weavers in this story, many States have promised their public employees the finest pension benefits but have funded their pension obligations with invisible money. In the private sector, employees generally contribute to their own retirement and IRAs and withdraw their savings later in life. In contrast, States have promised fixed payouts to their retired public employees without requiring any employee contribution. States are therefore on the hook to pay 100 percent of public employee pensions, in addition to other retirement benefits like health insurance.

Despite the high cost of these pensions, it is not for Congress to admonish States for spending their money as their elected leaders see fit. States are sovereign in our system of federalism and are free to make even very expensive decisions.

What is cause for Federal concern is that States have so consistently underfunded public employee pensions that, cumulatively,

they face pension deficits of approximately \$3 trillion. Some fear that States will eventually default.

Voters in spendthrift States should demand collective sacrifice from public employees. Someone must say the emperor has no clothes.

Notwithstanding States' fiscal woes, the era of Federal bailouts is over. Congress should not take money from taxpayers in fiscally healthy States to give to public employee unions in a handful of spendthrift States.

And while bankruptcy for States may seem like an attractive alternative to State bailouts, there are constitutional and policy concerns with this approach.

First, I am unsure whether Congress has the constitutional authority under Article I to allow a state to seek bankruptcy relief. States are co-sovereigns in our system of federalism and have authority to tax and spend.

Even if Congress could enact a State bankruptcy chapter, it is also highly unlikely that any State would ever take advantage of it. The National Governors Association and the National Conference of State Legislatures have announced that States do not want bankruptcy relief and would not use it.

States currently have ways to put their fiscal houses in order. Even the Governors in traditionally union-friendly States already have taken steps to reduce State spending and reform their public employee pension systems.

I am also concerned that a State bankruptcy option may actually encourage States to borrow more money, knowing that they could later restructure their debt in bankruptcy. Future borrowing levels would thus increase even in spendthrift States. And borrowing would be at higher interest rates for all States because lenders would justifiably charge a price for the risk of State bankruptcy.

Congress should not hinder restructuring efforts at the State level by passing laws that make it more expensive for States to access capital in the bond market during a recession, and it should not pass laws that unfairly punish prudent States with higher interest rates.

Finally, in a State bankruptcy case, it would be difficult to prevent the sort of political favoritism of unions over bondholders seen in the Chrysler and General Motors bankruptcies. Public employee unions have exerted influence over State officials to obtain substantial pension benefits. Why should Congress believe that this same political influence will not cause State debtors to protect public employee pensions in bankruptcy?

Still, I remain open to exploring how Congress may play a role in helping States restore fiscal sanity to their budgets. And, Mr. Chairman, I look forward to working with my colleagues to talk about and explore these alternative solutions.

And I yield back the balance of my time.

Mr. COBLE. I thank the gentleman.

The Chair recognizes the distinguished gentleman from Michigan, the Chairman emeritus of the Judiciary Committee, Mr. Conyers.

Mr. CONYERS. Thanks, Chairman Howard Coble and Members of the Committee.

We welcome the four witnesses today.

And I am impressed with Chairman Coble's description of the problem, particularly as it relates to bankruptcy. And he was kind enough to let me see his statement since I didn't quite understand his presentation.

"Neither should Congress permit States to file bankruptcy. Though States would have powerful tools in bankruptcy, like the power to break pension contracts with unions, States are sovereign entities and must handle their financial problems themselves.

"Bankruptcy for States would cripple bond markets. States issue bonds for capital projects like building roads and universities. Permitting States to break their promises to bondholders would decrease investor confidence and hurt States' ability to invest in much-needed infrastructure."

And so, Chairman Coble, I agree with you.

And I must say, Hank Johnson's statement was one that I am in agreement totally with.

And we find ourselves in unusual circumstances.

And my voice is getting like the Chairman's, so maybe I should give him a written copy of my statement so he can understand what I actually said, as well.

States aren't in particularly in good shape. A lot of them are not in the black, but none of them are seeking or going into bankruptcy. None are in bankruptcy. So wherein does the urging from Members of the Federal legislature come from that encourage bankruptcy?

Now, before bankruptcy, there could be bailout. And from the Detroit perspective, both automobile companies that sought bailout are—one has paid off, and the other one is paying off pretty well. The reason I know they are doing so well is that they are declaring bonuses for the leaders. So if they aren't in bankruptcy, this is a hearing that would encourage them, at least some of the members, to go into bankruptcy.

And I want to thank the witnesses. All of their statements, except our lead witness, from the professor, have indicated some need for caution in this area. And I think that is good.

Now, you will never catch me quarreling with why a Subcommittee or the full Committee called a hearing, because no one has called more hearings that were quarrelsome by the other side than me. And so, now it is my turn to listen to hearings that I may not have—would have called myself. But still, maybe we can think about this a little bit.

Well, look, there are so many conservatives that agree with my position of going slow that I am re-examining my own position. I mean, when the gentleman—where is Mr. Cantor from? Virginia? The gentleman from Virginia and I find ourselves in agreement. Other leaders are—the only people that I can prove are urging bankruptcy is Newt Gingrich, the former Speaker of the House; and Jeb Bush, the former Governor from Florida. Now, what is motivating them, outside of further busting public unions, I don't know. But maybe this hearing will shed some light on it, because that is what I would like to find out more.

And so, Mr. Chairman, I thank you for your time. And I am willing to make a copy of my statement available to you.

[The prepared statement of Mr. Conyers follows:]

**Statement of the Honorable John Conyers, Jr.
for the Hearing on Role of Public Employee Pensions in Contributing to State Insolvency
and the Possibility of a State Bankruptcy Chapter**

**Monday, February 14, 2011, at 4:00 pm
2141 Rayburn House Office Building**

Today's hearing highlights yet another casualty of the housing bubble that burst in 2006 and caused -- and continues to cause -- one of the highest rates of home foreclosures since the Great Depression.

The subsequent fallout in the financial marketplace affected virtually every sector of our Nation's economy and those who invested in it, including state public pension trust funds.

Fortunately, as the economy recovers, investors are likewise recovering, including state pension funds.

Unfortunately, some are opportunistically trying to use the temporary shortfall caused by the ongoing national recession to impose radical and very likely damaging changes to state pensions.

In particular, they advocate amending the bankruptcy law to allow a state to file for bankruptcy so that the state can override its own constitutional or statutory prohibitions against impairing contractual pension obligations.

First, the states and their pension trust funds are not in dire straits. Pension experts and economists agree that these funds will weather this recession as they have prior periods of economic upheaval.

For example, Mark Zandi -- one of the Nation's leading economists and a former economic advisor to Senator McCain during his presidential campaign -- testified earlier this month before the Senate Budget Committee that the risk of default by states was "remote."

The Cato Institute, a think-tank not widely known for being a bastion of liberals, believes this talk of financial crisis among the states is overblown.

Even House Majority Leader Eric Cantor thinks the state bankruptcy proposal is a waste of time. As he explains:

State governments have at their disposal the requisite tools to address their fiscal ills. They've got the ability to enter into new negotiations in there are any collective bargaining agreements in place. They've got the ability to adjust levels of spending as well as revenues at the state level.

As you might imagine, Mr. Cantor and I do not usually agree on much of anything, but I could not have given a better explanation of why state bankruptcy is a useless proposal.

Second, and to answer the question implied in today's hearing title, public pensions have a very limited role in a state's financial well-being.

This is because state retirement systems receive only minimal funding from state revenues. These systems are primarily paid out of a trust funded by workers and their employers.

In fact, *less than three percent* of all state and local government spending is used to fund public pension benefits.

Worse yet, all this talk about state bankruptcy has caused insecurity in the financial marketplace, which has, in turn, spooked the bond market and resulted in higher interest rates, just at a time when states can ill-afford them.

For example, both the National Governors Association, whose members are the governors of all 50 states and the Republican Governors Association strongly oppose the state bankruptcy proposal for this very reason.

As the NGA explains, "The mere existence of a law allowing states to declare bankruptcy only serves to increase interest rates, raise the costs of state government and create more volatility in financial markets."

And, finally, let's face it. This effort to have states file for bankruptcy is simply a blatant attack on public sector employees and unions.

Commentator Dick Morris could not be more blunt. He wrote, "[T]he Republican House should pass a state bankruptcy bill to break the political power of the unions and undermine the labor-Democratic Party coalition[.]"

Now, doesn't Congress have more important concerns to deal with?

Rather than wasting time on this proposal, we should be devoting our resources to the real problems Americans are facing, namely joblessness and home foreclosures.

Mr. COBLE. I thank you, sir.

Without objection, other Members' opening statements will be made a part of the record.

We are glad to have a distinguished panel with us today, and I will introduce them at this time.

Mr. Joshua Rauh is associate professor of finance at the Kellogg School of Management at Northwestern University and NBER faculty research fellow in the corporate finance and public economics programs. He studies corporate investment and financial structure,

with an emphasis on the ways in which corporations respond to incentives that are put in place by government policies.

Dr. Rauh received his Ph.D. in 2004 from the Massachusetts Institute of Technology with his dissertation, “Pensions, Corporate Finance, and Public Policy,” which won him the 2004 National Tax Association Dissertation Award. Prior to joining Kellogg, he held a faculty position at the University of Chicago Booth School of Business. And he is a former associate economist for Goldman Sachs International in London.

Mr. James E. Spiotto is a partner in the law firm of Chapman and Cutler, LLP. He graduated from the University of Chicago Law School and has represented banks, indenture trustees, bondholders, or governmental bodies in litigation over workouts of over 400 troubled debt finances in over 35 different States and in 3 foreign countries.

He is also the author of a chapter on sovereign debt, defaults, and debt resolution mechanisms for an upcoming book entitled, “The Oxford Handbook of State and Local Government Debt,” to be published by Oxford University Press. In 1995, Mr. Spiotto won an award for his presentation on municipal defaults and bankruptcy at a United States House of Representatives Subcommittee hearing on the Orange County crisis.

Mr. Fabian is the senior analyst—Mr. Matt Fabian—for Municipal Market Advisors, MMA, an independent research and strategy provider specializing in municipal bonds. Mr. Fabian has been a municipal analyst for 13 years and is the author of a widely read bond publication. He has been the senior analyst with Municipal Market Advisors since July of 2006.

Prior to his current position, Mr. Fabian spent 2½ years as the lead municipal research analyst for UBS and headed up an award-winning group within UBS Wealth Management Research. Mr. Fabian was the primary source on municipal bond research for the UBS network of nearly 7,500 U.S. financial advisors, also advising the company’s institutional training and investment banking clients.

Mr. Keith Brainard is currently serving as research director for the National Association of State Retirement Administrators and has held that position since 2002. Previously, he served as manager of budget and planning for the Arizona State Retirement System, and he also provided fiscal research and analysis for the Texas and Arizona legislatures.

He is coauthor of the second edition of the “Governmental Plans Answer Book,” and created and maintains the Public Fund Survey, an online compendium of public pension data. He has a master’s degree from the LBJ School of Public Affairs at the University of Texas in Austin.

Good to have you with us, gentlemen. If you will, we try to apply the 5-minute rule to you all and to us. When the amber light appears, you will know that the red light is imminent. So when the red light appears, that will be your warning that it is time to wrap up. If you could do that, we would appreciate it.

Mr. Rauh, I will start with you.

**TESTIMONY OF JOSHUA RAUH, Ph.D., ASSOCIATE PROFESSOR
OF FINANCE, KELLOGG SCHOOL OF MANAGEMENT, NORTH-
WESTERN UNIVERSITY, EVANSTON, IL**

Mr. RAUH. Thank you very much, Chairman Coble, Members of the Subcommittee.

The condition of State and local pension systems and the risks that these systems pose for Federal taxpayers is a critical aspect of our Nation's fiscal challenges. Pensions have become more than a means by which State and local governments provide retirement income for public employees. They have become a pervasive tool for circumventing balanced-budget requirements.

The mechanism is simple: State and local governments have promised pensions without setting aside adequate funds. The bill is then left to future taxpayers when the employees retire. By that time, the politicians who made the promises are out of office. In some cases, the bills will be so large that State and local governments will likely seek substantial Federal assistance.

The Government Accounting Standards Board, GASB, has been complicit in this hidden borrowing by allowing a flawed accounting of these promises. Under GASB rules, State and local governments have around \$1 trillion of unfunded pension liability. Using valuations consistent with financial economics, Professor Robert Novy-Marx and I have calculated that the already-promised part of these unfunded liabilities amounts to over \$3 trillion.

GASB treats the returns on risky assets as though they were riskless and certain. The government assumes that the actual return will be identical to the targeted return, most commonly 8 percent, ignoring the fact that if the assets do not return 8 percent, the taxpayers are on the hook for the downside. GASB confounds the measurement of the amount of debt with the government's risky plans for repaying the debt.

Consider how this would work if you could apply it to a Federal bond issue. Suppose you issued \$1 trillion of 10-year bonds. And suppose further that you spent half the proceeds immediately and put the other half in a fund invested in stocks and bonds, hoping that it would grow to repay the debt in 10 years.

Well, obviously, the government has a new debt of \$1 trillion and new unfunded liabilities of half a trillion dollars. But under GASB logic, the government could claim that, since the expected return on their portfolio is 8 percent, there was actually no unfunded liability. This would be a way to deal with the \$1.65 trillion budget deficit at the Federal level. You would just borrow another \$1.65 trillion, invest it in stocks and bonds, claim it will have an expected return of 8 percent. And, under GASB rules, that would be okay.

This is hidden debt, debt that will eventually force governments to choose among a group of unpalatable options: slashing public services, dramatically raising taxes, attempting to cut benefits, defaulting on debt, or seeking a Federal bailout.

Many pension systems are approaching a day of reckoning. Even assuming 8 percent returns, the assets of the systems in seven States and six big cities would be insufficient to pay for today's already-promised benefits past 2020. And what this means is that substantial contributions to the funds will be needed over the next decade to pay for legacy liabilities.

Some State governments are taking steps to address the issue, but many are going in the opposite direction. So, for example, by statute or by contract, many major public pension funds in Illinois do not contribute anywhere near the amount required to pay new costs and to begin to pay down unfunded liabilities. The California State Teachers' Retirement System contributed only 55 percent of the recommended amount in 2010, even by GASB standards. And New Jersey made only 5 percent of the recommended contributions to its State police and teachers funds.

Now, if States perceive implicit Federal backing, they may lack the incentive to undertake reforms of these systems. So I would argue that Congress should limit the liability of Federal taxpayers by providing States with those incentives. It should condition the availability of Federal money on pension reforms that limit off-balance-sheet borrowing.

In particular, the Public Employee Pension Transparency Act, H.R. 567, would be a very useful step. It would condition Federal tax benefits on disclosure by the States of the true financial value of these unfunded public pension promises. The bill establishes an incentive. If States want Federal subsidies, then they may not engage in off-balance-sheet borrowing through improperly valued pension liabilities.

Congress should consider further incentives-based approaches, both carrots and sticks, particularly if the idea of a State bankruptcy code is not going to be pursued. One approach would relate to the tax treatment of bonds that could be used to fund pensions. In a plan I developed with Professor Novy-Marx, a State would be allowed to issue tax-subsidized bonds for the purposes of pension funding if, and only if, it agreed to specific austerity measures, including closing its defined benefit plans to new workers, enrolling all employees in a defined contribution plan, plus Social Security. The cost savings from the new Social Security enrollment would offset a large portion of the costs from the debt subsidy.

So, in sum, I would say that urgent action at the Federal level is required to ensure the Federal taxpayers will not be the ultimate underwriters of State debts. The most useful action would be the establishment of financial incentives that encourage States not to gamble with the money of Federal taxpayers. This is a \$3 trillion problem, and the question is just simply how that \$3 trillion is going to be divided up among State taxpayers and Federal taxpayers and other claimants.

Thank you.

[The prepared statement of Mr. Rauh follows:]

Statement of Professor Joshua Rauh

for the hearing on "The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter"

Before the Subcommittee on Courts, Commercial, and Administrative Law

Monday, February 14th, 2011 at 4:00 p.m.
2131 Rayburn House Office Building

General Introduction

The condition of state and local defined benefit (DB) pension systems and the risks that these systems pose for federal taxpayers is a critical aspect of our nation's fiscal challenges. Until recently, the notion that state and local finances could pose a systemic threat to our national economy has not been at the forefront of public thinking. Almost all state and local governments operate within self-imposed legal restrictions against the extent to which they can run deficits and issue debt. These rules are designed to prevent politicians from spending money now and leaving the bills to their successors.

But just as companies have ways of issuing debt off their balance sheets, state and local governments have ways around the balanced-budget rules. The most pervasive means of circumventing balanced budget requirements at the state and local level has been to promise public employees pensions without setting aside adequate funds to meet the promises. The bill then is left to future taxpayers when the employees retire and collect their checks. By that time, the politicians who made the promises are long out of office. In some cases, the bills will be so large that the ability of state and local governments to operate will be threatened. Some states will likely seek federal assistance.

The state and local pension crisis in the U.S. reflects the fact that unfunded pension liabilities are the largest loophole in balanced budget pledges. When politicians have spent money without raising taxes, pensions have proven the perfect borrowing vehicle. The Government Accounting Standards Board (GASB) has been complicit in this hidden borrowing by allowing a form of accounting for these promises that violates the principles of financial economics.

This hidden debt will eventually force states and localities to choose among the unpalatable options of cutting services, raising taxes, attempting to reduce benefits owed to public employees, defaulting on other obligations, or seeking a federal bailout. The best hope for a soft landing for states is

to focus on measures that stop the growth of unfunded liabilities, and then attempt to renegotiate the most untenable pension obligations within the allowable state legal structures.

If states perceive implicit federal backing, they may lack the incentives to undertake these fundamental reforms. If the federal government is interested in limiting the liability of federal taxpayers to bailouts, it should provide states with those incentives by conditioning the availability of federal money on pension reforms that limit off balance sheet borrowing. Urgent action is required to ensure that federal taxpayers will not be the ultimate underwriters of state debts.

Disclosure

If a government promises deferred compensation in the form of pensions to employees when they retire, but does not set aside sufficient funds to honor those promises, it is effectively borrowing from future taxpayers. As a result, the definition of "sufficient funds" is crucial to determining whether governments are meeting their responsibilities to pay for today's services today and are properly representing the status of their budgets.

In 1994, GASB issued Ruling 25, which stipulated that public pension liabilities are to be discounted at the expected rate of return on pension assets. The ruling codified the approach already being used by most public systems. Under GASB state and local governments calculate whether their funds are sufficient by discounting their liabilities using an expected return on pension plan assets. This expected return is a direct function of the amount of risk taken in the pension fund assets, which are invested in a range of securities including stocks, bonds, real estate, private equity, and hedge funds. But the fact that the systems are taking risk in order to target these expected returns never enters the accounting. The government effectively assumes that the actual return will be identical to the expected return, most commonly 8%. The trouble with this methodology is that it ignores the fact that if the assets do not return 8%, the taxpayers will have to come up with the difference.

Consider how this procedure would work if it were used in conjunction with a federal bond issue. Suppose the federal government issued \$1 trillion of 10-year bonds. Suppose further that it spent \$525 billion of the proceeds immediately and put the other \$475 billion in a fund invested in stocks and bonds, which it hopes will grow to repay the debt in 10 years. Any reasonable observer should agree that the government now has new debt of \$1 trillion and new unfunded liabilities of \$525 billion. But

under GASB logic, the government could claim that since their expected return on the portfolio is 8%, there is actually no unfunded liability.¹

Consider further how this methodology would work in the realm of personal finance. Imagine you personally have a \$10,000 repayment of a loan due in 5 years. If you applied for another loan, any reasonable lender would ask you to record your other debts on the loan application. Are you allowed to assume a return on your stocks and bonds in recording the value of this debt? Of course not. Does the amount of debt you report to the bank depend on whether the savings you have is invested in stock or bonds? Once again, the answer is obviously not. But under GASB accounting procedures, state and local governments can treat the higher returns they hope to achieve as a sure thing. The higher the return the government assumes, the lower the pension debt that it reports to the public and to the rating agencies.

This procedure contrasts sharply with private sector accounting methods, as well as financial logic. It ignores the role of risk – the reality that a wide range of investment outcomes are possible – and, more specifically, the fact that future taxpayers will have to make up any shortfalls if the fund's assets fail to generate the expected 8 percent return. If a taxpayer's personal portfolio underperforms, he or she can cut back on their expenditures. But if the government's pension portfolio underperforms, the taxpayer will be asked to pay to the government the difference between what the government promised to public employees and the resources that are left to meet those obligations. Since most households are effectively long the stock market, either through their personal portfolios or through the fact that stock market downturns are usually accompanied by layoffs and poorer job opportunities, this hit comes when it hurts the most.

State pension systems typically defend the GASB procedure on the grounds that the historical returns realized on their assets over a long period of time have been around 8%. Indeed, over the period 1926-2010, large cap stocks in the U.S. have returned on average almost 12% annually, so diversified portfolios of stocks and bonds have achieved returns of around 8%. But that fact does not allow state and local governments to write down the value of their debts by assuming that such returns will be earned in the future.

¹ This is since $(\$475 \text{ billion}) * (1.08)^{10} > \1 trillion

Indeed, the leading theory for why such returns were earned over this time period is that there were potential large downside risks that could have materialized but ultimately did not (see for example Cochrane (2001)). Investors are compensated with higher expected returns only in exchange for bearing risk. An expected return is just that – a return that is expected but that may or may not be achieved. There is no guarantee that an investor will get higher returns over the long run by investing in the stock market.

A well-known property of the returns of any risky assets (and the stocks, real estate, private equity, and hedge funds that public pension funds invest in are risky assets) is that they have what is called positive skew. What this means is that poor outcomes are more likely than good outcomes, but the good outcomes could be very, very good. An implication is that in most instances, the probability of achieving the “expected return” is less than 50%. Using parameters that financial economists typically use to model the stock market, Robert Novy-Marx of the University of Rochester and I have calculated the probabilities of actually achieving the targeted expected return. A portfolio with an “expected return” of 8% has only about a 1/3 probability of achieving that return over the next thirty years, and has a 50% chance of achieving a return of 6% or lower.²

Some states, such as Illinois, have passed their own statutes that allow them to operate under a regime in which they contribute even less than what the GASB guidelines would stipulate. Indeed, while the contributions that emerge from GASB guidelines are often termed Actuarially Required Contributions, these contributions are not “required” in any legal sense. A primary example of this fact is the state of New Jersey, which in FY 2010 contributed only 5.4% of its “actuarially required contribution” to the state’s Teachers’ Pension and Annuity Fund.

In practice, the accounting standard being used sets up a false equivalence between pension payments, which are extremely likely to have to be made, and the much less certain outcome of a risky investment portfolio. In effect, state and local pension accounting treats expected returns on risky assets as though they were riskless and certain, and uses that fallacy to calculate the extent of their debts to public employees.

What is the Extent of the Fiscal Problem?

² This calculation assumes a market volatility of 0.16.

Under their own accounting rules, state and local governments have around \$1.3 trillion of unfunded pension liabilities. Using valuation methods and accounting practices that are consistent with financial economics, Robert Novy-Marx and I have calculated that the already-promised part of these unfunded liabilities actually amounts to over \$3 trillion, more than the approximately \$2.6 trillion of recognized debt on state and local government balance sheets. Each day that public pension systems continue to ignore risk in their pension budgeting, this debt is likely to grow.

The logic behind our calculation goes back to standard finance theory: financial streams of payment should be discounted at a rate that reflects their risk. If a state wanted to pay an investor (say, an insurance company) to take over its pension liability, the amount the investor demanded would not depend on the state's asset allocation or the expected return on its assets. If a state tells its employees that their accrued pension benefits are secure – not subject to risk like stocks – then it should use the yields on safe government securities such as Treasury bonds to calculate the pension fund's net position. Our calculation uses discount rates from the U.S. Treasury bond market to reflect the risk profile of the pension liabilities.

Our calculation considers only payments that the states have promised employees for years of work already done—that is, the payments that give rise to what is called the Accumulated Benefit Obligation liability. From the state's point of view, these cash flows are extremely likely to be incurred. First, state constitutions in a number of cases provide explicit guarantees that public pension liabilities will be met in full (see Brown and Wilcox (2009) for a complete analysis). Second, state employees are a powerful constituency, and unless a government is willing to contend with serious labor unrest among state and local workers, it seems likely that already-promised benefits based on today's level of service and salary will have to be met. Third, if there is any even remote chance that the federal government could end up assisting states in paying their debts to public employees, then obviously the federal government would want to see how these pensions looked if they were a federal government promise.

Our calculations do not include any future benefit accruals, no matter how likely they are. In most states it would be legal for states to change the benefit formula for future accruals, as many companies have done, for example by freezing their pension plans. From the state's point of view, these pension obligations that have yet to arise can be trimmed. That said, of the changes that states have attempted to undertake, virtually none of them have touched current workers, even with respect to their future accruals. Even provisions like the ability to let final salary determine the pension, which can

result in “pension spiking” or rotation into high paying jobs for a short period of time to bump up pensions, have generally been preserved for existing workers in current reform proposals – it is only new hires who cannot avail themselves of these privileges.³

To put the number in context, each \$1 trillion is just under \$8,500 per U.S. household, so our baseline number of \$3 trillion is more than \$25,000 per American household.⁴ Of course, that calculation implicitly assumes that these legacy liabilities will be shared equally by all taxpayers. In Illinois, for example, the liability per household is close to \$40,000. Table 1 shows the state governments with the largest unfunded liability expressed as a share of 2009 tax revenues.

Table 1 – States with Largest Unfunded Pension Liabilities, as of June 2009

State Name (# of plans)	Pension Assets (\$ billion)	Liabilities		Unfunded Liability		Unfunded Liability Scaled	
		Stated Basis (\$ billion)	Using Treasury rates (\$ billion)	Stated Basis (\$ billion)	Using Treasury rates (\$ billion)	Percent of Tax Revenue	Percent of Gross State Product
Ohio (5)	114.7	197.5	281.4	82.8	166.8	632%	35%
Colorado (1)	28.8	57.3	86.2	28.5	57.4	596%	23%
Illinois (4)	65.7	151.0	233.0	85.3	167.3	525%	26%
Oregon (1)	42.9	57.5	80.7	14.6	37.8	519%	23%
South Carolina (2)	20.3	42.4	63.5	22.0	43.2	511%	28%
Rhode Island (1)	6.6	13.9	20.5	7.3	13.9	503%	29%
Alabama (3)	21.4	42.0	61.8	20.6	40.4	445%	24%
Mississippi (3)	15.5	31.4	44.2	15.9	28.7	424%	31%
New Mexico (2)	15.9	28.8	39.8	12.9	23.9	424%	30%
Kentucky (3)	21.1	45.2	63.4	24.1	42.3	420%	27%
New Jersey (4)	67.2	132.8	191.2	65.6	124.0	405%	26%

Source: Novy-Marx and Rauh (2010). Only states with unfunded liabilities greater than 4 years revenue are shown in this table.

The fact that states cannot freeze pension accruals as easily as companies may argue for considering a liability measure broader than the already-promised accumulated benefit in the state

³ The latest example of the protection of current worker’s ability to spike pensions is revealed in the reporting on Mayor Michael R. Bloomberg’s proposed changes to New York City’s pension system: “Mr. Bloomberg would forbid all new employees to benefit from a time-honored practice: adding hundreds of hours of overtime at the end of their careers to balloon their final year’s pay and their pensions” (New York Times, 2 February 2011). Note the use of the word “new”.

⁴ According to the U.S. Census Bureau, the population of the U.S. was 307,006,550 in 2009. As of the last complete census in 2000, there were 2.6 persons per household, indicating approximately 118 million U.S. households.

pension context. Under the so-called Entry Age Normal method used by most state and local governments themselves, implementing Treasury discounting would lead to an unfunded liability of over \$4 trillion.

Systemic Risks and Bankruptcy

Many pension systems are approaching a day of reckoning. Even assuming 8% returns the assets of the systems in seven states (notably Illinois and New Jersey) and six big cities would be insufficient to pay for today's already-promised benefits past the year 2020. Another 20 states and 24 localities have assets insufficient to cover already-promised benefits past 2025. This means that substantial contributions to the funds will be needed over the next 15 years to pay for legacy liabilities – that is, future contributions will be required to pay for public workers' services performed in the past.

To address the solvency issue, state and local governments need to make contributions that substantially exceed the present value of the new benefits employees are accruing. On average, they are falling short of that baseline. Across 116 major systems sponsored by the 50 states, annual contributions were \$93 billion in 2009, while the present value of their new benefit promises has been around \$100 billion annually in recent years (see Rauh (2010)). For comparison, total annual benefits paid have surpassed \$150 billion.

Some state governments are taking steps to address the solvency issue, but many are not. Illinois over the past decade has, for example, routinely made pension contributions in the form of borrowing, transferring one type of obligation to another. New Jersey has made only a fraction of the contributions that the actuarial calculations require. As long as states continue operating under GASB rules, in an economic sense they start out behind on funding from the first day their employees earn any new benefits.

If state and local governments end up trying to cover the unfunded portion of pension bills from current revenues in the face of depleted pension funds, benefit checks will in most cases consume 20 to 50 percent of general tax revenues for these entities. And without significant tax increases pension payments of this magnitude would make it virtually impossible for state and local governments to provide essential services and to service their other debts.

Economists Jeffrey Brown of the University of Illinois and David Wilcox of the Federal Reserve have documented major legal obstacles to attempts to cut benefits. In seven states (including Illinois, New York, Michigan and Louisiana), the states' constitutions stipulate that pension benefits may not be diminished or impaired. Thus, any cost-saving measures acknowledged as benefit cuts would likely prove impossible. Even in states whose constitutions are not explicit on the subject historical precedent and political reality suggest that, in local public-finance crises, already promised pension benefits will be honored. The affected retirees are members of unions whose workers provide essential public services such as public safety and education.

In half of the 50 states, local governments can avail themselves of Chapter 9 bankruptcy in the restructuring of their debts. While this proceeding has allowed an increasing number of municipalities to restructure some of their debts, accrued pension promises have generally been preserved for the reasons discussed above. One recent example that illustrates the de facto seniority of pension benefits is Vallejo, California, a city in California undergoing a Chapter 9 bankruptcy. Under current proposals, some bondholders or their guarantors are facing the prospect of large losses, while promised pensions will remain intact. The bankrupt town of Prichard, Alabama, on the other hand, has cut employee pensions, but the town has extremely limited resources so that it is unclear how the pensions would be paid even if it were legally mandated. The mayor of San Diego last year rejected the idea of a bankruptcy for the city on the grounds that it would not help address the pension debt.⁵

The evidence on Chapter 9 bankruptcy at the municipal level suggests that a federal bankruptcy proceeding for states would not be a panacea. If the political reality is that public unions will require pensions to be paid regardless, then a bankruptcy framework for states does not help the restructuring of that type of debt. On the other hand, there are other aspects of labor contracts that could be renegotiated in bankruptcy, and the threat point of state bankruptcy could help states reduce some of their debts.

A bankruptcy code for states would also send a signal to municipal markets that the federal government has no intention of bailing out states. Of course, there is a bankruptcy code for corporations in the United States, and that has not stopped federal bailouts of corporations, so this signal may or may

⁵ "In the end, bankruptcy would cost hundreds of millions of dollars and net nothing in return. And the most compelling claim made on its behalf – that it would allow us to shed our pension obligations – is patently false." (Jerry Sanders, "Debunking the Bankruptcy Myth," <http://www.sandiego.gov/mayor/pdf/100131.pdf>).

not be credible. The main effect of introducing a bankruptcy code for states would likely be to increase pressure from municipal bond markets on states to implement reforms.

Regulation

The self-regulation of state and local governments stands in stark contrast to private sector DB pension plans, which are regulated at the federal level under the 1974 ERISA legislation and many future laws that amended and updated the rules. State and local pensions on the contrary have been outside the realm of federal regulation. The Public Employee Pension Transparency Act (H.R. 567), introduced on February 9, 2011, seeks to change that, arguing that Congress has the authority to condition the continuation of certain specified Federal tax benefits on disclosure by the states of the financial value of public pension liabilities using Treasury discount rates.

If state and local governments had to actually calculate the cost of their benefits using a financially sound framework the way the private sector does, the true economic cost of the public employee legacy liabilities will be revealed. Governments should be required to disclose the magnitude of their unfunded liabilities using discount rates that reflect the fact that pensions constitute a solemn promise to pay and that taxpayers backstop the guarantee.

Ideally, states themselves would use this method of accounting in setting their contribution rates. If states want to claim a balanced budget in an economic sense, they should be evaluating the cost of the benefits as the financial value of the promises. The trouble with the GASB rules is that they confound the pension debt itself with the state or local government's plan for repaying the debt.

It would also be useful for states to report the stream of payments they expect to have to make, an ingredient they presumably already calculate in the production of their actuarial liabilities. Observers can then compare this stream with the pension assets and the resources that states have available in order to see what kinds of returns and future tax revenue will be necessary to meet the promises.

H.R. 567 is a very useful step because it establishes an incentive for states: if they want federal subsidies, they may not engage in substantial amounts of off-balance-sheet borrowing through improperly valued pension liabilities. The state pension system exposes the financial system to substantial risk, and there is a further risk that the federal government would be called on for bailouts. Even if there were not an explicit bailout, federal taxpayers would be on the hook for part of the cost

because more federal cash would flow automatically to hard-hit states under programs ranging from unemployment insurance to Medicaid. Moreover, state fiscal problems arising from pension systems could have broader, unwanted consequences for the economy as a whole. For example, businesses could choose to avoid higher taxes and lower-quality government services by moving abroad, rather than to a lower-tax state.

The exposure of federal taxpayers to state fiscal problems argues for further incentives-based approaches by the federal government, particularly if the idea of a state bankruptcy code is not to be pursued. A wide range of incentives should be considered, including both carrots and sticks. The key idea is that some portion of federal money to states should be contingent on the states and localities getting their off-balance-sheet liabilities under control.

One promising approach in this regard relates to the tax treatment of bonds that could be used to fund pensions. Under current law, bonds floated by states for this purpose are fully taxable. As a result, such debt is considerably more expensive than municipal bonds qualifying for tax-exempt status or the lapsed Build America Bonds program.

This setup creates potential leverage for Washington to drive a deal with states. In a plan I developed with Professor Novy-Marx (Rauh and Novy-Marx (2010)), a state would be allowed to issue tax-subsidized bonds for the purpose of pension funding for the next 15 years if (and only if) it agreed to specific austerity measures. Specifically, the state would have to close its defined-benefit plans to new workers, fund existing defined-benefit plans on an actuarially sound basis using the new borrowing facility, and enroll all new employees in a defined contribution plan plus Social Security. The enrollment of state and local workers into Social Security would allow the federal government to achieve substantial cost savings in that program (see Diamond and Orszag (2005)). Those cost savings would offset a large portion of the federal government's costs from the debt subsidy, while also ensuring that the employees had the same safety floors on their retirement as all private sector workers do.

We calculate that the net cost to the federal government of subsidizing pension bonds under this program would be \$75 billion. That would constitute a bargain relative to the multi-trillion-dollar crisis that taxpayers will likely face otherwise. This is just one example of an incentives-based approach that would protect federal taxpayers from the pension problems of state governments.

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Mr. COBLE. Thank you, Mr. Rauh. And you beat the red light—
 Mr. RAUH. I sure did.
 Mr. COBLE [continuing]. Putting pressure your colleagues.
 Mr. Spiotto, good to have you with us. You are recognized for 5
 minutes.

**TESTIMONY OF JAMES E. SPIOTTO, ESQ., PARTNER,
CHAPMAN AND CUTLER, LLP, CHICAGO, IL**

Mr. SPIOTTO. Thank you, Mr. Chairman Coble. It is my pleasure to address you today.

Obviously, you all, in framing your statement, have clearly outlined the problem that is facing States and even local governments with regard to how do you meet all of your debt obligations, all of your financial obligations in challenging times, especially economic downturn.

The question posed is, given underfunding of pension obligations for State governments, should there be a chapter for a State bankruptcy? This question sounds like an easy solution to a difficult problem, but there are many practical problems to that. And what I would like to explore with you today is some of those practical problems and concerns that need to be addressed and, I think, in considering those, lead to the conclusion that bankruptcy is obviously, just like it is for municipalities, the last last resort. And, certainly, there are many other options available that should be used and can be used to solve the problem.

First of all, let's look at Chapter IX. Chapter IX was passed during the depression of the 1930's. Since 1937, when it was passed, only 620 municipalities have used Chapter IX, mainly small special tax districts and small municipalities. There have been a few exceptions. But, by and large, most municipalities, because of the stigma, because of the cloud, because they desire to be able to manage their own affairs, have chosen not to use Chapter IX.

You need to be authorized by your State to file Chapter IX. There are only 15 States that have unconditionally authorized their municipalities to file Chapter IX. So all the other States have either put a condition on it or do not authorize, presently, their municipalities to file.

You may ask yourself, is there the same demand and cry for a bankruptcy provision for States that there was during the Depression? The answer to that is "no." At the time that Chapter IX was adopted, there were over 4,000 local defaults by municipalities; there were over a thousand municipalities desirous of having Chapter IX adopted. As your opening statements have indicated, States and local governments are not asking for this at this time, and for good reason.

One of the questions raised is, what about the dual sovereignty of the Federal Government and the States? And does this really interfere with the ability of States to deal with their sovereign issues?

I think the simple fact is, and as we saw from the development of Chapter IX, any type of bankruptcy application to the States will cause various constitutional problems, which will need to be addressed and are not easily done. If you will recall, back in 1934, when they passed the first version for municipal bankruptcy, it took Congress and a few Supreme Court decisions to, by 1937, have something that passed the muster of constitutional scrutiny.

The Bivens case and the Ashton case by the Supreme Court outlined that a Federal judge of a dual sovereign, the Federal Government, cannot interfere with the revenues, with the property, with the government, with the affairs of a municipality. That municipi-

pality is a subsovereign of the State. When you take it on the State level, and given our constitutional background and the 10th Amendment and Supreme Court decisions, it will be very difficult to have a Federal judge be able to navigate those waters. And that difficulty will cost time, money, and effort and an inability to really address the problems.

So, on the constitutional basis, it seems that it would be very difficult to really solve that problem. Chapter IX, in the passage of that, outlines in the Bivens and the Ashton case those problems.

Are there solutions? Yes. States have for a long history solved their problems. Their general obligations have been paid since the 1800's. They have done almost anything to make sure they dealt with their problem. Yes, we have an economic downturn, but that does not mean that they will not be able to address it.

Are there solutions? We have, in the materials, talked about a public pension authority that might be established by the State to deal with these issues. We have talked about possibly a Federal independent court to deal issues that relate to unaffordable and sustainable obligations. There are also the ability to possibly facilitate with issuing bonds.

While there are many different ways of solving it, it really is the States and their proud history of meeting their obligations that has to be recognized. They may have difficult times. They have weathered through it in the past. And they clearly have done it through the Depression without any need of bankruptcy or additional help. And I think, with a little foresight and a little work on their part, they will come up, as they have in the past, with solutions that will address the problem.

Thank you.

[The prepared statement of Mr. Spiotto follows:]

U.S. HOUSE OF REPRESENTATIVES

**HOUSE JUDICIARY COMMITTEE'S SUBCOMMITTEE ON COURTS,
COMMERCIAL AND ADMINISTRATIVE LAW**

**HEARING ON THE ROLE OF PUBLIC EMPLOYEE PENSIONS IN
CONTRIBUTING TO STATE'S INSOLVENCY AND THE POSSIBILITY OF A
STATE BANKRUPTCY CHAPTER.**

February 2011

**TESTIMONY OF JAMES E. SPIOTTO
PARTNER, CHAPMAN AND CUTLER LLP**

Thank you for the opportunity to discuss with you the legal and practical concerns presented by the adoption of bankruptcy legislation for the States as a tool for dealing with underfunded State pensions. I am speaking to you from the perspective of someone who has represented clients in connection with financially-challenged situations related to State and local government debt financings, has studied and been involved with municipal bankruptcy for many years and is familiar with the limitations of Chapter 9. Obviously, the analogies are compelling.

A STATE BANKRUPTCY OPTION WOULD CREATE PRACTICAL PROBLEMS AND FACE LEGAL
CHALLENGES

As States continue to grapple with the issue of burdensome underfunding of public employee pensions, some have recommended the amendment of the existing U.S. Bankruptcy Code, 11 U.S.C. Section 101 *et seq.*, to add a Chapter permitting the adjustment of debts of a State. It is respectfully submitted that, while the creation of a vehicle for State bankruptcy may initially appear as an attractive solution to a difficult problem, upon careful consideration, its problems outweigh its benefits. In fact, it appears that State bankruptcy is a less desirable alternative than others that may be available to States. Both practical and constitutional considerations mandate the rejection of a State bankruptcy option in favor of other more surgical approaches to any pension underfunding problem. Further, there is a long, positive history of States meeting their financial obligations to debtholders that would necessarily be affected by the enactment of State bankruptcy legislation. A State bankruptcy risk could, obviously, increase borrowing costs to States and limit easy access to the capital markets at a time when a source of funding is needed. Before legislating a dramatic departure from the sound practices that have characterized States' treatment of creditors in the past, alternative solutions must be explored.

THE MUNICIPAL BANKRUPTCY EXPERIENCE

As you may be aware, of the 620 municipal bankruptcies filed in the United States since the adoption of the authorizing legislation in 1937, few debtors have been major municipalities. Orange County, California in 1994 and Bridgeport, Connecticut in 1991 are recent notable exceptions. For the most part, the 620 Chapter 9 filings have been small municipalities or special tax districts or utilities. Further, in the pending municipal bankruptcy of Vallejo, California, which was filed in 2008, disputes with municipal unions over pensions and benefits have bogged down the proceeding and await final resolution in a confirmed plan. It is safe to say that the availability of a bankruptcy option has not proven to be a “quick fix” to municipalities and is unlikely to be a panacea for States.ⁱ

LACK OF STATE DEMAND FOR BANKRUPTCY VEHICLE UNDERSTANDABLE

It is interesting to note that the impetus for a State bankruptcy mechanism has not, as a general rule, come from the States themselves.ⁱⁱ This reluctance by States to embrace State bankruptcy as the solution to the pension difficulty is undoubtedly a recognition that the existence or even discussion of State bankruptcy risk could quickly raise concerns in the capital markets. Up until now, the threat of a State not honoring in full its general obligation bonds but instead “readjusting them” through a bankruptcy was not considered a possibility. Indeed, currently, the inability of a State to institute a bankruptcy proceeding is an important part of the calculus upon which the cost of State financings are based. The existence of a State bankruptcy option could cause a cloud or stigma on State access to the financial markets and increase borrowing costs far beyond any possible benefit the remedy might create for States. In addition, the States likely recognize a bankruptcy would affect all the States’ relationships with creditors,

including many that are working well and should not be modified. There is an understandable leanness to jump into the uncharted waters of State bankruptcy when the cause of financial difficulty can be traced to several discreet problems that can be dealt with separately.

Historically, States have been perceived as solid credits, although admittedly some States have been viewed as stronger credits than others. Importantly, though, no State has defaulted in the payment of its general obligation bonds (as opposed to conduit debt where the State is not the actual obligor) since the late 1800s and the repudiation of the debt incurred after the Civil War. A notable exception was Arkansas in 1933, which defaulted on its general obligation bonds but later refunded the debt thus ameliorating the default. States have weathered financial storms, including the Great Depression, without access to a bankruptcy vehicle. Instead, expenditures have been cut, taxes have been increased and additional sources of revenue have been explored. This history of States meeting their financial obligations has permitted States to play an important role in the development and financing of this Country's infrastructure that our citizens rely upon and our industries depend on. Before unfunded pension liabilities bring a State to its knees in a bankruptcy forum, there are other more creative and, ultimately, more appropriate methods of dealing with the resolution of promises made to States employees that may not realistically be able to be fulfilled.ⁱⁱⁱ

**PRINCIPLES OF FEDERALISM AND DUAL SOVEREIGNTY PRECLUDE ANY BANKRUPTCY PROCEEDING
WITHOUT A STATE'S CONSENT**

The enactment of a bankruptcy vehicle for States would face a number of legal impediments. As a threshold matter, the dual sovereignty of the Federal Government and the States precludes the Federal Government from imposing a mandatory bankruptcy procedure on

the States. Dual sovereignty is a defining feature of our Nation's constitutional blueprint.^{iv} States, upon ratification of the Constitution, did not consent to become mere appendages of the Federal Government. Rather, they entered the Union "with their sovereignty intact."^v As noted in the decision of *Federal Maritime Commission v. South Carolina State Ports Authority*, 535 U.S. 743, 152 L. Ed. 2d 962, 122 S. Ct. 1864 (2002) ("*Federal Maritime Commission*"), the U.S. Supreme Court, has applied a presumption -- first explicitly stated in *Hans v. Louisiana*, 134 U.S. 1, 33 L. Ed. 842, 10 S. Ct. 504 (1890) -- that the Constitution was not intended to "raise up" any proceedings against the States that were "anomalous and unheard of when the Constitution was adopted."^{vi} In holding that the doctrine of sovereign immunity barred the Federal Maritime Commission from adjudicating a complaint against a State agency that had not consented to be subject to the proceeding, the Court held that it attributed great significance to the fact that States were not subject to private suits in administrative adjudication at the time of the founding of our Nation.^{vii} Accordingly, the initial hurdle a State bankruptcy statute would face is a challenge that it fails to afford the States the dignity and respect due sovereign entities. As there was no State bankruptcy procedure in effect at the time of the Nation's beginning, no such process should be "raised up" in the form of Federal legislation to be imposed upon the States at this time. In short, the State as dual sovereign can decide when to pay, what to pay and whether to pay and those decisions by a State cannot be changed by the Federal Government without the State's consent.

THE LESSONS LEARNED FROM CONSTITUTIONAL CHALLENGES TO MUNICIPAL BANKRUPTCY
PROVISIONS

The Tenth Amendment to the Constitution explicitly articulates the Constitution's principle of Federalism by providing that powers not granted to the Federal Government nor prohibited to the States by the Constitution of the United States are reserved to the States respectively or to the people. Accordingly, while Article I, Section 8 of the Constitution gives Congress the power to "establish uniform laws on the subject of bankruptcies throughout the United States," that power may not interfere with the power reserved to the States by the Tenth Amendment. While there may be precedent for the Federal preemption of bankruptcy law for corporations and individuals, there was, at our Nation's founding, no precedent for a dual sovereign passing a law regulating the bankruptcy of the other. This remains the case today. The earliest iterations of statutes providing for municipal debt adjustment (Chapter IX) not unexpectedly resulted in a review of the constitutionality of municipal bankruptcy by the U.S. Supreme Court. As municipalities are instrumentalities of the State or sub-sovereigns, the principles derived from those early decisions with respect to Federalism and the ability of Congress to legislate in the sphere of the States are applicable to the subject at hand.

As you know, the current version of Chapter 9 of the Bankruptcy Code attempts to embrace the concept of sovereignty of States and the limitations imposed by the Tenth Amendment. Section 903 of the Bankruptcy Code specifically reserves a State's power to control municipalities.^{viii} In addition, § 904 of the Bankruptcy Code specifically limits the jurisdiction and powers of the Court over the municipality.^{ix} As a result, the power of a Bankruptcy Court presiding over a Chapter 9 case is quite limited and cannot interfere with the revenue or government and affairs of the municipality. The jurisdiction of the Bankruptcy Court

over the municipality flows from the specific authorization of the State in question to allow the municipality to file. Most States have chosen not to specifically authorize their municipalities to file. In fact, only fifteen States have unconditionally authorized municipalities to file Chapter 9 petitions.^x

Earlier versions of municipal bankruptcy legislation attempted to deal with these concepts as well. Prior to 1934, Federal bankruptcy legislation did not provide a mechanism for municipal bankruptcy, insolvency, or debt adjustment.^{xi} During the period 1929 through 1937, there were 4,700 defaults by governmental bodies in the payment of their obligations.^{xii} In 1934, the House and Senate Judiciary Committees estimated that there were over 1,000 municipalities in default on their bonds.^{xiii} That was obviously a different stage of financial distress than presently exists today with no State in default of any its general obligation bonds.

Until World War II, units of local government were very heavily dependent upon property tax. During the Depression, there was widespread nonpayment of such taxes. Bondholders brought suits for accountings, secured judgments and obtained writs of mandamus for levies of further taxes. The first municipal debt provisions of the Bankruptcy Act of 1898 as amended from time to time (hereinafter the "*Bankruptcy Act*") were enacted as emergency legislation for the relief of such municipalities. The municipal tax provisions became effective on May 24, 1934.^{xiv} These provisions were to be operative for a two-year period from that date, but this period was later extended to January 1, 1940.^{xv}

The municipal debt adjustment provisions of the Bankruptcy Act enacted in 1934 reflected an attempt to protect municipalities from debilitating disputes with creditors.^{xvi} The

1934 legislation provided a procedure whereby a local governmental unit, if it could obtain acceptances from two-thirds of its creditors, could have a plan of readjustment enforced by the Federal courts. The 1934 legislation contained language similar to the policy expressed in the current § 904:

The Judge . . . shall not by any order or decree, in the proceeding or otherwise, interfere with (a) any of the political or governmental powers of the taxing district or (b) any of the property or revenues of the taxing district necessary in the opinion of the Judge for essential governmental purposes or (c) any income producing property, unless the plan of adjustment so provides.

Nevertheless, the Supreme Court determined that, under the 1934 legislation, the court, and to some extent, the creditors through the court, had certain control over the municipality's revenues and governmental affairs. In 1936, the Supreme Court of the United States held, in the case of *Ashton v. Cameron County Water Improvement Dist., No. 1*,^{xvii} that the 1934 municipal bankruptcy legislation was unconstitutional because it infringed upon the sovereign powers of the States and potentially permitted too much control by a Federal court and by Federal legislation over municipalities, sub-sovereigns of the sovereign States.

In 1937, new legislation was passed attempting to cure the defects outlined by the Court in *Ashton* and to protect municipalities from the injurious protracted litigation that some were enduring. The 1937 municipal bankruptcy legislation, enacted in response to the *Ashton* decision, required:

(1) no interference with the fiscal or governmental affairs of political subdivisions;

- (2) a restriction on the protection of bankruptcy to the taxing agency itself;
- (3) no involuntary proceedings;
- (4) no judicial control or jurisdiction over property and those revenues of the petitioning agency necessary for essential governmental purposes; and
- (5) no impairment of contractual obligations by the States.

This legislation was upheld by the Supreme Court in *United States v. Bekins*,^{xviii} where the Supreme Court noted that the statute was carefully drawn so as not to impinge upon the sovereignty of the States. Like the 1934 legislation, language similar to the § 904 concept was included, although references to “the opinion of the Judge” were deleted.

Chapter IX then, while part of the Bankruptcy Act, provided a forum in which a municipality could voluntarily seek an adjustment of indebtedness if authorized by the State to file. A Chapter IX proceeding was not a proceeding to adjudge the city a bankrupt. The court’s jurisdiction did not extend to declaring the city bankrupt or to administering its affairs as a bankrupt. The court was limited to approving as a matter of law or carrying out a proposed plan for reorganization of a municipality’s debt.^{xix}

This birth of municipal debt adjustment must be considered in analyzing possible State bankruptcy legislation. The principles enumerated in *Ashton* and the 1937 legislation are important in understanding the role of a Bankruptcy Court in a Chapter 9 proceeding today.^{xx} The Court cannot constitutionally interfere with the revenue, politics, or day-to-day operations of the municipality. The Bankruptcy Court cannot replace, by its rulings or appointments, the City

Council or any other elected or appointed official. The limited, but vital, role of the Bankruptcy Court is to supervise the effective and appropriate adjustment of municipal debt in accordance with applicable law. (Obviously, the special limitations on the power of the bankruptcy court in a Chapter 9 case would not be applicable if the city consented to the stay or order of the court which affected its political or governmental powers.^{xxi}) Historically, Chapter IX and its successor Chapter 9 were intended to facilitate rather than mandate voluntary municipal debt adjustment, not municipal debt elimination.

The constitutional challenges to Chapter 9 and the resulting Court solicitude for the sovereignty of the States are significant when assessing any attempt to impose Federal bankruptcy legislation on the States. Requiring the applicability of State bankruptcy without the consent of the State would run afoul of the Tenth Amendment to the Constitution articulated by the *Bekins* court. Conversely, a strictly voluntary procedure by which the State consents to a restructuring process is always available to the State as a sovereign and requires no Federal legislation to make it happen.

THE U.S. CONSTITUTION DOES NOT PRECLUDE THE STATES THEMSELVES FROM SOLVING THEIR
PENSION PROBLEMS

States may pursue changes to pension contracts that are not sustainable and affordable and impair the State's ability to provide essential governmental services. Some have suggested that States are powerless on their own to remedy any unfunded pension issues because the U.S. Constitution forbids States from impairing the obligations of contract.^{xxii} In fact, the U.S. Supreme Court has held that an impairment to a contract may be upheld where reasonable and necessary to serve an important public purpose.^{xxiii} In *U.S. Trust Company v. New Jersey*, the impaired obligation was a statutory covenant between New York and New Jersey addressing

revenues and reserves pledged as security for bonds related to the Port Authority.^{xxiv} A New Jersey statute repealed the covenant.^{xxv} The Court concluded that New Jersey's action was a contractual impairment and violated the Contract Clause of the U.S. Constitution in the absence of showing that the impairment was necessary and reasonable to serve an important public purpose.^{xxvi}

Courts employ a four-part inquiry under the Contract Clause.^{xxvii} First, a contractual obligation must be involved. Secondly, the legislation must impair that obligation. Next, the impairment must be substantial. Finally, in order to be valid, the impairment must be "reasonable and necessary to serve an important public purpose."^{xxviii} "An impairment rises to the level of substantial when it abridges a right which fundamentally induced the parties to contract initially or when it abridges legitimate expectations which the parties reasonably and heavily relied upon in contracting."^{xxix}

Determining that there is an impairment does not end the inquiry. As the Supreme Court in *U.S. Trust* noted:

The Contract Clause is not an absolute bar to subsequent modification of a state's own financial obligations. As with laws impairing the obligations of private contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose.^{xxx}

In *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942), the court sustained the alteration of a municipal bond contract. In *Faitoute*, the New Jersey Municipal Finance Act provided that a state agency could place a bankrupt local government into receivership. Under the law, similar to a Plan of Adjustment for a Chapter 9 municipal bankruptcy action, the interested parties could devise a plan that would be binding on nonconsenting creditors if a state court decided that the municipality could not otherwise pay its creditors and the plan was in the best interest of all creditors.^{xxxi} After certain bondholders

dissented, the court determined that the plan helped the city meet its obligations more effectively. “The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city’s debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired.”^{xxxii} The court then found that the plan protected creditors and was not in violation of the Contract Clause.

Similarly, if a State were able to demonstrate that it was in the impossible situation of choosing between providing essential governmental services and paying pensions and that it could not raise taxes further to fulfill both obligations, a court could find that legislation dealing with and adjusting the pension contracts is valid under the U.S. Contract Clause.^{xxxiii} This Contract Clause analysis is significant since it refutes the argument that Federal State bankruptcy legislation must be enacted because the States themselves cannot act to deal with pensions. Obviously, we are not suggesting that a State can reduce its financial obligations whenever it wishes. There is a difference between inability to pay and an unwillingness to pay. Any modification of pension benefits must be tied to being fair to the workers. Benefits can be adjusted to the extent the labor costs or pension obligations prevent the providing of essential governmental services where no further tax increase is possible. Accordingly, under the right set of facts, where the record demonstrates that the State cannot in good faith marshal any additional revenues or cut any State services without impairing the public welfare, the Contract Clause should not bar State action.

POSSIBLE REMEDIES FOR FINANCIALLY TROUBLED STATES

As noted, the Tenth Amendment to the U.S. Constitution, which is part of the Bill of Rights, reflects the sovereign nature of the States and the Constitution’s principle of Federalism by providing that powers not granted to the Federal Government nor prohibited to the States by the U.S. Constitution are reserved to the States or to the people. Accordingly, Congress cannot

legislate to impose an involuntary debt restructuring procedure on the States. A State is not a municipality within the statutory definition, and hence cannot be a debtor under Chapter 9 of the Bankruptcy Code. However, that does not mean there are not alternatives available to the States to deal with pension issues.

STATE PENSION AUTHORITY

The States themselves can create authorities established to (1) examine the State's pension obligations and the resources available to meet them and (2) if necessary, adjust the pension obligations to an affordable level in the light of other requirements of government. The Civic Federation of Chicago has proposed the creation of an Illinois Municipal Pension Protection Authority ("*IMPPA*") for municipalities to assist units of local government in providing a supervised forum for the determination of what post-employment benefits are affordable and sustainable and should be paid annually, based on the actuarially-required contributions, what cost cutting measures are necessary to achieve affordable and sustainable benefits that do not interfere with the provision of essential governmental services and what contribution increases by both public employers and employees are necessary. A similar authority structure could be devised by and for the individual States where this same type of analysis could take place. Since each State would draft its own unique legislation on a voluntary basis, the sovereign nature of the State would be respected. The pension authority would be a *quasi* judicial body like a special court with specialized expertise and independence. It would only adjudicate labor costs or benefits on an objective, independent basis considering whether those costs were sustainable and affordable and did not interfere with the State providing essential governmental services. The interference with the provision of essential governmental

services would create a governmental emergency. Part of the determination would be through the use of uniform standards for calculating pension liabilities (*“Uniform Protocol for Calculation”*). The use of Uniform Protocol for Calculation might prevent a possible criticism that there could be confusion caused by the possibility of fifty separate criteria for dealing with pension problems. Lack of Uniform Protocol for Calculation could result in confusion of the securities markets and make analysis of the soundness of state indebtedness difficult.

SOVEREIGN DEBT RESOLUTION MECHANISM

Uniform mechanisms for States, like other sovereigns, to utilize in the event of financial distress could also be considered.^{xxxiv} On the global stage, for example, both Greece and Ireland have received emergency funds from the European Financial Stability Facility established by the European Union applying similar principles.^{xxxv}

A sovereign debt resolution mechanism (*“SDRM”*) could be explored which could apply to the States in the United States. While a number of structures can be utilized, there are several leading approaches to a SDRM. On the most basic level, provision can be made for an entity to house a composition of creditors. In other words, a legal forum would be provided for creditors to meet to reach consensus, on a voluntary basis, as to what can be paid, to whom and what should be forgiven and provide a mediation forum for such a result.

Future debt financing also can include a “collective action clause,” which is meeting with increased approval in European debt financings. The collective action clause would be included in the governing documents of a financing, whereby a majority or super majority of parties (debt holders) to that contract have the power to bind all holders to a debt restructuring and, if need be,

forgiveness of debt. This type of provision is not currently acceptable in the U.S. capital markets where the requirement traditionally has been that all holders must consent to the modification of principal or interest on debt outside of a bankruptcy proceeding.^{xxxvi}

Another SDRM approach can be the mandatory inclusion of arbitration clauses in State contracts. One shortcoming is that arbitration does not have the transparency and creditor participation that sophisticated institutions in the United States may require. Arbitration in commercial agreements is often avoided by major institutions, and the same could be true of sovereign debt agreements.

In international finance, informal groups of creditors have gathered together to study ways of assisting troubled sovereigns dealing with unsustainable debt. These groups could serve as models for a SDRM. The Paris Club meets periodically in France and is attended by representatives of the world's wealthiest nations, including the United States. The Paris Club considers, on a confidential basis, requests from beleaguered countries, especially those whose debt stems from military conflict or dictatorship. The Paris Club structures a suggested debt rescheduling or debt cancellation as an alternative to default. The decisions are not legally binding but frequently honored. The London Club, composed primarily of major commercial banks, meets on an *ad hoc* basis on request. It shares the goal of the Paris Club of reduced payments rather than defaults. Thus, the London Club is an informal group of private creditors as compared to the Paris Club of public lenders.

Finally, a dispute resolution forum could be created as a SDRM to verify and reconcile claims and possibly act as a sovereign debt restructuring court or sovereign debt tribunal,

characterized by independence, expertise, neutrality and predictability. Dispute resolution procedures would include an attempt to reach the agreement of the parties. Any restructuring plan would have the vote of the majority of creditors and the ultimate hammer of a sovereign debt tribunal deciding what the path would be if a restructuring plan cannot be approved.

INDEPENDENT FEDERAL COMMISSION

As another alternative to State bankruptcy, Congress could establish an independent commission -- the State Public Pension Funding Commission -- before which States may voluntarily bring an action to restructure their pension obligations. This Commission, much like courts established under Article I of the U.S. Constitution, would be created pursuant to the bankruptcy clause to hear cases brought by financially-challenged States. To protect the sovereignty of the States, only a State could bring an action before the Commission.

To bring an action before the Commission, a State would be required to establish that it is incapable of paying its debts as they mature and provide essential governmental services (a governmental emergency) without relief. The authorizing legislation would set forth certain enumerated factors establishing a governmental emergency (which is the functional equivalent of insolvency for a government) that the State would use as a framework to present its case. A guide to consider in establishing the enumerated factors would be those factors set forth by the State of Pennsylvania in establishing the insolvency of a municipality under Act 47, the *Financially Distress Municipalities Act*, or other similar laws adopted by several States to rehabilitate financially troubled municipalities.^{xxxvii}

Once a State brings an action before the Commission, the Commission first will consider the threshold issue of the governmental emergency. Evidence could be submitted by the State, a representative designated by those currently receiving pension benefits, and a representative designated by its employees eligible for pension benefits. If the Commission determines that the

State is not suffering a governmental emergency and can afford and sustain payment of labor costs and pension obligations without impairing essential governmental services, it would issue a final, appealable decision dismissing the action. Were the Commission to determine that, based on the evidence before it, the State met the definition of governmental emergency, the action would proceed. This is a necessary step because, as discussed, under the Contract Clause of the U.S. Constitution, as interpreted by the U.S. Supreme Court, a State may only impair its contractual obligations where the impairment is necessary and reasonable to serve an important public purpose.

On a finding of governmental emergency, the Commission could then determine after hearing from the State and the designated representative of the workers what is a sustainable and affordable labor cost and pension benefit achievable without impairing essential governmental services. The Commission could then issue an order restructuring the State's pension benefits and other post-employment benefits to a level that would allow the State to continue to provide essential State services while making manageable payments to its pension fund. The Commission could restructure present and future promised benefits to current employees and retirees. The decision of the Commission would be appealable by the State, the designated representative of its current pension recipients or the representative of current, pension-eligible employees.

The Commission's decision would be appealable to a court established under Article III of the U.S. Constitution, such as the U.S. Court of Appeals for the Federal Circuit. The appellate court would review the Authority's decision and either enforce the decision or set it aside based on whether the decision was in accordance with law and supported by the evidence on the record. This is a necessary step because the members of the Authority, although appointed by the President and confirmed by the Senate, would not have the life tenure enjoyed by Article III

judges. Because of the specialized nature of pension obligations and the importance of individuals with independence and expertise in the area reviewing the States' obligations, the Authority would consist of 5 members, appointed for 14 year terms. Limited terms would allow for the turn-over necessary to allow fresh perspectives in balancing the interest of the States and current and prospective State pension recipients.

Once the Commission has issued its final decision and appeals have been exhausted, the State would be required to implement a plan to meet the terms of the Commission's decision. It would be intended that the plan would require annual payments of the actuarially-required contribution ("ARC") for the benefits so ordered by the Commission. If the State fails to take the necessary actions as required by the Commission's order, the Commission would maintain jurisdiction to issue further orders with respect to the enforcement of its decision. For instance, the underlying legislation should provide the Commission with the authority to withhold future federally designated funds to the State if the State fails to tender amounts it was ordered to pay to its pension benefits fund. Other enforcement mechanisms not encroaching on the State's sovereignty would also be advisable.

Although in an ideal world such a Commission would not be necessary, the Commission strikes a balance between a free-for-all bankruptcy proceeding, the rights of those currently receiving pensions, the rights of States employees, and the rights of the residents of the States to receive essential services.

ACCOMPANYING FINANCIAL ASSISTANCE

The legislation creating the Commission could also be accompanied by or could separately provide provisions whereby the Federal Government would back tax exempt bonds issued to restructure pension obligations at the lowest interest rate available for the financing in order to accomplish a real fix to the problem. Sometimes bridge financing is necessary to fix the

problem rather than to defer a resolution for lack of funding. It would be the intent that the State's plan would be a solution and not a band-aid so workers, retirees, taxpayers and the State are assured the problem would not resurrect itself again. When the State's pension problem has been dealt with as a real fix, this provision of financing or financial assistance by the Federal Government could be deemed reasonable.

CONCLUSION

State debt financing in the United States has a proud and successful history. With the exception of the default by Arkansas on highway bonds in 1933, which were quickly refinanced, States have not defaulted on their general obligations since the 1800s. In that era, thirteen States repudiated indebtedness that represented, for the most part, unacceptable overspending of a carpetbagger era after the Civil War. This historical fact is no accident. State governments have relied heavily on cheap financing for funding to bridge uneven tax revenues and to provide needed infrastructure and essential governmental services.^{xxxviii} Having that financing available and inexpensive has allowed State governments to chart their own destiny and develop infrastructure and essential services to suit their tastes and circumstances. However, individuals and market participants are now questioning whether this historic pattern will continue. The reaffirmation of the historical precedent of paying their obligations is essential for State governments if they are to weather the current storms as well as those that are on the horizon. Similar question and debate as to the dependability of municipal debt existed in the 1930s during the Great Depression and the annihilating lawsuits that municipalities faced for delayed or failed payments due to insufficient tax revenues.^{xxxix} That situation brought about Chapter 9, not as a universal remedy, but as a last resort when all else failed.

States have done almost anything to meet their payment obligations and avoid default and repudiation of their obligations. States have not defaulted on their general obligation bonds compared to the over 4,000 defaults in municipal bonds during the Depression that led to the implementation of Chapter 9 of the Bankruptcy Code. Certainly part of the reason has been the need for access to the market and the inexpensive financing. But another motivation has been that, in meeting these obligations, the State is assured that its citizens will continue to receive essential services and there will be steady progress.

The current crises of unfunded pension liabilities, aging infrastructure, increased costs of health, education and safety needs must lead to new, creative ways for States to meet their obligations of providing essential and improving services for a better tomorrow. A less creative and somewhat simplistic approach would be the creation of a bankruptcy court for the States to alleviate the current financial distress. Bankruptcy courts and tribunals do not provide bridge financing or interim provision of essential services. Bankruptcy affects virtually all constituents, taxpayers, government workers, suppliers, essential services and is an expensive, time-consuming, disruptive process that only can be used when there is no feasible alternative - the last resort. As I have indicated, better options need to be considered and put in place before the situation deteriorates. Perhaps the States can consider public pension authorities or similar vehicles if there really is a need to address these issues. As discussed, on the Federal level, the use of a Commission could also be explored. A resolution of the pension problem is conceivably possible at the State level if there is a preliminary determination of a governmental emergency. The use of pension restructuring bonds as part of a permanent fix to the pension problem would be appropriate.

Our future in part depends on our capacity, not to take the easy path, but to address the real problems directly while not destroying that which has worked and is working. Perhaps the next generation of sovereign debt resolution mechanisms will be tied to increased legislative use of oversight, assistance and refinancing authorities that can transfer certain burdensome services to other entities, provide bridge financing and, if needed, identify appropriate new tax sources and coordinate on a regional or state level to ensure the problem is solved and not transferred to another. The new mechanism should not be an approach that affects all constituents, including those who are not part of the problem. Rather, the mechanism should be focused to deal surgically with the problem in a discreet method that does not adversely affect that which works. This will lead to a new, effective mechanism that is less expensive, less intrusive and more focused on precisely what is broken.

ENDNOTES

i In fact, not all fifty States permit their municipalities to file for Chapter 9. Only fifteen States specifically authorize municipal bankruptcies. See:

ALA. CODE 1975 § 11-81-3
 ARIZ. REV. STAT. ANN. § 35-603
 ARK. CODE ANN. § 14-74-103
 CAL. GOV'T CODE § 53760
 IDAHO CODE ANN. § 67-3903
 KY. REV. STAT ANN. § 66.400
 MINN. STAT. ANN. § 471.831
 MO. ANN. STAT. § 427.100
 MONT. CODE ANN. §§ 7-7-132 and 85-7-2041
 NEB. REV. ST. § 13-402
 N.Y. LOCAL FINANCE LAW § 85.80
 OKLA. STAT. ANN. TIT. 62 §§ 281, 283
 S. C. CODE ANN. § 6-1-10
 TEX. LOC. GOV'T CODE § 140.001
 WASH. REV. CODE § 39.64.040

See page 14 of the Background Material for a summary of the State approaches which have been taken with respect to authorizing Chapter 9 filings. Fifteen States specifically authorize municipal bankruptcies. Nine States conditionally authorize municipal bankruptcies. Three States grant municipalities limited authorization, two States prohibit filing but one has an exception and twenty-one remaining States are either unclear or do not have specific authorization to file.

ii The leadership of the National Conference of State Legislatures and the National Governors Association have stated in a joint letter that they “do not support” Federal legislation permitting States to seek bankruptcy protection. The letter is available at <http://www.ncsl.org/default.aspx?TabId=22155>.

iii For a more extensive discussion of these topics, please see the presentation by the author “Unfunded Pension Obligations: Is Chapter 9 the Ultimate Remedy? Is there a Better Resolution Mechanism?” and “Historical and Legal Strengths of State and Local Government Debt Financing,” both of which are available at www.chapman.com/publications.php.

iv See *Gregory v. Ashcroft*, 501 U.S. 452, 457, 115 L. Ed. 2d 410, 111 S. Ct. 2395 (1991).

v See *Blatchford v. Native Village of Noatak*, 501 U.S. 775, 779, 115 L. Ed. 686, 111 S. Ct. 2578 (1991).

vi *Hans*, 134 U.S. at 18.

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- vii *Federal Maritime Commission*, 535 U.S. at 755.
- viii “This Chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise . . .” 11 U.S.C. § 903.
- ix “Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with - (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor’s use or enjoyment of any income producing property.” 11 U.S.C. § 904.
- x *See* States listed in Note 1.
- xi *See* The Bankruptcy Act of 1800, 2 Stat. 19 (1800); The Bankruptcy Act of 1841, 5 Stat. 440 (1841); The Bankruptcy Act of 1867, 14 Stat. 517 (1867); The Bankruptcy Act of 1898, 30 Stat. 544 (1898). That is not to say that there were no defaults in government obligations in the nineteenth century. Indeed, the 1842 default by the State of Pennsylvania on its bonded debt inspired William Wordsworth to pen the sonnet “To the Pennsylvanians” in which he spoke of “won confidence, now ruthlessly betrayed.” It was the defaults of local utility districts and municipalities in the 1800s that tarnished the integrity of the “new frontier’s” obligations. George Peabody, an eminent financier, sought to be admitted to polite English Society only to be rebuffed, not due to his lack of social grace, but because his countrymen did not pay their debts. It was the defaults by State governments in the early nineteenth century and municipalities in the late nineteenth century that brought about the procedures which are now taken for granted, including debt limitations on municipal issues, bond counsel, and clearly defined bondholders’ rights and State statutory provisions relating thereto.
- xii *See* A Commission Report, *City Financial Emergencies: The Intergovernmental Dimension* (Advisory Commission on Intergovernmental Relations, Washington, D.C., July 1973) (“*ACIR Report*”).
- xiii S. Rep. No. 407, 73rd Cong., 2d Sess. (1934).
- xiv 48 Stat. 798 (1934).
- xv 49 Stat. 1198 (1936).
- xvi *See* generally H.R. Rep. No. 207, 73rd Cong., 1st Sess. 103 (1933); H.R. Rep. No. 517, 75th Cong., 1st Sess. 3-4 (1937); H.R. Rep. No. 686, 94th Cong., 1st Sess. 541, 542 (1975); H.R. Rep. No. 595, 95th Cong., 1st Sess. 397-398 (1977); S. Rep. No. 95-989, 95th Cong., 2nd Sess. 110 (1978), reprinted in 1978 U.S.C.C.A.N. 5787.

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- xvii *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 80 L. Ed. 1309, 56 S. Ct. 892 (1936), *reh'g denied* 299 U.S. 619, 81 L. Ed. 457, 57 S. Ct. 5 (1936).
- xviii *United States v. Bekins*, 304 U.S. 27, 82 L. Ed. 1137, 58 S. Ct. 811 (1938), *reh'g denied* 304 U.S. 589, 82 L. Ed. 1549, 8 S. Ct. 1043 (1938).
- xix *Leco Properties, Inc. v. R.F. Crummer & Co.*, 128 F.2d 110 (5th Cir. 1942). Further, the court had no jurisdiction to determine the existence the city or boundary disputes in the nature of *quo warranto*. *Green v. City of Stuart*, 135 F.2d 33 (5th Cir. 1943), *cert. denied* 320 U.S. 769, *reh'g denied* 320 U.S. 813, 88 L. Ed. 491, 64 S. Ct. 157 (1943).
- xx Upon the adoption of the Bankruptcy Reform Act of 1978, the roman numerals which had previously been used to identify chapters of the Bankruptcy Act were abandoned in favor of arabic numbers. Hence, since the effective date of the Bankruptcy Code, "Chapter IX" has become Chapter 9.
- xxi *See, In re Richmond Unified School District*, 133 B.R. 221 (Bankr. N.D.Cal. 1991), (a chapter 9 debtor may voluntarily divest itself by consent of its autonomy rights under § 904 of the Bankruptcy Code.
- xxii U.S. CONST., Art. I, § 10.
- xxiii *U.S. Trust Company v. New Jersey*, 431 U.S. 1, 52 L. Ed. 2d 92, 97 S. Ct. 1505 (1977).
- xxiv *Id.*
- xxv *Id.*
- xxvi *Id.* at 32.
- xxvii For example, *In Royal Liquor Mart, Inc. v. City of Rockford*, the Illinois Second Judicial District identified this test as a three-step test including (1) whether the action in question has operated a substantial impairment of a contractual relationship; (2) if such impairment is found, whether the State can show a significant and legitimate public purpose behind the regulation; and (3) whether the change in rights is based upon reasonable conditions and is of a character appropriate to the public purpose of the regulation. 479 N.E.2d 485, 491, 133 Ill.App.3d 868, 877 (Ill.App.Ct. 1985).
- xxviii *Bricklayers Union Local 21 v. Edgar*, 922 F.Supp. 100, 105 (N.D. Ill. 1996) (citing *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411, 74 L. Ed. 2d 569, 103 S. Ct. 697 (1983)).
- xxix *Id.* at 106-07 (citing *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 246, 57 L. Ed. 2d 727, 98 S. Ct. 2716 (1978)).

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- xxx *U.S. Trust*, 431 U.S. at 25.
- xxxⁱ *Faitoute*, 316 U.S. at 504.
- xxxⁱⁱ *Id.* at 511.
- xxxⁱⁱⁱ *See Id.* (finding provision altering contracts did not violate the contract clause).
- xxx^{iv} The restructuring models utilized by sovereigns is instructive. *See*, Patrick Bolton, “Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World,” IMF Staff Papers, (2003), *available at* <http://www.imf.org/external/pubs/ft/wp/2003/wp0313.pdf>; Randall Dodd, “Sovereign Debt Restructuring,” The Financier, (2002), *available at* <http://www.financialpolicy.org/dscsovdebt.pdf>; John Murray Brown, “Europe Signs up to Irish Rescue,” Financial Times (November 21, 2010) *available at* <http://www.FT.com/cms/s/o/9338047c-f5a0-11df-99d6-00144feab49a.html>.
- xxx^v Jan Strupczewski and Padraic Halpin, “Ireland in aid talks with EU, Rescue Likely,” Reuters, November 12, 2010, *available at* <http://www.reuters.com/article/2010/11/13/us-g20-ireland-idUSTRE6AB0P420101113>.
- xxx^{vi} *See* Trust Indenture Act of 1939, Section 316(b).
- xxx^{vii} *See also*:
- Rhode Island: R.I. Gen Laws §§ 45-9-1 to 45-9-17 (Budget Commission);
- New York: N.Y. Local Finance Law §§ 85.00 to 85.90 (Emergency Financial Control Boards)
N.Y. Unconsol. Ch. 22, § 5 (New York Financial Control Board).
- xxx^{viii} See the accompanying slides which graphically portray this fact.
- xxx^{ix} *See generally*, ACIR Report at pp. 11-16.

ATTACHMENT

U.S. House of Representatives
House Judiciary Committee's
Subcommittee on Courts, Commercial and
Administrative Law

Hearing on
The Role of Public Employee Pensions in
Contributing to State's Insolvency and the
Possibility of a State Bankruptcy Chapter
Background Material for Testimony

of
JAMES E. SPIOTTO
February 2011

© 2011 by James E. Spiotto. All rights reserved. This is a preliminary work, paper for a chapter on Sovereign Debt Defaults and Debt Resolution Mechanisms for an upcoming book entitled *The Oxford Handbook of State and Local Government Debt* to be published by Oxford University Press. John Petersen and Robert Ebel, editors. Selected material is taken from Chapters 9 and 44, written by James E. Spiotto in *The Handbook of Municipal Bonds* published by John Wiley & Son. Sylvain G. Faldestein, Frank J. Fabozzi, editors.

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I. A Proud History of State and Local Government Financing

Prior to 2000 and the Dawn of this Century, State and Local Government Financing funded the most sophisticated Public Works System in the World, including:

- 3,866,000 Miles of Roadways
- 565,000 Bridges
- 1,000 Public mass transit systems
- 16,000 Airports
- 25,000 Miles of in coast and intercostals waterways
- 70,000 Dams
- 900,000 Miles of pipe in water systems
- 15,000 Waste water treatment plants

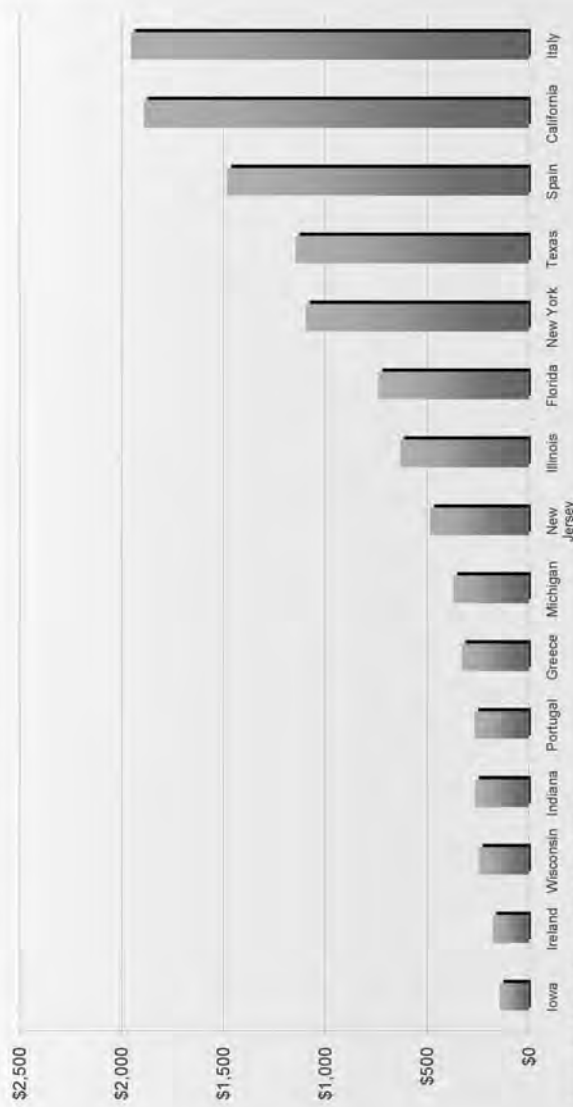
while at the same time assuring the funding of operation and infrastructure of the States, Cities, Towns and Villages of the largest economy in the World.

II. Default Statistics

Will any U.S. state become the next Greece or one of the PIIGS (Portugal, Italy, Ireland, Greece and Spain)?

- The per capita GDP of each of California, Texas, Florida, New York, Illinois and New Jersey (certain "Major U.S. States") is higher than Portugal, Greece, Italy and Spain.
- The percentage of debt to revenue ratio is lower for Major U.S. States than Portugal, Italy and Greece.
- The percentage of debt to GDP is lower for certain Major U.S. States than Spain, Ireland, Portugal, Greece and Italy.
- Market perception can be different than reality. Look at Credit Default SWAPs ("CDS") for certain Major U.S. States and the PIIGS, where Italy, Spain, Ireland, Portugal have lower CDS spreads than New Jersey, New York, California and Illinois.

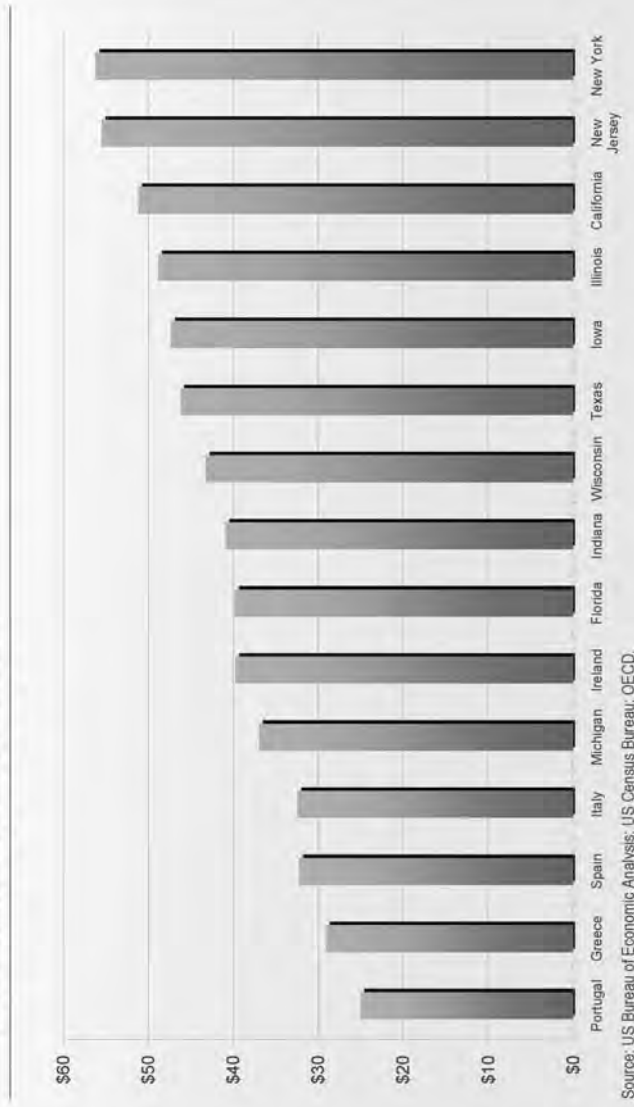
II. GDP of Selected U.S. States and European Countries Billions of 2009 USD



Source: US Bureau of Economic Analysis, OECD.

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II. GDP per capita of Selected U.S. States and European Countries Thousands of 2009 USD



Source: US Bureau of Economic Analysis; US Census Bureau; OECD.

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II. Debt-to-Revenue Ratio of Selected U.S. States and European Countries (2008 figures)



Source: US Bureau of Economic Analysis; US Census Bureau; Eurostat; OECD.

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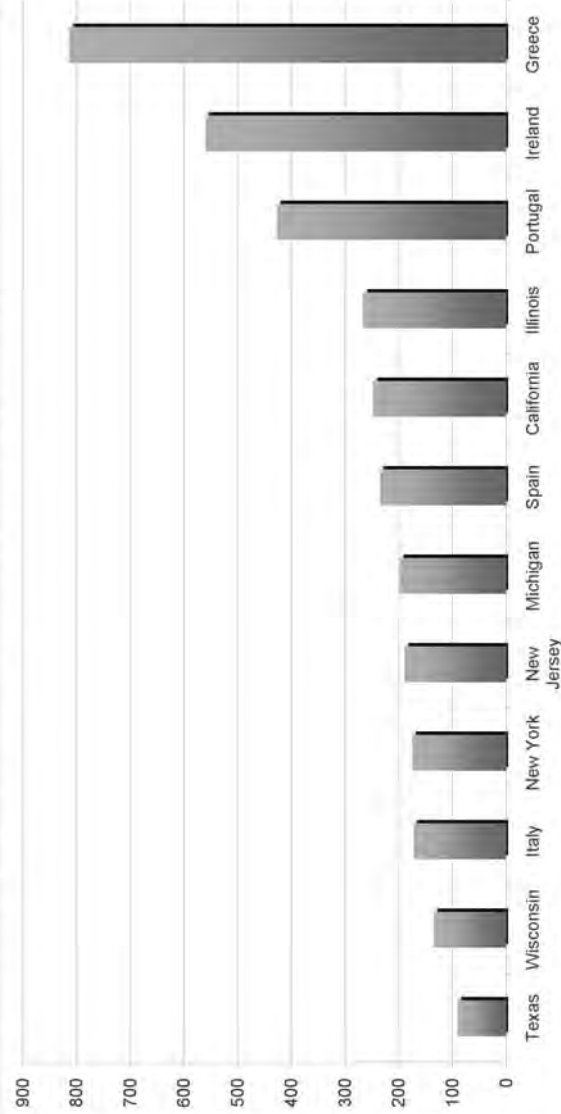
II. Debt-to-GDP Ratio of Selected U.S. States and European Countries (2008 figures)



Source: US Bureau of Economic Analysis; US Census Bureau; Eurostat; OECD.

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II. Credit Default Swap Spreads (bps) of Selected U.S. States and European Countries

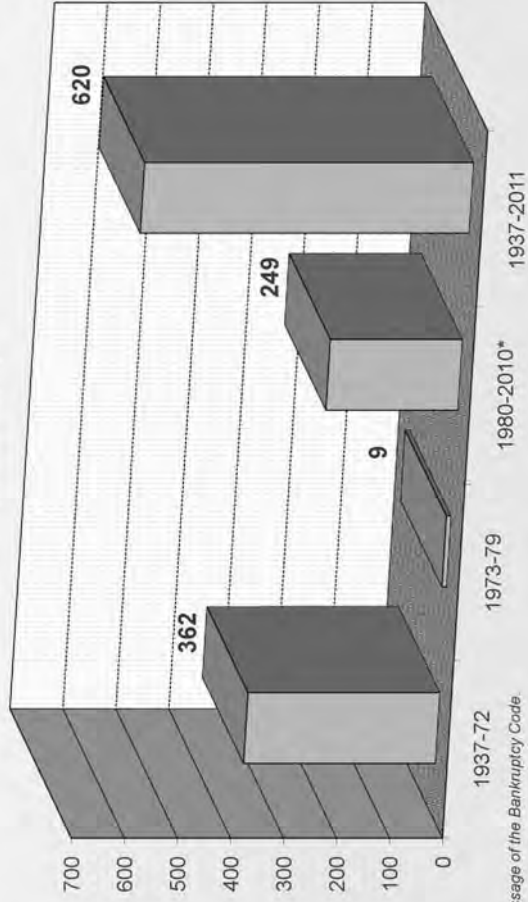


Source: Bloomberg (February 8, 2011).

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III. Municipal Bankruptcy

FREQUENCY OF MUNICIPAL BANKRUPTCIES • 1937-2011
(as of 2/7/2011)

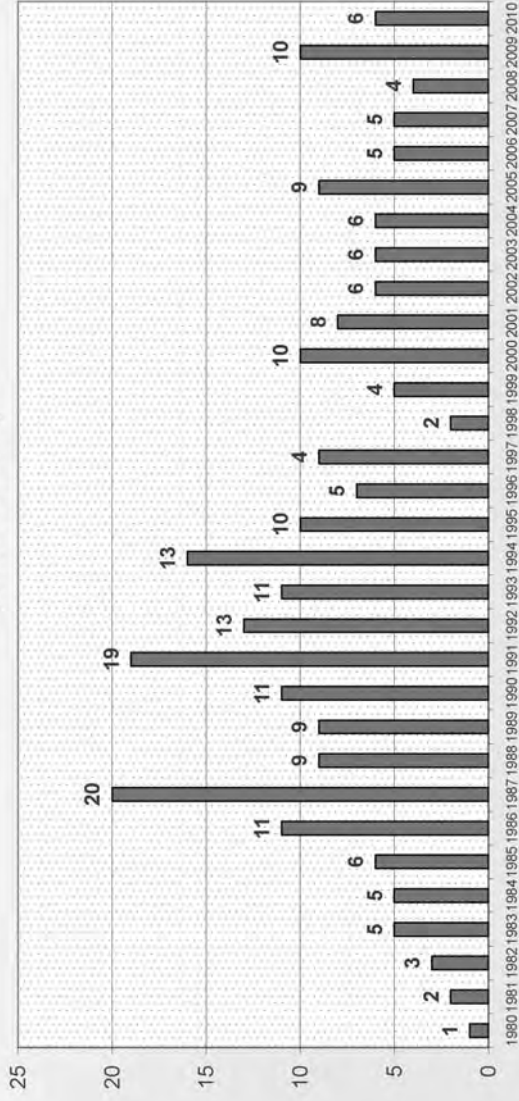


* Since passage of the Bankruptcy Code.

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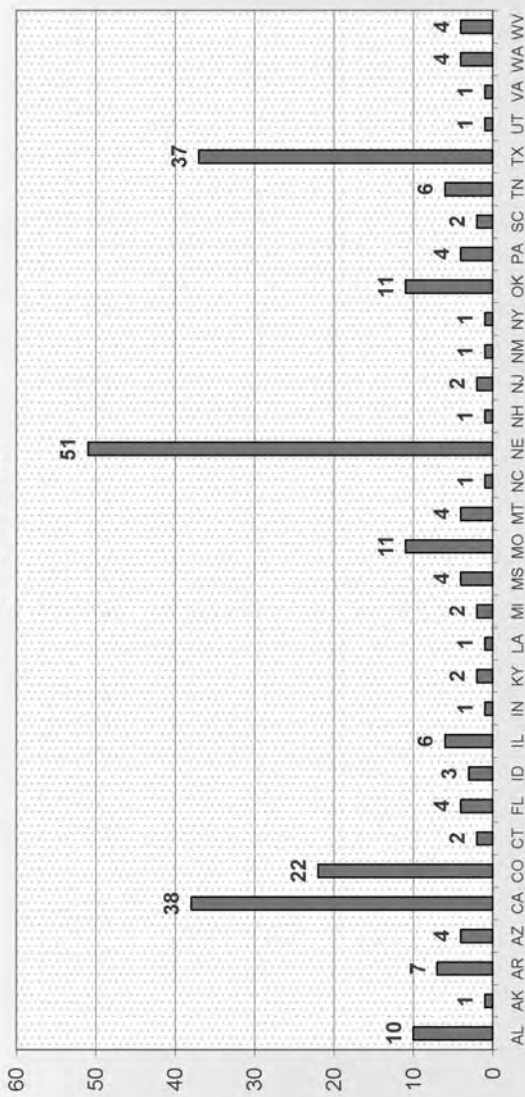
III. Municipal Bankruptcy

CHAPTER 9 FILINGS BY YEAR • 1980-2011
(as of 2/7/2011)



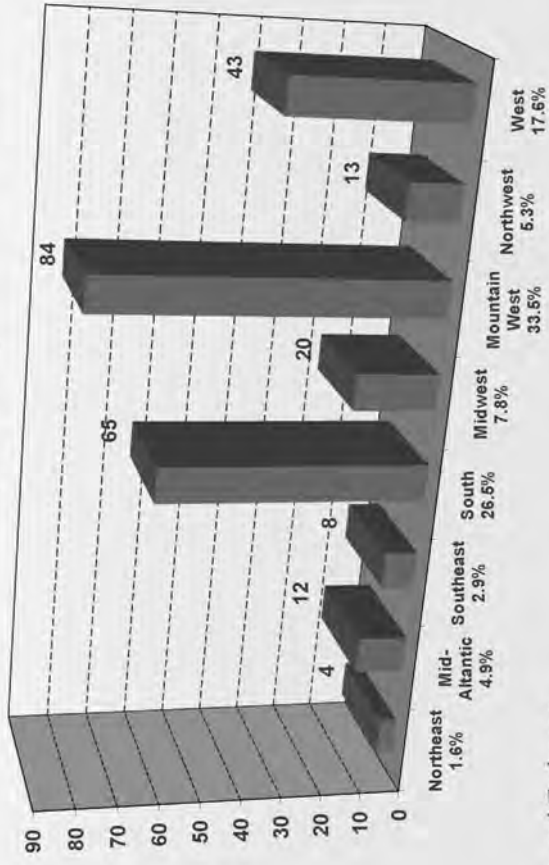
III. Municipal Bankruptcy

CHAPTER 9 FILINGS BY STATE • 1980-2011
(as of 2/7/2011)

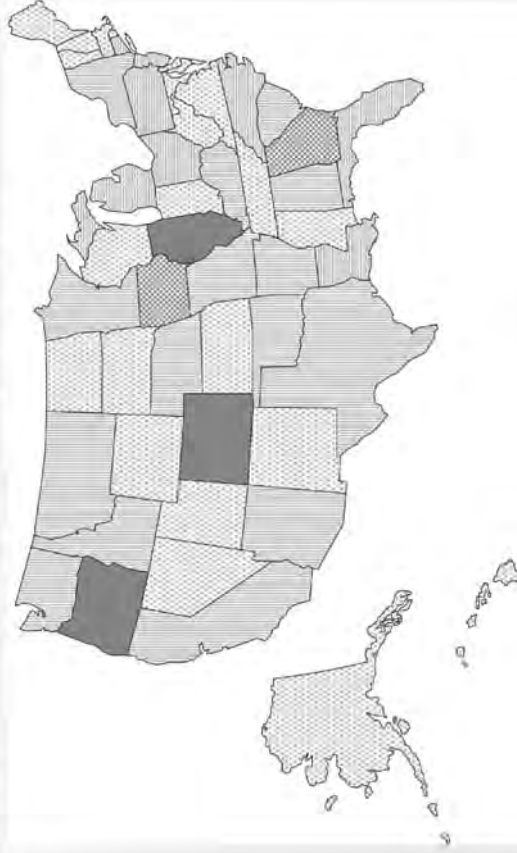


III. Municipal Bankruptcy

CHAPTER 9 FILINGS BY REGION • 1980-2011
(as of 2/7/2011)



IV. General Analysis of State Specific Authorization for Municipalities to File a Chapter 9 Case



- 15 States that specifically authorize municipal bankruptcies
- 9 States that conditionally authorize municipal bankruptcies
- 3 States with limited authorization
- 2 States prohibit filing, but one has an exception (Iowa)
- Remaining 21 States are either unclear or do not have specific authorization so there is no specific authorization

IV. General Analysis of State Specific Authorization for Municipalities to File a Chapter 9 Case

The following are statutory provisions in which states have authorized Chapter 9 filings for certain governmental entities

15 States that specifically authorize municipal bankruptcies:

Ala. Code 1975 § 11-81-3
 Ariz. Rev. Stat. Ann. § 35-603
 Ark. Code Ann. § 14-74-103
 Cal. Gov't Code § 53760
 Idaho Code Ann. § 67-3903
 Ky. Rev. Stat. Ann. § 66-400
 Minn. Stat. Ann. § 471.831
 Mo. Ann. Stat. § 427.100
 Mont. Code Ann. § 7-7-132
 Neb. Rev. St. § 13-402
 N.Y. Local Finance Law § 85-80
 Okla. Stat. Ann. tit. 62 §§ 281, 283
 S.C. Code Ann. § 6-1-10
 Tex. Loc. Gov't Code § 140.001
 Wash. Rev. Code § 39.64.040

9 States that conditionally authorize municipal bankruptcies:

Conn. Gen. Stat. Ann. § 7-566
 Fla. Stat. Ann. § 218.01
 La. Rev. Stat. Ann. § 39-619
 Mich. Comp. Laws § 141.1222
 N.J. Stat. Ann. § 52:27-40
 N.C. Gen. Stat. Ann. § 23-48
 Ohio Rev. Code Ann. § 133.36
 53 Pa. Cons. Stat. Ann. § 11701.261
 R.I. Gen. Laws § 45-9-7

3 States with limited authorization

- Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1403 of the Colorado revised statutes states that "any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition..." (CRS § 37-32-102 (Drainage & Irrigation District))
- Oregon permits Irrigation and Drainage Districts to file (Or. Rev. Stat. § 548.705)
- Illinois - specific authorization solely for the Illinois Power Agency (20 Ill Comp. Stat. Ann. 38551-201b)(15). The Local Government Financing and Supervision Act permits that commission to recommend that the Legislature authorize a filing but it is not specific authorization (20 Ill. Comp. Stat. Ann. 3209(b)(4))

2 States prohibit filing but one has an Exception

- Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 78.18) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 76.16A)
- Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

The 21 Remaining States are either unclear or do not have specific authorization.

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Attorneys at Law - Township of Franklin, NJ

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Mr. COBLE. Mr. Fabian, you are recognized for 5 minutes.

**TESTIMONY OF MATT FABIAN, MANAGING DIRECTOR,
MUNICIPAL MARKET ADVISORS, WESTPORT, CT**

Mr. FABIAN. Thank you very much, Mr. Chairman and the Committee, for inviting me here to speak.

I will skip over the details of my bio in the first paragraph. But just to emphasize, Municipal Market Advisors, the company for which I work, is a pure independent research company, so we don't buy or sell any bonds or securities. We don't advise in that. We are just—the near entirety of our revenues come from the sale of research and subscriptions to that.

Legislating State bankruptcy would certainly disrupt the current municipal bond market and undermine investor confidence going forward. We strongly believe that the municipal bond prices would fall, yields would rise, were States made able to file for bankruptcy. For longer-maturity bonds, interest rates could easily rise by 10 to 20 percent versus current levels. Shorter-maturity bonds should weaken somewhat less.

In large part, the yield increase belies the municipal industry's already highly conservative practice in assessing credit and default risk. The prospect of State bankruptcy, however remote, requires a much more corporate-like measure of risk and reward. This is because bankruptcy within a Federal court makes vulnerable the robust protections for bondholders—for example, first payment priorities and senior liens on tax revenues now provided by State bond laws and State constitutions.

The adjustment in yields could happen quickly, but any increase in rates, and thus increases in the cost of new infrastructure, would persist in the long term. From a policy perspective, this means upward pressure on State and local taxes, downward pressure on spending and State employment.

While the impact would be greatest on States perceived to be most likely to file for protection, like Illinois and California, all States, including those who have well-managed pensions and budgets, would reasonably pay a substantive penalty while coming to market for new loans. In effect, all States would suffer for the perceived faults of a few.

And because States and local governments are deeply intertwined with management of tax collections, spending and mandates, the impact would not be confined to just States but, rather, to all local governments. In addition, we would expect that school districts, which are essentially creatures of the States, rural issuers, and poor urban governments are those entities most dependent on State aid for revenue, would feel the brunt of investor rejection.

It is difficult to isolate the threat of State bankruptcy as a variable amid the recent losses in the municipal bond market. It is also contesting with a weaker Treasury market, the pervasive headlines of looming collapse, and the poor communication between the industry professionals and our investors. But keep in mind that, despite these adverse vectors, long-term municipal yields, as described by the Bond Buyer 20 yield index of high-grade, general obligation credits, are still 125 basis points below their average over the last 30 years. So, in other words, while market participants are following the current debate extremely closely, they are not yet pe-

nalizing issuers to the extent that might be required should State bankruptcy become law.

And while some observers have defined many States as already insolvent, professional market consensus does not support this view. Rather, the majority of institutional investors, municipal credit analysts, and issuer groups appear to believe that States already retain sufficient abilities to manage their short- and long-term liabilities without need of bankruptcy or other potential forms of Federal bailout. Thus, the immense economic and political costs of a hypothetical State bankruptcy filing reasonably outweigh the need for such an extreme remedy. We agree with this view.

Proponents of the bankruptcy legislation might argue that this law would simply add to the State managers' toolbox as a strategy of last resort. Thus, investors who are more bullish over States' economic or financial prospects could disregard the risk of any future filing. But this disregards the municipal credit analyst's duty to focus on worst-case scenarios and to protect their portfolios, their investors, and issuers themselves from default.

And, in practice, investors could not expect all elected officials within a State legislature to not at least discuss or threaten the use of bankruptcy while outside observers, political pundits, dedicated academics, journalists, and the like could be counted upon to remind the broader markets of the tool and its potential implications for various stakeholders. Thus, even an unused bankruptcy law would amplify related headline risk that has already been highly disruptive to normal capital market functions, exacerbating systemic illiquidity and pushing yields and spreads higher.

Thank you very much.

[The prepared statement of Mr. Fabian follows:]

Prepared Statement of Matt Fabian



PRESENTATION TO HOUSE JUDICIARY COMMITTEE, SUBCOMMITTEE ON COURTS,
COMMERCIAL, AND ADMINISTRATIVE LAW

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February 14, 2011

THE MUNICIPAL BOND MARKET AND STATE BANKRUPTCY

Thank you for providing the opportunity to present our thoughts on the potential market impact of legislation to allow US states to file for protection under the federal bankruptcy code. To briefly introduce myself and my firm, I am a managing director at Municipal Market Advisors ("MMA"), an independent research and strategy group based in Concord, Massachusetts. MMA does not buy, sell, or trade any bonds or financial instruments or advise on their trading; rather, our sole product is research, commentary, and training on the municipal bond market for active market participants. Personally, I have been a municipal credit analyst since 1993, and I'm the current chair of the Municipal Analysts Group of New York and a board member for the National Federation of Municipal Analysts. In my comments today, however, I solely represent my own views and those of my firm, MMA, and not the views of any other group with which I am affiliated.

- Legislating state bankruptcy would disrupt the current municipal bond market and undermine investor confidence going forward. We strongly believe that municipal bond prices would fall, yields would rise, were states made able to file for bankruptcy. For longer maturity bonds, interest rates could easily rise by 10-20% versus current levels. Shorter maturity bonds would weaken somewhat less.
- In large part, this yield increase would belie the municipal industry's already highly conservative practice in assessing credit and default risk. The prospect of state bankruptcy, however remote, requires a much more corporate-like measure of risk and reward. This is because bankruptcy within a Federal court makes vulnerable the robust protections for bondholders (for example, first payment priorities and senior liens on tax revenues) now provided by state bond laws and state constitutions.
- The adjustment in yields could happen quickly, but any increase in rates—and thus increases in the cost of new infrastructure projects—would persist in the long term. From a policy perspective, this means related upward pressure on state and local taxes, downward pressure on spending and state employment.

This statement has been prepared by Municipal Market Advisors

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PRESENTATION (CON'T)

- While the impact would be greatest on states perceived to be most likely to file for protection (e.g. Illinois and California), ALL states—including those with well managed pensions and budgets alongside the profligate—would reasonably pay a substantive penalty when coming to market for new loans. In effect, all states would suffer for the perceived faults of a few.
- And, because states and their local governments are deeply intertwined with management of tax collections, spending and borrowing programs, and mandates, the impact would not be confined to just states, but rather to all local governments. In addition, we'd expect that school districts; smaller, rural issuers; and poorer, urban governments—those entities most dependent on state aid for revenue—would feel the brunt of investor rejection.
- It is difficult to isolate the threat of state bankruptcy as a variable amid recent losses in the municipal market, which is also contesting with a weaker Treasury bond, headlines of looming issuer collapse, and poor communications between industry professionals and retail investors. But keep in mind that, despite these adverse vectors, long term municipal yields—as described by the Bond Buyer 20 yield index of high grade, general obligation credits—are still 125 basis points below their average over the last 30 years. In other words, while market participants are following the current debate extremely closely, they are not yet penalizing issuers to the extent that might be required should state bankruptcy become law.
- While some observers have defined "many" states as already "insolvent", professional market consensus does not support this view. Rather, the majority of institutional investors, municipal credit analysts, and issuer groups appear to believe that states already retain sufficient abilities to manage their short and long term liabilities, without need of bankruptcy or other potential forms of federal bailout. Thus, the immense economic and political costs of a hypothetical state bankruptcy filing reasonably outweigh the need for such an extreme remedy. We agree with this view.
- Proponents of this bankruptcy legislation might argue that this law would simply add to the state manager's toolbox as a strategy of last resort; thus, investors more bullish over a state's economic or financial prospects could disregard the risk of any future filing. However, this perspective disregards municipal credit analysts' duty to focus on worst case scenarios to protect their portfolios, their investors, and issuers themselves from default. And in practice, investors could not expect ALL elected officials within a state legislature to not at least discuss or threaten the use of bankruptcy, while outside observers, political pundits, dedicated academics, journalists, etc., could be counted upon to remind the broader markets of the tool and its potential implications for various stakeholders.
- Thus even an unused bankruptcy law would amplify related headline risk that has already been highly disruptive to normal capital markets functions, exacerbating systemic illiquidity and pushing yields and spreads higher.

FURTHER DISCUSSION AND THE EXAMPLE OF ILLINOIS

The municipal bond market has long afforded state and local governmental borrowers a low cost of capital to finance infrastructure, not only through use of the federal tax exemption and other subsidies, but also because of excellent issuer credit quality and low historical default rates. The latter follows a number of factors, including a general lack of refinancing pressure (which mitigates issuers' vulnerability to a loss of market access); very manageable annual debt service expenses; the limited benefit from, and lopsided costs of, default; close supervision of transaction structuring by analysts worried exclusively over default risk; flexibility by states to set revenue and spending policies and account for same; steadily improving management sophistication; and, perhaps most importantly, the exceptional structural protections of bondholders versus other government stakeholders as granted by state bond laws and state constitutions.

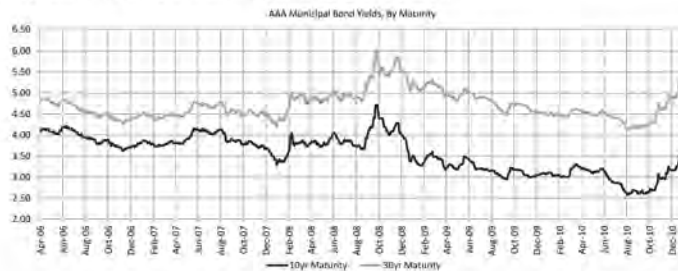
A hypothetical law to permit states to seek bankruptcy protection in Federal court would materially weaken our view, and we assume the market's view, of exactly these structural protections, aligning municipal default risk much more closely to the US corporate bond sector. For example, let's look at the state of Illinois. Pursuant to state law, the governor of Illinois has no discretion over whether or not to pay debt service; he or she must appropriate for the full payment of any outstanding general obligation debt. Again by state law, the state actually pays debt service by segregating sufficient cash at the end of each month to cover 1/6th of all coming semi-annual interest payments and 1/12th of all principal payments. Cash is deposited in the General Obligation Bond Retirement and Interest (GOBRI) Fund, which cannot be tapped for any other purpose. According to the Civic Federation's Institute for Illinois Fiscal Sustainability, "the monthly transfers to the GOBRI fund needed to make the State's debt service payments in FY11 will average between \$230MM and \$250MM ... compared to the estimated monthly General Fund receipts and transfers in ranging from \$2.3Bn and \$1.4Bn." This implies minimum five times monthly coverage by revenues, a good portion of which are under the complete and sovereign control of the state itself. And, should the General or Road Fund revenues be inadequate, or should the General Assembly not also appropriate for the payment of debt service, state law institutes an, "irrevocable and continuing appropriation of all amounts necessary for that purpose" along with compelling the state treasurer and comptroller to implement these actions as required.

In other words, Illinois' payment of debt service is effectively made senior to any other obligation of the state, while the monthly segregation schedule helps negate timing, seasonal, liquidity, and even political hurdles that might arise. It is thus very hard to see ANY problem with payment of debt service on the state's long term debt, even under the most strenuous or long-term scenarios being played in the media. And so, despite the state's extremely difficult budget situation, management's limited willingness to make structural corrections to that budget problem instead of relying on gimmicks and borrowing, and its enormous long term pension funding challenges, investors continue to buy and hold state of Illinois general obligation bonds. Were a hypothetical law passed to allow Illinois to file for bankruptcy, the state's GOBRI and other legal bondholder protections become potentially vulnerable to revision, while debts could be adjusted outside of these mechanisms altogether. This completely changes the measure of risk in holding state of Illinois paper, forcing yields higher. Similarly, investor and regulator demands for better financial and event disclosure would grow, bolstering efforts for SEC regulation of municipal issuers and bond issues. The economic and political cost of compliance with much stronger disclosure requirements would add to budget pressure, again increasing the potential for tax increases and/or spending reductions.

THE MUNICIPAL BOND MARKET IS FRAGILE BUT SURVIVING AT PRESENT

Since the summer of 2007, the US municipal bond market has experienced extraordinary price and volume volatility because of the housing market crisis, the flight to safety in Treasury securities, downgrades to the bond insurers, the auction rate securities collapse, the unwinding of leveraged bondholders, the downfall of Lehman Brothers and other bank counterparties, the ARRA and its Build America Bonds Program, the expiration of that program, the reversal of flight to safety demand for Treasuries, and, most lately, media pundit guesses that widespread municipal bond defaults are imminent. Tax exempt bond yields, which reached historical highs in 4Q08 amid forced selling by hedge funds and dealer proprietary desks, achieved all-time lows in 3Q10 because of relative product scarcity—most longer maturity, high grade issuance was being sold through the BAB program—and, drawn along with the Treasury market, have now climbed back to somewhat elevated levels. Still, media coverage analogizing municipal bonds as the next “subprime” collapse, not to mention a broader realization among investors of this market’s fundamental complexity and time-intensive demands on investment management, have precipitated large de-allocations to municipal portfolios. This has come via withdrawals from tax-exempt mutual funds, a weak reinvestment of principal payments being received by retail investors, and larger institutional portfolio downsizing to address liquidity, pricing, and credit concerns at both the portfolio manager and senior executive level. Further, weaker and inconsistent demand, in particular within the legacy of the financial collapse of 2007 to 2009, means that underwriters are currently less able to carry unsold loan proceeds when they bring a new bond to the primary market, meaning they cannot cushion poorly received primary loans with their own buying power as formerly. Issuers are thus already paying somewhat higher interest rates to help bonds move more quickly to buy-and-hold accounts, in addition to paying wider spreads and adhering to more stringent credit conditions.

So municipal issuers, apparently on expectation of a quick rebound in the bid side, have been reluctant to bring new loans in the primary market, depriving participants of what has historically been our market’s prime source of price discovery and, paradoxically, worsening illiquid conditions. This will drive a far lower new issue calendar in 2011 than in 2010; MMA has estimated long term sales will decline from \$430Bn last year to \$350Bn this year, with likely more downside than upside in that projection. And finally, while there has very recently been some opportunistic bidding for bonds by non-traditional municipal investors, our market will need a better bid from traditional institutional accounts before yields and spreads can become more organized and persistent. The concept of state bankruptcy is helping to delay this return.



On fears of sweeping credit defaults, MMA believes that, while a change in current default trends to a much higher level is possible, much more likely is a continuation of very low default activity for governmental and “safe sector” issuers. Historically, rating agency studies have shown that AAA-rated corporate bonds have defaulted almost ten times more frequently than single-A-rated municipal bonds. However, MMA also maintains a database of all ongoing default and impairment filings made to the MSRB’s EMMA system since July 1, 2009. These show that current municipal default activity is largely confined to smaller, non-rated transactions with security pledges that skew almost entirely to so-called “risky” sectors, meaning bond types that have been responsible for the large majority of payment defaults over the last four decades. As of January 28, 2011, there were \$8.1Bn of municipal bonds outstanding (issued by 258 different entities) where there is an uncured default in either principal or interest. Of those 258 entities, 117 were special districts created to speculate on the development of a real estate property or properties, 47 were bonds backed by the net income of an apartment building, and 27 were bonds backed by nursing homes. Only 15 of the 258 entities sold bonds that initially carried any rating at all, implying an effective default rate of less than 0.1% among the 25,000 or so rated municipal entities. Finally, none of these 258 bonds in payment default are

THE MUNICIPAL BOND MARKET IS FRAGILE BUT SURVIVING AT PRESENT (CON'T)

"traditional" munis, meaning governmental general obligation bonds. Thus, while fears persist of a looming credit crisis, that crisis, to date, has yet to begin. We also note that there are \$9.0Bn of outstanding municipal bonds that most recently relied on emergency sources (such as reserve funds or bond insurance) to cover debt service and have not yet replenished or repaid those source. And there is another \$8.0Bn of municipal bonds where management notes some financial pressure but is still able to service its debt by regular means.

Par (and #) of Loans Impacted in Notices of Payment Defaults and Credit Impairments (\$MM)				
Sector	All Notices	DEFAULT	Support	Other
ALL	\$25,121 (566)	\$8,111 (258)	\$8,974 (200)	\$8,035 (108)
Land Secured	\$4,432 (233)	\$2,261 (117)	\$1,585 (97)	\$585 (19)
Toll Road/Transit	\$1,760 (5)	\$1,488 (3)	\$143 (1)	\$129 (1)
Tribal	\$1,400 (7)	\$1,385 (6)	none	\$15 (1)
Housing	\$901 (63)	\$736 (47)	\$129 (12)	\$35 (4)
Retirement	\$1,591 (52)	\$685 (27)	\$263 (7)	\$643 (18)
Hotel	\$696 (12)	\$338 (5)	\$260 (6)	\$98 (1)
Hospital	\$1,401 (29)	\$288 (7)	\$692 (6)	\$421 (16)
Other Risky Sectors	\$5,818 (121)	\$882 (43)	\$1,732 (52)	\$3,204 (26)
Sale Sectors (GD, Wtr/Swr, Sales Tax)	\$7,122 (44)	\$47 (3)	\$4,173 (19)	\$2,904 (22)
Initially Non-Rated Bonds	\$9,278 (402)	\$5,006 (216)	\$2,614 (131)	\$1,658 (55)
Initially Insured/LDC Bonds	\$9,089 (80)	\$827 (5)	\$5,631 (44)	\$2,631 (31)
Initially Rated, Uninsured Bonds	\$5,398 (43)	\$1,306 (14)	\$427 (16)	\$1,665 (13)

PUBLIC PENSIONS AND THE MUNICIPAL BOND MARKET

As the recession has taken its toll on equity and alternative investment valuations, state and local pension systems have reported steep deterioration of assets and a resulting sharp growth in unfunded liabilities. This is a source of alarm for some municipal investors and commentators, reflecting widespread misunderstanding of the distinction between bondholder and other state government stakeholder risks. Because, while pension costs will, over the next twenty years, draw an increasing share of tax revenues away from more growth-friendly investments like infrastructure, education, and social services, there is only a remote risk of these costs getting between issuers and current bondholders.

This is not to say that long-term defined benefit funding challenges haven't grown worse; they have. Through September 2010, the US Census shows the 100 largest public pension plan assets at \$2.5Tr, down from \$2.9T at the end of 2007. Meanwhile estimates of unfunded pension benefit liabilities are at least \$800Bn, and, because public pension accounting rules employ what some have called aggressive liability discounting assumptions, this number may greatly understate the true gap in funding of future retiree costs. What's more, the severe and continuing recession in state tax revenues has led many governments to defer, restructure, or borrow for current employer contributions and/or unfunded liability amortizations, exacerbating the asset gap and undermining managers' aspiration to fiscal discipline.

Still, pension funding challenges are only an oblique threat to the near- and long-term payment of municipal bond debt service, and thus the municipal bond market itself.

- While total pension liabilities are very large, it is annual servicing charges and their related impact on state cash flow that is relevant to bondholders who are also being paid out of annual cash flow. And, with only 3% of state budgets currently being used to cover annual employer contributions to pensions, pension funds are not a prime source of budget distress. Even assuming a doubling or tripling of annual employer contributions, bondholders—who themselves receive 5-10% of state budgets via annual principal and interest payments—will feel only a modest competitive threat from pension funding needs.
- Unlike US corporations, which MUST amortize unfunded pension liabilities over seven years, the Governmental Accounting Standards Board (GASB) has given states and local governments thirty years to pay down their gap. Of course, this depends on whether or not the states choose to abide by GASB at all. Annually budgeted pension payments—away from actual benefit payments to current retirees which can approximate a state's obligation to pay GO debt service—are thus effectively optional, at least in a legal sense. (Were they not so optional, it is unlikely that such large deficits would exist in the first place). Recently introduced legislation to enhance and standardize the reporting of state pension liabilities may provide a modest benefit to analysts seeking more malleable information when constructing long-term state financial projections, although, again, higher disclosure costs and a new set of official numbers may put upward pressure on taxes and increase political volatility.
- Regarding actual benefit payments, states currently pay their retirees about \$150Bn per year in regular pension disbursements according to Novy-Marx and Rauh. The authors project that annual payments to current retirees and retired current employees will increase to about \$300Bn per year by 2030, meaning the states will likely need to source an additional \$150Bn in annual spending over the next twenty years. While this number is steep, it is still less than the immediate revenue crisis of the current recession. The National Conference of State Legislatures shows that, since FY08, states have closed cumulative budget gaps of \$414Bn. And of course, in their pension funds, the states have already accrued substantial cash balances in anticipation of this burden. The retirement costs of employees not yet hired are more manageable as these can, have been, and likely will continue to be reduced in future labor agreements.
- Keep in mind that state-by-state choices for addressing long-term funding gaps can have an impact on the state's near-term headline and rating risk and can even create actual credit risks. For example, Illinois' repeated decision to borrow in the public debt markets to fund both immediate and long-term pension costs has reduced that state's annual budgetary discretion, to the detriment of its ratings and capital market access costs. While the risk of Illinois actually defaulting on a bonded obligation is remote (see above), its continual replacement of flexible with inflexible obligations is making future budget challenges larger and weakening the state's ability to invest in projects for economic growth and education.
- In funding their future retiree costs, states make a combination of 1) regular employer contributions and 2) unfunded liability amortization payments. To cushion the General Fund against volatility in the latter, states typically smooth annual returns on invested assets over five years. So a large bull market will dramatically diminish a state's calculated unfunded liability, while a large sell-off will not dramatically reduce projected asset values. Thus, while assets under management at state pensions have been rising since June 2009, calculated funding gaps will continue to widen over the next few quarters as the

PUBLIC PENSIONS AND THE MUNICIPAL BOND MARKET (CON'T)

states slowly incorporate the impact of the market selloff in 2008.

- Consistently high liability funding ratios are not necessarily optimal as these can be subject to incremental benefit grants to employees, the implementation of high cost/high risk investing strategies, or employer payment holidays. We'd also argue that low funding ratios, in concert with long-term strategies to steer excess cash or credit into infrastructure and education or lower state taxes, might better facilitate tax base development, bolstering future tax revenues with which retirees can be paid.
- And finally, we believe that state and local pensions receive excessive attention because long term liabilities are easily visualized in accountants' reports. The fundamental issue for the country is the extent to which future retirees will have sufficient financial resources to live without undue stress. The recent recession—and its impact on long-term 401k and housing values—has created an enormous future funding challenge for non-pensioned employees and retirees. In our opinion, the impact of diminished retiree financial resources on a consumption-based economy like our own is likely to have more dramatic ramifications for the private than the public sector over the next several decades.

THE MUNICIPAL BOND MARKET AND STATE BANKRUPTCY

MMA The Power
of Independence**BANKRUPTCY AND THE MUNICIPAL BOND MARKET**

In the past, Chapter 9 bankruptcy has been seldom used by the local governments allowed to file for protection under their respective state laws. This limited use has meant: 1) few precedents as to the treatment of bondholders in bankruptcy, allowing 2) substantial room for speculation as to what would happen under a state bankruptcy. Still, it does not appear that state bankruptcy would be the financial panacea its proponents expect. In most recent cases, municipal bankruptcies have not resulted in serious losses to either bondholders or existing pensioners.

Below we show a table of all 25 Chapter 9 filings since 2007, including five in 2007, four in 2008, ten in 2009 and six in 2010. Sixteen of these governments had a total of \$627MM in debt outstanding at the time of filing, although more than half of that was issued by the Connector 2000 Association toll road in South Carolina, which filed last year. In that case, bondholders have tentatively agreed to large haircuts in their principal, in particular for subordinate debt holders; however, most filings have not resulted in significant impairments to bondholders. The second largest case in the table, the \$103MM Valley Health System in CA, saw redemption of all bonds at par. Vallejo is third-largest filing at \$52MM, and we note the city's recent proposal to repay all outstanding par plus interest, although not penalty interest currently due. Note that, contrary to fears at the time and since, Vallejo remains the last governmental entity (meaning a regular city or county or school district) with any public debt outstanding to file for bankruptcy. Importantly, Vallejo entered Chapter 9 ostensibly to restructure public employee contracts; however, it does not appear that contracts for existing employees were substantially revised. The city bankruptcy's high cost (estimates of legal fees are at least \$10MM), extended duration, and middling results are likely a good explanation of why other cities have not followed in Vallejo's footsteps.

Rounding out the top 5 filers since 2007 are the \$34MM Pierce Co. Housing Authority in WA where bondholders were fully repaid, and the \$33MM Sierra Kings Health District, received a ruling last fall reinforcing the non-impairment of GD bondholders when paid by a dedicated tax levy. Finally, 5 (or 20%) of all Chapter 9 filings since 2007 have been by Sanitary Improvement Districts: tiny non-rated land speculation entities in Nebraska. In general, trends in the last four years show little divergence from longer patterns of much higher incidence of bankruptcy filings in CA, NE, and TX versus any other state. 108 of the total 224 Chapter 9 filings since 1983 have been in just 3 states. While these data do not show that municipal credit issues are lightly dismissed, they DO indicate that the speculation over a wave of near term Chapter 9 filings is, to this point, just speculation.

Chapter 9 Bankruptcies since 1/1/07			
DATE	FILER	BONDS	NOTES
2/6/2007	Marion, MS	none	Case dismissed as cities in MS can't file for Ch 9.
4/2/2007	McCurtain Municipal Auth., OK	none	Authority used rural development loans
4/5/2007	Palm Drive Health Care Dist., CA	\$15MM	Bondholders unimpaired
8/30/2007	Timberon Water & Sanitary Dist, NM	none	Dismissed, closed
12/13/2007	Valley Health Sys., CA	\$103MM	Initial non-payment, all bonds redeemed at par
4/21/2008	Gould, AR	none	Case may still be open
5/23/2008	Vallejo, CA	\$52MM	Issuer plan: 100% principal repay, plus regular interest, minus penalty interest
7/22/2008	Benton Co. Prop. Owners Imp. Dist., AR	\$3MM	Bondholders ultimately received 21 cents
10/13/2008	Pierce Co. Housing Auth., WA	\$34MM	Bondholders unimpaired, mold lawsuit issues
2/12/2009	Natchez Reg. Medical Ctr., MS	\$17MM	LDC on bonds, holders unimpaired
2/24/2009	Douglas Co. Sanitary Imp. Dist. 452, NE	\$2MM	No plan available yet
4/10/2009	Westfall Twp., PA	none	Payment plan for lawsuit and bank loan
7/6/2009	Washington Park, IL	none	Tax/fee lawsuits & embezzlement
7/13/2009	Sargy Co. Sanitary Imp. Dist. 251, NE	\$10MM	Bondholders impaired, issue close to resolved
10/8/2009	Sierra Kings Health Dist., CA	\$33MM	Court affirmed bondholder lien on ad valorem taxes; bonds will not be impaired
10/27/2009	Moffet, OK	none	Follow up to 2006 filing, disincorporation
10/27/2009	Pritchard, AL	none	Pension issues, city also filed in 1999
11/19/2009	Douglas Co. Sanitary Imp. Dist. 509, NE	\$2MM	Bondholders unimpaired, managed bankruptcy
12/3/2009	New York City Off Track Betting, NY	none	Dismissed, closed
3/4/2010	Grimes Co. MUD #1, TX	\$1MM	Plan is to sell assets, distribute to bondholders
3/10/2010	Lost Rivers Dist. Hospital, ID	\$1MM	Bonds are paid by county tax levy, unimpaired
6/24/2010	Connector 2000 Assoc., SC	\$329MM	Bondholders agreeing to large haircuts in restructuring
8/27/2010	Lake Lotawana Comm. Imp. Dist., MO	\$9MM	Ongoing trial
9/28/2010	Douglas Co. Sanitary Imp. Dist. 507, NE	\$4MM	Plan extends maturities but pays 100%
12/14/2010	Douglas Co. Sanitary Imp. Dist. 525, NE	\$12MM	Proposing debt exchange, reduced interest

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February 14, 2011

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Mr. COBLE. Thank you, Mr. Fabian.
Mr. Brainard?

TESTIMONY OF KEITH BRAINARD, RESEARCH DIRECTOR, NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS, GEORGETOWN, TX

Mr. BRAINARD. Chairman Coble, Representative Johnson, Members of the Subcommittee, I would like to wish each of you a Happy Valentine's Day.

Mr. COBLE. Thank you.

Mr. BRAINARD. Thank you for inviting me to testify today on this important matter.

Given the unprecedented fiscal challenges facing all levels of government, the accuracy and integrity of information is vital. So I appreciate the opportunity to explain to the Committee how State and local pensions work. Unfortunately, much of the reporting on these retirement system seems drawn to those who lack this understanding or who use inappropriate methods and assumptions regarding their operation.

On the whole, State and local government pensions are weathering the financial crisis and making measured changes to ensure long-term sustainability. Only a generation ago, most plans operated primarily on a pay-as-you-go basis. Since then, States and cities have worked to advance fund pension benefits by required employees and employers to contribute enough to a pension trust during their working years to pay for their pension benefit. This was done without Federal intervention and has largely been a success. By 2000, the assets in most public pension trusts equaled or exceeded expected pension payments.

Public pension trusts are designed to weather market volatility, and have done so repeatedly over their history. Even at the market low of the most recent and unprecedented financial downturn, there was still over \$2 trillion in public pension trusts. Since then, values have rebounded sharply, researching \$2.8 trillion at the end of last year.

The assertion that public employee pensions are contributing in a meaningful way to State insolvency is simply not supported by the facts. Spending on public pensions has consistently been a relatively small amount of State and local government budgets, slightly less than 3 percent, on average. Although this percentage varies by State, for all States but three the spending on pensions was less than 4 percent of budgets. For half of the States, it was less than 2½ percent.

Similarly, reports citing pension-fund exhaustion dates for nearly every State are unfounded. The \$2.8 trillion that State and local retirement systems hold in trust is roughly 14 times the amount these funds distribute annually. Public employees and employers contribute to these trusts. Even if they earned a relatively modest annual return of 6 percent, investment earnings alone would be enough to pay most of the benefits distributed each year.

Predictions of widespread insolvency are inconsistent with findings of the professional actuaries who are certified to analyze these plans, as well as the findings of the Government Accountability Office, Center for Retirement Research at Boston College, Center for State and Local Government Excellence, bond-rating agencies, and others.

Such predictions are also at odds with my own analysis that, using even conservative estimates, the typical fund can continue to pay benefits for 25 years—enough time for States to make necessary adjustments to restore their plan's sustainability. Assuming a rate of asset growth consistent with historic market norms, most funds never run out of money.

Joshua Rauh's calculation uses historically low interest rates and depressed asset values following the financial meltdown, and combines these factors with the unlikely assumption that States and cities will violate their own constitutional and statutory pension funding requirements. The outcome of his approach is implausible but attention-getting.

Misrepresenting the true condition of the public pension community is, in my view, reckless and irresponsible and has caused needless confusion and turmoil among the public, policymakers, pensioners, and municipal bond markets. State and local retirement systems are highly transparent entities that publish audited annual financial reports in compliance with generally accepted accounting principles set forth by the Governmental Accounting Standards Board, with financial reporting standards set forth by the Government Finance Officers Association, in addition to sunshine laws in every State.

Pension benefits and financing structures are being examined by States and cities across the Nation. A different range of solutions will be required for each, and a factual assessment is critical. State and local government retirement systems do not require, nor are they seeking, Federal intervention in this process.

Joshua Rauh is the only individual I know of who is calling for Federal financial assistance for public pensions. His \$75 billion estimate of the cost of Federal intervention ignores the cost to State and local governments, which would be far more significant. Predictions made on the basis of selective use of data, inapplicable methods and assumptions, and calculations in conflict with financial and pension fund history are unhelpful. They distract from the important businesses of discerning and responding appropriately to the situation.

Mr. Chairman, thank you. I am happy to answer any questions.
[The prepared statement of Mr. Brainard follows:]

Hearing
 “The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility
 of a State Bankruptcy Chapter”
 February 14, 2011
 Subcommittee on Courts, Commercial and Administrative Law
 Committee on Judiciary
 House of Representatives
 Testimony of
 Keith Brainard
 Research Director
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Chairman Coble, Ranking Member Cohen, and Members of the Subcommittee: thank you for the opportunity to submit written testimony on this important matter.

As state and local governments lead efforts to address the unprecedented fiscal challenges created by stagnant economies, the accuracy and integrity of information is more vital than ever. The condition of pension plans for employees of state and local government has become the focus of unprecedented attention from the media and policymakers in recent months. Unfortunately, much of this interest seems drawn either to those who lack sound knowledge and understanding of how these plans work, or who rely on methods and assumptions that are inappropriate and inapplicable to the way these plans operate.

A careful review of the operations and funding of public pensions, their share of the overall budget picture at the state and local level, and the steps state and local governments are taking to bring their pension plans into long-term solvency, reveals that on the whole, state and local pensions are weathering the financial crisis and making measured changes to ensure their long-term sustainability.

Public pension plans have a rich history; many predate Social Security, and some were established even before the turn of the 20th century. These plans have evolved, migrating from simply making single distributions to certain disabled or retired classes of employees, to retirement, survivor and disability programs for substantially all state and local government workers. Plan financing has also changed dramatically. Only 30-40 years ago, most public plans were financed primarily on a pay-as-you-go basis. Since then, states and localities have endeavored to advance-fund pension benefits by requiring public employees and their employers to contribute to a pension trust during employees’ working years that is enough to pay for their pensions during their retirement years. This was done without federal intervention and has, by and large been a success story: “The miraculous aspect of the funding of state and local pensions is that it occurred without any national legislation.” (Center for Retirement Research, “The Miracle of Funding by State and Local Pension Plans,” April 2008)

By 2000, assets in most public pension trusts equaled or exceeded expected pension payments. Like all investors, recent market shocks, particularly in 2008, have affected asset values. Unlike many other investors, however, public pension trusts are designed to weather market volatility and have done so repeatedly, including during the S&L crisis, the bursting of the technology bubble, Enron, 9/11, the housing bubble and the Great Recession. Even after the most recent and

unprecedented financial downturn, most state and local government pension trusts have plenty of assets to continue to pay promised benefits for years, and values already have rebounded sharply since the market low. Many states nonetheless have been making changes to benefits and financing structures to strengthen reserves and ensure the trusts are sustainable for the very long term.

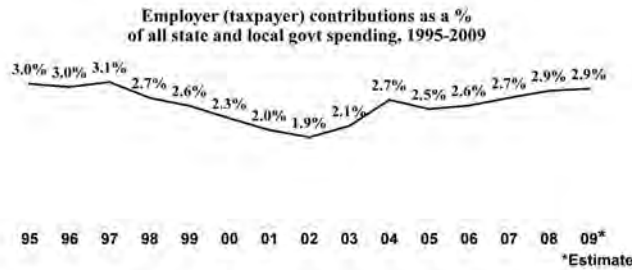
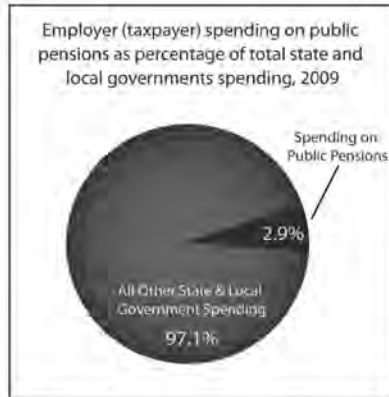
Pensions are a Relatively Small Portion of State and Local Budgets

State and local pensions' long-term financing strategy, which takes place over decades, often seems to be not understood and is mistakenly juxtaposed against current annual revenues and expenditures of state and local governments. Central to understanding public pension financing is to know that public pension benefits are *not* paid out of general operating revenues, but rather, from trusts fund to which retirees and their employers were required to contribute while they were working. The vast majority of public employees are required to contribute a portion of their wages—typically five to ten percent—to their state or local pension, and, with investment earnings, these contributions comprise the majority of public pension fund revenues. The average retirement benefit for public employees is \$22,600, and for many of them, including nearly half of all teachers and over two-thirds of firefighters and public safety officers, it is in lieu of Social Security.



State and local spending on public pensions is the employers' annual contribution to the pension trust – not the amount paid out of the trust each year to retirees. The percentage of all state and local government spending on pensions has hovered around three percent during the last decade.

The requirement that states balance their budgets is often a formidable task in difficult fiscal periods, such as now. However, the extent to which pension costs are impacting these budgets appears to be misunderstood and misreported in many cases. While the impact of the financial crisis on state and local pensions will likely require spending to increase, the most recent studies find that the share of state and local budgets dedicated to pension contributions would likely need to rise to about five percent on average, and to about eight to 10 percent for those with the most seriously underfunded plans. (Alicia H. Munnell, Jean-Pierre Aubry, and Laura Quinby, "The Impact of Public Pensions on State and Local Budgets," Center for Retirement Research, October 2010). However, many state and local governments have enacted or are considering changes to benefit levels and financing structures to lower these projections.



Significant Financing and Benefit Changes Already Underway or Enacted

Pension funds hold \$2.8 trillion in trust from which they pay benefits, roughly 14 times the amount they distributed in benefits last year. Pension funds representing the vast majority of public employees have assets to continue to pay benefits for decades, if not into perpetuity. My own calculations, which I'm happy to provide to the Committee upon request, find that using even conservative estimates, the median state pension fund is able to pay benefits until 2030, enough time for states to make necessary adjustments.

Assuming a rate of asset growth consistent with historic market norms, most funds will never run out of money. The Center on Retirement Research at Boston College said last October, "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" (Alicia H. Munnell, Jean-Pierre Aubry, and Laura Quinby, "Public Pension Funding in Practice," NBER Working Paper 16442, October 2010).

This is not to say that long-term pension costs are of no concern. The market shocks of the Great Recession lowered funding for all investors. While public pension trust funds are not in immediate crisis, most state and local governments are making changes to strengthen financing reserves and further enhance long-term solvency.

Among plans that have found their long-term sustainability in question, plan administrators and policymakers are aware of the problem. Adjustments have been made in many states, and more states are in the process of doing so. Last year, according to the National Conference of State Legislatures, an unprecedented number of states made changes to their pension benefits, contribution requirements, or both. Many more states are expected to follow suit this year. These changes are reducing both current costs and long-term liabilities. In fact, more states made significant changes to retirement benefits and financing in 2010 than in any year in recent history. (“Pensions and Retirement Plan Enactments in 2010 State Legislatures,” Ronald K. Snell, National Conference of State Legislatures, October 10, 2010).

Solvency Confirmed, Measured Approach Urged to Long-term Solutions

Although some states have accumulated significant unfunded liabilities, pension benefits are paid out over many years, not all at once. These are long-term funding issues, and most thorough analyses by those familiar with governments and public finance find patient and measured responses are required:

- In a 2008 report, the Government Accountability Office said, “[U]nfunded liabilities are generally not paid off in a single year, so it can be misleading to review total unfunded liabilities without knowing the length of the period over which the government plans to pay them off.” (U.S. Government Accountability Office, “State and Local Government Pension Plans; Current Structure and Funding Status,” July 2008 GAO-08-983T).
- Bond rating agency Fitch recently said, “[M]ost state and local governments have been making payments towards their projected long-term liabilities for decades, resulting in sizable pension trust balances and significant actuarial funding for most plans. Broadly speaking, significant adjustments to plan benefits and contributions will be required, and in some instances such changes are already underway. Since unfunded obligations in most cases are not due for many years, issuers have the opportunity to make these difficult adjustments.” (FitchRatings, “U.S. State and Local Government Bond Credit Quality: More Sparks than Fire,” November 16, 2010).
- Standard & Poor’s said last month, “[P]ension and other retirement liabilities ... in most cases, are not immediately jeopardizing the debt-paying capacities of the governments we rate. ... [W]e continue to believe that most governments are likely to make the difficult tradeoffs ... so they may preserve funding for important (sometimes legally required) programs and to protect their credit and market access.” (Standard & Poor’s, “U.S. State and Local Governments Must Navigate Turbulent Conditions to Maintain Credit Stability,” January 24, 2011)
- In July 2008, just before the most recent market decline, the Government Accountability Office said, “Most state and local government pension plans have enough invested resources set aside to fund the benefits they are scheduled to pay over the next several decades.” (U.S. GAO, *ibid.*). Although that report preceded the market decline, investment markets have rebounded and pension funds have regained much of the assets lost.

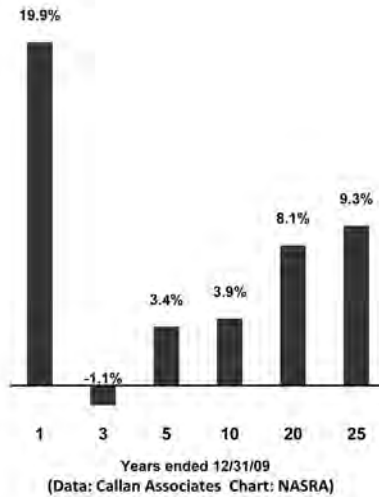
Faulty Analysis is Unhelpful to State and Local Recovery Efforts

Reports that inappropriately calculate and intermingle unrelated long-term obligations with short-term budget issues can be misleading. Much misinformation regarding state debt and pensions is being circulated, mostly based on dramatic and improbable conclusions, but which nonetheless creates the mistaken impression that drastic and immediate measures are needed. A closer look at the suppositions on which many of these reports are based, finds the use of overly pessimistic assumptions that simply are not in line with historical practice. In certain cases, these distortions compound each other. The result is a mischaracterization of public pensions vis-à-vis state fiscal arrangements that obfuscates and misleads more than informs and enlightens.

- Recent studies estimated public pension unfunded liabilities of more than \$3 trillion are based on a measure—current interest rates, which are near record lows—that reflects the dynamics of bond yields rather than the fundamental characteristics of the plan. These studies also use asset values from 2009, near their recent low points, and they project liabilities using current low interest rates, inflating the value of the obligations.
- Studies authored by Joshua Rauh promote confusion by mixing apples with oranges. For example, his report “Are State Public Pensions Sustainable?,” compares, for many states, local governments’ unfunded pension liabilities with the tax effort of only the state. This is akin to measuring the mortgage capacity of a working couple, yet considering the income of only one of them. Excluding local sources of revenue when local governments are responsible for funding pension liabilities, produces a distorted and misleading measure.
- This and other studies by Joshua Rauh compare unfunded pension liabilities with “state tax revenues,” excluding the state and local government revenues from fees and charges for services such as utilities, tuition, vehicle registration, etc. These non-tax funding sources finance government operations as much as tax revenues, yet the reports ignore them. This results in a misleading characterization of unfunded liabilities that is intended to present state and local government funding conditions in an unrealistically negative manner.
- A study authored by Joshua Rauh and Robert Novy-Marx, “Public Pension Promises: How Big Are They and What Are They Worth?,” is based on asset values in June 2009, near their recent market low point, and using interest rates when they were at near-record lows. Since June 2009, US equity markets have risen by 40 percent and public pension asset values have grown by some 25 percent. The Rauh-Novy-Marx study’s reliance on depressed asset values produces an outdated—but dramatic—calculation of unfunded liabilities.
- Regarding the use of interest rates to calculate public pension funding conditions, the National Institute for Retirement Security said in recent testimony to the American Academy of Actuaries: “Plans sponsored by long lived entities that face a low risk of insolvency are best evaluated on a going basis, which is captured well by actuarial methods currently in use for state and local plans. Moreover, to the extent that such measures would drive funding policy, the volatility they introduce would either create untenable, counter cyclical funding burdens for public entities or force plans into so-called “liability driven” investment strategies that would involve greater taxpayer costs. Thus, termination or liquidation basis measures do not serve the public interest. Even disclosure of these misleading measurements poses risks. In light of the public’s knowledge gap about public pensions, the introduction of termination like liability measures would create new opportunities for politically motivated interest groups to

mislead the public about the health of these plans and exaggerate their cost. This kind of misrepresentation is already a serious problem when it comes to state and local pensions.”

Like all investors, public pension funds have been affected by the unprecedented market downturn in 2008. However, since 1985—a period that has included three economic recessions and four years of negative median public fund investment returns—public pension investment returns have exceeded their targeted eight percent return on investments. For the 25-year period ended 12/31/09, the median public pension investment return was 9.25%. For the year ended 6/30/10, this return was 12.8 percent. The chart below shows median public fund returns for periods ended 12/31/09, illustrating the volatility in short-term market returns and the inappropriateness of basing long-term policy decisions on a snapshot in time, particularly at the market low;



Federal Intervention Unwarranted

Given the differing plan designs and financial pictures across the country, a different range of solutions will be required for each plan to best secure their viability for the very long-term. **State and local government retirement systems do not require, nor are they seeking any Federal financial assistance.** A fact sheet recently released by 10 national state and local government organizations—the National Conference of State Legislatures, National Association of Counties, United States Conference of Mayors, National League of Cities, International City/County Management Association, National Association of State Auditors Comptrollers and Treasurers, Government Finance Officers Association, International Public Management Association for Human Resources, National Council on Teacher Retirement and the National Association of State Retirement Administrators—notes that, “[T]he great strides made in the ability of state and local government retirement systems to ensure that more than 20 million working and retired public employees have financial security in retirement have been achieved

without Federal intervention. One-size-fits-all Federal regulation is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels.”

A recent letter, signed by the leaders of the National Governors’ Association and the National Conference of State Legislatures, reminds members of Congress that:

[F]or the last three years, states have faced growing budget deficits and in each of those years, we have closed those deficits by spending cuts and when necessary increasing taxes. Governors and legislators have had to make tough and politically unfavorable decisions to be fiscally responsible and balance our budgets. Throughout this process, our colleagues never contemplated walking away from our obligations to our constituents or to the bond markets by requesting that the federal government allow states to receive bankruptcy protection. While a number of states continue to face budget deficits over the next few years, we will continue to use our sovereign authority to balance our budgets and meet our obligations.

State and local leaders are interested in working with their federal partners to improve the fiscal stability of government at all levels. We call on Congress and the Administration to work with our members to eliminate unfunded mandates, provide greater flexibility to use federal funds more efficiently and avoid federal restrictions such as maintenance-of-effort provisions that hinder state and local authority to control their own finances. These are difficult times in which to govern, but the challenges also provide us with the opportunity to work more closely together to find common solutions. We look forward to working with you to address the financial needs of the country and ensure our prosperity for the future.

Like all investors, public retirement systems have been affected by the recent unprecedented market decline. Governments, their plans and their employees, working through State and local legislative and regulatory structures, are aggressively engaged in the process of examining benefit levels and financing structures in order to strengthen reserves. Given the differing plan designs and financial pictures across the country, a different range of solutions will be required for each in order to best secure their viability for the very long-term. Hyperbole and distortion are not helpful to these efforts or to the long-term fiscal health of state and local governments and their retirement systems. State and local government retirement systems do not require, nor are they seeking any Federal financial assistance, which is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels.

Again, I thank you for inviting me here today. I would be happy to discuss various strategies being explored in numerous jurisdictions around the country, and I look forward to answering any questions.

I am attaching for the record the following documents to accompany my statement:

- NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems
- Facts on State and Local Government Pensions
- Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts
- NGA/NCSL Letter to Congress

Bio

Keith Brainard has served as research director for NASRA since 2002. Previously, he served as manager of budget & planning for the Arizona State Retirement System, and he provided fiscal research and analysis for the Texas and Arizona legislatures. He is co-author of the Governmental Plans Answer Book, 2nd Edition, and created and maintains the Public Fund Survey, an online compendium of public pension data. He has a master’s degree from the LBJ School of Public Affairs, University of Texas at Austin.

NASRA ISSUE BRIEF:
STATE AND LOCAL GOVERNMENT SPENDING ON PUBLIC
EMPLOYEE RETIREMENT SYSTEMS

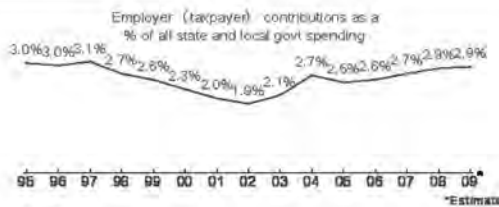
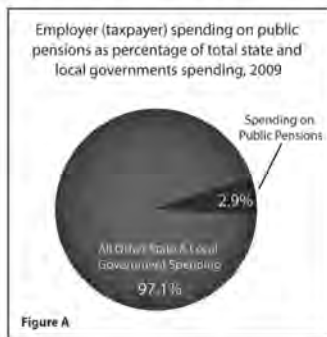


January 2011

Employer (taxpayer) spending on pension benefits for employees of state and local government has been the object of growing attention. A closer look reveals that a relatively small portion of all state and local government spending goes to public pensions. According to the latest estimates, *less than three percent* of all state and local government spending was used to fund public pension benefits. Figure A, illustrates spending on public pensions as a percentage of all state and local government spending. Although public pension costs have risen due to the loss of pension assets during the 2008 decline in capital markets, and are likely to rise further, this cost should be considered in the context of a) the benefits retirement systems

distribute each month to more than 7.5 million retired public employees, their beneficiaries and survivors; and b) the economic effects these benefits generate in local and state economies. In 2008, public retirement systems distributed more than \$175 billion in pension benefits, an amount more than double the amount paid in by taxpayers through employer contributions. These benefits reach every city of every state in the nation, and their economic effects are well documented.ⁱⁱ

The vast majority of public employees are required to contribute a portion of their wages—typically five to 10 percent—to their state or local pension fund; some share pension costs equally with their employers. An estimated 30 percent of employees of state and local government do not participate in Social Security, including substantially all of them in seven states, approximately one-half of all of the nation's public school teachers, and two-thirds to three-fourths of firefighters and police officers. In most of these cases, employers and employees are contributing to the pension fund *in lieu of* contributions to Social Security, reducing state and local taxpayer costs by an estimated \$15.6 billion annually.ⁱⁱⁱ On a national basis, as shown in Figure B, employer (taxpayer) contributions to pension plans have remained fairly steady. Since 1995, employer contributions as a percentage of all state and local government spending have remained around three percent, providing most employers with a fairly predictable expenditure for attaining retirement security.



**Employer (taxpayer) contributions to pensions
as a percentage of all state and local government spending, by state, 2008**

Alabama	2.93	Louisiana	3.46	Oklahoma	3.68
Alaska	2.33	Maine	2.85	Oregon	2.47
Arizona	2.41	Maryland	2.81	Pennsylvania	1.61
Arkansas	3.07	Massachusetts	3.35	Rhode Island	4.65
California	3.83	Michigan	2.46	South Carolina	2.26
Colorado	2.16	Minnesota	1.60	South Dakota	1.72
Connecticut ¹	4.07	Mississippi	2.82	Tennessee	2.15
Delaware	1.50	Missouri	3.29	Texas	1.95
District of Columbia	1.24	Montana	2.27	Utah	2.69
Florida	2.37	Nebraska	1.36	Vermont	1.03
Georgia	2.02	Nevada ²	5.44	Virginia	3.83
Hawaii	3.70	New Hampshire	1.97	Washington	1.51
Idaho	2.55	New Jersey	2.84	West Virginia	3.91
Illinois	3.40	New Mexico	3.06	Wisconsin	1.35
Indiana	2.82	New York	3.96	Wyoming	1.28
Iowa	1.74	North Carolina	0.92	United States	2.89
Kansas	2.01	North Dakota	1.40		
Kentucky	2.43	Ohio	2.92		

¹/ Excludes \$2 billion in pension bonds issued by the state in 2008.

²/ In addition to being a non-Social Security state, one-half of Nevada PERS employers' contribution is attributable to a non-refundable pre-tax salary reduction to fund the employees' portion of the contribution.

Sources:

<http://www.census.gov/govs/estimate/> - Total spending by states and local governments

<http://www.census.gov/govs/retire/2008ret02a.html> - State and local government retirement system sources of revenue

See also: *The Impact of Public Pensions on State and Local Budgets*, Center for Retirement Research at Boston College, October 2010 (The CRR measure excludes capital spending in its calculation of pension contributions as a percentage of all state and local government spending.)



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¹ Estimated by applying normal annual growth rates to 2008 data.

² For example, *Pensionomics: Measuring the Economic Impact of State and Local Pension Plans*, National Institute on Retirement Security, February 2009; see also "Economic Effects of Public Pensions," <http://www.nasra.org/resources/economic.htm>

³ Author's calculation based on 30 percent of state and local government employees not participating in Social Security.



FACTS ON STATE AND LOCAL GOVERNMENT PENSIONS

Retirement systems remain a small portion of state and local government budgets. State and local government pensions are not paid out of general operating revenues, but instead, a trust that public retirees and their employers contributed to while they were working. The portion of state and local government spending dedicated to retirement system contributions is about three percent.¹ While some pension trusts are fully funded (they have enough assets in the trust now for all pension obligations), following the recent market decline, plans will need to increase their contribution levels to five percent on average to return to full funding.² The unprecedented number of benefit and financing changes in public plans over the last few years will help to keep any required increases to a minimum.

Public pension plans are not in crisis. Most state and local government employee retirement systems have substantial assets to weather the economic crisis; those that are underfunded are taking steps to strengthen funding. It is important to understand that pensions are funded and paid out over decades. There is currently \$2.7 trillion already set aside in pension trusts for current and future retirees. Further, state and local government retirees do not draw down their pensions all at once. Employees must reach certain age and/or years of service before they are eligible for a pension; once retired, they must receive their pension in installments over their retirement years (as an annuity).

State and local governments are already taking steps to secure their pensions for the long-term. More state and local governments enacted significant modifications to improve the long-term sustainability of their retirement plans in 2010 than in any other year in recent history. In the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures, or both; many local governments have made similar fixes to their plans.³

Public employees share in the financing of their pension, which in many cases is in lieu of Social Security. The vast majority of public employees are required to contribute a portion of their wages—typically five to ten percent—to their state or local pension, and these contribution rates are being raised in many state and local governments. Employee contributions along with investment returns comprise the majority of public pension fund revenues. The average retirement benefit for public employees is \$22,600 and for many of them, including nearly half of all teachers and over two-thirds of firefighters and public safety officers, it is in lieu of Social Security. State and local salaries on which these pensions are based are lower than those for private sector employees with comparable education and work experience, even when benefits are included.^{4, 5}

Pension dollars help the economy of every jurisdiction. Public employees live in every city and county in the nation; more than 90 percent retire in the same jurisdiction where they worked. The over \$175 billion in annual benefit distributions from pension trusts are a critical source of economic stimulus to communities throughout the nation, and act as an economic stabilizer in difficult financial times. Recent studies have documented public retirement system pension distributions annually generate over \$29 billion in federal tax revenue, more than \$21 billion in annual state and local government tax revenue, and a total economic impact of more than \$358 billion.⁶

Long-term investment returns of public funds continue to exceed expectations. Since 1985—a period that has included three economic recessions and four years of negative median public fund investment returns—actual public pension investment returns have exceeded assumptions.⁷ For the 25-year period ended 12/31/09, the median public pension investment return was 9.25%.⁸ Moreover, for the year ended 6/30/10, this return was 12.8%.⁹ These actual returns exceed the 8% average public pension investment assumption, as well as the average assumed rate of return used by the largest corporate pension plans.¹⁰

State and local government retirement systems do not require, nor are they seeking, Federal financial assistance. The great strides made in the ability of state and local government retirement systems to ensure that more than 20 million working and retired public employees have financial security in retirement have been achieved without Federal intervention. One-size-fits-all Federal regulation is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels.

ENDNOTES

- ¹ [NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems](#)
- ² [The Funding of State and Local Pensions](#), Center for State and Local Government Excellence
- ³ [Pensions and Retirement Plan Enactments in 2010 State Legislatures](#), National Conference of State Legislatures
- ⁴ [The Wage Penalty for State and Local Government Employees](#), Center for Economic and Policy Research
- ⁵ [Out of Balance? Comparing Public and Private Sector Compensation Over 20 Years](#), Center for State and Local Government Excellence/National Institute on Retirement Security
- ⁶ [Pensionomics: Measuring the Economic Impact of State and Local Pension Plans](#), National Institute on Retirement Security
- ⁷ [Investment Return Assumption for Public Funds: The Historical Record](#), Callan Investments Institute Research
- ⁸ [NASRA Issue Brief: Public Pension Plan Investment Return Assumptions](#)
- ⁹ [The Public Fund Survey](#)
- ¹⁰ [Milliman 2010 Pension Funding Study](#)
- OTHER RESOURCES:
- [The Impact of Public Pensions on State and Local Budgets](#), Center for Retirement Research at Boston College
- [Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts](#), National Association of State Retirement Administrators
- [Frequently Asked Questions About Pensions](#), National Institute for Retirement Security
- [Research Brief on America's Cities](#), National League of Cities

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Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts

October 2010



As state and local governments lead efforts to address the unprecedented fiscal challenges created by stagnant economies, in the face of aging populations and workforces, the accuracy and integrity of information is more vital than ever. Authors of a new paper, *The Crisis in Local Government Pensions in the United States*, would be more constructive, as well as provide more accurate municipal pension information, if their assumptions were based on historical experience and their methodology appropriate for the government sector. Robert Novy-Marx and Joshua Rauh – who also earlier this year authored, *Are State Public Pensions Sustainable?* – again vastly underestimate projected future contributions to public pension plans and expected investment returns to draw dramatic and improbable conclusions regarding the solvency of these plans.¹ Both papers are based on pension fund assets values as of 2009, prior to the recent improvement in financial markets. Further, their method used to determine future pension liabilities of states and localities is not recognized by governmental accounting standards. The authors additionally ignore changes already underway at the state and local levels to restore long-term pension sustainability, and they make recommendations that would only serve to worsen the financial condition of these plans.

Assumptions of Future Behavior Are Not Supported by Past Practice

The reports' findings are premised on two key suppositions: 1) state and local governments will contribute nothing to amortize past pension liabilities, and 2) funds will generate rates of return commensurate with highly conservative, "risk-free" all-bond portfolios, rather than the diversified portfolios actually in use. These two assumptions are inconsistent with plans' actual experience, as most governments have a history of paying their pension contributions. In fact, according to the Public Fund Survey, from FY 01 to FY 09, on average, pension plan sponsors paid 91 percent of their required contributions. Regarding investment returns, the standard assumption is that pension fund portfolios will earn a real (after inflation) return of 4.5 percent annually, based on the mix of assets they typically hold, and more reasonable given the current ratio of stock prices to trend earnings.² Further, analysis shows that public pension funds' actual long-term investment returns still exceed this assumption, even after incorporating losses from the 2008 market collapse.³

Projections Are Based on Asset Values Near Their Market Low Point

The authors base their financial analysis on pension asset values as of June 30, 2009, at the end of a 12-month period when the S&P 500 had a return of -36.2%, and prior to much of the market increase that took place the following year. Pension fund asset values have been growing since March 2009, and for the year ended June 30, 2010, median public pension fund investment returns were 12.8 percent, well above plans' typical assumed investment return of eight percent. In addition, historical investment experience over 20-, 25- and 30-year time periods, a more appropriate measure of the long-term investment horizon of public funds, also exceed this assumed rate of return.⁴

The Method Used to Value Future Liabilities Is Inconsistent With Accounting Standards

Another factor driving the authors' findings is the method used to value future pension liabilities, which is not compliant with public sector accounting standards. In fact, the Governmental Accounting Standards Board, which has been reviewing these standards over the past three years, recently affirmed its support for the use of a long-term expected rate of return, rather than the use of current interest rates. In its Preliminary Views, published last June, GASB specifically "considered but rejected" an interest rate-based method for valuing future liabilities (the approach used in the Novy-Marx-Rauh paper), stating instead that, "The rate used should be a reasonable estimate of the rate at which plan net assets are expected to grow, over a term commensurate with the accounting measurements for which the rate is used, as a result of investment earnings."

¹ Based on original analysis prepared by Paul Zorn and Mia Drazilov at Galanter, Rueder, Smith & Company, Paul Amodeo at The Segal Company, and Keith Brimard at NASRA.

² "More Safe-Than-Sure: About State Pensions at the SYP," Dean Baker, Center for Economic and Policy Research, June 20, 2010.

³ "NASRA Issue Brief: Public Pension Plan Investment Return Assumptions," National Association of State Retirement Administrators, March 2010.

⁴ "Investment Return Assumption for Public Funds: The Historical Record," Citian Investments Institute Research, June 2010.

Analysis Does Not Account for Recent State/Local Pension Changes

More state and local governments have enacted significant modifications to their retirement plans in 2010 than in any other year in recent history.⁵ Since 2006, nearly two-thirds of the states have made changes to benefit levels, contribution rate structures, or both⁶ and many more local governments also have made adjustments. Ignoring these alterations results in a gross mischaracterization of the current situation and disregards the measured approach that can be and has been taken to *realistically* and responsibly close pension funding gaps.

The Authors' Recommendations Do More Harm Than Good

In response to their dire projections, the authors have suggested that state and local governments should no longer offer pensions to new hires, recommending instead that such employees be covered with Social Security and a 401(k) plan, and that states and cities should issue debt – possibly at a federally subsidized rate – to pay off the added cost of closing pension plans. These recommendations ignore the significant cost and disruption that would be imposed by such changes:

- **Mandating Social Security Adds Billions in Expenses.** Conservative estimates of the added expense of mandating newly hired public workers into Social Security are over **\$44 billion in the first five years alone,**⁷ which would worsen the financial condition of the sponsoring governments and their pension systems.
- **Putting New Hires Into a 401(k) Increases Costs.** Recent studies have shown that closing pensions to new hires can have several serious, unintended consequences, including increasing administrative costs associated with running two plans, forgoing or undermining economic efficiencies of traditional pension plans, accelerating pension costs for employees in the closed plan, worsening retirement insecurity, and potentially damaging employer recruitment and retention efforts.⁸ Moreover, although 401(k)-type plans are a useful means of supplementing pension benefits, they are inherently not as effective or efficient as a primary source of retirement income. By pooling mortality and investment risks, traditional pensions reduce participants' risk of outliving retirement assets and can provide the same benefit at nearly half the cost of a defined contribution plan.⁹ Unlike a traditional pension plan, a 401(k) does not include provisions for disability and death benefits, which are especially important for employees in hazardous occupations such as firefighters and police officers, who face higher risks in the line of duty. Without a pension, these benefits would have to be provided through commercial insurance, likely at significantly higher costs to the employer.
- **Issuing Debt and/or Asking for Federal Involvement Adds Risk.** Proposing that state and local governments should issue debt to fund their pension benefits adds risk to the funding equation. Such debt would become a liability for the sponsoring government. If the markets fall after the funds are invested, the government now has two sets of liabilities: the outstanding debt and the pension liability. Even with a federal subsidy – which is unlikely given current federal government budget constraints and which raises additional challenges – this is a risky approach.^{10, 11}

In the wake of the Great Recession, states and cities are examining and adjusting pension benefit levels and financing structures to restore reserves and long-term sustainability. Hyperbole and distortion, as presented in the referenced academic papers, are not helpful to these efforts or to the long-term fiscal health of state and local governments and their retirement systems.

Contact:

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⁵ *"Pensions and Retirement Plan Enactments in 2010 State Legislatures,"* Ronald K. Snell, National Conference of State Legislatures, October 10, 2010.

⁶ *"Pensions and Retirement Plan Enactments in 2010 State Legislatures,"* Ron Snell, National Conference of State Legislatures, May 17, 2010.

⁷ *"The Cost Impact of Mandating Social Security for State and Local Governments,"* Cathie Eitelberg, Alexander Sussman, F.S.A., and Leslie Thompson, Revised 2005.

⁸ *"Look Before You Leap: The Unintended Consequences of Pension Freezes,"* Jim Bojor and Beth Almeida, National Institute on Retirement Security, October 2008.

⁹ *"A Better Bang for the Buck: The Economic Efficiency of Defined Benefit Pension Plans,"* Beth Almeida, William B. Frazee, FSA, National Institute on Retirement Security, August 2008.

¹⁰ *"Evaluating the Use of Pension Obligation Bonds,"* *Government Finance Officers Association Journal* (1997 and 2005).

¹¹ *"Issue Brief: Pension Obligation Bonds: Financial Crisis Exposes Risks,"* Mitch H. Mumell, Chad Galbreath, Aashy Mittal, and Joan Patrici Aubrey, Center for State and Local Government Excellence, January 2010.



February 4, 2011

The Honorable John Boehner
Speaker of the House
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Harry Reid
Majority Leader
United States Senate
Washington, D.C. 20501

The Honorable Nancy Pelosi
Minority Leader
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Mitch McConnell
Minority Leader
United States Senate
Washington, D.C. 20510

Dear Mr. Speaker, Ms. Pelosi, Senator Reid and Senator McConnell:

The nation's governors and legislators do not support proposals to provide states with bankruptcy protection.

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 proposals suggest 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 state and local finance.

For the last three years, states have faced growing budget deficits and in each of those years, we have closed those deficits by spending cuts and when necessary increasing taxes. Governors and legislators have had to make tough and politically unfavorable decisions to be fiscally responsible and balance our budgets. Throughout this process, our colleagues never contemplated walking away from our obligations to our constituents or to the bond markets by requesting that the federal government allow states to receive bankruptcy protection. While a number of states continue to face budget deficits over the next few years, we will continue to use our sovereign authority to balance our budgets and meet our obligations.

State and local bonds and fiscal instruments remain some of the safest investments in the world. State leaders are keenly aware of their responsibility to manage their finances and repay their obligations. In contrast, the mere discussion of legislation, let alone the existence of a law allowing states to declare bankruptcy would only serve to increase interest rates and create more volatility in bond markets.

State and local leaders are interested in working with their federal partners to improve the fiscal stability of government at all levels. We call on Congress and the Administration to work with our members to eliminate unfunded mandates, provide greater flexibility to use federal funds more efficiently and avoid federal restrictions such as maintenance-of-effort provisions that hinder state and local authority to control their own finances.

These are difficult times in which to govern, but the challenges also provide us with the opportunity to work more closely together to find common solutions. We look forward to working with you to address the financial needs of the country and ensure our prosperity for the future.

Sincerely,



Governor Christine O. Gregoire
Chair, National Governors Association



Senator Richard T. Moore
Massachusetts Senate
President, National Conference of State
Legislatures



Governor Dave Heineman
Vice Chair, National Governors Association



Senator Stephen R. Morris
Senate President, Kansas
President-Elect, National Conference of State
Legislatures

Mr. COBLE. Thank you, gentlemen, and appreciate you all being with us today. We will now examine you all from our podium here.

Professor Rauh, how much fiscal difficulty or trouble would there be if States—regarding the all new public employees—starting today were forced to have defined contribution as opposed to defined benefit plans?

Mr. RAUH. Well, thank you very much, Chairman Coble.

I just want to start off by saying that the witness Mr. Brainard presents some very misleading statistics. And perhaps this is not surprising given that he represents State retirement administrators, whose interests in this issue are at odds with those of the taxpayers.

For example, it was claimed that pension contributions are a small share of State budgets. Three percent was the number that was thrown out. First of all, States are not making the contributions that they ought to be, even under their own accounting. So this is a bit analogous to looking at—it is like looking at a sample of households who have stopped paying principle on their mortgages and concluding that mortgages aren't a problem for household finance because their principle payments are a low fraction of their spending.

Second, a figure was cited as the fraction of spending. Well, that counts the deficits that the States are running. So it is like saying that someone who is living way beyond their means and running up a large credit card debt has a relatively small cash-flow problem because their actual credit card payments are small.

And, finally, one-third of the revenue that he is counting on in that calculation is coming from you, actually, the Federal Government. So the assumption is that you are completely willing to pick up the pro-rata share of this tab based on the amount that the Federal Government has been sending to the States.

So I would say, looking at all owned revenue, excluding transfers from the government, the contribution share is around 10 percent already, and it is going to have to grow substantially to pay down this debt.

Mr. COBLE. Mr. Spiotto, I mispronounced your name earlier. I apologize for that.

We saw recently in the Vallejo, California, case that, even in Chapter IX, the city was unwilling to reject its pension contract. Would a State be more likely to reject collective bargaining agreements in bankruptcy?

Mr. SPIOTTO. The problem you have with trying to reject your collective bargaining agreements in bankruptcy is, the next day, you need an agreement with your workers as to what is fair and affordable to pay them going forward. And the problem with bankruptcy and the dynamics is that, in rejecting it, you create an equal issue of how do you pay for it going forward and what do you pay. And that is a significant problem.

Vallejo filed in 2008. They went through a significant period of time, tried to negotiate a resolution of their labor issues, and it took them a long time. They are still in bankruptcy. They have a plan pending. The time, money, expense, confusion, and difficulties to the city was significant.

Mr. COBLE. Thank you, sir.

Professor, I didn't follow you, whether you responded directly to my question.

Mr. RAUH. Perhaps I did not.

The answer to your question, which my understanding is, even if State and local governments froze all promises today, how deep of a hole would we be in, the answer is \$3 trillion. The number

that we calculate is assuming that all future benefits are going to be fully funded and secured.

So, even if all plans were frozen today and all future work were put on a defined-contribution-type plan, the number would still be \$3 trillion.

Mr. COBLE. Mr. Fabian, who holds most of the State and municipal paper currently? Or, in other words, if bond holders are crammed down, who is most likely to suffer?

Mr. FABIAN. Well, households—in general, households own about a third of the municipal bond market directly and about another third of the municipal bond market through mutual funds. So, in general, it is individuals who own about two-thirds of the market. So they would, in theory, be the ones the most subject to a cramdown.

Mr. COBLE. I got you. Thank you, sir.

Mr. Brainard, do you believe any reforms are needed to the GASB rules to require States to accurately report their pension liability? Because I am told, oftentimes some of these have been laced generously with inaccuracy.

Mr. BRAINARD. GASB has been—Mr. Chairman, GASB has, for the last few years, been considering a range of changes to State and local pension reporting requirements. And among the reforms that they are seriously considering at this point is a modification to the investment return assumption the plans use to discount their future liabilities. That modification appears sound to me.

There are some other adjustments that they are considering with regard to how quickly public pension plans recognize investment gains and losses that, generally, we are not uncomfortable with. And very quickly you get into the range of GASB reforms that becomes eye-glazing material. I am not quite sure what level of detail you would like me to get into.

Mr. COBLE. I thank you. My red light has appeared, so I will have to terminate.

The gentleman from Georgia.

Mr. JOHNSON. Thank you, Mr. Chairman.

Professor Rauh—it is also Dr. Rauh, correct?

Mr. RAUH. That is correct.

Mr. JOHNSON. And, Doctor, in addition to your duties and responsibilities as an associate professor, you have some other professional responsibilities that you tend to. Isn't that correct?

Mr. RAUH. I don't know what you are referring to.

Mr. JOHNSON. Well, I mean, you do some consulting on the side, and you write papers for various groups.

Mr. RAUH. For various groups? No, I have never written a paper that has been commissioned by a group, no.

Mr. JOHNSON. Uh-huh. Well, who have you written—tell us some of the folks you have written papers for.

Mr. RAUH. No, I don't write papers for anyone. I write papers under my own name, and I present them at conferences, and that is all. I will occasionally—

Mr. JOHNSON. Well, let me ask you this. You make a little outside money in addition to your salary as a professor, isn't that true?

Mr. RAUH. I receive—I have a small amount of consulting income. That is correct.

Mr. JOHNSON. And you have your own consulting company?

Mr. RAUH. No, I do not have my consulting company, no.

Mr. JOHNSON. Now, who do you consult for? What companies pay you to consult?

Mr. RAUH. I have not actually taken money from—I mean, okay, so—I am not sure whether this is an allowable line of questioning, but I can—

Mr. JOHNSON. Well, you inferred that Mr. Brainard had an interest in preserving the status quo, and I just wanted to explore what your interest is.

Mr. RAUH. I have never worked for an organization that has any kind of stake in this particular—this matter, none whatsoever.

Mr. JOHNSON. Well, what about politicians? Have you been working with any politicians on this issue? Members of Congress?

Mr. RAUH. I was invited by Governor Schwarzenegger to go to Sacramento and present at a roundtable.

Mr. JOHNSON. What about Members of Congress? Who have you been working for here?

Mr. RAUH. I have not worked for any Members of Congress.

Mr. JOHNSON. You have not consulted with any Members of Congress?

Mr. RAUH. I received some e-mailed questions about the Public Employee Pension Transparency Act—

Mr. JOHNSON. Yes.

Mr. RAUH [continuing]. From Congressman Nunes' office. I answered those questions—

Mr. JOHNSON. Devin Nunes from California?

Mr. RAUH [continuing]. For no fee. Yeah, I mean, I was e-mailed questions, and I answered the questions.

Mr. JOHNSON. And these questions concerned the fiscal health of the State of California in so far as its pension liabilities are concerned. Isn't that correct?

Mr. RAUH. No. The questions that Congressman Nunes' office e-mailed me were about simply my calculations that the unfunded liability was \$3 trillion and just some explanations about how I arrived at that number. That was all. There was no money that was exchanged hands.

Mr. JOHNSON. Now, you are of the opinion that the State of California is in big trouble with its pension obligations.

Mr. RAUH. When one discounts the—

Mr. JOHNSON. Yes or no.

Mr. RAUH. I don't like to put the word "big trouble" on it.

Mr. JOHNSON. Okay, but they have some issues.

Mr. RAUH. Five hundred billion dollars of unfunded liabilities for the State of California. I think that is not a trivial amount.

Mr. JOHNSON. And you believe that the Federal taxpayers may be asked to bail out California because of its unfunded pension responsibilities?

Mr. RAUH. I think there are a number of States around the country—

Mr. JOHNSON. Is that true or is that false?

Mr. RAUH. California in particular? I think there is a chance that the Federal Government will be liable—will be asked to come to the assistance of California. And I think that part of the issue is that they have borrowed from public employees to the tune of \$500 billion above and beyond the assets that they have set aside to pay for those promises.

Mr. JOHNSON. But now they also have—so your concern, you want to tie the States' hands insofar as its relationship with its recipients of pensions and with its employees by allowing them to get out of trouble through a bankruptcy. Is that what you want to do?

Mr. RAUH. Through a bankruptcy, no, no. I have said nothing of the kind.

Mr. JOHNSON. You support California if it decided to avoid having to pay pensions because they have not funded their—they have borrowed money from their pension fund?

Mr. RAUH. I have said nothing of the kind. In fact, I want to be clear. I do not call for cuts in benefits that have already been promised. All of the proposals that I have made have been—

Mr. JOHNSON. You are just trying to keep the States from borrowing from their pension funds. Is that what your motivation is?

Mr. RAUH. I am trying to stop the States from borrowing from public employees in a way that is not transparent to taxpayers.

Mr. JOHNSON. And you figure the best way to do that is to allow States to avoid the pension obligation.

Mr. RAUH. No, no. Avoid their pension obligations, no. I have never—

Mr. JOHNSON. That is what a bankruptcy would do, wouldn't it?

Mr. COBLE. The gentleman's time has expired.

Did you have one more question for him?

Mr. JOHNSON. You know, I don't understand, you are coming here to testify about allowing States to have an opportunity to file bankruptcy so that they can eliminate their pension obligations and thus won't have to come to the Federal Government for bail-outs.

Mr. RAUH. With all due respect, sir, I think you are putting words in my mouth. I did not—my testimony was not about that. It was about how we got the situation we are in. The fact that States owe \$3 trillion to public employees is a problem.

Mr. COBLE. The gentleman's time has expired.

The gentleman from South Carolina, Mr. Gowdy, is recognized for 5 minutes.

Mr. GOWDY. Thank you, Mr. Chairman.

Mr. Brainard, I also want to thank you for reminding us it is Valentine's Day. And in the long run, you saved us more money than all of the States cumulatively owe by that reminder. So thank you. If you saw a lot of people visually texting, it was because of your reminder. So thank you for that.

Mr. Spiotto, you mentioned Bekins. You are concerned about the constitutionality of Federal involvement in State bankruptcies. Extrapolate on that for us.

Mr. SPIOTTO. Yes. The big problem with the Federal Government setting up a bankruptcy court for the States or a State is, one, it could only be voluntary because given the 10th Amendment, the

Federal Government cannot mandate that. Asked in Bevins, it is very clear on that from the Supreme Court.

Second, there will be very limited power of any Federal bankruptcy court to really deal with any problem that the State has.

And third, States probably, if they had to define their problems and put it into a hierarchy, they may have a small number of real problems in their creditor relations. And many issues they don't want to overturn, they don't want to tip over that relationship. And it is working quite well.

And what bankruptcy does is throw them all up in the air and you have to find a solution to them. And it puts the State in a situation where it has to work through these problems in a system that doesn't provide any additional funding to them, no additional tax source, and puts them in jeopardy and puts them with a cloud, which normally they have worked hard the last hundred-plus years to avoid; i.e., that they have met their obligations when they have had to and they have not failed to do so.

And therefore, it puts a cloud without a mechanism to solve it.

Mr. GOWDY. Mr. Brainard, if I am missummarizing your testimony, correct me. I thought I heard you say that you think that there is a sufficient amount of money available for the next 25 years so long as changes are made in that quarter century to correct what I assume you would agree are some structural defects.

What kind of changes would you like to see States make, and what has taken them so long?

Mr. BRAINARD. Representative Gowdy, in any number of States some degree of reform is required. It is going to vary by State and indeed by individual pension plan.

The National Conference on State Legislatures recently reported that in 2010, last year, an unprecedented number of States took action to modify their pension plans. This includes reducing benefit levels and increasing contributions either from employers but also from employees.

So the solution is going to be unique, depending on the unique pension plan but generally it is a reduction in benefits and an increase in contributions from employees, employers or both.

Mr. GOWDY. But you don't disagree even with the professor that some systemic structural changes must be made.

Mr. BRAINARD. In many cases. Not all.

Mr. GOWDY. Professor, are there any trends among the States that are in the most serious trouble with respect to right-to-work status versus union status, Tax Code, regulatory code? Are there any trends with respect to the States that are in the most amount of trouble fiscally?

Mr. RAUH. Well, the trend that I am seeing is that there is a serial correlation, if you will, where the States that have been in bad shape are kind of getting worse, particularly with we respect to Illinois which, you know, has simply not been addressing their pension problems, as well as New Jersey which simply has not been contributing.

You know, I have observed—it was pointed out that North Carolina does not have unionized public employees at the State level. North Carolina is a State that is in reasonable shape with regards

to these matters. But I haven't done a systematic study across all 50 States to see whether you would find that correlation.

Mr. GOWDY. What is "smoothing?" Is that a term that is used as people evaluate their pensions plans, and what is it?

Mr. RAUH. "Smoothing" is the idea that instead of having to look at how much your assets are worth today when declaring your unfounded liabilities to the public, you can take an average over a certain number of years. And as a result, in times when the market is going up very quickly, the value of the assets that is being reported is understating the market value of the assets and in times when assets are going down very quickly it is overstating the value of the assets.

Mr. GOWDY. I am out of time. Thank you.

Mr. COBLE. I thank the gentleman. The Chair recognizes the distinguished gentleman from Michigan, Mr. Conyers.

Mr. CONYERS. Thank you, sir.

Point of order before the clock starts running.

As the Chair knows, the PATRIOT Act is on the floor, the first thing up. And as has been our policy, we do not hold hearings in any of the Subcommittees when one of our bills is on the floor.

Mr. COBLE. Well, I was told to be here at 4 o'clock, Mr. Chairman. That is why I was here.

Mr. CONYERS. Yeah. But what are you going to do when the PATRIOT Act comes up on the floor?

Mr. COBLE. Well, 5:30 I think is when it convenes, at 5:30.

Mr. CONYERS. Oh, okay.

But you agree with the principle that we do not have bills of the Judiciary Committee on the floor at the same time the Subcommittees are holding hearings.

Mr. COBLE. I am not sure about it. I will take your word for it.

Mr. CONYERS. But you have been here almost as long as me. I mean, Lamar Smith had that rule, Henry Hyde had that rule, Jim Sensenbrenner had that rule, and now you are not sure.

Mr. COBLE. Well, I will state to you, if the gentleman will yield, I didn't call the hearing. So hold me harmless for that.

I think it has been a good hearing, by the way.

Mr. CONYERS. It has been. I quite agree, sir.

But we are starting not at 5:30 but in 10 minutes on the floor of the House. We just called and checked.

So I don't want you to get in trouble because you weren't sure. I am here to help.

Mr. COBLE. I stay in trouble, Mr. Conyers.

Mr. CONYERS. Yeah. But I think we ought to summon the Chairman of the full Committee here to help us straighten this up, because I am the floor manager for the minority on the PATRIOT Act. Hank Johnson has already requested time to speak on the PATRIOT Act. And you are suggesting that we just stay here because you are not sure.

Mr. COBLE. We are planning to adjourn at 5:20. But we need to get moving.

Mr. CONYERS. No, that is unacceptable.

I would make a point of order and ask someone to call in Lamar Smith because I don't have an obligation to choose between this im-

portant Subcommittee of yours and my managerial responsibilities on the House floor. Would you help me with that?

Mr. COBLE. I am not sure. I can't help you with it.

Mr. CONYERS. You mean I just make a choice. Since I can only do one or the other, it is on me and not on the Committee.

Don't we have this in the rules somewhere, Chairman Coble?

Mr. COBLE. Well, the Judiciary Committee is on the floor at 5:30, I am told, Mr. Conyers.

Mr. CONYERS. Who told me 10 minutes from now?

COUNSEL. The Intel Committee is up first. The Judiciary Committee is at 5:30.

Mr. CONYERS. Okay. That is good enough for me. And I always take the counsel for the Judiciary's word for it. We have never had a disagreement yet. And I thank you, Mr. Chairman.

Mr. COBLE. Thank you.

Mr. CONYERS. Now, let's begin to see if we can thread together where we have areas of agreement here.

Here is the Manhattan Institute. More than half of all State expenditures go to Medicaid, K-12 public school aid, and other transfer payments. These are the areas, not current pension bills or debt service, that have been the prime source of unsustainable and unaffordable spending growth in State budgets. True or false.

Mr. Brainard?

Mr. BRAINARD. Representative Conyers, I am not an expert on State finance but that is my understanding, is that K-12, higher Ed and Medicaid make up the bulk of State and local spending.

Mr. CONYERS. Matt Fabian, true or false?

Mr. FABIAN. I say true to that.

Mr. CONYERS. Thank you. Attorney Spiotto, true or false?

Mr. SPIOTTO. That is my understanding.

Mr. CONYERS. Right.

Professor Rauh, true or false?

Mr. RAUH. On spending, yes, States have spent more on those things than on other things. But you can't look at this like spending. This is debt, and it is like debt that is not being paid.

Mr. CONYERS. True or false?

Mr. RAUH. I think I didn't understand the question.

Mr. CONYERS. You can say "false." It is okay.

Mr. RAUH. I mean, I think if I understand the question.

Mr. CONYERS. Well, then why don't you agree with everybody else and say "true"?

Mr. RAUH. Have they spent more on that than on pensions? True. Will they have to spend more on pensions than on this? Yes, they will have to spend more on pensions in the future.

Mr. CONYERS. But you didn't answer my question, sir. My question is true or false.

Mr. RAUH. I will give you true.

Mr. CONYERS. Well, thank you. Thanks for your cooperation.

Because the Manhattan Institute is a—have you heard of the Manhattan Institute?

Mr. RAUH. [Nods head.]

Mr. CONYERS. Do you acknowledge that they are a pretty conservative think tank organization?

Mr. RAUH. I don't understand why their politics would have any bearing on this.

Mr. CONYERS. I didn't say it was political. I said that they were conservative.

Mr. RAUH. Is that so? I didn't know.

Mr. CONYERS. I see. All right.

Let me ask you this: Have you heard of attorney Joe—the late attorney Joseph Rauh.

Mr. RAUH. Yes, I have.

Mr. CONYERS. And your name is Rauh.

Mr. RAUH. Yes, it is.

Mr. CONYERS. Are you two related?

Mr. RAUH. Not that I know of.

Mr. CONYERS. Well, wait a minute. Everybody commonly knows all Rauhs are related. I mean whether they know it or not.

Do you realize that he might be turning over in his grave now to be hearing your testimony?

Mr. RAUH. I don't know why that is here or there.

Mr. CONYERS. No. It isn't here, it is irrelevant. But don't you think that the late Joe—who used to testify before this Committee.

Mr. RAUH. I think the late Joseph Rauh would actually care about the fact that what we have all—all the promises, the unfunded promises that have been made are going to have to be paid back in the future and that that is going to crowd out spending on essential public services like schools and education.

Mr. CONYERS. Perhaps he would.

But I am happy—do you acknowledge any possible relationship between you, the late Joe Rauh that I knew pretty well, and my pleasure in meeting you this afternoon, between you and him?

Mr. RAUH. Do I—I have never met him. I know of his name. I am not quite sure what you are asking, sir. I don't know of any relationship between us.

Mr. CONYERS. I will explain it to you.

When I meet people named Conyers, and some I don't know, guess what. They ask are we related. I don't say I don't know. I say all Conyers are related. They didn't go into probate court and change their name to "Conyers" and neither did you. So I think it is fair to assume that there is some relationship, don't you?

Mr. RAUH. Sir, genealogy is not my area of expertise. I really don't know if we are related or not.

Mr. CONYERS. Would you be interested in finding out?

Mr. RAUH. Sure.

Mr. CONYERS. Well, thank you. I want to help you in that respect, if I can.

I thank you, Mr. Chairman.

Mr. COBLE. The gentleman's time has expired.

The gentleman from New York, Mr. Reed, is recognized for 5 minutes.

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

I am not going to inquire about anybody's familial relations with anyone else. I am really concerned about the issue that we are facing with the unfunded liabilities that are facing our Nation.

As a city mayor, I saw this issue firsthand. I saw GASB 45 and its requirement that we disclose our unfunded liabilities and try to

quantify that. And when I did that as a mayor, I tell you my eyes popped out of my head because I said shame on my predecessors who never dealt with this issue and who now are saddling me plus the children of my community with these debts.

So I am very comfortable in coming to the conclusion that we have a serious problem when it comes to this issue. Even Mr. Brainard, you indicated in your written testimony even today that even under conservative estimates the median State pension fund is able to pay benefits until 2030. You said 25 years today. So 2035 I guess is your verbal testimony.

So my question is, and I do recognize the concern about—I do recognize the concern about bankruptcy. And I want to make a note. I believe the State of California issued IOUs. A great State of our Union had to go to IOUs to meet its monetary obligations. That is very scary to me. And as a freshman Member of this Congress, that puts generations of children in jeopardy that America will not be here because States such as California are coming up with different types of currency to cover their obligations.

So I don't want to make light of this issue. This is a serious issue. And it is part of a bigger problem that we are facing in this Nation.

So I recognize the issue with bankruptcy, and I recognize the issue that that will send, reviewing your written testimony, to the municipal bond markets and the fact that people may look at that investment as something where historically it has always been looked at as a secured investment, something that is going to keep the rates low because they are going to fulfill their obligations.

So I am interested in talking to any of you. I guess I will start with Mr. Spiotto.

H.R. 567 appears to be a solution that is on the table about requiring transparency on the issue of unfunded liabilities.

Do you have any comments on H.R. 567?

Mr. SPIOTTO. Thank you.

I think transparency is always a good thing. And one of the things that the municipal market has striven for over the years is more and more transparency. One of the questions is what is the price or the cost of it. And as you mentioned, GASB 45 was helpful in bringing to the forefront that issue. And I think that municipal issuers have, over a long period of time, tried to make sure that the investors understood what the costs are. And so I think that bill is an interesting bill from the standpoint of providing some impetus for more disclosure.

Mr. REED. I appreciate that.

Professor Rauh, do you want to comment on that?

Mr. RAUH. Yes. Well, I mean to comment on the bill, the Public Employee Pension Transparency Act, I think this is a critical step forward because, you know, if States are going to be running large hidden budget deficits and subjecting Federal taxpayers to the risk that in the future there will be requests for bailouts, then it is very important for the Federal Government and Federal taxpayers to understand just the size of the unfunded liabilities. And I think that the Public Employee Pension Transparency Act, H.R. 567, is a very critical step forward toward doing that, and it would calculate the liabilities the way that we calculate them.

Mr. REED. I appreciate that input.

Mr. Brainard, you said that one way that you would look forward to the States dealing with this issue is that they would renegotiate their relationships with their employees and employers with reduction of benefits, increases in contributions. That would be a contractual renegotiation, would it not?

Mr. BRAINARD. Representative, with respect, I don't think I used the word "renegotiate."

Mr. REED. How do you get to reduction of benefits, increases in contribution to deal with the problem that you are proposing to us as a solution that would deal with the issue?

Mr. BRAINARD. The levels of protection, benefit levels and contribution rates vary by State. And in some States those levels of protections are more lax, and in other States they are more ironclad. So to this point I am not aware of a State that has modified their benefit structure or financing arrangement that is in contravention to the State constitution or statutes. Those States in which that is permitted, some have taken advantage of it.

Mr. REED. So what you are referring to is the State legislative makeup that allows the benefits to be redesigned legislatively?

Mr. BRAINARD. Yes, sir.

Mr. REED. Okay. But in the collective negotiation contracts with employees, that would have to be reopened up, would it not?

Mr. BRAINARD. Well, in cases where employees have the right to bargain collectively; for example, California, public employee groups, my understanding is last year a number of them provided concessions.

Mr. REED. So voluntary concessions that they would have to come to the table to deal with the issue.

Mr. BRAINARD. Yes, sir.

Mr. REED. Okay. I see my time has expired.

Thank you, Mr. Chairman.

Mr. COBLE. I thank the gentleman from New York.

The Chair recognizes the distinguished gentleman from Illinois for 5 minutes.

Mr. QUIGLEY. Thank you, Mr. Chairman.

Mr. Chairman, I sure don't need to be convinced that this is a serious problem. I come from Illinois, which seems to compete with California to dive off the cliff like lemmings in not recognizing this as a serious problem. And I see it as, you know, years of neglect. And in Illinois, it is 20, 30 years of underfunding and having ridiculous rules about what people think they can do in providing, in some cases with all due respect, sweetheart deals to some folks that put this system in this vein.

It wasn't until the economic downturn that this really came to light. The economic downturn is blamed for this, but in reality that is only part of it. I mean, the symptoms were there and we weren't paying attention. The economic downturn just made it so much more dramatic.

And as part of the larger picture, State and local governments as a whole in terms of financial management or forgetting the story of Jacob in Genesis that during the 7 good years, you should save for the 7 lean years. So we know how we got there.

But there is some nuance here. This is my second hearing on this in less than a week. One more and I get a set of steak knives, I am told. But everyone seems to be kind of in the middle. There is not going to be a bailout and States need to recognize that and act accordingly. They need to reinvent themselves, streamline, consolidate, and reform, including their pension plans.

But to bankruptcy, I have just heard so many concerns within the bond market and among many others about the ramifications on that.

So if I could start briefly with you, Mr. Fabian, you seem to speak of what is almost a contagion if there is not just bankruptcy but do you also see that potential if pension funds had something more than a big hiccup in terms of affecting the bond market not just in the 8 to 10 States that are problematic but beyond?

Mr. FABIAN. So the question is about an event happening within the pension funds?

Mr. QUIGLEY. Short of a bankruptcy.

Mr. FABIAN. Sure.

Well, the municipal market right now—the issue of bankruptcy, the issue of a collapse is something that would affect the market regardless. The municipal market right now is particularly vulnerable because we have been under a fairly intense media assault, a warning of a looming collapse of the market. So this fear of bankruptcy is for sure attracting the attention of everyone in the market. Certainly all of our subscribers and probably many more.

The idea of something outside of bankruptcy, I am not exactly sure what that might be but I am thinking of—

Mr. QUIGLEY. Defaults?

Mr. FABIAN. On the pensions?

Mr. QUIGLEY. Well, some major financial hiccup in that vein.

Mr. FABIAN. The one thing—there is a study on—

Mr. QUIGLEY. Payments on loans for those bonds.

Mr. FABIAN. The way that most States are set up—actually Illinois is an excellent example. For Illinois to actually—what Illinois does is they actually sequester cash about a year ahead for the debt service that is due over the coming year. And they have the access, the first access to all revenues of the State regardless of where they came from to fill up that fund. And that fund can't be used for any other purpose. And it is a monthly set-aside. So and just in case the legislature doesn't actually appropriate or the governor doesn't appropriate, there are mechanisms to do it for them.

So the risk of them actually defaulting on their bonds is extremely low. It is hard actually to see the scenario in which they would.

With Illinois, there is a study by the Boston College Center for Retirement Research which shows that, you know, were Illinois to just continue to underfund its pension, in 2022 to 2027, I believe, their cost of converting from a pension fund, which is a simply PAYGO system of pension funding, would increase the—it would cost about an additional 12 percent of the State's budget.

Mr. QUIGLEY. I don't mean disrespect. I am just short on time. We are all leaving.

To put that to you, Professor, the problem that Mr. Fabian talked about earlier to the bond market of bankruptcy and affecting all the States, not just the 8 to 10 who have been bad apples.

Mr. RAUH. I think the risk is that we are referring to if there is no bankruptcy code introduced then the risk that one is looking at at that point is you know what happens if a few years down the line, you know, when some States have been relying even more on borrowing to fund pensions if the muni markets at that point say you know what, we have had enough of this and we are not interested in buying the new bonds at an auction.

And just to give a perspective, I mean if you look at bonds on Greek debt, you know, a month before the Greek crisis that erupted in Europe and the European debt crisis, the spreads were really small over German bonds. Those bonds were trading very close to looking like German bonds. And then all it really took was a couple auctions where investors weren't interested. And all of a sudden the rates spiked and then there was contagion.

So I think the risk of contagion is there a bankruptcy code or not.

Mr. QUIGLEY. Thank you.

Mr. COBLE. The gentleman's time has expired.

The distinguished gentleman from Florida, Mr. Ross, is recognized for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman.

Professor Rauh, from tone of what I have heard, I appreciate Mr. Brainard wishing us a Happy Valentine's Day, I can just about bet, though, you are not on his Christmas card list.

But more importantly, as I have read some of his reports, he indicates that on the whole State and local pensions are weathering the financial crisis and making measured changes to ensure their long-term sustainability. It goes on to refer to a study authored by you saying it promotes confusion by mixing apples with oranges. And then goes on further to also say that the method used to determine future pension liabilities of States and localities is not recognized by governmental accounting standards.

How do you respond to that, Professor?

Mr. RAUH. Well, those governmental accounting standards are flawed in the perspective of finance, economics, and, frankly, common sense.

Mr. ROSS. I guess what I am concerned about is that we are talking about government pensions. But yet on the private side, is there more uniformity for regulating or evaluating private pensions?

Mr. RAUH. There is more uniformity and that is because there is also more Federal involvement. I mean of course the Federal Government explicitly insures defined benefit pension plans that are sponsored by corporations. And you know part of the 1974 ERISA legislation that introduced that insurance was that a regulatory layer was also applied where companies had to calculate their liabilities using certain assumptions and they also had to contribute to the funds under certain pre-specified assumptions.

With State and local pension plans, we are kind of operating under the idea that the States are on their own and therefore they haven't been regulated up until now. And I think that the Public

Employee Pension Transparency Act recognizes that there is some systemic risk.

Mr. ROSS. So presently under the GASB, is there any statement of actuarial assumptions that must be made or disclosed by anybody who is accounting for the pension funds?

Mr. RAUH. To be sure, there are some standards of practice that have to be followed. But there is also wide leeway. And in particular, I think the biggest problem is the expected return on planned assets and being able to assume that because your portfolio made 8 percent in the past it is going to make 8 percent in the future and then to write down, reduce the value of your debts as a function of that.

If I go to a bank and try to take out a second mortgage and the bank rejects my application, I can't go back the next day and say, look, I rebalanced my assets and now I am holding more equities which are going to have a higher expected return in the future, you know, will you reconsider.

Whereas for State and local governments, the fact that they can assume 8 percent returns in their portfolios allows them to reduce the value of the debts that they are stating to the public, and these standards misrepresent the value of the liabilities. They misrepresent how much State and local taxpayers owe to public employees. It is often beyond what is being set aside.

Mr. ROSS. As I understand it, there is no uniformity between States in terms of their accounting practices of their pensions.

Mr. RAUH. Well, there are some frameworks that all of the States follow because they are voluntarily following the GASB recommendations. But I mean to give you an example, I mean there is something under GASB called the actuarially required contribution. But of course you know the State of New Jersey contributed 5 percent to the actuarially required contribution to its teacher and police fund. So in what sense is that required. It isn't really required.

Mr. ROSS. It is a relative term.

Mr. RAUH. I like to call it a recommended contribution.

Mr. ROSS. Mr. Brainard, the Public Employee Pension Transparency Act that we have talked about, you shouldn't have any objection to that, should you, or your members?

Mr. BRAINARD. Representative Ross, we do object to it.

Mr. ROSS. I mean why? If it is going to make it more uniform, more accountable and, more importantly so that the pension recipients are going to have some idea of what is being done with their plan and the posting of 20-year plan of the actuarial assumptions made, what would be wrong with that?

Mr. BRAINARD. Representative, I understand the appeal on the surface. However, if you dig down a little deeper you will recognize that we believe, as has happened on the corporate pension side, the use of current interest rates, which is what this legislation proposes to measure public pension funding liabilities, introduces extreme volatility.

Mr. ROSS. More so than the discount rate now being used?

Mr. BRAINARD. Yes, sir, absolutely. The purpose for the discount rate currently in place as promulgated by GASB is to promote—to oppose volatility and promote consistency in the funding level. And

we believe that the introduction of current interest rates makes the condition of the pension funds a condition more of current bond yields than the underlying dynamics of the plan itself.

Mr. ROSS. So you would assume then that the accountability of the government pension plan should remain status quo?

Mr. BRAINARD. I think that government pension plans are accountable to the taxpayers in each of the States, sir.

Mr. ROSS. And not to a board.

Mr. BRAINARD. Well, those—

Mr. ROSS. An appointed board.

Mr. BRAINARD. Representative, those boards are appointed by governors and legislative members and elected by—appointed by legislators and they work within a statutory framework that is approved of course by every legislature.

Mr. ROSS. Would you recommend that any of your pension plans purchase any of the bonds issued by your States?

Mr. BRAINARD. Representative, that is a very broad question. But there are many—my understanding of the municipal bond market is that there would be many prudent investment opportunities, yes, sir.

Mr. ROSS. Thank you.

Mr. COBLE. I thank the gentleman from Florida. And I thank the Members for staying with us to the last doll is hanged. I would be remiss if I did not extend Happy Valentine's greetings to each of you. Thank you for your testimony.

Without objection, all Members will have 5 legislative days to submit to the Chair additional written questions for the witnesses which we will forward and ask the witnesses to respond as promptly as they can do so, so that their answers may be made a part of the record.

Without objection, all Members will have 5 legislative days to submit any additional materials for inclusion in the record.

With that, again, I thank the witnesses and those in the audience, and this hearing is adjourned.

[Whereupon, at 5:30 p.m., the Subcommittee was adjourned.]

A P P E N D I X

MATERIAL SUBMITTED FOR THE HEARING RECORD

Response to Post-Hearing Questions from Joshua Rauh, Ph.D., Associate Professor of Finance, Kellogg School of Management, Northwestern University, Evanston, IL

Response to Questions for the Record for Re State Bankruptcy

Professor Joshua Rauh

1. **What will be the impact of H.R. 1's cuts to discretionary spending have on states and local municipalities?**
I have not studied that issue or the bill, so I will decline to comment.
2. **Why is it that leading economists (such as Moody's Mark Zandi) and conservative think tanks (such as the Cato Institute and the Manhattan Institute), believe that the states' financial health is not in crisis and that, in particular, the states can manage their public pension obligations?**
There are aspects of state accounting that I believe give an obscured picture of their true financial health, such as their use of expected returns on pension assets to discount liabilities.
3. **Please identify specifically what entities fund your research on the public employee pensions.**
Northwestern University is my employer since July 2009, and the University of Chicago was my employer from July 2004-June 2009. I am a research associate at the National Bureau of Economic Research (NBER) and a research fellow at Netspar (Netherlands) and have received financial support from these organizations. I have also received grants on this topic from the Zell Center for Risk Management at Northwestern University, the Rotman International Centre for Pension Management at the University of Toronto, the Brookings Institution, the Initiative on Global Markets at the University of Chicago, and the Global Association of Risk Professionals.
4. **Testifying before the Senate Banking Committee earlier this month, Mark Zandi stated the following:**

Odds that a state would default on its debt obligations are remote. The biggest and most hard-pressed states, including California and New York, have graduated income tax systems that produce significant revenue when the economy improves, as it should this year. States also have low debt loads, and their interest payments account for only a small percentage of their cash flow.

What is your response?
The states have substantial off-balance-sheet pension obligations that will start claiming an increasing share of tax revenue. The longer states wait to reflect the true costs of pension promises, the more they are effectively borrowing from public employees. I believe the most likely scenario is that states will request increased federal aid that will help them these obligations, and that it is that federal aid that reduces the likelihood of an outright municipal bond default.
5. **The Center for Economic and Policy Research concludes:**

In sum, most states face pension shortfalls that are manageable, especially if the stock market does not face another sudden reversal.

The major reason that shortfalls exist at all was the downturn in the stock market following the collapse of the housing bubble, not inadequate contributions to pension funds.

What is your response?

Discounting at the Treasury yield curve, Robert Novy-Marx and I found that state pensions were underfunded by \$2 trillion even before the crisis (see “The Intergenerational Transfer of Public Pension Promises,” NBER Working Paper 14343, September 2008). The 2008 financial crisis and following recession led to a deterioration of approximately \$1 trillion in the funding status of state-sponsored pension systems. The downturn in the stock market is responsible for only one-third of the properly-measured shortfalls in the pension systems.

6. What impact did the last two recessions have on pension trust funds?

The 2008 financial crisis and following recession led to a deterioration of approximately \$1 trillion in the funding status of state-sponsored pension systems. I have not studied the previous recession.

7. Do you agree that before these recessions, “state and local pensions were, in the aggregate, funded at 100 percent of future liabilities,” according to the Center on Budget and Policy Priorities?

Using the accounting provided by the state and local governments themselves, which I believe to be flawed, state and local pensions were in aggregate fully funded. Discounting at the Treasury yield curve, Robert Novy-Marx and I found that state pensions were underfunded by \$2 trillion even before the crisis (see “The Intergenerational Transfer of Public Pension Promises,” NBER Working Paper 14343, September 2008).

8. According to the National Governors Association, 30 states have made pension changes between 2005 and 2010. What impact will these changes have on pension trust funds?

The vast majority of these changes only affect new hires. A typical change that affects new hires would be that the new hire has a somewhat higher retirement age or a somewhat lower cost of living adjustment. If contribution rates are kept constant, these changes do not affect the cash flow positions of the pension fund until the new hires enter retirement, so that one is unlikely to see any positive effects for decades. Furthermore, changes that affect new hires have in some instances been used as justification for reducing government contributions today, so that changes to benefits that affect new hires only can perversely harm the health of the pension funds in the near term. The *New York Times* has reported that such techniques have been used in Illinois, Rhode Island, Texas, Ohio, Arkansas, and “a number of other places” (see “The Illusion of Pension Savings,” September 17, 2010, *New York Times*).

9. According to the Manhattan Institute, “More than half of all state expenditures go to Medicaid, K-12 public school aid and other transfer payments. These are the areas – not current pension bills or debt service – that have been the prime source of unsustainable and unaffordable spending growth in state budgets.”

What is your response?

The growth in pension promises has come along with an increase in current cash spending on pension contributions that to my understanding has been smaller than the growth in cash spending on the other areas mentioned in the question. However, the growth in pension promises has resulted in a very large increase in off-balance-sheet state debt, and the need to service that debt in the future will absorb increasing amounts of state and local revenues.

10. **FitchRatings, a major ratings agency, says that by making bankruptcy available to states would cause it “to assess whether the entity’s current rating should be maintained, as consideration of bankruptcy not only indicates severe financial stress but also a willingness to compromise the credit standing of bondholders through a bankruptcy filing.”**

What is your response?

The question cites a rating agency’s comments on how its assessment procedures for states might change if state bankruptcy were introduced. I don’t have a response.

11. **We note that 3 of your 6 citations are references to your own publications. When one cites to oneself as a reference, isn’t that a self-fulfilling prophecy?**
My testimony is based on my academic research. I cited the papers so that those at the hearing would know what to read for further details on my methodology.

12. **In your paper “Are State Public Pensions Sustainable?,” you assume that no future state or local government contributions go toward amortizing the current unfunded liability. This assumption, in turn, helped lead to your conclusion that “many states systems will run out of money in 10-20 years.” However, standard practice among public plans is to amortize unfunded liabilities in the contributions, and many states have constitutional or statutory requirements that the full contribution be made. Therefore, on what basis did you assume no future contributions would go toward amortizing unfunded liabilities?**

Total contributions in aggregate across the country during 2006-2008 were roughly equal to or somewhat less than our best estimate of new benefit accruals. So in aggregate there has been little progress in paying off unfunded liabilities. That is because many states are not following the rules referred to in the question: approximately 45% of state government systems we studied paid less than the full Actuarially Required Contribution (ARC) in 2009, 40% paid less than 90% of the ARC, and 25% paid less than 80%. Finally, to pay down unfunded liabilities under these rules will require very substantial tax increases or spending cuts in other budget areas, and the study illustrates what is likely to happen in the absence of those substantial spending cuts or tax increases.

13. **Local government tax revenues and non-tax revenues from various fees account for nearly half of all state and local revenues.**

Why did you not include these in your calculations when you compared state and local pension obligations to state revenues?

We compared plans sponsored by state government entities to state level revenues, and plans sponsored by local government entities to local level revenues. The issue raised in the question is that sometimes state-sponsored plans

are aggregates of local employee plans that may receive local funding. One could re-allocate some of the state costs to the local level, but that will make the local liabilities look much worse relative to local revenues.

14. **As everyone knows, changes in the market value of assets and interest rates have an effect on pension liabilities. Your findings were based on values at a time when markets and interest rates were very low. Since then, both the market value and interest rates have increased significantly and are expected to continue that trend. Are you prepared to correct your findings based on current and expected future values?**

Our findings on the present value of pension liabilities were measured as of June 2009, a time at which the levels of interest rates on Treasury securities were very close to those as of February 2011 (for example, the 10-year yield was 3.6% on June 30, 2009 and it was 3.5% on February 28, 2011). On the asset side, there has been an increase in asset values that has made up some of the losses during the financial crisis, which to the best of my understanding might have restored about \$0.5 trillion of the \$3 trillion in unfunded liabilities. This is not a matter of “correction” but rather a matter of updating for recent developments, which were not predictable.

15. **Mr. Fabian says that legislating state bankruptcy would disrupt the current municipal bond market and cause interest rates for longer maturity bonds to rise by 10 to 20%.**

What is your response to that statement?

I have not studied this issue, so I will decline to comment.

16. **Mr. Fabian says that the impact of having a state bankruptcy law could put “upward pressure on state and local taxes, [and] downward pressure on spending and state employment.”**

What is your reaction to that statement?

I have not studied this issue, so I will decline to comment.

17. **Mr. Fabian says that the impact of a state bankruptcy law would affect all states – including those with well-managed pensions and budgets – and they would have to “pay a substantive penalty when coming to market for new loans.” In addition, he says that municipal governments would also suffer, as their local governments are deeply intertwined with the management of tax collections, spending and borrowing programs, and mandates.**

What are your thoughts regarding these observations?

I have not studied this issue, so I will decline to comment.

18. **Using Illinois as an example, Mr. Fabian concludes that it is “very hard to see ANY problem with payment of debt service on the state’s long term debt, even under the most strenuous or long-term scenarios being played in the media.”**

What is your response?

Illinois faces serious fiscal challenges, and in my view the more “strenuous” scenarios would indeed challenge its ability to service its debt.

19. **In your paper “Are State Public Pensions Sustainable?” you assume that future state and local government contributions will be sufficient only to pay for benefits accrued going forward, and none will be used to pay off unfunded pension liabilities. What is the basis for this assumption? Also, how would this contribution pattern compare with contributions state and local governments have been making in recent years, on a national basis?**

Same answer as question 12.

20. **In your paper “Are State Public Pensions Sustainable?” you compare pension obligations of both states and local governments, with the tax revenues of states alone, ignoring local government tax revenues and state and local revenues from fees and other charges, such as tuition, parks, and others. Yet non-tax revenues account for nearly half of all state and local revenues. Why do you compare, for many states, unfunded pension liabilities attributable to political subdivisions with tax revenues of states only? Do you believe this comparison is fair, and if so, on what basis? Also, why does your comparison exclude non-tax revenue sources?**

The figures you refer to examine state-sponsored pension systems relative to state revenues. We also examine locally-sponsored pension systems relative to local revenues. If one wants to attribute the state-sponsored teacher pensions to local governments, then the problems of the local governments (cities and counties) will look substantially worse.

21. **Since you published your papers projecting the insolvency of state pension funds and estimating unfunded state pension liabilities at \$3+ trillion, certain important factors have changed: many states have made changes to their pension plan designs and financing arrangements, and the market value of pension fund assets has risen significantly. Considering the dramatic findings and projections of your papers, the publicity and attention they have received, the magnitude of the increase in pension asset market values since you measured them, and since you believe that pension plans should be measured on the basis of their market—not actuarial—value of assets, would it appropriate to update your findings in these papers to incorporate these changes? If your answer is yes, do you intend to do so? If your answer is no, why not?**

As new data becomes available, it is appropriate to update the calculations of unfunded liabilities. The data of the systems are released with substantial time lags. Even including recent asset performance, my best estimate is that state and local plans combined are still underfunded by roughly \$3 trillion.

22. **Do you believe that public pension plan contribution rates should be determined and required to be made on the basis of a risk-free investment return? If your answer is yes, do you agree that such contribution rates would become highly volatile in response to changing interest rates, leading to public sector budget volatility and uncertainty?**

Yes, public pension plan contribution rates should be determined and required to be made on the basis of a risk-free investment return. If the assets in the fund are invested in assets that are sensitive to those same interest rates then there would be little volatility in the plans' funding status and in required contribution rates. Investing the trust funds in risky securities is by far the leading cause volatile contribution rates.

23. **Can you reconcile why state and local government pension plans should use a discount rate that is lower than rates used by corporate pension plans, which would result in higher public pension liabilities and costs, under equal circumstances, than their corporate counterparts? Stated differently, what practical sense does it make to require public pensions to have more unfunded liabilities and to cost more, than corporate plans, under identical circumstances?**

The regulatory and practical circumstances for public pension systems and corporate pension systems are completely different. Financial accounting rules have firms using corporate bond rates because the company gets to transfer the pension obligations to the US government in the case of bankruptcy. Not so for state and local governments.

24. **Do you agree that state and local policymakers must consider multiple risks, in addition to pension fund investment risk, and that requiring the use of a risk-free investment return would introduce other types of risk that policymakers must also consider and manage? If not, why not? If so, what risks would be introduced as a result of the adoption of a risk-free investment return, and how should policymakers address those risks?**

Funding at risk-free rates and investing the assets in securities that more closely matched the liabilities of the pension systems would decrease financial risk associated with pension funds.

25. **The imposition of federal regulations and FASB standards onto corporate pension funds has, by most accounts, been a major factor in corporations abandoning their pension plans, in lieu of defined contribution plans. Do you believe that the Public Employee Pension Transparency Act would have similar results for pensions sponsored by state and local governments? If not, why not?**

The Act would lead to a proper reflection of the costs of making defined benefit pension promises to public employees. Some taxpayers might respond by demanding that more money be set aside to fund these promises today to ensure that we can continue to provide pensions to public employees at current levels. Others might respond with proposals that the retirement plans offered to public workers become less expensive, which could include the use of defined contribution plans either in addition to or in place of defined benefit plans. Voters will have to decide which of these two options they prefer. The alternative of pretending that the plans are less expensive than they are is not a viable option.

26. **You have recommended that states and local governments close their defined benefit plans in lieu of defined contribution plans. Do you agree that the onset in defined contribution plans as the nation's predominant retirement benefit has contributed to the retirement crisis many believe this nation now faces? If you disagree, what consequences have there been of the reduction in the portion of the private sector workforce with access to a traditional pension plan? If you agree, do you believe it is good retirement policy to close traditional pension plans for employees of state and local government?**

If state and local governments are unwilling to embrace proper cost measurement for defined benefit pension plans, then the defined benefit model as implemented by them will ultimately harm society on a number of dimensions. Not least of these is that the repayments of the debts to public employees will crowd out public spending on essential public services. The defined contribution model as implemented by corporations has also had flaws, but there are better models such as the Federal Thrift Savings plan, or collective defined contribution schemes used in some parts of Europe.



Response to Post-Hearing Questions from James E. Spiotto, Esq., Partner,
Chapman and Cutler, LLP, Chicago, IL

U.S. HOUSE OF REPRESENTATIVES

**HOUSE JUDICIARY COMMITTEE'S SUBCOMMITTEE ON COURTS,
COMMERCIAL AND ADMINISTRATIVE LAW**

**HEARING ON THE ROLE OF PUBLIC EMPLOYEE PENSIONS IN
CONTRIBUTING TO STATE'S INSOLVENCY AND THE POSSIBILITY OF A
STATE BANKRUPTCY CHAPTER.**

February 2011

**FOLLOW-ON QUESTIONS DIRECTED TO JAMES E. SPIOTTO
PARTNER, CHAPMAN AND CUTLER LLP**

ANSWER TO QUESTIONS RAISED BY THE HOUSE JUDICIARY COMMITTEE

Question #1. If state bankruptcy relief was available, would that prevent a state from pursuing federal funding either as an alternative to bankruptcy or, like GM or Chrysler, to fund a repayment plan under the protection of bankruptcy?

The availability of bankruptcy under a federal statute would not prevent a state from pursuing or requesting federal financial assistance for a resolution of its problems. For example, if you take the case of New York City in 1975, there had been changes made to the Bankruptcy Act at that time to try to accommodate a New York City filing, but New York City chose to request financial assistance from the federal government at the beginning of the fiscal crisis. President Ford refused. New York City worked with the New York State Legislature and developed the Municipal Assistance Corporation which provided oversight and financial guidance to the City of New York helping the City of New York better assess its financial condition, appropriately address unnecessary expenses, deal with necessary revenues, rectify accounting issues, refinance debt which became due and owing and use the credit of the state to help back the refinancing of that debt. As we all know, the successful efforts of the Municipal Assistance Corporation and New York City from 1975 forward worked. In fact, after the Municipal Assistance Corporation came into place and appropriate accounting and financial reforms had been established, the federal government did provide assistance due in no small part to the fact the state and city had taken corrective action and the funding was constructive and would not lead to the waste of funds on an unresolved situation as opposed to helping a situation improve. The GM and Chrysler bankruptcies are obviously unique situations where the federal government took an active role, either as a shareholder or the funding source. The direction

provided by the federal government in those bankruptcies would be difficult, if not impossible, with regard to a state bankruptcy proceeding for a number of reasons including: (1) the fact that the federal government and each state are co-sovereign and (2) the fact that, even as recognized for municipalities in Sections 903 and 904 of the Chapter 9 of the Bankruptcy Code, the federal bankruptcy court and federal government cannot limit or impair (a) the power of the state to control a municipality by legislation, (b) the political or governmental powers of such municipality including expenditures or any property or revenue of a municipality or its use and enjoyment of any income producing property. Accordingly, the ability of the federal government to take an active role in the restructuring or to influence the result of a state bankruptcy (unless on a voluntary basis with the state), would raise issues of adversely affecting the sovereign nature of the state.

Question #2. Are you aware of any Chapter 9 case that was filed solely because of the debtor's pension obligations?

The only Chapter 9 that has been filed recently that I know was caused by obligations to pay pensions along with other financial difficulties was Pritchard, Alabama¹. There, given the laws of Alabama and the requirements of funding, the town of Pritchard has pension obligations that it cannot afford and does not have revenues sufficient to pay for such obligations. Even if it were to go through a Chapter 9 successfully and adjust those debts, it does not appear that Pritchard would have the ability in the future to raise enough revenues to pay the pension obligations going forward unless Pritchard drastically reduces the obligations and number of public workers. Actually, Pritchard has filed Chapter 9 twice in the last 11 years, once in 1999

¹ Kelly Nolan, *Alabama City's Bankruptcy A Harbinger of Pension Woes*, Dow Jones Newswires, May 13, 2010, available at www.djnewsplus.com.

and again in 2009. The City of Vallejo did not file solely because of pension obligations, but rather, because of labor costs that were not affordable and sustainable. In Vallejo's currently filed Plan of Adjustment, Vallejo intends to make the payments to its retirees and to Calpers. Another interesting example is the San Jose School District, which filed for Chapter 9 in 1983 because of an "unfavorable arbitration" with its teachers with increased costs which the School District claimed it could not afford. The School District proceeded, while in a Chapter 9, to continue discussions with teachers and representatives, worked out a resolution that was affordable from a revenue standpoint by the School District, resolved the dispute and dismissed the Chapter 9. Generally, municipalities filing for Chapter 9 to date have been related to the inability to pay costs and expenses or an extraordinary financial obligation related an event or judgment entered by a court and therefore the need for relief. This type of financial problem has arisen, for example, out of unsustainable operating costs or a judgment entered because of a policeman firing at a suspect and hitting a citizen and having a large award entered against the municipality (South Tuscon, Arizona) or judgments entered against Boise County, Idaho, which filed a Chapter 9 proceeding on March 2, 2011², where a jury awarded a development firm \$4 million plus attorneys fees over a claim for violation of the Federal Fair Housing Act in handling of a developer's proposal to building a 72 bed residential treatment facility for teens.

Question #3. What impact would the availability of state bankruptcy relief have on -- the availability of credit? The cost of credit?

The availability of state bankruptcy is a concept which presently has not been put into the calculus used to assess the creditworthiness or cost of the state borrowing, and the introduction

² Katy Moeller, *Boise County Files for Bankruptcy*, Idaho Statesman, March 2, 2011, <http://www.idahostatesman.com/2011/03/02/>.

of that alternative would create additional issues regarding what is the right pricing, cost and access to the market for state governments. As you know, interest is a function of the ability to repay and an assessment of all of the risks for states. To date, the market has not included as one of the alternatives available to a state if it has financial difficulties the ability to go into a federal bankruptcy proceeding. That ability to go into a federal bankruptcy proceeding will be viewed in the marketplace as a negative and will affect pricing and possibly access to the market as to how much or what limits might be placed on the ability to borrow. As you know, no state has defaulted on general obligation bonds since the late 1800's with the exception of Arkansas in 1930's. As indicated in the popular press, in relationship to consideration of states being able to file for bankruptcy, many market participants have raised concerns and, especially at this time, when the municipal bond market has experienced in excess of over \$40 billion of withdrawals from bond funds by individual investors over the last few months because of concerns about local government creditworthiness, state access to bankruptcy would not be viewed as constructive in the debt market. Recently, the State of Indiana considered Senate Bill 105³ which provided that political subdivisions and certain creditors may file a petition with an appeal board seeking a designation of the political subdivision as a distressed political subdivision. The Bill provided certain oversight, financial review and financial rehabilitation by a financial board, which included the power to authorize the filing of a Chapter 9 proceeding by the local governmental body. Indiana had previously not specifically authorized its municipalities to file for bankruptcy and, therefore, Chapter 9 was not available to them (at least since 1995 and the change in the Bankruptcy Code). This provision in the Bill created enough concern and issues

³ S.B. 105, 117th Leg. (Ind. 2011).

that it prevented the Bill from being able to pass both houses in Indiana and become law⁴. The Senator who sponsored the Bill has promised to reintroduce the legislation next January. The concern in the market and those who purchase debt of local governments in Indiana is the effect such legislation would have on them and the purported fear that it will increase costs of borrowing and decrease access. In fact, some major purchasers of local government debt of Indiana had raised concerns about the ability to file a Chapter 9 as opposed to working through the financial problems, as numerous municipalities have in the past, and resolving those difficulties without the adverse effect of eliminating debt obligations.

Question #4. Mr. Fabian says that legislating state bankruptcy would disrupt the current municipal bond market and cause interest rates for longer maturity bonds to rise by 10 to 20%. What is your response to that statement?

I believe the statement by Mr. Fabian is correct. If you look at current interest rates of 3% to 4% for municipal obligations, depending upon the credit rating, 10% would be 30-40 basis points, 20% would be 60-80 basis points. That is not dissimilar to the increased interest rates that California communities experienced after Orange County filed for Chapter 9 in 1994 when there was a fear that the actions taken by Orange County (which was not perceived to be truly insolvent but rather unwilling to pay) might be a trend that other California municipalities and local governments would follow⁵. (See Exhibit A chart on Chapter 9 filing 1980-2011 by year

⁴ Dan Carden, *House Strips Bankruptcy Option for Distressed Local Governments*, McClatchy-Tribune Information Services, April 21, 2011 available at www.istockanalyst.com/business/news/5082039; Dan Carden, *Legislature Does Not Act on Tool to Help Broke Local Governments*, The Times, Munster, Indiana, April 30, 2011 available at www.nwiimes.com/news/local/govt-and-politics.

⁵ See generally, James Granelli, *OC Bankruptcy Affects Others Borrowing*, L.A. Times, Oct. 11, 1996; California Debt Advisory Commission, 1995.

and by state). Ultimately, there was no significant increase of Chapter 9's filed in California or elsewhere and that temporary interest bubble returned to a more normal rate. Clearly, when Orange County issued its debt two years after filing, as part of its exit from bankruptcy, it paid a price consistent with this principle⁶.

Question #5. Mr. Fabian says that the impact of having a state bankruptcy law could put “upward pressure on state and local taxes, [and] downward pressure on spending and state employment.” What is your reaction to that statement?

I generally agree with what Mr. Fabian has said. One of the issues raised by the access to bankruptcy is whether the credit markets will restrict the amount of borrowing and also increase the cost. The net effect of restricting the amount of borrowing and increasing the cost means that more tax dollars per dollar borrowed would go up while the number of dollars that could be borrowed for essential governmental services and infrastructure improvements would be limited. As you know and as the attached Exhibit B indicates, since 1949, whenever there has been an economic downturn, part of the recovery, i.e. the year over year increase in employment and increase in GDP is attributable to increased borrowings by state and local governments to pay for essential governmental infrastructure improvements which has helped employ those who are not employed and increased the economic activity in the region and state.

Question #6. Mr. Fabian says that the impact of a state bankruptcy law would affect all states - including those with well-managed pensions and budgets - and they would have to pay a substantive penalty when coming to market for new loans. In addition, he

⁶ Mark Baldassare, *When Government Fails: The Orange County Bankruptcy*, 180 (1998).

says that municipal governments would also suffer, as their local governments are deeply intertwined with the management of tax collections, spending and borrowing programs, and mandates. What are your thoughts regarding these observations?

If states were authorized to voluntarily file for protection under a federal bankruptcy law, even those states that are well-managed and have met their obligations to reduce expenses and have increased revenues so that they don't have budget deficits currently would have to explain what the effect might be of that legislation. Since bond indebtedness is repaid over a 20-30 year period, it is the long-term ability to repay that is of significant concern to the market. A state that may be in very good financial health today might, in 20-30 years, be in a different situation because of changing economics and local market conditions and changes in the fate of its local businesses and ability to generate increased business activity and employment opportunities for its citizens. Because of that, no state would be immune or be given a pass from explaining how it would deal with it and possibly many states would at least say that they don't intend to ever avail themselves of that remedy, which might frustrate the very purpose and interests of the legislation. As you know, both the National Governor's Association and the National Council of State Legislatures have stated they do not believe states need federal bankruptcy legislation at this time. If the state bankruptcy legislation is enacted into law, there may be good faith pledges made by states not to use or avail themselves of that legislation in order to calm or assuage these concerns. If some states pledge not to file and others are silent or possibly more judicious in what they say, that could lead to a penalty being put on those states who do not disavow the ability to file for bankruptcy. The net effect of that would probably be increased borrowing costs for those who do not disassociate themselves from the ability to file for bankruptcy. We should note that there presently isn't any good analysis or study as to whether the states that have not

authorized their municipalities to file for Chapter 9 have received any significant benefit in the market as far as borrowing costs or access. As noted in our testimony, only 15 states specifically authorized the filing of Chapter 9 for their municipalities, and 9 states have conditional authorization for filing based upon approval of a state official or state entity. (See Exhibit C attached). It is also true that if a state were to file a Chapter 9, the relationship between the state and its local government, the ability to continue to funnel tax revenues collected by the state or collected by the local governments to the state or from the state to the local governments might be impaired without some effort to address that issue similar to the “Special Revenues Concept” that are already in Chapter 9 for municipalities. Accordingly, such collection and payment of those tax revenues where the governmental body acts as a conduit for payment to another governmental body would be unaffected by a bankruptcy proceeding. As you may be aware, the notion of “Special Revenues” was incorporated into the Bankruptcy Code based upon the experience of Cleveland in 1978 and 1979⁷, while under financial distress, of not being able to obtain financing from traditional sources because of fear that any pledge of revenues could be voided in a Chapter 9 filing. If the municipality were to provide Special Revenues, which is a pledge of certain revenues derived from a municipal enterprise or a specified tax source, as defined in the Bankruptcy Code, that pledge of revenue, just like statutory liens, is not affected in a Chapter 9 and therefore is immune from any impairment in a bankruptcy proceeding. The market has taken comfort based upon that legislative history and understands pledges of Special Revenue and statutory liens would be unaffected by a subsequent bankruptcy filing which therefore provides more availability and protection to municipalities especially in times of financial distress.

⁷ James E. Spiotto, *A History of Modern Municipal Defaults in The Handbook of Municipal Bonds*, p. 711 (Sylvan Feldstein, Frank Fabozzi, ed. 2008).

Also, we are in the process of doing a 50 state survey to provide a general overview of: (1) the protections, remedies and limits that state legislatures have provided over the years to permit assistance in times of financial distress and (2) guidelines that have been enacted to limit the ability to tax and the amount of debt that can be obtained by municipalities and the states. We are still in the process of finalizing the survey, but we thought you might be interested. A preliminary assessment follows:

Virtually all State have some statutes providing for:

- Ability to refund. (All States have some provision for Refunding Bonds).
- Appointment of receivers (at least 43 states).
- Mandamus or remedies upon default to require payment of debt or levying taxes. (All 50 states have mandamus and at least 21 states have some provision for foreclosure and at least 18 states have other remedies).
- Statutory liens or Special Revenues. (All 50 states have some form of Special Revenue and at least 27 states have statutory liens.)

Active financial supervision or financial review (over half of the States):

At least 2 - Debt Advisory Commission.

At least 8 - Statutes providing for debt compromise or adjustment process and intercepts for payment.

At least 15 - Active technical assistance, grants, loans, budget review.

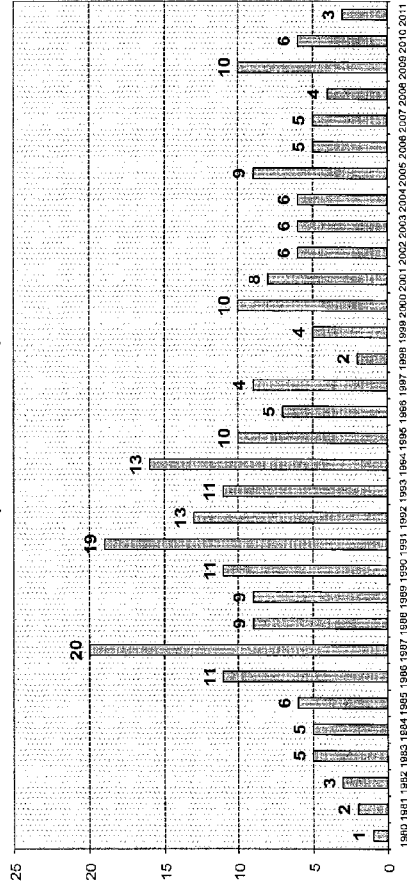
At least 19 - Financial control boards, refinance authorities and active outside supervision and review.

Every state has some form of limitation on taxes or debt or a combination of both.

EXHIBIT A

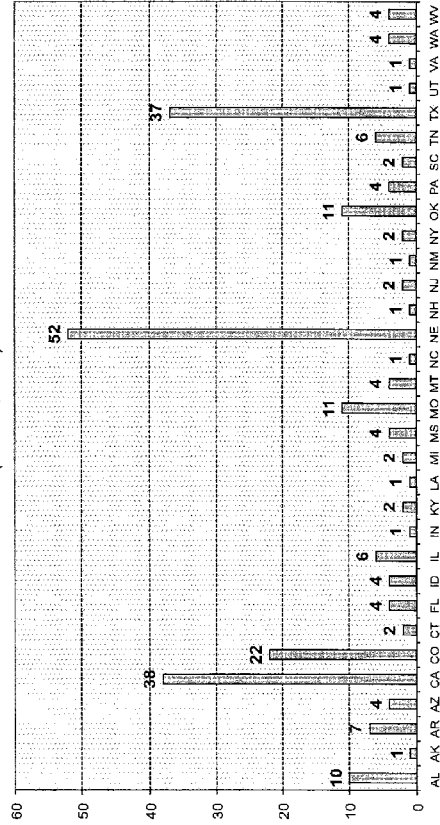
III. Default Statistics (cont'd)

CHAPTER 9 FILINGS BY YEAR - 1980-2011
(as of 04/15/2011)



III. Default Statistics (cont'd)

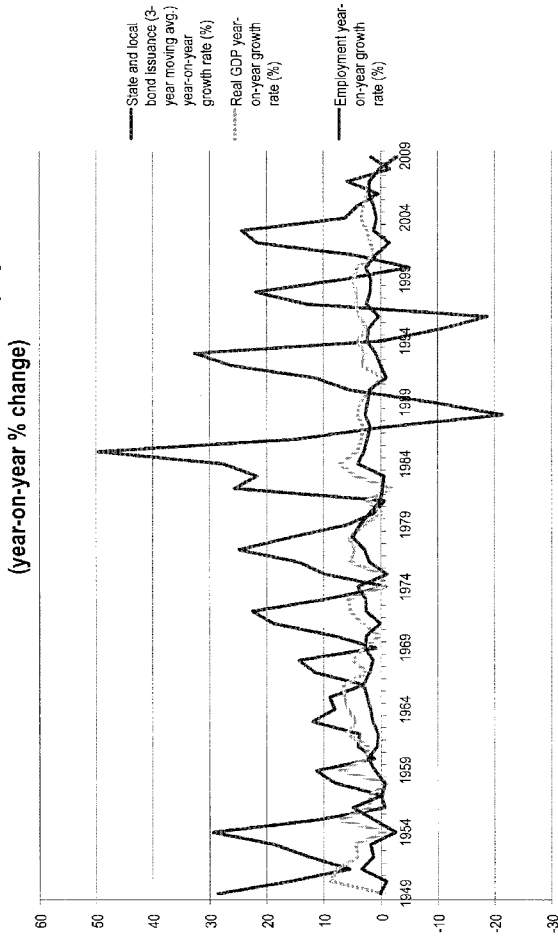
CHAPTER 9 FILINGS BY STATE • 1980-2011
(as of 04/15/2011)



Chapman and Cutler, LLP
Attorneys at Law • Focused on Results

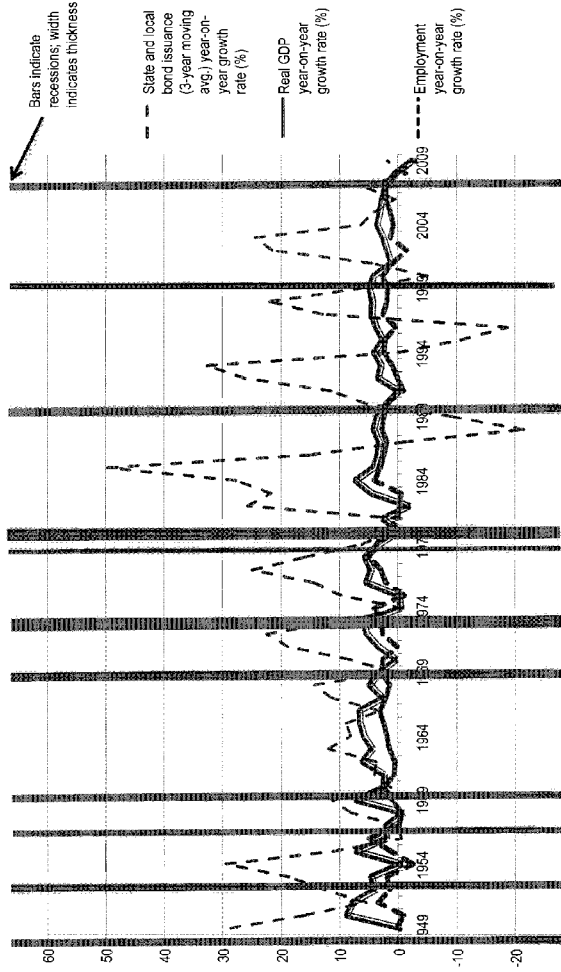
EXHIBIT B

In Economic Downturns, Increased Issuance of State and Local Bonds Is Followed by Increases in Employment and GDP Growth
U.S. Economic Trends, 1949-2009:
State/Local Bond Issuance, Real GDP, Employment



Chapman and Cutler LLP
Attorneys at Law - Focused on Finance

**In Economic Downturns, Increased Issuance of State and Local Bonds
Is Followed by Increases in Employment and GDP Growth**
U.S. Economic Trends, 1949-2009 (year-on-year % change):



Chapman and Cutler LLP
Attorneys at Law - Real Estate Finance

EXHIBIT C

General Analysis of State Specific Authorization for Municipalities to File a Chapter 9 Case

The following are statutory provisions in which states have authorized Chapter 9 filings for certain governmental entities

15 States that specifically authorize municipal bankruptcies: 9 States that conditionally authorize municipal bankruptcies:

Ala. Code 1975 § 11-81-3
 Ariz. Rev. Stat. Ann. § 35-803
 Ark. Code Ann. § 14-74-103
 Cal. Gov't Code § 53760
 Idaho Code Ann. § 67-3903
 Ky. Rev. Stat. Ann. § 66-400
 Minn. Stat. Ann. § 471.831
 Mo. Ann. Stat. § 427.100
 Mont. Code Ann. § 7-7-132
 Neb. Rev. St. § 13-402
 N.Y. Local Finance Law § 85-80
 Okla. Stat. Ann. tit. 62 §§ 281, 283
 S.C. Code Ann. § 6-1-10
 Tex. Loc. Gov't Code § 140.001
 Wash. Rev. Code § 39.64.040

Conn. Gen. Stat. Ann. § 7-566
 Fla. Stat. Ann. § 218.01 and § 218.503
 La. Rev. Stat. Ann. § 39-619
 Mich. Comp. Laws § 141.1222
 N.J. Stat. Ann. § 52:27-40
 N.C. Gen. Stat. Ann. § 23-48
 Ohio Rev. Code Ann. § 133.36
 53 Pa. Cons. Stat. Ann. § 11701.281
 R.I. Gen. Laws § 45-9-7

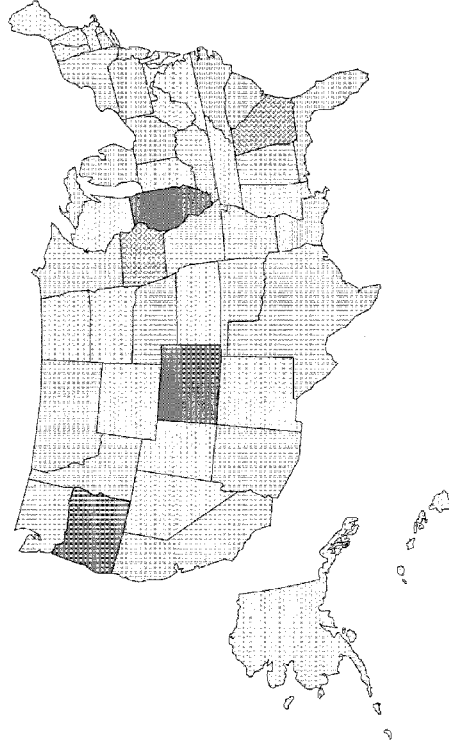
3. States with limited authorization.

- Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1403 of the Colorado revised statutes states that "any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition..." (CRS § 37-32-102 (Drainage & Irrigation District)).
- Oregon permits irrigation and Drainage Districts to file (Or. Rev. Stat. § 548.705)
- Illinois – specific authorization solely for the Illinois Power Agency (20 Il Comp. Stat. Ann. 3655/1-20(b)(15)). The Local Government Financing and Supervision Act permits that commission to recommend that the Legislature authorize a filing but it is not specific authorization (20 Il. Comp. Stat. Ann. 320/9(b)(4)).
- 2. States prohibit filing, but one has an Exception.
- Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 75.16) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 75.16A).
- Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

The 21 Remaining States are either unclear or do not have specific authorization. AK, DE, HI, IN, KS, ME, MD, MA, MS, NE, NH, NM, ND, SD, TN, UT, VA, VT, WV, WI, WY

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General Analysis of State Specific Authorization for Municipalities to File a Chapter 9 Case



- 15 States that specifically authorize municipal bankruptcies
- 9 States that conditionally authorize municipal bankruptcies
- 3 States with limited authorization
- 2 States prohibit filing, but one has an exception (Iowa)
- Remaining 21 States are either unclear or do not have specific authorization so there is no specific authorization

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ATTORNEYS AT LAW • FIDELITY AND SECURITY

Response to Post-Hearing Questions from Matt Fabian, Managing Director,
Municipal Market Advisors, Westport, CT

Questions for Matt Fabian

- 1. What will be the impact of current Republican proposals to slash discretionary spending by up to \$100 billion have on states and local municipalities?**

Spending cuts will have an incremental, negative impact on economic growth. As revenues have improved, states and local governments are still facing persistent budget deficits, now driven by spending pressure. This comes from: 1) higher federal mandates and programs like Medicaid; 2) the repayment of one-time borrowings and budget gimmicks used over the last 3 years; and 3) a return to regular trend spending. Further cuts to state and local aid will worsen budget balance and extend the impact of the national recession.

- 2. According to the National Governors Association, “The mere existence of a law allowing states to declare bankruptcy only serves to increase interest rates, raise the costs of state government and create more volatility in financial markets.”**

What is your response?

This is absolutely correct.

- 3. Are state pension obligations the greatest financial challenge that states face?**

I do not believe so. Medicaid is far larger, and will consume a greater share of state revenues in the long term. Pension funding issues exacerbate long term revenue and expense imbalances that are building as the US economy slows. States will be hard pressed to maintain regular service provision and stakeholder equity in the face of long term declines in revenues.

- 4. Do the states have sufficient tools to implement cost effective savings to avoid a financial crisis?**

States have full control over the lions share of their budgets, and have the option to raise taxes—which we see as an inevitable solution, regardless of ideology. However, willingness to use these measures is in question: a trend that will only worsen if anti-tax sentiment continues to grow in the electorate.

- 5. In your prepared statement, you express severe concerns about the impact a state bankruptcy law would have not only on states with significant pension obligations, but also on all states and their municipalities in the form of higher interest rates.**

Do you know why others strongly favor the enactment of a state bankruptcy law? Pursuit of state bankruptcy in Congress appears to be a short-sighted political maneuver to punish the citizens in states perceived as “profligate” like California and Illinois.

6. **You appear to disagree with Prof. Rauh's dire prediction of the states's financial distress.**

What accounts for your difference of opinion? Professor Rauh is relying on static projections of assets and liabilities; in reality, states will adjust and modify their revenue and spending programs to accommodate pressure from pension funding issues. The long term costs are undeniable, but there is no reason to believe that these will trump regular, prudent management on a year-to-year basis by state managers.

7. **What would be the impact of forcing a state to convert its defined benefit plan to a defined contribution plan?**

On an immediate basis, it could worsen the economics of existing defined benefit plans as these lose a source of income from new employee benefits. Longer term, defined contribution plans transfer the risk of retirement affordability to the employees and, by extension, to the country's economic base. I am unaware of statistics showing that defined contribution funds are invested more efficiently or effectively than defined benefit funds; thus the issue is one of who carries the risk of underperformance or financial inadequacy.

8. **On page 7 of your prepared statement states: "In our opinion, the impact of diminished retiree financial resources on a consumption-based economy like our own is likely to have more dramatic ramifications for the private than the public sector over the next several decades."**

Could you please elaborate on this observation?

I believe that public pensions have come under scrutiny because these have a denominator: how much is owed versus how much they have. By contrast 401ks and other defined contribution plans have been allowed to substantially lag the needed investment to keep their beneficiaries solvent through retirement. As more citizens retire with depleted house values and depleted 401ks, consumption will decline by definition; there are serious deflationary effects to this. It could instead be that defined benefit public pensioners are a major source of economic "stimulus" as these individuals will be relatively better funded and able to consume post retirement.

9. **Do you have any thoughts with regard to Mr. Spiotto's Public Pension Funding Authority?**

As usual, Mr. Spiotto has provided excellent ideas for a potential solution; I support his program, in particular that it is voluntary, which does not impinge on state sovereignty in finding adequate solutions to these issues.



Response to Post-Hearing Questions from Keith Brainard, Research Director,
National Association of State Retirement Administrators, Georgetown, TX

Questions for Keith Brainard

1. **What will be the impact of current Republican proposals to slash discretionary spending by up to \$100 billion have on states and local municipalities?**

To be clear, state and local retirement systems are solely the fiscal responsibility of the states and localities. It is my understanding that no state or local government retirement system has asked for Federal financial assistance. That said, the recession has negatively impacted revenues collected by states and local governments, which rely heavily on sales and property taxes. Employment by states and local governments has declined steadily since 2008, and is now lower by some 500,000 from its level in September 2008. To the extent that a reduction in discretionary spending reduces federal commitments to shared programs and other direct payments to states and local governments, that reduction would likely exacerbate the fiscal challenge states and local governments face.

2. **Professor Rauh asserts that at least 7 states, even assuming an 8% return on fund assets, will only have sufficient funding to pay already promised benefits at least until the year 2020. And, to address this shortfall, substantial contributions to these pension trust funds will have to be made over the next 15 years to pay for these legacy liabilities.**

What is your response?

Professor Rauh's projections are flawed in two respects: first, they are based on the depressed market value of assets in 2009, before rising capital markets increased the value of public pension assets. Second, Professor Rauh's projections assume that state contributions will be improbably low. Specifically, he projects that states will contribute nothing to pay off their unfunded pension liabilities.

Please see the attached issue brief, "Strong Investment Gains and Legislative Changes Speeding Public Pension Recovery," which describes the strong gains in assets public pension funds have experienced since their low point in 2009. As the brief points out, public pension asset values grew by nearly one-fourth from June 2009 to the end of 2010, and have grown further in 2011.

Also, most public pension plan sponsors have a record of paying all or most of the cost to amortize their unfunded pension liabilities. From FY 01 to FY 09, public pension plans received an average of 91 percent of the cost of their Annual Required Contribution. Although there are some states (and cities) that have chronically failed to pay their contributions, most pension plan sponsors have made a good faith effort to honor their contribution requirements. Professor Rauh's projection that every state will fall woefully short of its contribution requirement is unrealistic, unfounded and contrary to actual experience.

Those state and local retirement funds whose investment returns continue to exceed expectations (see attached issue brief on state and local investment return assumptions),

and continue to make all or nearly all of their required contributions (on average they have been 91% since FY 01), by definition, will never be exhausted. For the seven states Professor Rauh identified as having assets that would be exhausted by 2020, most, in fact, have more than an additional decade before they are projected to run out of assets. This provides much more time to make changes. For example, Rauh indicates that Oklahoma will exhaust pension funds in 2020. However, when the Center on Retirement Research at Boston College made a comparable exhaustion calculation based on an ongoing plan using the same discount rate as that used by Professor Rauh, the Oklahoma PERS fund is found to have sufficient funds to last until 2062, without making any plan changes and making only the plans' normal cost contribution.

3. **Professor Rauh claims that if states try to cover the unfunded portion of pension shortfalls from current revenues, benefit checks will in most cases consume 20 to 50% of general tax revenues for those entities and without significant tax increases, pension payments will make it virtually impossible for state governments to provide essential services and to service their other debts.**

What is your response?

Please see the response to Question 2, above, including the reference to the issue brief. We believe that the basis of Professor Rauh's projections that state pension funds will be exhausted in the near-term, thereby forcing the use of current tax receipts to pay for pension benefits, to be unfounded.

Please find the attached NASRA Issue Brief titled, "State and Local Government Spending on Public Employee Retirement Systems." This brief reports that in FY 2008, pension contributions accounted for less than three percent of total spending by states and local governments. A recent study by the Center for State and Local Government Excellence and the Center for Retirement Research reported that spending on pension contributions would need to rise only modestly, to around five percent, to continue to fund pension benefits. This study also found that even if rates used by public plans to discount liabilities were reduced significantly, overall state and local government spending on pension contributions would remain less than 10 percent.

Moreover, Professor Rauh's projections for the portion of "general tax revenues" that pension benefits putatively would consume, inappropriately exclude the large portion of state and local revenues derived from non-tax sources, such as fees for services, tuition, federal assistance, etc. Professor Rauh's sole focus on "general tax revenues," to the exclusion of other revenue sources, results in a distorted and unrealistic depiction of the state and local revenue situation.

For additional insight into Professor Rauh's claims regarding the effects of revenue shortfalls, please see responses to Question 14, below.

4. **What would the costs that would be entailed should a state convert its defined benefit pension plan to a defined contribution plan?**

The cost of converting a state defined benefit plan to a defined contribution plan would depend on a number of factors, listed below. Generally, studies have found that such a switch would increase—not decrease—costs to the state, at least in the near-term, if not also the long-term. Studies identifying these costs have been completed in recent months in Minnesota, Nevada, and Kansas.

The factors that would determine the cost of switching from a DB plan to a DC plan include the funding condition of the defined benefit plan, and specifically, the cost of amortizing its unfunded liabilities; the demographic composition of the pension plan's participants; and the employer contribution rate to the new defined contribution plan.

In addition to the actual conversion costs involved in moving to a DC plan, states and local governments would forgo efficiencies embedded in DB plans that enable them to deliver the same level of retirement income at nearly one-half the cost compared to a defined contribution (DC) account. The National Institute on Retirement Security documented in its paper, "Bigger Bang for the Buck" that a defined benefit plan can provide a worker earning \$50,000 at retirement age with a lifetime income of about \$26,700 at a cost of 12.5% of payroll each year while the defined contribution plan would require much higher contributions – 22.9% of payroll each year.

5. **The National Association of State Retirement Administrators observes that states and localities contribute less than 3% of their total spending to pensions.**

In light of this fact, why do some claim that states are facing a fiscal crisis because of their pension obligations?

Pension contributions as a percentage of state and local spending vary among states, from less than one percent to more than four percent. In the wake of market declines that took place in 2008-09, additional revenue is needed to amortize the increased shortfall between assets and accrued liabilities. The result is that pension contributions for many plan sponsors are rising while state and local government revenues are stagnant or declining. Meanwhile, other demands for public spending are also rising. Thus, despite the relatively small portion of total state and local government spending that is committed to pension contributions, even small increases in the midst of a difficult fiscal situation can be challenging. However, states are not facing a fiscal crisis because of their pension obligations.

Pension costs remain a relatively small portion of spending for most states and local governments; and some who have an ideological opposition to government sponsorship of pension benefits may be using the downturn in investment markets and economic and fiscal conditions as an opportunity to terminate these retirement plans for employees of state and local government.

6. **What types of measures can states undertake to address their fiscal and budget problems?**

NASRA does not believe it is appropriate to suggest how public pension plan sponsors might address their fiscal and budget challenges. We do believe that states should (and most have) tailor solutions to their fiscal situations, and that one-size-fits-all mandates are inappropriate and unhelpful.

7. **Are you familiar with Mr. Spiotto's proposal for a Public Pension Funding Authority? If so, what are your thoughts?**

I have read of Mr. Spiotto's Public Pension Funding Authority proposal. This proposal may have merit, as long as such an authority is established and administered by state legislative and regulatory processes. NASRA resolutions express the organization's support for the following concepts that may pertain to an authority like that proposed by Mr. Spiotto:

- the collection of required [pension] contributions on a timely basis;
- the participation of all relevant stakeholders in discussions and processes pertaining to public retirement plans;
- tailored solutions, achieved by affected stakeholders working through the state and local legislative and regulatory processes;
- financing of retirement benefits that is shared by employees and their employers;
- removal of federal policy barriers to the preservation of sound retirement policies; and
- efforts to work with the national government as partners in our federal system.

NASRA resolutions also express the organization's opposition to "federal intervention in areas that rightfully belong to the States, efforts of the federal government to unduly limit States' autonomy, efforts to usurp State governments' and their political subdivisions' authority to perform their responsibilities and meet the needs of their citizens, and the imposition of costly or unwarranted federal mandates on States and their political subdivisions."

8. **What are some of principal problems that could result if states were permitted to file for bankruptcy?**

The prospect of state bankruptcy appears to present a multitude of constitutional, legal, financial, and other problems that have been well described in recent testimony to Congress by experts in the field, which I do not consider NASRA officers or staff to be.

9. **What has been the median rate of return for state and local public pension plans? How does this compare to the so-called "riskless rate" that some believe should be used?**

For the 25-year period ended December 31, 2010, the median annualized public pension fund investment return was 8.8 percent. For the 20-year period ended December 31, 2010, the median annualized public pension fund investment return was 8.7 percent.

All investments bear risks, including the risk of forgoing a higher return. Opinions vary of what a so-called “riskless” rate should be, including the yield on US Treasuries to states’ individual borrowing rates. Current rates on US Treasuries are approximately 4.5 percent. Current borrowing rates for states generally range from 5.0 percent to 5.5 percent.

10. **Mr. Fabian says that legislating state bankruptcy would disrupt the current municipal bond market and cause interest rates for longer maturity bonds to rise by 10 to 20%.**

What is your response to that statement?

Testimony and published opinions by multiple individuals knowledgeable in the fields of state bankruptcy and municipal bonds indicate strong support for Mr. Fabian’s assertion that legislating state bankruptcy would disrupt the municipal bond market and likely cause interest rates for longer maturity bonds to rise. Since public discussion of the possibility of permitting states to declare bankruptcy began in earnest in late 2010, municipal borrowing rates have risen sharply, greater than that of other fixed income instruments.

11. **Mr. Fabian says that the impact of having a state bankruptcy law could put “upward pressure on state and local taxes, [and] downward pressure on spending and state employment.”**

What is your reaction to that statement?

Although I am neither a lawyer nor an expert in municipal finance, the evidence presented in Question 10, above, strongly suggests that the higher interest rates resulting from the presence of state bankruptcy laws would increase state and local borrowing costs. States and local governments spent more than \$110 billion in FY 2008 on interest costs associated with borrowing, for such projects as roads, schools, utilities, etc. Any increase in borrowing costs will cause some combination of reduced resources available to states and local governments for capital projects, services, and employment; and higher required revenues, such as through taxes and fees.

12. **Mr. Fabian says that the impact of a state bankruptcy law would affect all states – including those with well-managed pensions and budgets – and they would have to “pay a substantive penalty when coming to market for new loans.” In addition, he says that municipal governments would also suffer, as their local governments are deeply intertwined with the management of tax collections, spending and borrowing programs, and mandates.**

What are your thoughts regarding these observations?

I agree with Mr. Fabian's observations. Higher interest rates affect all borrowers, even those with excellent credit, such as most states and local governments, and those with well-funded pension plans.

13. **With respect to public pensions, Mr. Fabian states that "while pension costs will, over the next twenty years, draw an increasing share of tax revenues away from more growth-friendly investments like infrastructure, education, and social services, there is only a remote risk of these costs getting between issuers and current bondholders."**

What is your reaction to this statement?

As discussed above, pension contributions account for a relatively small portion of overall state and local government spending. A recent study by the Center for Retirement Research at Boston College found that spending on pension contributions would need to rise only modestly, to around five percent, to continue to fund pension benefits. This study also found that even if rates used by public plans to discount liabilities were reduced significantly, overall state and local government spending on pension contributions would remain less than 10 percent.

14. **You observe in your prepared statement that "[s]tudies authored by Joshua Rauh promote confusion by mixing apples with oranges."**

Please elaborate.

Professor Rauh's studies rely on methods that inaccurately reflect the public pension community and its dynamics. For example:

- His paper, co-authored by Robert Novy-Marx, "Public Pension Promises: How Big Are They and What Are They Worth?" relies on the market value of public pension assets as of June 2009. As shown in the attached issue brief, "Strong Investment Gains and Legislative Changes Speeding Public Pension Recovery," public pension assets in June 2009 were depressed due to the market decline that lasted from July 2008 to early March 2009. Public pension asset values have grown by more than one-fourth since that date. This paper also implies that the cost of unfunded pension liabilities should be calculated using an economic theory that is irrelevant to the method used by public pensions to fund their benefits. The implication of the Rauh-Novy-Marx paper is that public pension funds can be expected to generate returns on their investments consistent with those associated with so-called riskless securities. Yet, public pension funds invest in diversified portfolios of stocks, bonds, real estate, private equities, infrastructure, commodities, and other securities. No credible investment expert would support a low projected long-term return for such a diversified portfolio.
- Professor Rauh's paper, "Are State Public Pensions Sustainable?," makes repeated references to "state tax revenues," as a means of providing context and comparisons of pension obligations with states' ability to honor those obligations.

Yet “tax revenues” account for only about one-half of all state revenues. The remainder comes from federal receipts and revenue from services, such as health care, tuition, and myriad other sources. With state tax revenues, non-tax revenues are used to fund the cost of pension benefits. Yet, by excluding these other revenue sources, Professor Rauh paints an unrealistically pessimistic projection of states’ ability to fund their pension benefit obligations.

- Also in the paper, “Are State Public Pensions Sustainable?,” Professor Rauh projects insolvency dates for most state pension funds. These projections are based on a) the use of market asset values from 2009, near the low point of the global decline in capital markets and of public pension asset values; and b) the assumption that the contributions to public pensions will be dramatically lower than they have been in recent years. The combination of low asset values and inadequate contributions enables Professor Rauh to arrive at an unlikely conclusion—that most state pension funds will run out of money in the near future.
- The paper, “Are State Public Pensions Sustainable?,” also compares pension benefit payouts projected in future years with “tax revenues” from 2008. Table 1, for example, reports that pension payouts for the state of Alabama will be 41 percent of that state’s 2008 tax revenue. Yet this calculation compares projected pension payouts in 2023 with 2008 tax revenues, revenues that account for only one-half of the state’s total revenues. This comparison alone creates an alarming and misleading impression of pension costs relative to the state’s ability to pay, an impression that is further compounded by the distortions described in previous bullet, i.e., the use of depressed market values and unrealistically low contributions.
- “Are State Public Pensions Sustainable?,” compares pension obligations of both states and local governments, with the tax revenues of states alone, ignoring local government tax revenues and state and local revenues from fees and other charges, such as tuition, user fees, etc. (as described above). Yet non-tax revenues account for nearly half of all state and local revenues and are available revenue sources with which to make pension contributions.
- The paper, “Are State Public Pensions Sustainable?,” also does not incorporate nearly all of the manifold changes to benefit levels and financing structures that states have made since 2009. The National Conference of State Legislatures has stated that an “unprecedented” number of states made changes to their pension plans in 2010 alone.