Southern Legislative Conference of The Council of State Governments

# Municipal Bonds: Trends in 2011

## A Regional Resource from the SLC

**Sujit CanagaRetna**
Senior Fiscal Analyst
Southern Legislative Conference
**January 2012**

Photo courtesy of flickr user Tracy O via Creative Commons License

### Background: Shock Waves Ripple Through Municipal Bond Market

In December 2010, shock waves rippled through state financial circles. Financial analyst, Meredith Whitney, who drew unprecedented attention after her prescient report on the dire financial position of Citibank and other bank stocks (a year before the 2008 global financial meltdown), appeared on the acclaimed CBS news program *60 Minutes* to predict that as many as 100 American cities would default on their municipal bonds within a year. Whitney stated "[T]here is not a doubt in my mind that you will see a spate of municipal bond defaults. Fifty to 100 sizable defaults, more. This will amount to hundreds of billions of dollars in the next 12 months." The spate of defaults would force "the U.S. government to bail out the struggling states" with these cash-strapped cities, opined Whitney. Governor Chris Christie, New Jersey, appearing on the same program that day also expressed grave concerns about the dismal outlook for state finances in 2011 and stated, "[T]he day of reckoning has arrived, that's it. And it's going to arrive everywhere."

### Municipal Bond Issues Crucial to State and Local Government Finances

Given that thousands of state and local governments use the funds from their bond issues to "build, repair and improve schools, streets, hospitals, airports and many other public works," Whitney's predictions sent tremors throughout the already weakened fiscal foundation of the United States and destabilized the fragile state economic recovery in progress. State and local governments were still reeling from the deleterious effects of the Great Recession, the worst economic downturn to impact the U.S. economy in some eight decades. Municipal bond issuances, as a financing mechanism, remain an absolutely critical component of state and local government finances; the diverse operations of state and local governments would screech to a standstill if not for the liquidity afforded by the funds flowing from these issues. Hence, many public and private officials were justifiably alarmed about the potential seismic shift in the financing operations of state and local governments as a result of the widespread municipal bond defaults predicted by Ms. Whitney.

### State and Local Government General Obligation and Non-General Obligation Bonds

Along with U.S. Treasuries, debt securities issued by the U.S. Department of the Treasury that carry the full faith and credit backing of the U.S. government, municipal bonds have ranked among the safest and most popular of investment instruments for many decades. While some municipal bonds are backed by a general obligation (GO) pledge from the state or local government entity, confirming that the entire revenue-generating potential of the entity will be devoted to servicing the bond, other municipal bonds are of the non-GO bond or revenue bond variety. The debt on non-GO bonds is serviced by the revenue expected to spring from the fees levied on individuals who use these services or facilities.

General obligation bonds typically include projects that benefit the entire community, such as projects to finance the construction of schools, hospitals, home purchasing programs, courthouses and municipal office buildings. Hence, bonds have been issued to finance projects such as



THE SOUTHERN OFFICE OF THE COUNCIL OF STATE GOVERNMENTS
PO Box 98129 | Atlanta, Georgia 30359
ph: 404/633-1866 | fx: 404/633-4896 | *www.slcatlanta.org*

the Hospital Finance Authority in West Virginia, Housing Finance Corporation in Florida and Highland Park Independent School District in Texas. In terms of projects funded by non-GO bonds, these usually benefit actual users of operations. Numerous water and sewer entities (Gwinnett County Water and Sewerage Authority in Georgia), electric companies (Florida Power & Light Company), toll roads (I-495/Capital Beltway HOT Lanes in Virginia and State Highway 130 in central Texas), bridges (Lake of the Ozarks Community Bridge in Missouri) and public-private entities, such as the Port Authority of New York and New Jersey (the entity that operates the airports, cargo ports and bridge and tunnel tollbooths in the New York metropolitan area), are built with non-GO bonds, which are then operated and debt serviced with the revenue generated by the operation of these facilities.

On balance, GO bonds contain a very high level of security since they are guaranteed by the full faith and credit of the government entity issuing the bond; non-GO bonds have a lesser degree of security, though a distinction must be drawn between entities such as electric power companies and water and sewer systems as opposed to toll roads, toll bridges and airports. The former involves essential services (electric, water, sewer), while the latter depend on usage for revenue (toll roads, toll bridges and airports). Experts generally agree that bonds issued by entities providing essential services are more secure than those that rely on usage for revenue and, eventually, debt servicing. For example, a downturn in the economy could result in reduced driving patterns, which in turn could lead to sharply lower revenue at toll roads or toll bridges, a development that could jeopardize debt servicing; concurrently, since they are essential services, a downturn in the economy does not necessarily lead to a sharp drop in electricity and water usage and reduced revenue flows, a development that ensures debt service payments.

## Municipal Bond Defaults and Bankruptcies

The incidence of municipal bond defaults is extremely rare, and analysts regard the safety record of municipal bonds second only to that of U.S. Treasury securities. State and local governments place a great deal of emphasis on making full and timely debt service payments, even in extremely tight budget situations. A report issued in late 2010 by the rating agency Fitch documented that, over a 10-year period through 2009, the cumulative default rate for all rated municipal bonds, including those rated below investment grade, ranged between 0.04 percent and 0.29 percent, an extremely low frequency. Additional research documents that, in the first nine months of 2011, there were 42 municipal defaults totaling $949 million, a drop from the 79 municipal defaults experienced in 2010 totaling $2.89 billion. In terms of prior years, in 2009, there were 204 defaults (totaling $7.3 billion), and in 2008, 162 defaults (totaling $8.2 billion), confirming the downward trajectory of this trend.

Even municipal bankruptcies are relatively rare. In 2011, only six municipalities filed for Chapter 9 bankruptcy protection with the most prominent locales being Jefferson County, Alabama (related to financial woes flowing from a sewer renovation project with debts amounting to $4 billion), Harrisburg, Pennsylvania (related to expenditures incurred on a trash-to-energy incinerator project with debts amounting to about $500 million) and Central Falls, Rhode Island (related to unfunded pension and retiree health liabilities in this town of 18,000 residents with debts amounting to $80 million). In fact, one has to go back to 1933, during the peak of the Great Depression, to identify a state (Arkansas) that actually defaulted on some of its bonds; at that time, Arkansas received funds from the federal government to assist with its debt service obligations.

As of 2010, total outstanding municipal debt amounted to $2.7 trillion. The number of debt-issuing public entities runs into the thousands (50 states; 19,000 cities and towns; 4,000 counties; 15,000 school districts and a vast number of special purpose entities and enterprises) and the municipal bond default amounts, the number of municipalities declaring bankruptcy and the amounts involved in these bankruptcy declarations remain relatively miniscule. This point is valid even for 2008 and 2009, the height of the Great Recession. As *The Wall Street Journal's* noted financial analyst David Wessel observed, "Most municipal defaults and bankruptcies so far involve either behind-schedule, over-budget construction projects that did not yield promised revenue or overstretched hospitals, not cities or counties." Another analyst described the 2011 Jefferson County, Alabama, and Harrisburg, Pennsylvania, bankruptcies as ones involving "human error by the officials charged with managing Jefferson County's Sewer System and Harrisburg's Incinerator Project." In sum, the markets are regarding these 2011 incidents as "isolated" and not as "evidence of an underlying, systemic issue."

## Investors Pull Back from Municipal Bond Market

In the aftermath of Ms. Whitney's *60 Minutes* interview, the municipal bond mutual fund market did experience setbacks as investors and the market-at-large pulled back to digest the import of her projections. Specifically, between November 8, 2010, and December 19, 2010, the S&P

Municipal Bond Exchange-Traded Fund lost more than 5 percent. According to data collated by the Securities Industry and Financial Markets Association, after U.S. municipal bond issuance (GO and non-GO or revenue) totaled $45.8 billion and $41.5 billion in November and December 2010, it dropped to $12.2 billion, $16.3 billion and $18.3 billion in January, February and March 2011, respectively. For the fourth quarter of 2010, the Merrill Lynch Municipal Master Index reported that returns on municipal securities experienced their steepest decline in 16 years, while the cost for AAA-rated issuers to borrow for 30 years rocketed upward by almost one third, from 3.85 percent on November 1, 2010, to 5.09 percent on January 17, 2011. For the week ending January 19, 2011, investors withdrew $4 billion from the municipal bond mutual market, the most since Lipper U.S. Funds began compiling data in 1992. The reduction in bond issues in early 2011 might have been triggered by both the expiring federal Build America Bonds (BAB) program* and Whitney's comments.

## State and Local Government Policymakers Concerned

Given these developments, state policymakers were concerned about further erosions in the municipal bond market in 2011, a development that would have intensified the already significant fiscal pressures faced by state and local governments since the Great Recession. This is because, along with the unprecedented revenue shortfalls sweeping over states, the extremely tight global credit markets that swept over the U.S. economy beginning in fall 2008 posed considerable challenges for municipal bond issuers. State and local governments were justifiably anxious that the market's reactions to Ms. Whitney's pronouncements would ominously raise their borrowing costs in 2011.

## The Municipal Bond Market's Progress in 2011

In the context of these disturbing trends in late 2010 and early 2011, how has the municipal bond market held up in the rest of 2011? Were the fears expressed by the well-known analyst Meredith Whitney in late 2010 realized in 2011? Has there been a spate of municipal defaults as predicted ("50 to 100") in the 12 months following the December 2010 interview? Have investors shed their holdings in municipal bonds and fled to other asset categories? How have some of the specific municipal mutual funds fared in 2011, particularly those funds that experts generally acknowledge as a good indicator of the municipal bond market's overall trajectory? This ***SLC Regional Resource*** addresses these questions along with the broader issue of the latest developments regarding state finances and state debt loads.

* A provision of the 2009 American Recovery and Reinvestment Act encouraged borrowing for infrastructure development by offering a 35 percent interest payment subsidy to state and local government bond issues that took place before December 31, 2010.

**Table 1 Historical Monthly Performance Report, S&P National AMT-Free Municipal Bond Fund**

| Month | Monthly Return (Percent) |
|---|---|
| 12/31/2010 | -2.04 |
| 1/31/2011 | -0.95 |
| 2/28/2011 | 1.73 |
| 3/31/2011 | -0.46 |
| 4/30/2011 | 2.05 |
| 5/31/2011 | 1.92 |
| 6/30/2011 | 0.27 |
| 7/31/2011 | 1.01 |
| 8/31/2011 | 1.66 |
| 9/30/2011 | 1.12 |
| 10/31/2011 | -0.49 |
| 11/30/2011 | 0.5 |
| 12/31/2011 | 2.07 |
| **12-Month Yield** | 8.39 |

Source: *http://us.ishares.com/product_info/fund/overview/MUB.htm?qt=MUB*

## Performance of Selected Municipal Bond Funds in 2011

In 2011, the municipal bond market was one of the most closely watched indicators of state and local government finances by public officials, pension funds, insurance companies, institutional investors (mutual funds and 401-K plans), households (individual investors), international investors, financial institutions and interested others. All these entities are active investors in the municipal bond market.

While there are numerous measures to assess the performance of the municipal bond market, a review of the historical monthly performance of the S&P National AMT-Free Municipal Bond Fund offers a good starting point. Bond issues from California (23 percent of total),

New York (17 percent of total) and Texas (7 percent of total) rank as the top three municipal issues in this fund, while a distribution by sector shows transportation and utility bond issues as the top two. Table 1 presents data for the 12-month period from December 31, 2010, to December 30, 2011, the period immediately after Ms. Whitney's municipal default prediction.

A review of the 12 months immediately following the December 2010 prediction demonstrates that the S&P National AMT-Free Municipal Bond Fund experienced a cumulative return of 8.39 percent, an impressive yield. While the Fund did see a decline of 2.04 percent in December 2010, it picked up steam and sustained an increase in monthly returns in nine of the subsequent 12 months. In fact, the negative 2.04 percent in December 2010, represented the largest decline for the entire 12-month period under review. Further examination (Table 2) of the S&P National AMT-Free Municipal Bond Fund—as demonstrated by net asset value and net assets for the past several years—provides additional insights.

Table 2 provides details on net asset value (the Fund's price per share dollar amount) and net assets (the Fund's total assets less the value of its liabilities) for the period February 2008 through December 2011. Even though both these indices are not the best gauge of a fund's overall performance, they are reflective of the growth of the Fund, both in terms of per-share value and overall size. While the Fund's net asset value grew by 4 percent for the year ending February 2011, it grew by another 4 percent by the end of December 2011. In terms of net assets, the Fund experienced a much sharper increase: 16 percent for the year ending February 2011, and 27 percent by December 2011, a striking achievement. In essence, investors flocked to acquire an increasing amount of the Fund, permitting the expansion of net assets from $1.7 billion in February 2010, to $2 billion in February 2011 (nearly 10 weeks after the December 2010 prediction), and $2.5 billion in December 2011 (12 months after the prediction), notwithstanding the forecast of financial calamity in state and local governments.

After a review of this important fund, which invests primarily in a variety of state and local government bond issues, it is apparent that Ms. Whitney's December 2010 prediction that a large-scale collapse in the finances of as much as 100 municipalities would occur in the next 12 months did not come to fruition. The large-scale financial collapse in state and local governments that was projected would have resulted in a mass exodus from bond funds such as the S&P National AMT-Free Municipal Bond Fund. In fact, the reverse has occurred, with the Fund actually increasing its net asset size by 27 percent between February 2011, and the end of 2011. In addition, the Fund's nearly 8.39 percent annualized return—the best gauge of a fund's financial position—remains an affirmation of the market's confidence in the financial position of state and local governments as represented by the striking demand for the Fund.

To obtain a more rounded perspective on the performance of the municipal bond market, it is appropriate to review key financial criteria in several other municipal bond funds. An important consideration in featuring these particular funds is the fact that Morningstar, one of the leading providers of investment research in the globe, concluded that "these funds avoid the most volatile bonds and do not borrow" to artificially inflate returns. Table 3 features this information.

As mentioned earlier, one of the most important criteria in a fund's performance involves assessing total returns. On this scale, as demonstrated in Table 3, a comparison of total returns in 2011 for the six leading municipal bond funds reveals noteworthy growth levels. While two of the three Fidelity bond funds reached growth rates that exceeded 10 percent, the remaining Fidelity fund turned in a growth rate of nearly 8 percent. Of the remaining three funds, in 2011, while the two Vanguard funds accomplished a return rate of nearly 11 percent and 10 percent, respectively, the T. Rowe Price Fund came in at nearly 11 percent. In terms of growth in net assets in 2011, four of the six funds all experienced an expansion ranging from 1 percent to 18 percent. The performance of the Fidelity Tax-Free Bond Fund was particularly notable in this category, with a growth rate of 18 percent between December 2010 and December 2011. Even though two of the six funds experienced a decline in net asset size between the two periods, the declines were relatively minor.

Figure 1 provides a graphical representation of the return rates of these highlighted funds in 2010 and 2011. The data from 2011 demonstrates that investors continue to express confidence in the ability of these entities to handle their finances.

## Fiscal Challenges: Near-Term vs. Long-Term

On a more comprehensive level, a number of astute analysts of municipal finances highlight the importance of carefully separating the current fiscal challenges of states

## Table 2 Selected Financial Highlights from the S&P National AMT-Free Municipal Bond Fund

| Period | Net Asset Value | Change | Net Assets (in $ thousands) | Change |
|---|---|---|---|---|
| **February 28, 2008** | $100.30 | | $356,983 | |
| **February 28, 2009** | $96.48 | -4% | $1,021,581 | 186% |
| **February 28, 2010** | $99.18 | 3% | $1,698,153 | 66% |
| **February 28, 2011** | $103.55 | 4% | $1,974,566 | 16% |
| **December 30, 2011** | $107.37 | 4% | $2,512,348 | 27% |

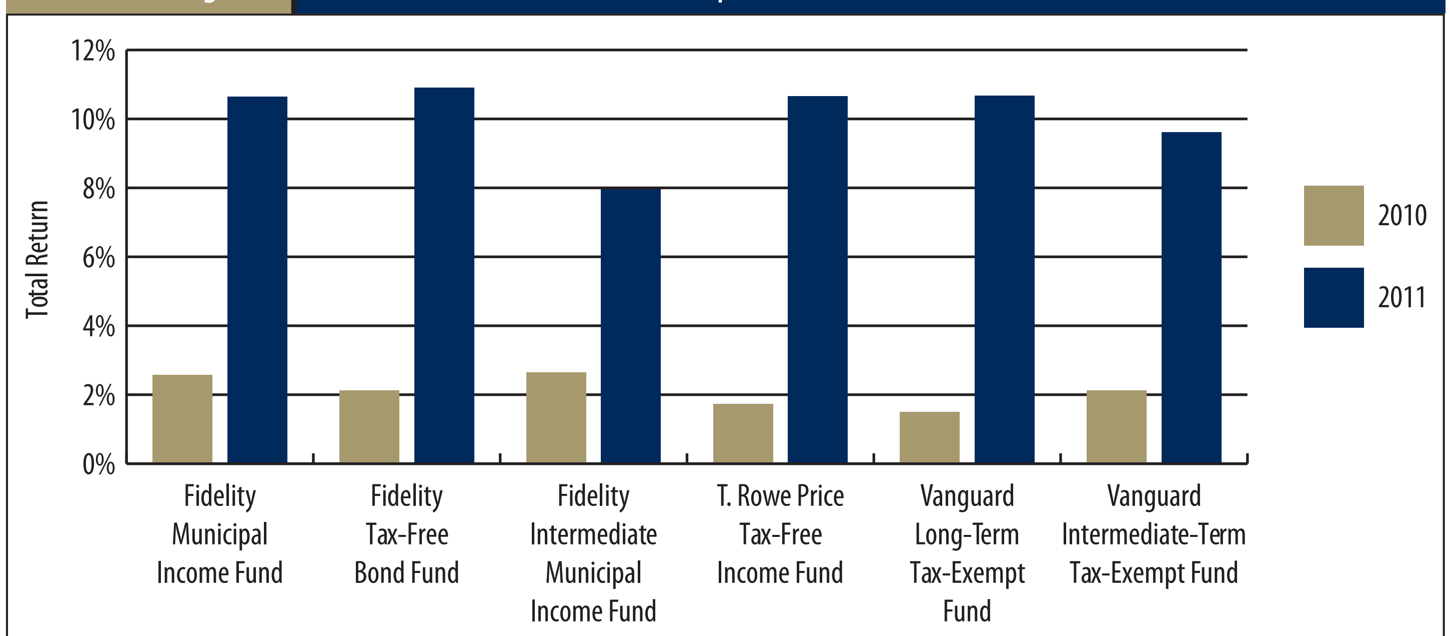
Source: *http://us.ishares.com/product_info/fund/overview/MUB.htm?qt=MUB*

## Table 3 Financial Criteria on Selected Municipal Bond Funds

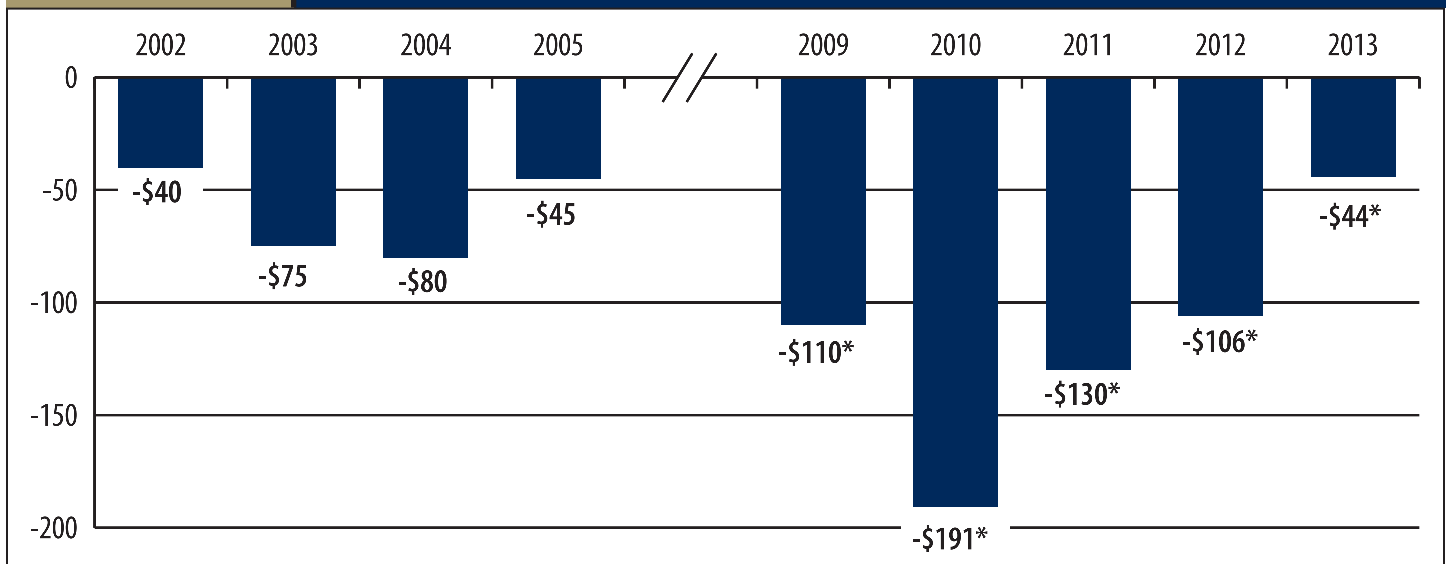
| | Total Returns | | Net Assets (in $ millions) | | |
|---|---|---|---|---|---|
| **Fund Name** | **2010** | **2011** | **2010** | **2011** | **Change** |
| **Fidelity Municipal Income Fund** | 2.58% | 10.64% | $5,653.42 | $5,902.02 | 4% |
| **Fidelity Tax-Free Bond Fund** | 2.12% | 10.90% | $1,784.47 | $2,099.01 | 18% |
| **Fidelity Intermediate Municipal Income Fund** | 2.65% | 7.96% | $3,797.63 | $3,994.14 | 5% |
| **T. Rowe Price Tax-Free Income Fund** | 1.73% | 10.66% | $1,683.80 | $1,692.30 | 1% |
| **Vanguard Long-Term Tax-Exempt Fund** | 1.50% | 10.68% | $1,138.00 | $1,084.60 | -5% |
| **Vanguard Intermediate-Term Tax-Exempt Fund** | 2.13% | 9.61% | $6,876.70 | $6,819.30 | -1% |

Sources: *http://fundresearch.fidelity.com/mutual-funds/performance-and-risk/31638R204; http://fundresearch.fidelity.com/mutual-funds/performance-and-risk/316128503; http://fundresearch.fidelity.com/mutual-funds/performance-and-risk/316089507; http://fundresearch.fidelity.com/mutual-funds/performance-and-risk/779576107; http://fundresearch.fidelity.com/mutual-funds/performance-and-risk/922907209; http://fundresearch.fidelity.com/mutual-funds/performance-and-risk/922907308*

## Figure 1 Performance of Selected Municipal Bond Funds, 2010-2011




Sources: Same as *Table 3: Financial Criteria on Selected Municipal Bond Funds* (above)




Source: *http://www.cbpp.org/cms/index.cfm?fa=view&id=711*
Note: * = Current as of December 2011

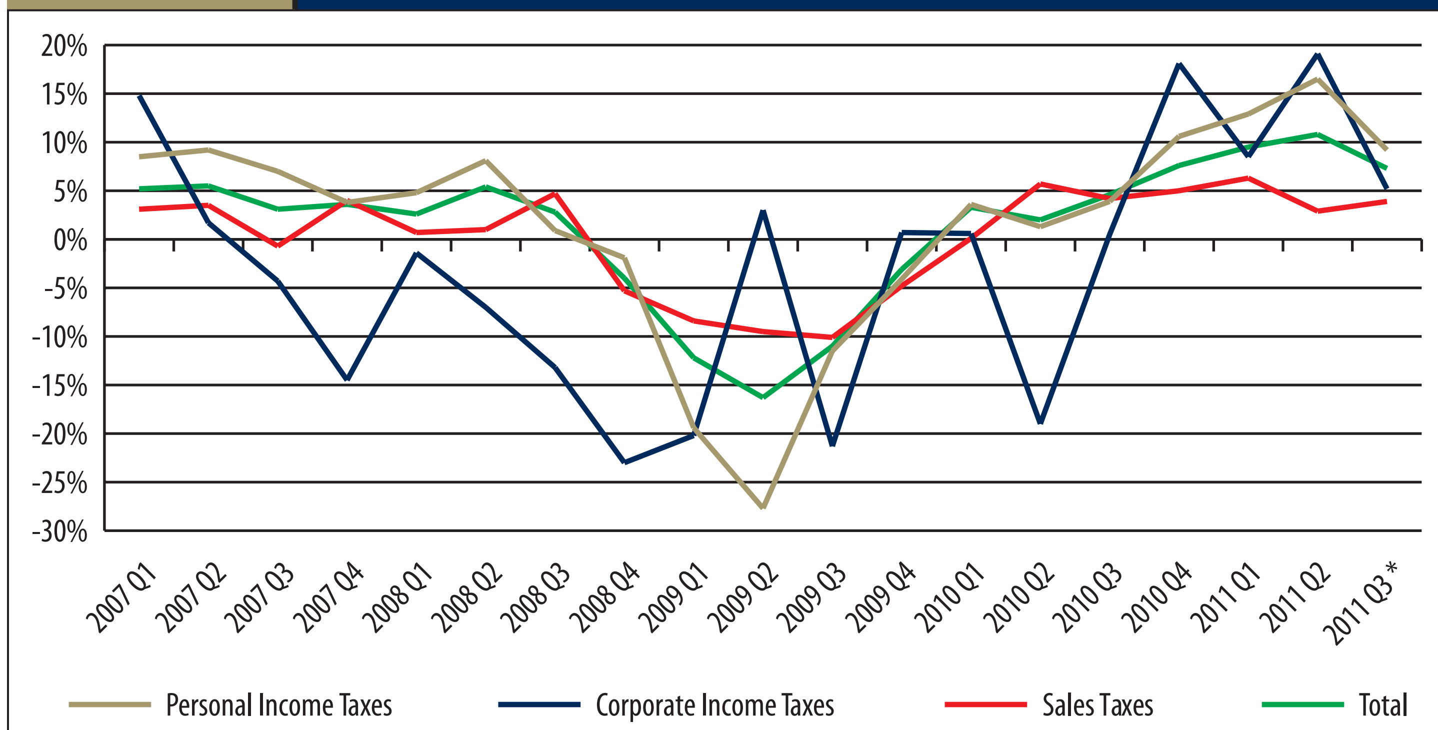
and local governments—challenges directly traceable to the Great Recession—with the longer-term challenges related to debt, pensions and retiree healthcare expenditures. State and local governments did and continue to face enormous fiscal challenges, but a more nuanced review of their finances reveals the importance of responding to the current (short-term) and long-term obstacles with different strategies. The colossal revenue shortfalls caused by the largely cyclical fiscal pressures have to be distinguished from the more long-term fiscal challenges that have to be met over a period of several decades.

## State Budget Shortfalls: Fiscal Years 2009 to 2013

States experienced the sharpest drop in revenues in more than 80 years during the Great Recession, a development that forced them to impose a combination of wrenching budget cuts, utilize funds from the federal government, deploy rainy day funds, expand gaming and raise taxes and fees to meet the balanced budget requirements contained in the constitutions of 49 of the 50 states. Figure 2 provides insights into the largest state budget shortfalls since the late 1920s with the onset of the Great Recession.

As evident in Figure 2, between fiscal years 2009 and 2013, a five-year period, states closed or will close a cumulative shortfall of $580 billion, an extraordinary amount by any standard. While the breadth and depth of the Great Recession has had a near-unprecedented effect on state finances, state policymakers have acted expeditiously to deal with their massive budget shortfalls and staved off a financial cataclysm. The vital point here is that these shortfalls are cyclical, precipitated by the Great Recession and, once the economy begins recovering with more pronounced rates of growth, the fiscal pressures caused by the shortfalls should ease.

In fact, the latest revenue reports from the states, for the first half of fiscal year 2012, indicate a very different scenario to the struggles experienced by states in the same period the last three fiscal years. Not only did a majority of states report that they expect to meet or exceed general fund revenue targets, but more than half of the states indicated that they expected their revenue inflows to stabilize for the rest of the fiscal year, a welcome improvement from the prior three years. As an example, in Kentucky, the Consensus Forecasting Group, composed of independent economists, released its final forecast for state revenue for the next biennium on December 22, 2011, a forecast that generally was rosier than a preliminary one released in October 2011. According to the forecast, not only will Kentucky lawmakers have slightly more money to appropriate during the next two fiscal years than originally expected, the deposit of about $121 million into its rainy day fund last fiscal year, more than any other state and the largest one-time deposit in state history, reflects the state's improved revenue picture.




Source: Rockefeller Institute, December 8, 2011, *http://www.rockinst.org/newsroom/data_alerts/2011/12-08.aspx*

For the 50 states at large, the Rockefeller Institute reported that preliminary data for the July-September quarter of 2011 documented expansion in overall state tax collections and, importantly, for personal income tax and sales tax revenue. Not only was this the seventh consecutive quarter of growth, albeit at a slower level than in the previous three quarters, but state tax collections improved by 7.3 percent in this quarter of 2011, compared to 4.6 percent in the same quarter of 2010. Figure 3 provides this data broken down by quarter for the period, quarter 1 in 2007 to quarter 3 in 2011.

While states face a series of critical choices in a host of areas—healthcare, education, pensions, retiree healthcare, infrastructure, emergency management, unemployment insurance, bond indebtedness—viable solutions for these longer-term issues have to be addressed over the period of the next several decades. They do not have to be resolved in the near-term. It is extremely dangerous to conflate the near-term, or current, challenge of resolving state budget shortfalls—activated by the Great Recession—with the longer-term challenges outlined earlier. While state policymakers have responded to the near-term budget challenges, as demonstrated by the often difficult choices made to balance budgets, they also are grappling with strategies for the longer-term challenges.

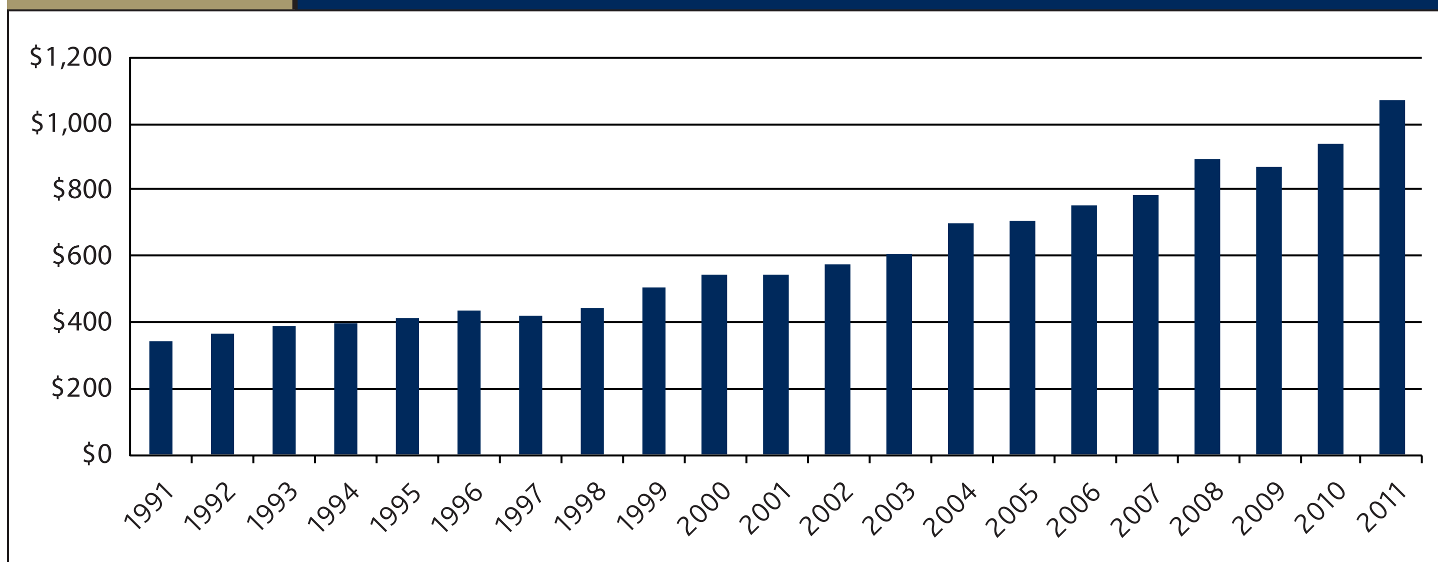
## Addressing Structural Weaknesses Eroding State Tax Systems

Policymakers also are addressing the structural weaknesses that continue to erode state and local government revenue systems. There are three main weaknesses: (1) state sales taxes largely do not include services, even though the national economy has been transformed to one dominated by the service sector; (2) state and local governments are unable to levy a sales tax on purchases made online, even though online purchases have increased by stratospheric proportions in the last decade; and (3) the enormous losses experienced by states and local governments on account of the surfeit of sales tax exemptions, often embedded in their tax codes for many decades.

## Latest State Bond Indebtedness Trends

In further probing the likelihood of widespread municipal defaults, the level of bond indebtedness by states quickly emerges as an important topic for review. In fact, the strategies devised by states to deal with their bond indebtedness levels, particularly those states with relatively high levels of net-tax supported debt, remain an area that institutional investors will focus on when making investment decisions. In recent years, debt issuance by municipal entities has soared. In calendar year 2010, the latest year

## Figure 4 Median Net Tax-Supported Debt Per Capita for 50 States




Source: Moody's Investor Services, 2011 State Debt Medians Report

available, Moody's reported that state net-tax supported debt increased by 8.5 percent to $499 billion from $460 billion in 2009.

In terms of further scrutinizing the recent state debt median levels, as noted earlier, there was an increased number of debt issuances in 2010 because of the expiring Build America Bonds subsidy program. Hence, a number of these municipal issuers advanced their issuances to 2010 and away from 2011 to not only take advantage of this valuable tax consideration but also the favorable overall interest rate environment. Among the states that stood out in 2010 with significant debt issuances were Arizona, California and Utah.

Along with cumulative debt loads, another statistic that remains important is the median net tax-supported per capita debt level in the individual states. For calendar year 2010, this figure for all the states increased by 14 percent from $936 in the prior year to $1,066. Some of the states that drove this increase were Illinois, Kentucky, New Hampshire, Utah and New Mexico. In contrast, Alaska and Nebraska experienced a decline in their median net tax-supported per capita debt in 2010. Figure 4 provides a graphical representation of this trend over a 20-year period.

Additionally, Table 4 presents data from the 2011 Moody's report on state debt loads, one of the variables that prove helpful in gauging the possibility of states defaulting on their debt. For each state, the table indicates its debt load broken down on a per capita basis; as a percentage of gross state domestic product (GSP); and as a percentage of personal income, as well as state rankings in these three criteria. A state's performance in the three criteria listed above acts as a useful signpost to the likelihood of default.

A review of the performance of the 50 states in each of these categories demonstrates a fairly controlled level of debt, with 48 states not even having a debt load in two categories (debt as a percentage of GSP and debt as a percentage of personal income) in double-digits. Only two states (Connecticut and Hawaii) were in double-digits under these two categories, and just barely exceeding 10 percent.

The relevance of these state percentages rises in importance when compared to a number of advanced economies in Europe that are battling enormous levels of debt and even the debt level of the United States. While analysts contend that "there is no automatic tipping point beyond which a country's debt — the sum of past annual deficits — does cause bond markets to shut down," there is general consensus that countries such as Italy, Portugal and Ireland have reached that point. According to data compiled by the International Monetary Fund (September 2011), general government net debt as a percent of gross domestic product (GDP, or the equivalent of GSP for a nation) in 2011 in the three countries listed stood at 100.4 percent, 101.8 percent and 98.8 percent, respectively. (While there was no net general government debt data listed for Greece, the amount listed for Greece's general govern-

## Table 4 Latest State Bond Indebtedness Levels

| State* | Net Tax-Supported Debt (NTSD) Per Capita | | Net Tax-Supported Debt as Percentage of Gross State Domestic Product | | Net Tax-Supported Debt as Percentage of Personal Income | |
|---|---|---|---|---|---|---|
| | Amount | Rank | Percent | Rank | Percent | Rank |
| Alabama | $856 | 32 | 4.76% | 19 | 2.6% | 29 |
| Alaska | $1,257 | 18 | 8.88% | 5 | 3.0% | 22 |
| Arizona | $910 | 28 | 1.96% | 42 | 2.8% | 26 |
| Arkansas | $361 | 44 | 3.95% | 25 | 1.1% | 43 |
| California | $2,542 | 8 | 5.08% | 18 | 6.0% | 9 |
| Colorado | $524 | 40 | 4.03% | 24 | 1.3% | 42 |
| Connecticut | $5,236 | 1 | 10.80% | 1 | 9.5% | 2 |
| Delaware | $2,676 | 6 | 6.35% | 12 | 6.8% | 5 |
| Florida | $1,150 | 23 | 3.93% | 26 | 3.0% | 23 |
| Georgia | $1,103 | 24 | 2.79% | 34 | 3.3% | 20 |
| Hawaii | $4,236 | 3 | 10.30% | 2 | 10.1% | 1 |
| Idaho | $519 | 41 | 3.03% | 33 | 1.6% | 39 |
| Illinois | $2,383 | 9 | 3.87% | 27 | 5.7% | 10 |
| Indiana | $471 | 42 | 1.92% | 43 | 1.4% | 41 |
| Iowa | $67 | 49 | 2.24% | 40 | 0.2% | 48 |
| Kansas | $1,239 | 19 | 2.78% | 35 | 3.2% | 21 |
| Kentucky | $1,961 | 12 | 4.64% | 20 | 6.1% | 8 |
| Louisiana | $1,308 | 17 | 3.77% | 28 | 3.5% | 18 |
| Maine | $865 | 31 | 10.14% | 3 | 2.4% | 30 |
| Maryland | $1,681 | 15 | 3.20% | 31 | 3.5% | 19 |
| Massachusetts | $4,711 | 2 | 8.65% | 6 | 9.5% | 3 |
| Michigan | $762 | 36 | 6.03% | 14 | 2.2% | 34 |
| Minnesota | $1,159 | 22 | 6.87% | 9 | 2.8% | 24 |
| Mississippi | $1,534 | 16 | 4.55% | 22 | 5.1% | 14 |
| Missouri | $775 | 35 | 1.98% | 41 | 2.2% | 35 |
| Montana | $371 | 43 | 1.55% | 46 | 1.1% | 44 |
| Nebraska | $13 | 50 | 0.05% | 50 | 0.0% | 50 |
| Nevada | $878 | 30 | 2.44% | 38 | 2.3% | 32 |
| New Hampshire | $812 | 33 | 3.75% | 29 | 1.9% | 37 |
| New Jersey | $3,940 | 4 | 7.81% | 7 | 7.9% | 4 |
| New Mexico | $1,827 | 13 | 5.37% | 16 | 5.6% | 12 |
| New York | $3,149 | 5 | 5.61% | 15 | 6.8% | 6 |
| North Carolina | $782 | 34 | 1.80% | 44 | 2.3% | 33 |
| North Dakota | $315 | 47 | 4.26% | 23 | 0.8% | 47 |
| Ohio | $1,007 | 27 | 3.44% | 30 | 2.8% | 25 |
| Oklahoma | $634 | 38 | 1.38% | 47 | 1.8% | 38 |
| Oregon | $2,006 | 11 | 9.28% | 4 | 5.6% | 11 |
| Pennsylvania | $1,075 | 25 | 3.11% | 32 | 2.7% | 27 |
| Rhode Island | $2,191 | 10 | 7.09% | 8 | 5.3% | 13 |
| South Carolina | $887 | 29 | 2.75% | 36 | 2.7% | 28 |
| South Dakota | $328 | 46 | 1.30% | 48 | 0.9% | 46 |
| Tennessee | $345 | 45 | 2.26% | 39 | 1.0% | 45 |
| Texas | $612 | 39 | 1.66% | 45 | 1.6% | 40 |
| Utah | $1,222 | 20 | 6.86% | 10 | 3.9% | 16 |
| Vermont | $747 | 37 | 5.32% | 17 | 1.9% | 36 |
| Virginia | $1,058 | 26 | 2.70% | 37 | 2.4% | 31 |
| Washington | $2,626 | 7 | 6.82% | 11 | 6.2% | 7 |
| West Virginia | $1,221 | 21 | 6.15% | 13 | 3.8% | 17 |
| Wisconsin | $1,795 | 14 | 4.60% | 21 | 4.8% | 15 |
| Wyoming | $71 | 48 | 0.11% | 49 | 0.1% | 49 |
| **Mean** | **$1,404** | | **4.48%** | | **N/A** | |
| **Median** | **$1,066** | | **3.94%** | | **2.8%** | |

Source: Moody's Investor Services, 2011 State Debt Median Report
Note: * = Highlighted states reflect SLC member states

ment gross debt as a percent of GDP in 2011 was 165.6 percent). Even for the United States, general government net debt as a percent of GDP in 2011 was 72.6 percent. In direct contrast, net tax-supported debt as a percentage of GSP in 2011 for the 50 states was refreshingly low: the mean and median averages were 4.48 percent and 3.94 percent, respectively.

## Borrowing Hurdles Faced by Heavily Indebted Governments

Heavily indebted government entities, whether nations, individual states or municipalities, eventually lose access to bond markets, a development that makes the cost of government operations extremely high due to the steep rise in borrowing costs. However, there is an exception to this general rule: the United States. Despite the onerous debt levels reached by the United States as a whole, one of the reasons the rating agency Standard and Poor's downgraded overall U.S. debt in the summer of 2011, investors from around the globe have been flocking to acquire U.S. Treasury securities. In fact, the interest rates on 10-year Treasury Notes currently hover around 2 percent, a very low rate of interest. In contrast, in November 2011, Spain had to offer an average interest rate of nearly 7 percent on its 10-year bond at an auction, a Euro-era record. In this context, the relatively low percentages of the debt loads in the states, as reflected in net tax-supported debt as a percentage of GSP, stand in stark contrast to the levels reached in several of the advanced European countries and the United States as a whole.

## State Bond Indebtedness Data: Record of SLC States

Alongside the low debt levels prevalent in all 50 states, the 15 member states of the Southern Legislative Conference (SLC), the Southern Office of The Council of State Governments (CSG), fared even more admirably in regard to state debt loads. None of the SLC states appear in the top 10 of a listing of the 50 states by debt loads broken down by per capita; in fact, Kentucky ($1,961), Mississippi ($1,534) and Louisiana ($1,308) are the only three SLC states that even appear in the top 20 in this category. Similarly, in a 50-state listing of net tax-supported debt as a percentage of GSP in 2011, once again, the SLC states do reasonably well and none appear in the top 10. Only West Virginia (13$^{th}$ at 6.15 percent), Alabama (19$^{th}$ at 4.76 percent) and Kentucky (20$^{th}$ at 4.64 percent) appear in the top 20 of this listing. Finally, in a 50-state listing of net tax-supported debt as a percentage of personal income in 2011, a single SLC state appears in the top 10 (Kentucky, coming in eighth with 6.1 percent). Several other SLC states do appear in the top 20 of this listing (Mississippi, 14$^{th}$ with 5.1 percent; West Virginia, 17$^{th}$ with 3.8 percent; Louisiana, 18$^{th}$ with 3.5 percent; and Georgia, 20$^{th}$ with 3.3 percent).

Given that the states have a relatively low level of debt, as demonstrated in Table 4 and the preceding analysis, it is possible to conclude that the likelihood of a widespread municipal bond default remains a highly unlikely event. While there will be a relatively small number of municipal defaults every year, defaults of the magnitude forecasted did not occur in 2011. As specified earlier, the rating agency Fitch noted in late 2010 that, over a 10-year period through 2009, the cumulative default rate for all rated municipal bonds, including those rated below investment grade, ranged between 0.04 percent and 0.29 percent, an occurrence rate that is exceptionally low.

## Conclusion

In closing, a review of the municipal bond market's performance in 2011 reveals that it has fared quite well, notwithstanding the overall weaknesses in the economy brought on by the intensity of the Great Recession. The fears expressed by the financial analyst Meredith Whitney that up to a 100 municipalities would default on their municipal bonds in 2011 did not occur and, in fact, there has been renewed interest by the investment community to increase their exposure to the municipal bond investment class. The scant number of municipal defaults in 2011, mostly involving hospitals, industrial development organizations and housing development projects, along with the miniscule number of municipal bankruptcies, starkly contradict the projections made in December 2010. As Bill Gross, founder and co-chief investment officer of the fixed income-focused Total Return Fund (a fund that has outpaced 98 percent of its rivals in the past five years) noted recently in a forecast for 2012, "municipal bonds [have] been a deserted asset class." His valued expertise, based on decades of working with municipal bonds, led to his conclusion that investors were "overly pessimistic" about municipal bonds in 2011; his assessment "that there are a lot of A- and AA-rated municipal bonds [that are not] going to default" served to boost confidence in this investment class.

There are a number of unique features contained in the financial structure of state and local governments—as opposed to corporations—that protect investments in municipal bonds, features that resulted in municipal bond investments appreciating in 2011 compared to the previous year. Some of these unique features include "captive tax bases" and the ability of state and local governments to both impose stringent spending cuts and/or tax increases

to supplement their revenue flows, a practice that resulted in states cumulatively slashing, or preparing to slash, about $580 billion in expenditures between fiscal years 2009 and 2013. In addition, all but one state (Vermont) and a vast majority of local governments have balanced budget requirements enshrined in their constitutions and charters, another measure that ensures that these municipal budgets are balanced either by reducing spending, raising taxes, using reserves or a combination of actions. Also, state and local government borrowing is a long-term proposition, usually with 20- to 30-year terms with the related debt servicing costs spread out over that long period, another feature that enhances the ability of municipal entities to meet their obligations. Municipal debt usually is secured by a first lien on sales or income taxes (particularly in states) and an unlimited property tax pledge (particularly in local governments) ensuring that state and local governments will meet the debt service payments associated with municipal bond issues. Furthermore, all states and many local governments have procedures in place to deal with problems related to meeting debt service payments well before an actual default, i.e., a system of prioritizing debts that, once again, ensures all debt service payments. These are some of the features which contrast unambiguously with the financial operations of corporate or private sector entities and provide a critical layer of security for municipal bond investors.

Finally, as demonstrated in this ***SLC Regional Resource***, the historic record of state and local governments in meeting their debt service obligations has been stellar, another fact that extinguishes the argument that bond defaults of up to a 100 municipalities would be commonplace in 2011. While state and local governments faced incredible challenges during the Great Recession, and will continue to face significant hurdles dealing with a number of major expenditure categories looming on the horizon, the state fiscal situation has improved notably compared to the last three years and policymakers have and are continuing to introduce measures to remedy the long-term situation.

## References


"U.S. State and Local Government Bond Credit Quality: More Sparks than Fire," *Fitch Ratings*, November 16, 2010

"Default is Dirty Word to America's Willing and Able," *Bloomberg*, November 28, 2010

"Meredith Whitney on 60 Minutes: Muni Bond Troubles Ahead," *San Francisco Chronicle*, December 19, 2010

"Crying Wolf about Municipal Defaults, *National League of Cities*," December 22, 2010

"How Bonds Impact You, *Investinginbonds.com*," January 2011

"Crying Wolf about Municipal Defaults: Part 2," *National League of Cities*, January 12, 2011

"Whitney Municipal Bond Apocalypse: Short on Specifics," *Bloomberg*, February 1, 2011

"Meredith Whitney's Muni Prediction Draws Scrutiny," *The New York Times*, February 8, 2011

"State and Municipal Debt: The Coming Crisis?" Testimony of Iris J. Lav, *Center on Budget and Policy Priorities*, before the U.S. House of Representatives' Oversight Sub-Committee on TARP, Financial Services and Bailouts of Public and Private Programs, February 9, 2011

"Meredith Whitney's Misinformation Campaign," *National League of Cities*, May 19, 2011

"It's Not Your Father's Muni Market," *NorthJersey.com*, June 1, 2011

"Whitney Still a Bad News Bear on State Munis," *Portfolio.com*, June 7, 2011

"Whitney Stands by U.S. Muni Bond Defaults Forecast," *Reuters*, June 8, 2011

"2011 State Debt Medians Report," *Moody's Investor Services*, May 25, 2011

"Central Falls Bankruptcy Driven by Pensions Cast Shadow over Rhode Island," *Bloomberg*, August 2, 2011

"Fiscal Monitor: World Economic and Financial Surveys," *International Monetary Fund*, September 2011

"Harrisburg Files for Bankruptcy on Overdue Incinerator Debt," *Businessweek.com*, October 12, 2011

"Largest Municipal Bankruptcy in U.S. History Filed After Creditor Deal Crumbles," *National Association of Credit Management*, November 2011

"Spain Borrowing Costs Soar Past Greek, Portugal Levels in First Post-Election Bond Auction," *The Washington Post*, November 22, 2011

"Municipal Bonds in 2011: An Update on State and Local Borrowing," *National Association of State Budget Officers*, November 23, 2011

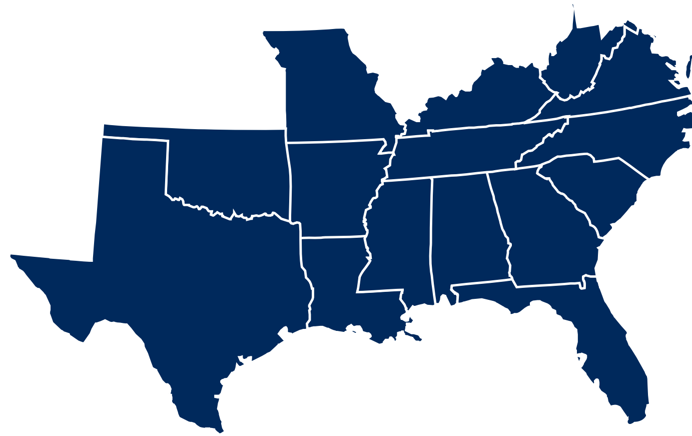
"Bye-bye, Keynes," *The Washington Post*, December 18, 2011

"Expert Predictions for Stocks, Fixed Income and Real Estate," *The New York Times*, December 30, 2011

# SOUTHERN LEGISLATIVE CONFERENCE

## THE SOUTHERN OFFICE OF THE COUNCIL OF STATE GOVERNMENTS

## REGIONAL VIEW NATIONAL REACH



Founded in 1947, the Southern Legislative Conference (SLC) is the largest of four regional legislative groups operating under The Council of State Governments and comprises the states of Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, Missouri, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia and West Virginia.

The mission of the Southern Office/Southern Legislative Conference is to foster and encourage intergovernmental cooperation among its 15-member states. In large measure this is achieved through the meetings, publications and policy positions of the Conference's six standing Committees. Committee members are appointed by their chamber's legislative leadership and each committee elects its own officers. Through the deliberations of committee members, an array of issues facing all Southern state legislatures is considered.

The Southern Legislative Conference is the Southern Office of The Council of State Governments (CSG), the only national organization serving all three branches of state government. As a national organization with a regional structure, CSG is uniquely positioned to provide a forum for dialogue and discovery among state policymakers and to promote the interests of states at the national level.

The Council of State Governments was founded during the Great Depression and, for nearly 80 years, CSG has worked hard to provide state leaders with what they need to succeed in difficult times. The members of CSG include every elected and appointed state and territorial official in the United States. Through our committees and task forces, supported by our exceptional team of policy and research specialists, the SLC considers and makes recommendations on promising approaches to public policy.

This report was prepared by Sujit M. CanagaRetna, senior fiscal analyst, for the Fiscal Affairs and Government Operations Committee of the Southern Legislative Conference of The Council of State Governments, under the chairmanship of Representative James Fannin, Louisiana.

**SERVING THE SOUTH**

THE SOUTHERN OFFICE OF THE COUNCIL OF STATE GOVERNMENTS
PO Box 98129 | Atlanta, Georgia 30359
ph: 404/633-1866 | fx: 404/633-4896 | *www.slcatlanta.org*