Village of Barrington Hills

Memo

To: Karen Selman, Finance Committee

From: Rosemary N. Ryba, Treasurer

CC: Board of Trustees, Village President

Date: August 24, 2012

Re: Monthly Summary – **AUGUST**

- Second installment 2011 property tax bills are due for the following:

    1. Kane County – September 4, 2012
    2. Lake County – September 6, 2012
    3. McHenry County – September 11, 2012
    4. Cook County – was due August 1, 2012 [$576,032.93 collected 8/1-8/23]

- The Illinois Municipal Retirement Fund (IMRF) has issued the Village's 2013 contribution rate at 7.01%. The 2012 contribution rate is 2.35% or approximately $23,000 by year-end, historic chart attached. The Village's contribution for 2013 for fourteen employees would be approximately $66,500 if salaries stay static. This increased contribution amount of $43,500 will need to be addressed in the upcoming budget and levy.

- Governmental Accounting Standards Board (GASB) approved two new pension statements designed to increase the transparency, consistency and comparability of pension information across governments. Statement No. 67 will take effect for pension plans in fiscal years beginning after June 15, 2013 and Statement No. 68 will take effect for employers and governmental nonemployer contributing entities in fiscal years beginning after June 15, 2014. Attached is a GASB release detailing the new requirements.

- Moody's is performing its annual review of the Village's credit rating which is currently at Aa1. A possible upgrade to the highest level of Aaa is unlikely. Attached is a recent publication that outlines Moody's negative outlook for local governments in 2012.

- The 2013 Budget Worksheets are available to the Board of Trustees in the e-Packet online along with other August Agenda materials such as Treasurer's Report 2.1 and Schedules A-L. Included in the packets and sent via email, is each committee chair's assigned responsibility (ies). The goal is to complete the worksheets for submittal to the Finance Committee by the week of October 8th. The completed worksheets can be dropped off or emailed treasurer@barringtonhills-il.gov any time prior to that date. Archive records can be found online at www.barringtonhills-il.gov/treasurer.

VILLAGE OF BARRINGTON HILLS
ILLINOIS MUNICIPAL RETIREMENT FUND
CONTRIBUTION SCHEDULE

	EMPLOYER RATE	* DOLLAR AMOUNT	
2006	1.03%	$ 7,090.86	
2007	1.07%	8,645.49	
2008	0.86%	7,083.24	
2009	0.84%	7,299.14	
2010	6.50%	58,871.96	
2011	5.57%	54,399.94	
2012	2.35%	13,280.74	*Through 7/31/12
2013	*7.01%*	*66,500.00*	**Projected*

* Source: Treasurer's Report 2.1 at December 31

New rules expose bigger funding gaps for public pensions
By Michael A. Fletcher, Washington Post
Published: August 16, 2012

State budgets in crisis: As U.S. states struggle with unprecedented deficits, they are taking controversial measures to try to boost revenue and keep spending down.

[PHOTO] Gov. Scott Walker survives Wisconsin recall after more than a year of political turmoil: After a brief but bruising campaign that followed a fight over union rights and Wisconsin's cash-strapped budget, voters in the narrowly divided state cast their ballots Tuesday to retain Gov. Scott Walker. Already-strapped state and local governments are coming under increasing pressure to reduce pension benefits or increase taxpayer contributions that help pay for them because of new rules that would require them to report those obligations more honestly, advocates say.

The latest rules come on line from the bond-rating firm Moody's at the end of this month. They are projected to triple the gap between what states and municipalities report they have in their funds and what they have promised to pay out to retirees. That hole would stand at $2.2 trillion.

For the worst-off cities, the new pension debt calculations could mean bond rating downgrades and increased borrowing costs when localities try to raise money for new projects, Moody's has warned.

The accounting changes themselves will not force policymakers to alter how they fund pensions. But finance experts say that by simply highlighting greater funding gaps, the rules will intensify pressure on state and local governments to allocate more of taxpayers' dollars to their pension funds. More likely, public workers may have to contribute more to their retirements or see promised benefits curtailed, measures that have already been implemented in more than 40 states.

Virginia and Maryland have cut benefits for new hires while preserving retirement packages for current employees.

"It is hard to believe that higher numbers would not put increased pressure on governments to deal with this," said Scott D. Pattison, executive director of the National Association of State Budget Officers. "If you only have so many dollars, if you are going to put more into pensions, that means less for other things."

The new rules come at a difficult time for state and local governments struggling with weakened tax revenue and stronger demand for services in the wake of the recession. In addition, states and localities face the prospect of substantial reductions in aid from the federal government beginning in January unless Congress and the White House come up with an alternative to automatic budget cuts.

The changes add to the growing tensions over the often generous retirement benefits that public employees receive. Union leaders argue the packages compensate for lower pay, but critics, including GOP governors, say the pensions are unfair and have become unaffordable for taxpayers.

"It is what we call pension envy," said David Urbanek, spokesman for the Teachers' Retirement System of Illinois. "You have an economy that is not performing the way people are used to. For a lot of people, their standard of living is being held steady or declining. Then they see a group of people getting pensions that they've earned and it makes them uncomfortable. They ask, 'Why not me?' Or, more to the point, 'Why them?' "

Retired Illinois teachers earn annual pensions of a little more than $46,000 a year on average; they do not participate in Social Security under a state opt-out. Under the old accounting rules, their pension fund has $37 billion in assets and $81 billion in future liabilities — making it among the most poorly funded large public plans in the country.

Under the new accounting rules, the assets would be counted even lower, leaving an unfunded liability that one estimate put at 83 percent.

"The new standards are essentially a public relations problem," Urbanek said. "It doesn't change the fact that we owe a total liability of $81 billion over 30 years."

But the situation could get worse, he added. Illinois faces $9.2 billion in unpaid bills, and lawmakers could be tempted to reduce pension funding.

Pension systems are financed through a combination of annual budget allocations and employee contributions. They also greatly rely on investment earnings. But the stock market's erratic performance over the past decade or more has contributed to a worrisome gap between the amount of money pension funds are projected to have on hand and what they have pledged to pay retirees.

The problem grows even greater when governments factor in the soaring cost of retiree health benefits, for which many of them have not set money aside.

Under current rules set by the Governmental Accounting Standards Board, public pensions are estimated to be about 75 percent funded. This June, like Moody's, GASB approved new guidelines that would shrink that estimate to 57 percent. GASB's rules take full effect by 2015.

"Government entities are trying to move toward full funding; that is the goal," said Cathie G. Eitelberg, senior vice president for the Segal Company, an employee-benefits consultancy. "Having different sets of numbers out there is going to be a communications challenge. It could also require public officials to look at these plans and make decisions about how to best finance them over time."

Among other things, the new accounting rules from Moody's and GASB limit the rate of return on future investments that pension funds can assume for accounting purposes. Most government pension funds assume a 7 percent to 8 percent return, which critics say overstates future investment income.

Unions and many pension fund managers dispute that critique, pointing out that investment returns have surpassed that over the past several decades, even if recent history has been more difficult. Still, others say the changes are long overdue and will better reflect the funding situations of public employee pension funds.

"The action by GASB and Moody's will convince people they can't continue to wait to rein in these costs," said Chuck Reed, mayor of San Jose, where voters in June overwhelmingly ratified a sweeping pension reform plan. "These costs are enormous and nobody can afford them. To the extent that the real costs are obvious, it provokes people into action."

In San Jose, retirement costs have more than tripled in the past decade and now consume one-fifth of the city's general fund budget. Reed said the ballooning cost of pensions and retiree health benefits has forced the city to cut 2,000 jobs.

Under the recently approved plan, new city workers would be forced into a less expensive pension plan. Incumbent workers have the choice of joining the less expensive plan or paying much more for the old one. That plan allows workers to retire when they are as young as 55 or have put in 30 years on the job, and they can receive up to 90 percent of their salaries. In addition, they receive a 3 percent cost-of-living increase every year.

Under the reform plan, the city can suspend those increases if it declares a fiscal emergency.

"The retiree costs were going to affect service delivery or cause insolvency," Reed said. "So we had to do something to reduce them."

Governmental Accounting Standards Board
of the Financial Accounting Foundation

June 2012

New GASB Pension Statements to Bring about Major Improvements in Financial Reporting

In June 2012, the GASB approved a pair of related Statements that reflect substantial improvements to the accounting and financial reporting of pensions by state and local governments and pension plans. Statement No. 67, *Financial Reporting for Pension Plans,* addresses financial reporting for state and local government pension plans. Statement No. 68, *Accounting and Financial Reporting for Pensions*, establishes new accounting and financial reporting requirements for governments that provide their employees with pensions.

The guidance contained in these Statements will change how governments calculate and report the costs and obligations associated with pensions in important ways. It is designed to improve the decision-usefulness of reported pension information and to increase the transparency, consistency, and comparability of pension information across governments.

Statement 67 replaces the requirements of Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, for most public employee pension plans. Statement 68 replaces the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, for most government employers. The new Statements also replace the requirements of Statement No. 50, *Pension Disclosures*, for those governments and pension plans.

Background

To ensure that GASB pronouncements continue to be of high quality and are in sync with the continuously evolving government environment, the GASB periodically reexamines its standards. Reexamination typically takes place after a Statement has been in place and fully implemented for at least five years. Research on the GASB's pension standards indicated opportunities for significant improvement.

Governments provide pension benefits through various types of *defined benefit* pension plans, which specify the *amount of benefits* to be provided to the employees after the end of their employment. *Single-employer* pension plans provide pension benefits to the employees of one employer (a *single employer*). *Multiple-employer* pension plans provide pension benefits to the employees of more than one employer. Under an *agent* multiple-employer pension plan, the assets of a multiple-employer pension plan are pooled for investment purposes but separate "accounts" are maintained for each individual *agent employer,* so that each agent employer's share of the pooled assets is legally available to pay the pensions of only its employees. In a *cost-sharing* multiple-employer pension plan, *cost-sharing employers* share their assets *and* their obligations to provide pension benefits to their employees—plan assets can be used to pay the pensions of the employees of any employer that provides pensions through the plan. The new Statements address all of these types of plans, as well as *defined contribution* plans, which stipulate the amount to be contributed to employee accounts each year, not the amount of benefits that will be paid in the future.

The Statements apply specifically to governments and pension plans in which a government's contributions to the trust used to administer a pension plan are (a) irrevocable, (b) restricted to paying pension benefits, and (c) are beyond the reach of creditors. Pension benefits provided through trusts that do not meet those three criteria are not addressed in these new Statements and those pension benefits would continue to be accounted for and reported following Statements 25, 27, and 50.

It is important to note that the new Statements relate to *accounting and financial reporting* issues only—how pension costs and obligations are measured and reported in audited external financial reports. The Statements do not address how governments approach pension plan *funding*—a government's policy regarding how much money it will contribute to its pension plan each year. While there has been a close relationship between how governments fund pensions and how they account for and report information about them until now, the new guidance establishes a decided shift from the *funding-based* approach to an *accounting-based* approach. The Board crafted its new Statements with the fundamental belief that funding is squarely a policy decision for elected officials to make as part of the government budget approval process.

Reporting by Governments in Defined Benefit Plans

Recognizing a Liability Related to Pension Promises for Single and Agent Employers

State and local government employees often earn two types of compensation in return for their efforts—current compensation and deferred compensation. Salaries and other forms of current compensation reflected in the paycheck are received by employees during their employment. On the other hand, deferred compensation, including pension benefits, is not received until after the employee's tenure with the government has concluded and vesting and age requirements have been met.

Nevertheless, a government has a present obligation to pay these deferred benefits in the future—a *total pension liability*—once they have been earned. When the total pension liability exceeds the pension plan's net assets (now referred to as plan net position) available for paying benefits, there is a *net pension liability.* Governments will now be required to report that amount as a liability in their accrual-based financial statements (for example, the government-wide statement of net position). The pension plan's net position available for paying benefits is to be measured using the same valuation methods that are used by the pension plan for purposes of preparing its financial statements, including measuring investments at fair value.

This is an important change that will more clearly depict the government's financial position. While this information will, in some cases, give the appearance that a government is financially weaker than it was previously, the financial reality of the government's situation will not have changed. Reporting the net pension liability (or asset, if plan net position exceeds the total pension liability) on the face of the financial statements will more clearly portray the government's financial status because the pension liability will be placed on an equal footing with other long-term obligations.

Measuring the Pension Liability

The new pension standards reflect several changes from those currently in place regarding how governments calculate their total pension liability. The measurement process detailed in the new standards involves three essential steps:

1. Projecting future benefit payments for current and former employees and their beneficiaries

2. Discounting those payments to their present value

3. Allocating the present value over past, present, and future periods of employee service.

The standards continue the general existing practice of incorporating expectations of future employment-related events into projections of pension benefit payments—like projected salary increases and projected years of service—if they affect the amount of pension payments employees will receive. Provisions for automatic cost-of-living adjustments (COLAs) and other automatic benefit changes (which generally are written into the pension benefit terms) will also continue to be included in projections. On the other hand, *ad hoc* COLAs and other ad hoc benefit changes—which are made at the discretion of the government—will only be included in projections if they occur with such regularity that they are effectively automatic.

To discount projected pension benefit payments to a present value, governments assume a *discount rate.* Standards now in effect require governments to apply a discount rate equal to the long-term expected rate of return on the investments of the pension plan. The long-term expected rate of return will continue to be the starting point for the discount rate. However, the new standard makes it clear that this rate should be applied only to available pension plan assets that are expected to be invested using a strategy to achieve that return.

To the extent that a pension plan's net position and projected contributions associated with active and inactive employees, including retirees, is expected to fully cover projected benefit payments for those individuals, the long-term expected rate of return will be used. If there comes a point in the projections when plan net position and contributions related to active and inactive employees is no longer projected to be greater than or equal to projected benefit payments related to those employees and administrative expenses, then from that point forward a government would be required to discount the projected benefit payments using a municipal borrowing rate—a tax-exempt, high-quality (an average rating of AA/Aa or higher, including equivalent ratings) 20-year general obligation bond index rate.

Finally, benefit payments—discounted to their present value—are allocated to past, current, and future periods. The new standards require all governments to use the entry age actuarial cost method to allocate present value, and to do so as a level percentage of payroll. Under this method, the present value of projected benefits is attributed to employees' expected periods of employment starting from when employees first begin to earn benefits.

Calculating Pension Expense

A government's net pension liability varies from year to year for a variety of reasons, including actual earnings on plan investments, employee compensation changes, interest on the outstanding pension liability, contributions from employers and employees, and actual economic or demographic changes not matching up with assumptions made in the actuarial calculations. When these period-to-period changes should be included in the calculation of the cost of a government's operations—as expenses in the accrual-based financial statements—is a key issue.

The new standards will better align the recognition of pension expense with the period in which the related benefits are earned. Considered in total, the changes set forth by the GASB will have the overall effect of expense recognition being accelerated. Under the new standards, several causes of change in the net pension liability will be factored into the calculation of pension expense *immediately* in the period in which the change occurs:

1. Benefits earned each year
2. Interest on the total pension liability
3. Changes in benefit terms
4. Projected earnings on plan investments
5. Changes in plan net position from other than investments

The effects on the total pension liability of (a) changes in assumptions and (b) differences between assumptions and actual experience are to be recognized initially as deferred outflows of resources or deferred inflows of resources and then introduced into the expense calculation systematically and rationally over the average remaining years of employment of employees (active employees and inactive employees, including retirees). This period is likely to be significantly shorter than the period of up to 30 years over which governments may now recognize portions of their pension expense.

The difference between the expected earnings on plan investments and actual investment earnings is to be recognized as deferred outflows of resources or deferred inflows of resources and included in expense in a systematic and rational manner over a five-year closed period rather than longer periods that are allowed under the current standards.

Reporting by Governments in Cost-Sharing Multiple-Employer Plans

Under the pension standards now in effect, cost-sharing employers have not been required to present actuarial information about pensions. Instead, information has been required to be presented in the pension plan's own financial statements for all of the participating governments combined.

Through its research, the GASB concluded that the needs of users of information regarding cost-sharing employers do not differ significantly from those interested in single and agent employers. Therefore, the GASB believes it is important to give users of the financial statements of cost-sharing employers access to better, more transparent financial information. Consequently, under the new standards the GASB is requiring that cost-sharing governments report a net pension liability, pension expense, and pension-related deferred inflows and outflows of resources based on their proportionate share of the collective amounts for all the governments in the plan.

Note Disclosures and Required Supplementary Information

The new standards contain requirements for disclosing information in the notes to the financial statements and presenting required supplementary information (RSI) following the notes. Due to the complexity of the array of pension plan features, the Board concluded it was critical that financial statement users have access to certain basic plan information through governments' own financial statements. The Board believes that including this information will enhance the usefulness of financial reports for both decision making and assessing accountability.

All governments participating in a defined benefit pension plan will now include the following information in their note disclosures:

- Descriptions of the plan and benefits provided
- Significant assumptions employed in the measurement of the net pension liability
- Descriptions of benefit changes and changes in assumptions
- Assumptions related to the discount rate and the impact on the total pension liability of a 1 percentage point increase and decrease in the discount rate
- Net pension liability and deferred outflows of resources and deferred inflows of resources.

Single and agent governments also will be required to disclose, for the current period, the beginning and ending balances of the net pension liability, and the effects of changes during the period (such as the effects of service cost, benefit changes, and actual investment earnings).

Single and agent governments will be required to present RSI schedules with the following information for each of the past 10 years (generally on a prospective basis):

- The beginning and ending balances of the total pension liability, the plan trust's net position, and the net pension liability, and their components
- Total pension liability, the plan's net position, the net pension liability, a ratio of the plan's net position to the total pension liability, the covered-employee payroll, and a ratio of the net pension liability as a percentage of the covered-employee payroll.

If a single, agent, or cost-sharing government has an actuarially determined annual pension contribution (or, if not actuarially determined, then the statutorily determined contribution), it is also required to present an RSI schedule with the following information for each of the past 10 years (generally on a prospective basis): (1) the actuarially determined annual pension contribution (or, if not actuarially determined, then the statutorily determined contribution), (2) the amount of employer contribution actually made, (3) the difference between 1 and 2, (4) the payroll of employees covered by the plan, and (5) a ratio of 2 divided by 4.

Governments are also now required to present notes to the RSI schedules regarding factors that significantly affect the trends in the schedules. For single and agent employers, significant assumptions also should be disclosed.

Special Funding Situations

Special funding situations are circumstances in which (a) a *nonemployer contributing entity* (such as a state government) is legally responsible for contributions directly to a pension plan that is used to provide pensions to the employees of another government (such as school districts located within that state) and (b) one or both of the following is true:

1. The nonemployer is the only entity with a legal obligation to make contributions directly to the plan

2. The amount of the contributions for which the nonemployer is legally responsible is not dependent upon one or more events unrelated to the pensions.

In a special funding situation, the nonemployer has essentially assumed a portion of the employer entity's pension obligation as its own. Consequently, if the nonemployer is a government, it will recognize its proportionate share of the net pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources related to the employer's pensions in its own financial statements.

The government benefitting from the nonemployer's contributions in a special funding situation will calculate its net pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources related to pensions prior to the nonemployer government's support, but would *recognize* in its financial statements only its proportionate share.

Reporting by Governments in Defined Contribution Plans

As previously noted, defined *contribution* plans stipulate the *amount to be contributed to an employee's account* each year, and not the amount of benefits employees will receive after the end of their employment. The new standards generally carry forward the existing requirements regarding defined contribution pensions. Governments will report an expense equal to the amount they are required to contribute for employee service each year and a liability equal to the difference between that required contribution and what the government actually contributes. Governments will also make descriptive disclosures about the plan and its terms, and the method by which contributions to the plan are determined.

Reporting by Pension Plans

Statement No. 67 on plan reporting details guidance for financial reporting by *defined benefit pension plans* administered through trusts that meet the criteria described earlier. This guidance generally carries forward the present framework for the separately issued financial reports of defined benefit pension plans. Statement 67 will significantly improve related financial reporting through enhanced note disclosures and new RSI schedules. The Statement also details note disclosure requirements for *defined contribution pension plans* administered through trusts that meet the criteria.

Effective Dates

Statement No. 67 will take effect for pension plans in fiscal years beginning after June 15, 2013 (that is, for years ended June 30, 2014 or later). Statement No.68 will take effect for employers and governmental nonemployer contributing entities in fiscal years beginning after June 15, 2014 (that is, for years ended June 30, 2015 or later). However, the GASB encourages plans and governments to implement the new standards earlier.

Obtaining the New Statements

The new Statements should be available in early August to download free from the GASB website (www.gasb.org) or to purchase in printed form.

- Order a printed copy of Statement 67
- Order a printed copy of Statement 68
- Read the news release

MOODY'S
INVESTORS SERVICE

OUTLOOK

Outlook for U.S. Local Governments Remains Negative in 2012

Tough Choices Ahead as Weak Economy Continues to Pressure Revenues

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Moody's outlook for the U.S. local government sector is negative. This outlook expresses our expectations for the fundamental credit conditions in the sector over the next 12 to 18 months. It does not speak to expectations for individual rating changes and is not a prediction of the expected balance of rating changes during this time frame.

The outlook for the U.S. Local Government sector remains negative in 2012 for the fourth straight year. Given diminished financial reserves and expenditure reduction efforts already made, local governments face tough budget choices to balance revenues and expenditures. Continued weak revenue performance resulting from a tepid U.S. economic recovery could be further challenged by a European recession. Expected reductions in federal spending will likely add to pressure as states continue to cut aid to local governments. While economically sensitive revenue streams have improved since the depths of the recent recession, real estate assessed values remain depressed and in some cases continue to decline, affecting property tax receipts, which are a primary revenue source for most municipal entities.

This report discusses the following key operating environment challenges that contribute to our negative outlook for the local government sector:

» The national economy continues to expand slowly while showing renewed signs of weakness.

» Property taxes and state aid remain under pressure.

» Budgetary tradeoff decisions are getting tougher.

» Enterprise and debt structure risks continue to cause financial strain.

Weak Economic Recovery Is Primary Drag on Local Government Credit Quality

Economic recovery continues at a very slow pace, and signs of weakness remain. Moody's Investors Service forecasts real GDP growth between 1.5% to 2.5% in 2012, but the risks are skewed to the downside. Economic gains remain relatively tepid due to slow income growth, weak consumer confidence, persistently high unemployment, and a soft real estate market. The euro area debt crisis presents the most immediate risk to global growth with many economists commenting on the high risk of a euro area recession and a potential for spill-over into other economic regions, including the U.S. The slow national economic recovery and global economic risk contribute to the negative credit condition of local governments, producing revenue pressures and limiting the options available to address fiscal challenges.

GDP Improves, but Real Disposable Income Still Below First Quarter

U.S. GDP improved throughout 2011, going from 0.4% annualized growth in Q1 to 2.8% in Q4. The trend is positive heading into 2012, but there are reasons for caution. After five consecutive quarters of slowing growth, real disposable income declined in the 2nd and 3rd quarters of 2011 (Figure 1) due to weak wage growth and higher prices. Although real disposable income increased in the fourth quarter, it is still below the level of the first quarter.

FIGURE 1

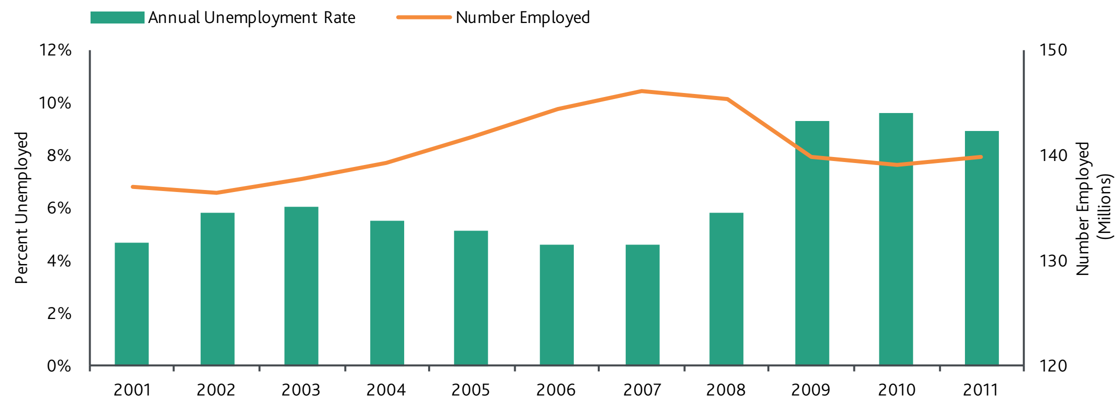
Real Disposable Income Growth Has Weakened

Source: U.S. Bureau of Economic Analysis (Seasonally Adjusted Annualized Rate)

Unemployment Remains Persistently High

The decline in the unemployment rate from 9.1% in January 2011 to 8.5% in December 2011 is a modest sign of economic recovery. Despite this progress, however, unemployment persists at a high rate relative to historical levels. The average unemployment rate during 2011 was 8.9%, which, excluding 2009 and 2010, is the highest annual rate since 1983. Furthermore, the recent reduction in unemployment during 2011 is partly due to a decline in labor force participation. The number of people employed in 2011 was 139.9 million, higher than the 139.1 million 2010, but still below the peak 146.0 million employed in 2007.

FIGURE 2
Number Employed Is Significantly Below Peak Despite Decline in Unemployment Rate

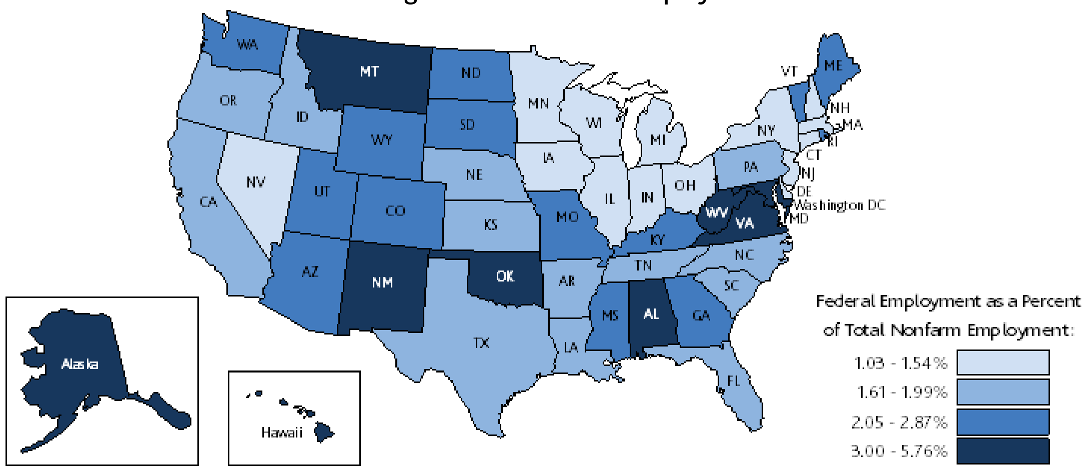


Source: U.S. Bureau of Labor Statistics

Federal Cuts Expected to Impact Some More than Others

Moody's Analytics forecasts that the expiration of stimulus funds and federal budget cuts agreed to in the August 2011 debt-ceiling deal will shave 0.8 percent from real U.S. GDP growth in 2012. Though local governments are not directly reliant on federal revenues to a significant extent, many local economies are correlated with the national economy. Some local governments receive significant aid from state governments that may themselves experience direct cuts in federal funding and may choose to extend less aid downstream. Federal spending cuts are not expected to impact regional economies equally. At greatest risk are local governments in regions with high concentrations of federal employment, procurement, and defense and healthcare spending, such as those in the Washington D.C. area and San Antonio, Texas, for example. Of the local governments with an "indirect link" to the U.S. federal government rating, thirty-six Aaa-rated local governments now carry a negative outlook.[1]

FIGURE 3
Local Governments in States with High Levels of Federal Employment Face Additional Pressures



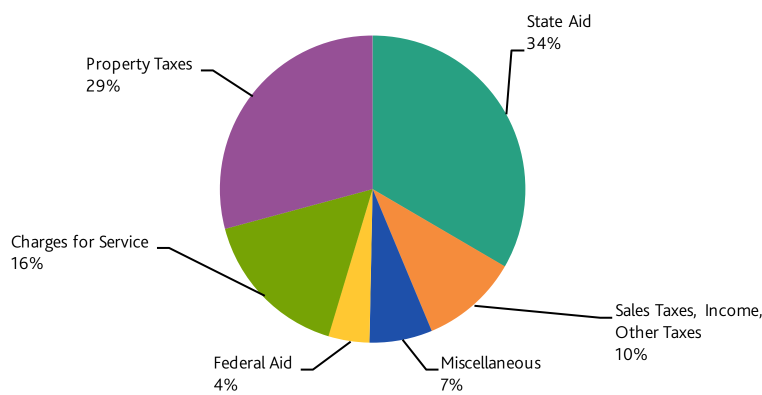
Source: U.S. Bureau of Labor Statistics

[1] See Moody's Report, "Most Aaa-Rated State and Local Governments Revert to Stable Outlooks, Despite Negative Pressure on U.S. Government Rating", December 2011

Declining Revenues from Ties to Housing Market and State Governments Are Unlikely to Be Offset by Increase in Other Revenue Sources

Local governments face significant challenges due to their primary dependence on property taxes and state aid, which have underperformed for several years and are expected to remain pressured in 2012. Local governments in the U.S. received 29% of their revenues from property taxes and 34% from state aid in 2009. The health of the housing market, which is still facing the effects of the recent recession, greatly impacts local government property tax collections. Because property tax appraisals typically occur 12 to 18 months before the property taxes are collected, the substantial property value reductions at the end of 2010 and throughout 2011 have started to affect local government revenue collections. Likewise, as the housing market recovers, any improvements will not be felt by local governments for some time. As local governments continue to feel the effects of declines in property values, they will likely simultaneously experience further state aid cuts. It is unlikely these declines will be offset by other revenue sources, such as sales taxes.

FIGURE 4
Property Taxes and State Aid Comprise Over 60% of Local Government Revenues



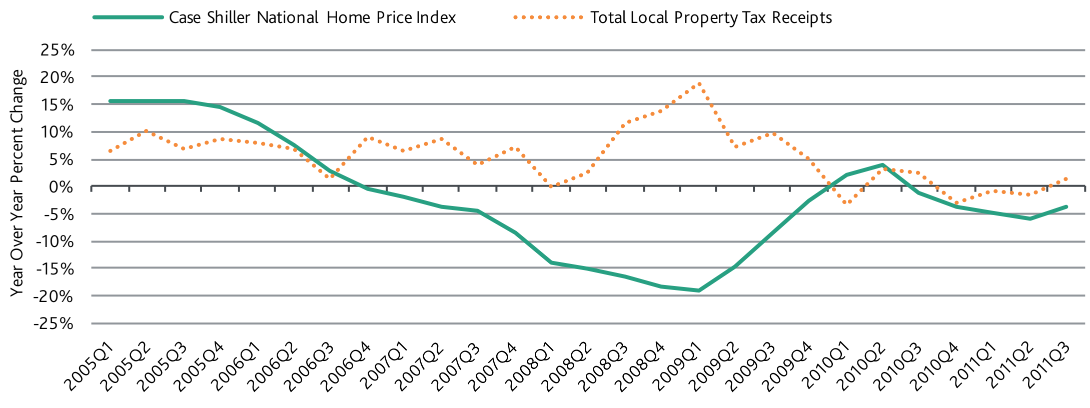
Source: U.S. Census Bureau, for 2008-2009

2011 Third Quarter Upturn in Property Tax Revenue Not Expected to Continue

Though we expect declines in 2012, property tax revenues improved recently due to the lag between appraisals and collections. The large property value declines experienced in late 2008 and 2009 began impacting property tax revenues in the final quarter of 2010 and the first two quarters of 2011 when they fell on a year-over-year (YOY) basis by -3.01%, -0.77%, -1.42%, respectively. This trend reversed in the third quarter of 2011 when property tax revenue increased by 1.5% YOY, due largely to property value increases experienced in the first half of 2010 (Figure 5) when the federal government offered a homebuyer tax credit. However, home values resumed their decline in the second half of 2010 and through most of 2011, which is just starting to affect property tax collections. Additionally, some local governments will be hindered by new state laws. New York State recently approved a property tax cap that will limit local government levy increases to the lower of 2% or inflation.

FIGURE 5

Property Taxes Lag Changes in Property Values



Source: Case-Shiller Index; U.S. Census Bureau[2]

Some Local Governments Are Raising Taxes

For those with the ability and willingness, raising tax rates is one strategy local governments have utilized to mitigate revenue pressures. Tax rate increases have moderated the decline of property tax revenues relative to the larger declines seen in valuations. Some communities have also raised sales tax rates. For example, the City of Philadelphia, PA (A2/Stable G.O.) enacted a fiscal recovery plan in 2010 upon legislative approval that included a temporary 1% sales tax increase. Additionally, the City's fiscal 2011 budget included a 10% property tax increase, which early results suggest provided an additional $86 million in net revenues to the city.

State Aid Cuts Continue

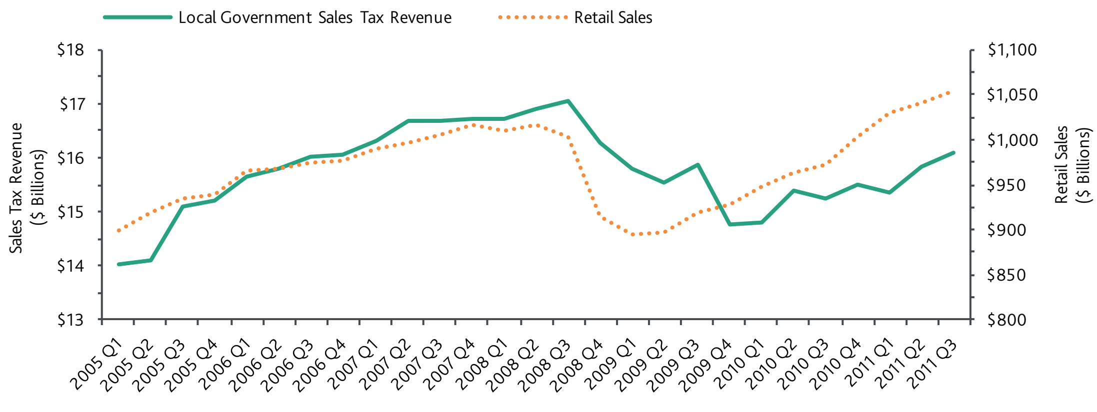
Many state governments cut aid to local governments in fiscal 2011 and 2012, and this trend is likely to continue in fiscal 2013. According to the Fiscal Survey of States by the National Governors Association, eighteen states reduced local aid in fiscal 2012, up from thirteen in fiscal 2011, and six states have already proposed cuts to local governments for fiscal 2013. Some of the reductions have been quite substantial. The State of Texas, for example, cut $4 billion in funding to school districts for fiscal years 2012 and 2013. According to the Center on Budget and Policy Priorities, thirty states now provide lower levels of school funding than in 2008. Additionally, mid-year budget cuts have become the norm for many states, often impacting local governments. In fiscal 2011, 19 states enacted mid-year cuts, 18 of which included cuts to K-12 education.

Sales Tax Increases Slow

Economically sensitive revenues, such as sales taxes, have increased considerably since the end of the recession, although the rate of growth is slowing. Local government sales tax receipts increased for 5 of the past 7 quarters, providing much needed revenue to struggling local governments. These revenues increased by 3.1% in the second quarter of 2011 but slowed to 1.7% in the third quarter as growth in retail sales slowed.

[2] The U.S. Census Bureau revised the methodology for the Quarterly Tax survey in 2008 as discussed in "Bridge Report for the Quarterly Tax Summary: A Study of the Methodological Changes to the Local Property Tax Component in 2008-2010."

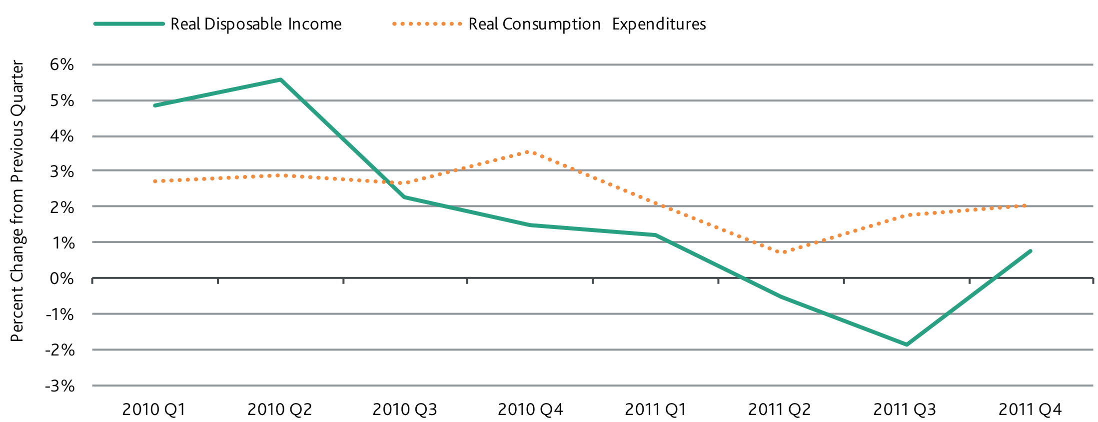
FIGURE 6
Sales Taxes Track Retail Sales



Source: U.S. Census Bureau

Downside risks to local government sales tax revenues are exacerbated by declines in disposable income. Consumer spending diverged from disposable income in the second and third quarters of 2011, due in large part to declines in the savings rate. Disposable income and consumer spending began to converge in the fourth quarter as disposable income increased and consumer spending growth slowed. However, disposable income has still not returned to the levels seen in the first quarter. Unless disposable income further increases in 2012, local governments will not likely experience meaningful increases in sales tax receipts.

FIGURE 7
Real Disposable Income is Diverging from Real Consumer Spending



Source: U.S. Bureau of Economic Analysis (Seasonally Adjusted Annualized Rates)

Tough Choices: Local Governments Will Be Making Tradeoffs in 2012

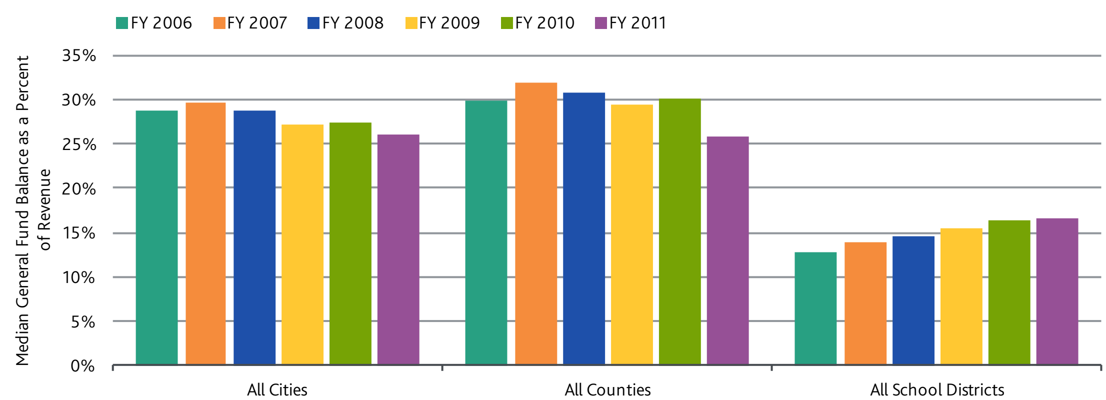
With reserve levels reduced from prior year drawdowns, many local governments will be forced to choose between cutting core services, raising taxes, or significantly depleting their remaining financial cushions. Spending priorities and levels that were once considered inflexible are now on the table for cutback. Workforce reductions, for example, have been much steeper than in prior downturns. Pensions and post-employment healthcare benefits are also the subject of restructuring efforts in many states and communities. We could see an increase in the number of municipalities that file for bankruptcy, although we still expect this will be a very small number.[3] These financial adjustments are necessitating more state financial intervention and oversight of distressed local governments.

General Fund Reserves Have Declined

Adequate financial reserves remain a significant mitgant for most local governments, but average reserve levels have declined since 2007. The median General Fund balance for Moody's rated cities was 30% of annual revenues in fiscal 2007. In fiscal 2010, the median declined to just over 27%. The decline has been acute for some cities. The number of Moody's rated cities with a General Fund balance less than 5% of revenues increased by 48% from fiscal 2007-2009. In addition, there was a 31% increase in the number of cities with negative fund balances from fiscal 2009-2010. Similarly, the median General Fund balances for Moody's rated counties declined from 32% in 2007 to 30% in 2010. Though not as severe as cities, the number of Moody's rated counties with General Fund balances of less than 10% increased 27% between fiscal 2007 and 2010. Although only a portion of 2011 audits for Moody's-rated entities have been published to-date, early indications point to further draws on reserves by cities and counties. Cities and counties can support on average one-quarter of their annual budget with reserve levels on hand. Though cities and counties have drawn down reserves, school districts have added to reserves due largely to an increase in federal stimulus aid.

FIGURE 8

General Fund Reserve Balances Are Materially Lower than in 2007 for Cities and Counties



Source: Moody's Data (incomplete for fiscal year 2011)

[3] See Moody's report, "Key Credit Considerations for Municipal Governments in Bankruptcy", January 2012

Depletion of Stimulus Funds and Rising Costs Challenge School Districts

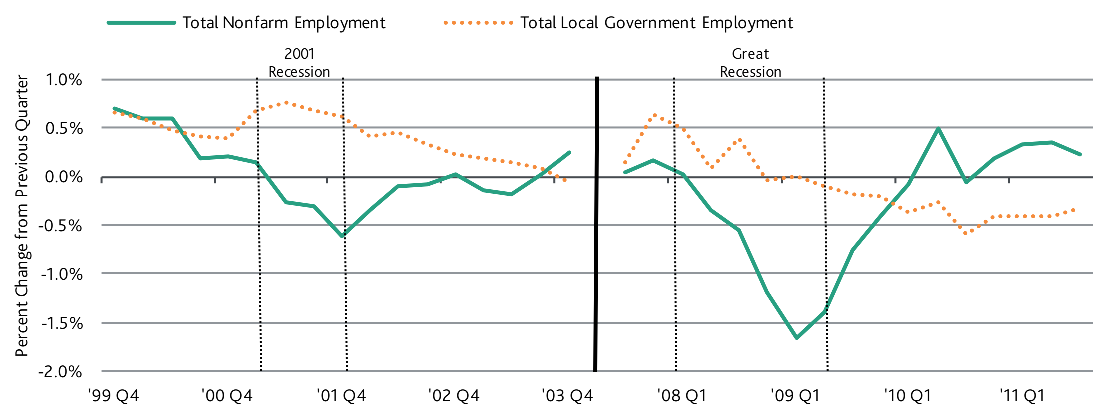
Federal stimulus funding for education has blunted the effects of the recent recession on school districts. School districts were able to use these funds to fill budgetary gaps resulting from declining state aid and property tax revenues as well as build up reserves. We expect the increase in average reserves to be a temporary phenomenon for 2011, given that federal stimulus funds ended in June 2011, thereby leaving school districts with tough choices in the coming year. Additionally, the Center on Budget and Policy Priorities notes that in addition to the recession, inflation and demographic changes have increased the cost of providing K-12 education.

Payroll Cuts Are Greater This Time

The bulk of local government employment layoffs tend to happen after recessions are officially over, and this cycle has resulted in much more severe payroll cuts compared to past recessions. In the two years following the 2001 recession, local government employment actually grew by 603,000 positions, though the quarterly growth slowed throughout the period. In contrast, the recent "great recession" has had a severe impact on the total number of local government employees. Government payrolls have declined in 11 of the past 12 quarters, falling by over 478,500 positions from the peak level of employment in the third quarter of 2008, or 3.3% of total. Over 238,000 of the local government positions cut were in education.

FIGURE 9

Local Government Employment Declined Following the Great Recession, Unlike the 2001 Recession



Source: U.S. Bureau of Labor Statistics

Some local governments have made substantial cuts in unexpected areas. For example, Camden, NJ (Ba2 G.O.), which has one of the highest crime rates in the nation, recently cut its police force by 46%. The city of Elyria, OH, (A1 G.O.) closed its jail and laid off 24% of its workforce. Nassau County, NY (A1/Negative G.O) began fiscal 2011 with 8,410 employees. In addition to cuts during fiscal 2011, the county's 2012 budget further reduces its work force to 7,400, which is a 12% overall decline.

First Signs of Reductions in Pension Benefits

In several regions across the country, local governments are implementing post-employment benefit cuts. The number of such cuts reported to date is small relative to the number of plans, but we expect this trend to continue as rapidly escalating pension obligations and retiree health care plans become more of a burden on local government budgets.

In September 2011, voters in Hollywood, Florida, (A1 G.O.) approved a referendum to reduce pension benefits for city workers, saving the city $8.5 million in fiscal 2012. The referendum was put to voters after the city declared fiscal urgency and city and union officials failed to reach an agreement. Similarly, in Central Falls, RI, (Caa1/Negative G.O.) when the city and its retired and active employees could not reach an agreement on benefit reductions to keep the pension system solvent, the city filed for bankruptcy. Ultimately, the retired and active employees agreed to concessions which reduced the city's current budget gap by 48%. In Detroit, MI, (Ba3 G.O.), police officers made voluntary concessions on pension benefits by ratifying a collective bargaining contract that reduced pension benefits for current plan members. The city expects the agreement will save $50-$100 million over the next five years.

Financial Strain Triggers States to Increase Oversight

States are expanding their oversight of local governments as a result of financial stress. For example, Michigan passed the Local Government and School District Fiscal Accountability Act, which allows for earlier state intervention in financially stressed municipalities and greatly increases authority of appointed emergency financial managers. These managers now have the authority to implement financial plans, order property tax millage elections and suspend the authority of local elected officials. Efforts are currently under way to put the law before the voters. This would suspend the law until the November 2012 election.

Some state legislatures have changed the state municipal bankruptcy laws to try to limit filings and the associated collateral damage to investor confidence. Pennsylvania passed a law prohibiting certain cities from filing for bankruptcy. Although Harrisburg (not rated by Moody's) qualified as one of these cities, it filed for Chapter 9 protection anyway. Its bankruptcy filing was subsequently rejected by the court upon objections filed by the state. Rhode Island passed a law providing all local general obligation bonds with a statutory first lien on government revenues. After passage, Central Falls (Caa1/Negative G.O.) declared bankruptcy and has continued to meet its G.O. debt payments during the bankruptcy process.

Enterprise and Debt Structure Risks Continue to Be Sources of Potential Financial Strain

During times of economic expansion, many local governments pledged financial support for projects beyond their essential services and in competitive enterprises that are typically provided by private entities, such as golf courses, power generators, sports facilities, convention centers, and healthcare facilities. Now, during weaker economic times, some of those projects are severely stressed and their debts are falling on the local government's balance sheets at a time when government finances have weakened. When the projects are sizable relative to general fund budgets, the financial impact is pronounced and can have significant credit implications. Approximately one quarter of all Moody's below-investment-grade G.O. ratings for local governments are directly linked to enterprises which have contributed to increased financial strain.

Enterprise Guarantees Can Be Costly

One of the most recognized cases of out-sized enterprise risk is the city of Harrisburg, PA, (not rated by Moody's) which provided a general obligation guarantee on $262 million of Harrisburg Authority debt related to an incinerator project. By comparison, the city began 2011 with only $31 million of outstanding general obligation debt. When the Authority was unable to support debt service payments from the incinerator project net revenues, the city defaulted on its obligations under its guaranty agreement to support the debt of the incinerator project, given the city's relatively small general fund budget and already strained financial resources.

The City of Wenatchee (A3 G.O.), Washington, provided a backstop for interest on bond anticipation notes (BANs) issued in 2008 by the Wenatchee Regional Events Center Public Facilities District to finance the construction of a 4,300 seat sports and entertainment arena. When the public facilities district was unable to pay debt service in 2011, the city had to pay $1.7 million from its General Fund and will continue to provide interest support as long as the BANs remain outstanding. General Fund reserves as a result declined from 26.6% of revenues to 14.2%. The unforeseen note interest payments have substantially diminished the city's operational flexibility. Long term financing plans under consideration to take out the BANs will also stress Wenatchee's tight finances and borrowing capability.

Short Term and Puttable Debt Structures Can Pose Significant Refinancing Risk

During the financial market stability that preceded the great recession, some local governments entered into debt structures, such as variable rate demand bonds and put bonds, which initially provided cheaper financing than traditional long-term fixed rate bonds. These instruments expose local governments to the credit risk of counterparties through credit support, liquidity facilities, and interest rate swap agreements. If capital market disruption were to occur, such as due to deterioration in credit quality of bank counterparties, some local governments will face financial strain.

The majority of local governments can operate effectively under a constrained capital market environment because they generally do not rely on cash flow borrowing or market access to refund principal maturities. However, some local governments with greater exposure to these debt instruments are relatively more exposed to capital market risks. These include local governments that rely on seasonal cash flow borrowing, bond anticipation notes that need to be rolled over, and variable rate demand bonds (VRDBs) with commercial bank liquidity agreements. Market disruption could affect issuers of VRDBs by resulting in shorter than expected amortization periods, bullet repayments, and increased costs of funds and liquidity. Local governments with BANs, VRDBs, and other forms of puttable debt in excess of available cash and investments are particularly exposed to potential market disruptions. Currently, most local governments are successful at rolling over maturities and obtaining affordable liquidity facilities.

Further Projections of Low Interest Rates Carry Negative and Positive Implications for Local Government Credit Quality

The Federal Reserve has projected that interest rates will remain low for a longer period of time than previously expected. Low interest rates can negatively influence local governments by exposing them to negative mark-to-market valuations from swap agreements and increasing pension pressures by dampening future returns on fixed income pension assets. Additionally, low interest rates can weaken local government operating income by reducing interest earned on bank deposits, Treasury bonds, repurchase agreements, and money market funds. According to the Federal Reserve, these short-term securities comprise 42% of municipalities' operating fund assets. Although interest income is a small percentage of total operating income, the decline is another revenue pressure for local governments.

Although low interest rates can have a negative influence on local governments, they can also provide several benefits. Low interest rates have enabled local governments to finance capital projects at lower debt services costs as well as refund outstanding debt for budget savings. Also, local governments with VRDBs are incurring historically low debt service costs because of the low interest rates. Finally, low interest rates can create positive returns for equity and real estate pension assets.

Conclusion

We believe that 2012 will be another tough year for local governments. They continue to face a slow economic recovery, pressured revenues, and enterprise and debt structure risks. However, the sector still benefits from many ongoing strengths which include the ability to raise property tax rates and user fees, the monopolistic provision of essential services and relatively low debt service expenses. Several factors would lead us to consider revising the U.S. local government sector outlook from negative to stable. These include: multiple quarters of ongoing economic growth; sustained growth in property and sales tax revenues; and continued financial market stability.

Moody's Related Research

Outlook:

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» Key Credit Considerations for Municipal Governments in Bankruptcy, January 2012 (136814)

» The Impact of US Federal Fiscal and Economic Strain on Municipal Credits, November 2011 (135447)

» The Great Credit Shift: U.S. Public Finance Post Crisis, September 2011 (136136)

» Sector Outlook for U.S. Local Governments Remains Negative, September 2011 (135632)

» Most U.S. Municipal Issuers Well-Insulated from Volatility of Capital Markets: Some Have Greater Exposure, August 2011 (135186)

» US Muni Sector Skillfully Navigating Deluge of Bank Facility Expirations, August 2011 (134705)

» State Oversight of Distressed Local Governments Varies Widely, February 2011 (131127)

Rating Methodology:

» General Obligation Bonds Issued by Local Governments, October 2009 (119982)

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