National Association of Counties (NACo)
International Association of Fire Fighters (IAFF)
U.S. Conference of Mayors (USCM)
National Education Association (NEA)
National League of Cities (NLC)
National Association of Police Organizations (NAPO)
International City/County Management Association (ICMA)
American Federation of State, County and Municipal Employees (AFSCME)
National Association of State Auditors Comptrollers and Treasurers (NASACT)
Service Employees International Union (SEIU)
Government Finance Officers Association (GFOA)
International Public Management Association for Human Resources (IPMA-HR)
National Public Employer Labor Relations Association (NPELRA)
National Council on Teacher Retirement (NCTR)
National Conference of State Social Security Administrators (NCSSSA)
National Association of Government Defined Contribution Administrators (NAGDCA)
National Conference on Public Employee Retirement Systems (NCPERS)
National Association of State Retirement Administrators (NASRA)

April 15, 2015

The Honorable Mike Crapo
Co-Chair, Committee on Finance Tax Reform Working Group on Savings & Investment
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Co-Chair, Committee on Finance Tax Reform Working Group on Saving & Investment
United States Senate
Washington, DC 20510

VIA ELECTRONIC MAIL: Savings@finance.senate.gov

Dear Co-Chairs Crapo and Brown:

On behalf of the national organizations listed above—representing state and local governments, elected and appointed officials, public employees and public retirement systems—we are writing in response to the request for public input regarding bipartisan tax reform. We greatly appreciate the important policy work before the Senate Finance Committee Tax Reform Working Group on Saving & Investment. Our organizations are diverse, but we have come together to urge the Working Group to ensure that any changes to the federal tax code in the area of savings and investment continue to support the ability of state and local governments to successfully design, invest, finance, and manage their public employee retirement systems.

State and local pensions are integral to national retirement policies; each is unique and issues are not systemic

State and local government pension plans currently hold some $3.7 trillion in assets and are an essential part of public workforce management and retirement policy. Public employees and their employers contribute to their pensions while they are working. Pension assets are held in trust and professionally invested in diversified portfolios over decades to prefund the cost of pension benefits for over 14 million working and 9 million retired employees of state and local government. Their long time horizon enables public funds not only to continue paying benefits to retirees and their survivors during economic declines, but also to provide a critical economic stimulus – more than $240 billion last year alone – that reaches virtually every community across the country.

State and local retirement systems are established and regulated by state laws and, in many cases, further subject to local governing policies and ordinances. Thus, each is designed to meet the distinctive needs of the sponsoring government and its employees. Differing plan designs, financial conditions, and fiscal frameworks across the country do not lend themselves to one-size-fits all solutions, but rather, require a range of tailored approaches, agreed to by the relevant stakeholders.

Most public plan sponsors have taken action; none have required federal intervention

There have been efforts over the years to impose Federal requirements on State and local government pension systems that duplicate, conflict or preempt State and local pension laws, such as recent attempts to impose onerous reporting requirements. There have also been proposals to restrict plan investment options or tax plan contributions, assets or investment gains. Finally, there have been proposals to mandate Social Security on state and local governments, despite the fact that a number of public retirement plans are structured and funded in lieu of such coverage. Ultimately, Congress has continued to recognize the importance of broad coverage, retirement savings opportunities and meaningful benefits provided to the public sector workforce. Unlike private pension plans that are preempted from State statutes and solely regulated by Federal law, State and local retirement systems are established and regulated by State and local laws, which provide strong protections for plan participants and assets.

Following the Great Recession, public employers, plans and participants, working through State and local legislative and regulatory structures, examined benefit levels and financing needed to put their retirement systems on a sustainable path. Between 2009 and 2014, every state made changes to pension benefit levels, contribution rate structures, or both. Many local governments have made similar fixes to their plans. These changes have included increases in employee contributions to pension plans, increased risk sharing and the establishment of other hybrid features, higher retirement ages and lower cost-of-living adjustments. Some modifications apply to new workers only; others affect current employees, retirees, or both. None of these reforms has required federal intervention or federal financial assistance.

Federal tax policy should support distinguishing elements of public plan design

While there have been many changes, most state and local government employee retirement systems have retained features that meet the unique needs of their workforce. The federal tax code should continue to preserve the ability of States and localities to retain these public plan characteristics that promote retirement security and workforce management, including:

- **Mandatory participation**. Most state and local governments require participation in the retirement program as a condition of employment.
- **Cost sharing between employers and employees**. Public employees typically are required to contribute 5 to 10 percent of their wages on a tax-deferred basis to their state or local pension.
- **Pooled and professionally managed assets**. By providing professional management, greater portfolio diversity and economies of scale, pooled investments in public pension trusts can earn higher returns and lower fees.
- **Targeted income replacement**. Most public pension policies aim to replace a certain percentage of pre-retirement wages to better assure financial independence in retirement.
- **Lifetime benefit payouts**. The vast majority of state and local governments do not allow for lump sum distribution of benefits; rather, they require retirees to take their pensions in installments over their retired lifetimes.
- **Survivor and disability benefits**. Many state and local pensions integrate survivor and disability protections into their retirement programs, a particularly critical feature for hazardous public sector positions.
- **Supplemental savings**. Many governmental entities sponsor a supplemental defined contribution plan in addition to the general retirement plan to allow participants to defer an additional portion of their salary in anticipation of retirement needs, and some governments provide matching contributions and automatic enrollment/escalation features to encourage participation.

State and local laws govern the design, investment policies, financing and management of public retirement systems. Any changes to Federal tax policy should support the elements of public plan design necessary to meet their diverse workforce goals, and recognize the distinctive characteristics of state and local governments when considering legislative changes that may affect their primary and supplemental retirement vehicles.

Attached for your review are "State and Local Fiscal Facts: 2015," a compendium of information regarding state and local finances, municipal bonds and public pensions that correct many misperceptions regarding the financial condition of governments and their retirement plans. Please feel free to contact any of the representatives from our national organizations listed below for more information. We would also be pleased to arrange a meeting time that is convenient for you or your staff to discuss State and local government retirement policies, as well as participate

in the very important national policy dialogue needed to ensure retirement security for all Americans.
Sincerely,

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Cc: Members of the Senate Finance Committee Tax Reform Working Group on Savings & Investment:

The Honorable Richard Burr
The Honorable Johnny Isakson
The Honorable Dean Heller
The Honorable Tim Scott
The Honorable Benjamin Cardin
The Honorable Bob Casey
The Honorable Mark Warner
The Honorable Robert Menendez

Attachment (4 pages)

State and Local Fiscal Facts: 2015

State and Local Finances ■ Municipal Bonds ■ State and Local Pensions

Fiscal Condition of State and Local Governments

In the past few years, state and local government revenues have been slowly improving. While challenges remain, officials have been taking steps to replenish rainy day funds and address long-term structural imbalances.

State Finances[1] [2]

For states, 2014 brought a moderate improvement in fiscal conditions and the trend for 2015 is that improvements will continue. General fund spending and revenues are projected to increase for the fifth consecutive year based on state-enacted budgets. Since the end of the recession, states have transitioned to a sustainable period of fiscal rebuilding, but progress remains slow and fiscal challenges are likely to continue because of rising spending demands in areas such as healthcare and education and limited gains in revenue collections.

- Forty-three states enacted higher general fund spending in FY15 than in FY14.
- States have enacted minimal mid-year spending cuts over the last several years indicating that states' fiscal situations have stabilized.
- States have replenished some spending for areas cut back during the recession, such as K-12 and higher education.
- Forty-one states and the District of Columbia expect to meet or exceed their FY 2015 revenue projections.

City Finances[3]

City fiscal conditions are improving as the recession recedes. A number of factors determine the revenue performance, spending levels and overall fiscal condition. Among the factors that negatively influence city conditions are a decrease in federal and state aid and an increase in infrastructure demands, cost of services and employee compensation. Positive factors include the health of the local economy and the value of the local tax base.

Issued By:

NGA — National Governors Association

NCSL— National Conference of State Legislatures

CSG — The Council of State Governments

NACo — National Association of Counties

NLC— National League of Cities

USCM—U.S. Conference of Mayors

ICMA — International City/County Management Association

NASBO — National Association of State Budget Officers

NASACT — National Association of State Auditors, Comptrollers and Treasurers

GFOA — Government Finance Officers Association

NASRA—National Association of State Retirement Administrators

- Property tax revenue is anticipated to have positive growth for the first time in five years.
- Sales and income tax revenues continue to show positive rates of increase.
- Ending balances are nearing pre-recession highs, but are still below 2006 levels.
- For the first time since 2008, more cities are increasing, rather than decreasing, the size of municipal workforces.

Full recovery for cities is still on the horizon. The trend in 2015 and beyond will be determined by a number of factors including national employment, the real estate market, internet commerce and external policy shifts that could affect a government's long-term fiscal health.

County Finances[4]

For counties, recovery remains sluggish and uneven. Last year was one of significant growth for county economies, yet most have not returned to pre-recession levels. Notably:

- Unemployment has yet to return to pre-recession lows in 95 percent of county economies.
- Job growth accelerated in 2014, while economic output expanded and county housing markets stabilized across the country.
- Economic recovery is starting to spread, although only 65 county economies have fully recovered.

Municipal Bankruptcy

While the fiscal condition of state and local governments as a whole is improving, there are governments where fiscal stress continues. Generally, these governments' fiscal troubles are based on long-standing economic problems and other unique circumstances. It is important to note that bankruptcy, while headline-grabbing, is rare and is not an option for most localities.

- Bankruptcy is not a legal option for state sovereign entities. States have taxing authority and have constitutional or statutory requirements to balance their budgets.
- States determine whether their political subdivisions may pursue bankruptcy in the event of insolvency.
- Only 12 states authorize Chapter IX bankruptcy filings for their general purpose governments and 12 states conditionally authorize such filings. Twenty-six states have either no Chapter IX authorization or such filings are prohibited.
- Bankruptcies remain rare and are a last resort for eligible municipal governments. Since 2010, only 8 out of 37 filings have been by general purpose governments. The majority of filings have been submitted not by cities, but by lesser-known utility authorities and other narrowly-defined special districts throughout the country.[5]
- Chapter IX of the federal Bankruptcy Code does not provide for any federal financial assistance, and filing under this section of the law is not a request for federal funding.

Federal Intervention

The Founding Fathers believed in a balance between state and federal power. The 10th Amendment reads "*The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."* State and local governments can weather difficult economic periods and officials are taking steps to restore fiscal stability. Interference in the fiscal affairs of state and local governments by the federal government is neither requested nor warranted. Long-term issues such as outdated methods of taxation, rising health care costs and growing pension liabilities are already being discussed by state and local government leaders and changes in many areas are underway.

Municipal Bonds

Municipal securities are predominantly issued by state and local governments for governmental infrastructure and capital needs purposes, such as the construction or improvement of schools, streets, highways, hospitals, bridges, water and sewer systems, ports, airports and other public works. Between 2003 and 2013, states, counties, and other localities invested $3.5 trillion in infrastructure through long-term tax-exempt municipal bonds[6]; the federal government provided $1.43 trillion.[7]

On average, 11,000 municipal issuances are completed each year.

The principal and interest paid on municipal bonds is a small and well-protected share of state and municipal budgets:

- Debt service is typically only about 5 percent of the general fund budgets of state and municipal governments.
- Either under standard practice or as required by law or ordinance, debt service most often must be paid first before covering all other expenses of state and municipal governments.
- Municipal securities are considered to be second only to Treasuries in risk level as an investment instrument. The recovery rate of payment for governmental debt far exceeds the corporate recovery rate.

Types of Debt and Default

Municipal debt takes two forms: General Obligation, or GO Debt, backed by the full faith and credit of a general purpose government like a state, city, or county; and Non-GO debt issued by governments and special entities that is usually backed by a specific revenue source (special

taxes, fees or loan payments) associated with the enterprise or borrower.

There are two types of defaults: (1) the more minor "technical default," where a covenant in the bond agreement is violated, but there is no payment missed and the structure of the bond is the same and (2) defaults where a bond payment is missed, or in the rare event that debt is restructured at a loss to investors.

From 1970 through 2014, there were 92 rated municipal bond defaults, of which only six were rated city or county governments. The majority of rated defaulted bonds were issued by not-for-profit hospitals or housing project financings.

Historically, municipal bonds have had lower average cumulative default rates than global corporates overall and by like rating category. Between 1970 and 2013, the average 10-year default rate for Moody's Aaa-rated municipal bonds was zero compared to a 0.49 percent default rate for Moody's Aaa-rate corporate bonds.[8] Furthermore, over the last five years, during which state and local governments struggled to recover from the recession, rated state and local GO defaults were remarkably low at 0.004 percent.[9]

- In the double-A rating category to which the majority of municipal ratings were assigned, average cumulative default rates are much lower for municipals than for corporates with the same double-A symbol.[10]
- There has only been one state that has defaulted on its debt in the past century, and in that case bondholders ultimately were paid in full.

Federal Tax Exemption

The federal tax exemption for municipal bonds is an effective, efficient and successful way for state and local governments to finance infrastructure. Municipal securities existed prior to the formation of the federal income tax in 1913. Since then, the federal Internal Revenue Code has exempted municipal bond interest from federal taxation. Many states also exempt from taxation the interest earned from municipal securities when their residents purchase bonds within their state. Because of the reciprocal immunity principle between the federal government and state and local governments, state and local governments are prohibited from taxing the interest on bonds issued by the federal government.

State and Local Pensions

Although some state and local government pension trusts are fully funded with enough assets for current pension obligations, there are legitimate concerns about the extent of underfunding in certain jurisdictions. In most cases, a modest increase in contributions to take advantage of compound interest, modifications to employee eligibility and benefits, or both, will be sufficient to remedy the underfunding problem.[11]

Significant Reforms Enacted

State and local employee retirement systems are established and regulated by state laws and, in many cases, further subject to local governing policies and ordinances. Federal regulation is neither needed nor warranted, and public retirement systems do not seek federal financial assistance. State and local governments are taking steps to strengthen their pension reserves and operate under a long-term time horizon.

- Between 2009 and 2014, every state made changes to pension benefit levels, contribution rate structures, or both. Many local governments have made similar fixes to their plans.[12]
- Although pension obligations in some states are backed by explicit state constitutional protections or statutes, states generally are permitted to change retiree health benefits, including terminating them, as they do not carry the same legal protections. Therefore, it is misleading to combine unfunded pension liabilities with unfunded retiree health benefits.
- Thirty-three states hold approximately $33 billion in other post-employment benefits (OPEB) assets as of FY 2013. This figure is up from 18 states reported for the period FY 2009-FY 2011. At the same time, state government units offering retiree health care benefits have declined during the past decade.[13]

Pension Finances

Public retirees and their employers contribute to their pensions while they are working. Assets are held in trust and invested in diversified portfolios to prefund the cost of pension benefits[14] for over 14 million working and 9 million retired employees of state and local government.[15] Public pension assets are accumulated, invested, and paid out over decades, not as a lump sum.

- Public employees typically are required to contribute 5 to 10 percent of their wages to their state or local pension. Since 2009, 36 states have increased required employee contribution rates.[16]
- As of September 30, 2014, state and local retirement trusts held $3.7 trillion in assets.[17]
- For the vast majority of state and local governments, retirement systems remain a small portion of their budget. On average, the portion of combined state and local government spending dedicated to retirement system contributions is four percent.[18] Current pension spending levels vary widely and are sufficient for some entities and insufficient for others.
- Funded levels - the degree to which a plan has accrued

assets to pay expected benefits for current and future retirees - among pension plans vary substantially. Although a number of plans are more than 100 percent advance-funded, on average, the funded level in 2013 was 72 percent, and 22 percent were less than 60 percent funded.[19]

- Many public pension plans have reduced their return assumption in recent years. Among the 126 plans measured in the Public Fund Survey, more than one-half have reduced their investment return assumption since FY2008. The median return assumption is 7.75 percent. For the 25-year period ending June 30, 2014, the median annualized public pension investment return was 8.8 percent; the 10-year median was 7.3 percent.[20]

Endnotes

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