STATE AND LOCAL TRAVELS: US NON-FEDERAL DEBT VISTAS

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"Woke up this morning, we had them Statesboro blues", Blind Willie McTell's "Statesboro Blues"

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CONCLUSION

Europe's ongoing sovereign debt and banking crisis grasps many headlines and excites worldwide fear. America's continuous federal fiscal fiasco and restless debates regarding it will continue to capture attention as election year 2012 beckons. Yet noteworthy debt, deficit, and funding issues lurk in other financial corners.

In America, state and local debt topics generally feature less prominently in marketplace and national media commentary. However, the federal story is not the whole story. State and local debt is substantial. Moreover, pension (and other benefit) funding obligations represent a huge challenge for many states and communities. It pays to focus on these matters alongside federal and household indebtedness, for it further highlights the status and policies of the 50 United States as a major debtor nation.

DEBT: STATE, LOCAL, HOUSEHOLD

Each of the assorted American states has its own financial and political issues. Of course, each state has its own budget. Debt burdens vary. Cities obviously are not identical in their political interests and economic orientation. Some states and localities (including cities) are prosperous, other much less so. Yet why not summarize the state and local government debt situation, reviewing the period from 1976 to the present?

State and local debt has grown substantially over recent decades. That debt is large, although it is much less of a share of total US nominal GDP than the federal debt.

At end second quarter 2011, total state and local debt was about $2.42 trillion, down slightly from end 2010's $2.46tr. These outstanding obligations are ten times the level of 35 years ago. In 1976, total state/local debt was $237.8 billion. (Federal Reserve Board, Z.1, "Flow of Funds", Table D.3, 9/16/11).

At end 2Q11, state and local debt was 24.8 percent the size of the $9.77 trillion of (publicly held) federal government debt. This slips from 2007's peak of 2007's 42.9pc, when state/local was about $2.20tr and federal was $7.32tr. Since 2007, states have not become much more austere in absolute terms; rather, the federal government has borrowed more.

Nominal US GDP in 2010 was about $14.5 trillion. GDP at end second quarter 2011 ascended to just over $15.0 trillion (annualized). It climbed to nearly $15.2tr for 3Q11. As a percentage of US nominal GDP, the low for state and local debt (1976-2011) was 11.9pc in 1981 (12.0pc in 2000). The 1976-present high was 1991's 18.0pc. It edged up (though much less dramatically than the federal counterpart) from 2000 to 2010, when it reached almost 17.0pc. Federal government debt as a percentage of nominal GDP soared from 32.9pc in 2001 to 64.6pc at end 2010. It inched up to 65.1pc at end 2Q11. State/local debt edged slightly down to 16.1pc by end 2Q11.

Thus the overall American debt situation is gloomier than a survey of the federal one alone indicates. The combined debt of the state/local and federal realms was 72.9 percent of nominal GDP. By end 2010, the state/local plus federal sum ascended to 81.6pc of nominal GDP, dipping only slightly to 81.3pc in 2Q11. The current burden towers over the 45.5pc of 2001 (1981 was 38.1pc). Compare the prior 1976-2011 summit of 67.3pc in 1991.

In America, in principle, each citizen "is king of its castle". However, in a representative democracy, it should not be surprising that debt trends and levels for "individuals in general" substantially mirror those for the nation as a whole. As thriftiness can be popular, so can appetite for debt. Analyze Federal Reserve Z.1 numbers further.

Total US household debt at end 2010 was about $13.38 trillion. This equaled 92.1 percent of nominal GDP. End 2Q11's $13.30tr still hovers closely in dollar terms to 2008's $13.84tr pinnacle. The 2008 level represented 96.9pc of nominal GDP. The pc high versus nominal GDP was 2007's 98.4pc (2009's was 97.7pc. Relative to nominal GDP 2Q11's household debt level has slid to 88.6pc, but it remains very lofty from the historical perspective.

The 1976-2010 average household debt versus GDP percentage was about 67.0pc. The current total close to ninety percent looms way above this. From 1976 to 2011, the low was 1976's 44.9pc. It broke sixty percent with 1989's 60.5pc, seventy percent with 2000's 70.2 pc. During the Goldilocks Era, it flew to 85.3pc (2003) and beyond.

Nominal GDP probably will keep going up (aided by sustained Federal Reserve easing efforts and notable federal deficit spending). However, household debt reduction (deleveraging) probably still has quite a bit of ground to cover.

What about 3Q11? The Federal Reserve Bank of New York reports that "total consumer indebtedness" at end September 2011 fell only $60 billion (.6pc) from its revised 2Q11 level. Total household debt in some stage of delinquency rose to 10.0 percent from 2Q11's 9.8pc. ("Quarterly Report on Household Debt and Credit", 11/28/11). The next Fed Z.1 release is 12/8/11.

FIXING A HOLE?

"All politics is local." Former US Speaker of the House of Representatives, Thomas Phillip "Tip" O'Neill, Jr.

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Debt securities issued by nations, states, municipalities, and corporations are not the only "obligations" intertwined with economic and political playgrounds. A "promise to pay" is not restricted to a Treasury bill, note, bond, or some similar financial instrument.

Much has been said about near term and long run challenges involving America's federal entitlement plans. In current political practice, solutions continue to be postponed.

Less emphasized, but still quite important, is the underfunding of America's state and local pension plans. Gurus disagree as to the size of this hole, but most agree that it is rather big. Economic recovery, higher taxes, or negotiations with beneficiaries may reduce or eliminate the funding gap. But in any event, state and local pension (and other) "obligations" nowadays add substantially to the "debt" (in the broad sense of that word) represented by the total of debt

securities outstanding. For both the state/local and overall national estimates of debt relative to nominal GDP discussed above, consider including the following estimates.

The Congressional Budget Office a few months ago offered interesting information regarding the state/local debt load from the pension fund pasture. ("The Underfunding of State and Local Pension Plans", May 2011).
http://www.cbo.gov/ftpdocs/120xx/doc12084/05-04-Pensions.pdf

According to the CBO: "By any measure, nearly all state and local pension plans are underfunded, which means that the value of the plans' assets is less than their accrued pension liabilities for current workers and retirees." There are two leading methods for valuing assets and liabilities. Depending on the one selected, the amount of underfunding varies significantly.

As of 2009, a review of state and local pension plans (Public Fund Survey, representing about 85pc of US pension assets and participants) had unfunded liabilities of about $700 billion. This estimate "is calculated on the basis of actuarial guidelines currently followed by state and local governments" (the Government Accounting Standards Board approach; "GASB"). The CBO notes this "share of liabilities covered by assets in 2009 was the lowest in the past 20 years."

However, the situation arguably is much worse. The CBO states: "Another approach for measuring pension assets and liabilities, which more fully accounts for the costs that pension obligations pose for taxpayers, yields a much larger estimate of unfunded liabilities for those plans in 2009- between $2 trillion and $3 trillion." This method, "the fair-value" approach, "generates estimates of funding more comparable to those reported by the private sector." The CBO declares: "By accounting for the different risks associated with investment returns and benefit payments, the fair-value approach provides a more complete and transparent measure of the cost of pension obligations." At end second quarter 2011, total state/local debt was $2.42 trillion.

Prior to the advent of the worldwide economic crisis in 2007, Wall Street and its allies had wonderful models regarding real estate in general and subprime mortgages in particular. Though the GASB model is popular, is it a very good one?

Two trillion bucks is a massive sum (even though it is not needed all at once), about 13.3 percent of US nominal GDP around $15.0 trillion. But even $700 billion is a large number, equaling 4.7 percent of GDP. These pension funding shortfall numbers are not updated to the present. However, despite the economic recovery in 2010 and 2011, this pension funding gap probably has not narrowed dramatically. Interest rates (using US Treasury yields as a benchmark) have remained fairly low. The 12/2/11 S+P 500 level around 1244 exceeds end 2009's 1115 by about 11.6pc (not a huge percentage), and it is about even with end 2010's 1258.

Who may ultimately foot the bill for state and local pension funds? Ask the CBO. "If the financial condition of state and local pension plans worsened, the federal government might be asked to assist in the funding of such plans. If granted, such assistance would raise the federal deficit and debt, unless offset by higher taxes or lower spending in other areas."

What are the rating agencies doing? A NYTimes article states (based on Moody's analysis; 1/27/11, pB1): "When pension obligations for state employees are included [in addition to bonded debt], total debt for many states rises significantly." "Moody's Investors Service has begun to recalculate the states' debt burdens in a way that includes unfunded pensions." Yet "In adding

together the value of the states' bonds and their unfunded pensions, Moody's is using the pension values reported by the states."

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A footnote in the CBO analysis remarks that the data in the Public Fund Survey "do not include costs for retirees' health care". Thus the obligation faced by state and local governments is even greater than the numbers discussed.

"Retiree health care and other benefits", according to The Pew Center on the States, had a gap of over $600 billion between the promises states made and money set aside to pay for them in fiscal year 2009. "The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs" (4/25/11). This analysis apparently does not deal with municipal obligations.
http://www.pewcenteronthestates.org/uploadedFiles/Pew_pensions_retiree_benefits.pdf
http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839
See also the Financial Times article, "Regions of rancour" (p7, 10/27/11).

But could national health benefit obligations be even greater? The Empire Center for New York State Policy (10/13/10), looking at New York alone, states: "Based on a review of financial reports for the state and its largest local governments, school districts, and public authorities, this report estimates that New York's total unfunded liability for public-sector health insurance comes to $205 billion."

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Other opinions relevant to the funding and requirements of state and local government pensions include R. Novy-Marx and J. Rauh's "The Crisis in Local Government Pensions in the United States" (10/13/1), and their "The Revenue Demands of Public Employee Pension Promises" (June 2011). Compare the views of the National Association of State Retirement Administrators. See also the Boston College Center for Retirement Research.

America's cities face significant challenges, according to the "City Fiscal Conditions Report" by the National League of Cities (9/27/11).
http://www.nlc.org/find-city-solutions/research-innovation/finance/city-fiscal-conditions-in-2011

Will places like Harrisburg, PA and Jefferson County, Alabama ultimately escape or reduce their financial problems via bankruptcy? In any event, the less of a problem they have, the greater the one their creditors probably face.

The October 2011 "State Revenue Report" from the Nelson A. Rockefeller Institute of Government offers lots of detail on state revenues and related issues.
http://www.rockinst.org/pdf/government_finance/state_revenue_report/2011-10-26-SRR_85.pdf

Monitor credit spread yield relationships between US Treasury obligations and various state and municipal securities.

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The private sector of course can have large pension gaps too, which may widen or narrow depending on the travels of stocks and interest rates. The Financial Times (9/6/11) remarks "Poor equity markets and low rates bite". Citing a Credit Suisse analysis, the FT reports that US corporate pension plans had a $388 billion gap.

THE LEARNING CURVE (A DEBT FOOTNOTE)

"Won't you believe it? It's just my luck No recess" sings Nirvana in "School"

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Within the debt field in general and the household domain in particular, student loans receive little attention. According to the NY Fed's "Household Debt and Credit" report, outstanding US student debt at end 3Q11 was $865 billion (end 2Q11 $845bb). Perhaps this arena should interest marketplace players more.

Citing Moody's, the Financial Times (10/17/11, p7) says: "'The long-run outlook for student lending and borrowing remains worrisome.'" The FT adds: "But even though the total level of outstanding student loan debt is projected to reach $1,000bn in the near future, according to the Department of Education, it is still considerably smaller than the estimated $2,500bn in risky subprime loans." But one trillion is not small change. Does comparing student loans to the subprime territory offer much comfort?

Admittedly, the FT notes: "While homeowners can default on their mortgages, students cannot walk away from their loans. The wages of student loan borrowers can be garnished and the debts cannot be included in a bankruptcy filing, except in cases of undue hardship." Yet what if many former students simply refuse to pay? What if many of them do not have well-paying work, or even any job?