The Health of Municipal Finances

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In April, two independent research organizations published their reports on the financial condition of the states, and retirement benefit plans for public employees. Although both reports were published in April, 2011, one evaluates the circumstances based on the data available as of year-end 2009, and the other based on the data available as of year-end 2010. Not surprisingly, the conclusions drawn vary accordingly. Based on the more recent data, it is apparent that, as the economy has shown signs of improvement, tax revenue collected by the states has also improved. That situation, along with a willingness on the part of state legislators to address budgetary challenges, is contributing to an improving trend in state finances.

The Pew Center on the States released their report The Widening Gap: The Great Recession's impact on State Pension and Retiree Health Care Costs. The report indicates that many states are not prepared to meet obligations associated with their employees' retirement benefits, and that the gap between their obligations and current funding is growing wider due to the recent recession's impact on revenue collections along with weak investment performance of pension funds. After analysis of data available through year-end 2009, The Pew Center believes that improvement in states' ability to meet annual commitments may not progress quickly as state tax revenues are expected to continue a slow recovery. The Nelson A. Rockefeller Institute of Government released their State Revenue Report based on data through year-end 2010, and paints a somewhat brighter picture of the health of local and state governments.

Following are the findings of both reports, a snap-shot of the states in which we manage single state municipal bond funds, and our outlook for the municipal bond market.

The PEW Center on the States

The health of state pension programs

According to Pew's 2009 data, the gap between state employee retirement benefits and the money set aside to pay those benefits grew to at least $1.26 trillion in 2009, a 26% increase over the 2008 gap. State pension plans represented more than half of the shortfall, with $2.28 trillion available to cover $2.94 trillion in long-term liabilities, leaving a gap of $660 billion. State retiree health care and other benefits accounted for the remaining shortfall. Reductions in fiscal 2009 revenue constrained the ability of states to make annual retirement payments. In all, state pension systems were less than 78% funded in 2009, a decline from 84% in 2008, and below the Government Accountability Office's recommendation of an 80% funding level.

Retiree health care and other benefits straining state government finances

State retiree health care and other benefits are funded with approximately $31 billion available to cover $635 billion in liabilities, creating an additional $604 billion gap beyond pension liabilities. In 2009, nineteen states had set aside nothing to pay for future health care benefits, and were functioning on a pay-as-you-go basis, covering costs as they are incurred by existing retirees. Based on the Pew Center's assessment, this method may be manageable for states offering relatively low benefits, but not for those who have made significant promises to current and future retirees. Other commentators have indicated that pay-as-you-go funding may be reasonable, to some extent, for these liabilities.

The impact of investment return assumptions

The rate of return that states routinely assume when calculating liabilities has been the subject of debate. States typically assume an 8% average annual rate of return. In the past, actual returns either met or exceeded this assumed rate. Between 1984 and 2009, the median investment return was 9.3%. Looking at the shorter time span from 1990 through 2009, the median annual return fell to 8.1%, still slightly higher than the 8% assumption. However, over the past decade, the figure fell to 3.9%. With this in mind, some observers believe that the return assumption used should be reduced, however the consequence of doing so would be to increase the unfunded liability and the annual contribution requirement dramatically. Some experts are proposing a "riskless rate" that may be comparable to a long-term treasury bond. Using the 30-year Treasury bond's mid-March 2011 rate of 4.3% would increase the states' combined liability to $4.6 trillion, with $2.4 trillion unfunded.

Consequences of under-funding liabilities and recent reform

As of 2009, annual pension contribution requirements had grown 152% since the start of the decade. If states' annual retirement contributions continue to rise at this rate, the liabilities may eventually compete for funding with other important publicly funded programs such as education and human services. In 2010, at least 19 states took corrective action to reduce their liabilities. More states are expected to take corrective action during the 2011 legislative sessions.

The Nelson A. Rockefeller Institute of Government

Overall state and local revenue situation
Most state tax revenue sources are heavily influenced by the overall economy. When the economy does well, tax revenues rise rapidly; likewise, when the economy performs poorly, tax revenues decline. According to the Rockefeller Institute, total state tax collections at 2010 year-end, as well as sales and personal income tax collections, showed growth for the fourth straight quarter following five consecutive quarters of decline. Forty-two states reported total revenue growth, with nine states reporting double-digit growth. While gains are still comparatively weak by historical standards, the year-over-year change in total state tax collections, adjusted for inflation, has averaged 3.3% over the previous four quarters, a modest improvement over the 12.4% average decline through 2009. Income tax and sales tax both showed growth of 10.6% and 5.6% respectively in the fourth quarter year-over-year. Corporate income tax collections increased 17.2% year-over-year.

In a May 24, 2011 update, the Institute reported that tax revenue grew 9.1% in the first quarter of 2011 for 47 states that had reported collections, marking the fifth straight quarter of growth and the fastest growth rate in five years.

Local tax collections were strong during and after the recession, but are starting to feel the lagging impact of the economic decline. In the last two decades, property taxes made up two-thirds of local tax collections. Property tax revenue fell by 3% in the fourth quarter of 2010, likely due to falling housing prices. Personal income tax showed a slight decline for the fourth quarter, but local sales tax collections increased by 3.7% in the fourth quarter of 2010, which was the third consecutive quarter it had increased after six straight quarters of decline. Overall, there was a 0.8% year-over-year decline in local tax collections for the fourth quarter of 2010, compared to 1.3% growth for 2009.

Gross domestic product, which has been improving slowly since mid-2009, showed fourth quarter 2010 growth of 2.8%, following growth of 2.6% in the third quarter. Although slow, this is evidence that economic activity, along with state tax revenue, has been on a positive trend toward recovery.

How the states in which we invest stack-up

The PEW Center on the States released another report titled <u>Road to Reform: Changes to Pubic Sector Retirement Benefits Across States</u> in November, 2010 that outlined key developments in state retirement systems. Following is a snap-shot of how the states in which we manage single-state municipal bond funds are handling reform.

• **Arizona** has lengthened the average monthly compensation used in calculating a retiring employee's pension benefit, increased employee and employer contributions and created a voluntary, supplemental defined contribution plan.

• **Colorado** enacted some of the nation's most extensive public pension reforms in 2010, nearly all for newly hired workers. Lawmakers increased employer and employee contributions and raised the minimum retirement age from 55 to 60 for future employees. The State also capped cost-of-living adjustments for current and future retirees at 2%, down from 3.5%, and froze them for a year.

• **Hawaii's** public pension plan funding level dropped between 2000 and 2006 largely because the state diverted employer contributions to help balance the state budget. Hawaii has passed some recent reforms. In 2010, the legislature banned retirees from being rehired by the state or a county government unless they re-enroll in the state retirement system. In 2007, Hawaii restricted benefit enhancements or reductions in retirement age if there was an unfunded liability between 2008 and 2011. In 2006, Hawaii instituted a new plan that offered more generous benefits in exchange for increased employee contributions.

How the states in which we invest stack-up (continued)

• **Kentucky** lawmakers approved a series of reforms in 2008 affecting new hires. Salaries are now calculated at the final five years of pay, not the highest five years of service. The legislature also implemented a graduated tier system for new employees which reduces retirement benefits. Kentucky teachers also began making higher retiree health care contributions in 2010. Despite the reforms, the state still faces serious long-term pension issues because of its past failure to make its full required payments each year.

• **Oregon** shifted to a hybrid pension plan in 2003 that provides less in benefits to new employees than to those hired before them. State officials also doubled employers' contribution rates beginning in 2011.

• **Rhode Island** raised the age of retirement from 60 to 62 for new hires, provided a somewhat smaller benefit as a percent of final salary, reduced future annual benefit increases and tightened eligibility for disability benefits in 2010. The minimum retirement age for current workers will depend on their length of service.

• **Utah** had been facing a crisis in its pension fund after the 2008 Wall Street crash. The State replaced its traditional defined benefit plan in 2010 with one that offers newly hired employees a choice between a defined contribution plan or an arrangement that combines features of a defined benefit and defined contribution plan.

The Municipal Bond Market today

Investing in municipal bonds has become undoubtedly more challenging over the past several quarters. The asset class saw unprecedented outflows in the fourth quarter of 2010 and in early 2011 when a combination of structural changes, and misperceptions expressed in the media, contributed to a decline in municipal bond prices. The collapse of municipal hedge funds, an increase in new issue supply, and rising rates on Treasury securities led to a slump in demand and a spike in bond yields. The demise of the monoline insurers shifted the focus from interest rates to the credit profiles of individual issuers; requiring more research and due diligence on the part of investors.

State and local government finances have been a growing concern for investors as the affects of the Great Recession have left budgets difficult to balance. Very controversial and highly publicized comments of an independent analyst appeared to intensify the negative perception of state and local fiscal situations, as well as the municipal bond asset class, which motivated indiscriminant selling on the part of individual investors in municipal bonds, and municipal bond funds. Though state and local governments were surely strained by the loss of tax revenue, most of them are feeling some relief after three years of program reductions. A good number of state and local governments plan to continue cuts into 2012. The need for pension reform is now clearly recognized and 20 states have already proposed or made changes to their pension structure; a positive note for municipal credit strength.

We expect state and local governments will continue to protect their access to the municipal bond market by ensuring timely payment on debt service. The benefits of investing in the municipal bond asset class continue to be compelling in the current market. The ability to earn double tax-free income, while investing in projects that benefit community infrastructure and services, remain the primary reasons investors often consider municipal bonds to be an important part of a wealth management strategy.

The Aquila Group of Funds

For over 25 years, the Aquila Group of Funds has managed single-state municipal bond funds. Our strategy emphasizes local, professional investment management working to provide as high a level of current income exempt from State and regular Federal income taxes as is consistent with the preservation of capital. The municipal bond market is extremely diverse and in the current market environment, individual credit selection is important. We continue to dedicate ourselves to the objectives of the funds we manage, and to monitor economic and political developments on behalf of fund shareholders.

For more information on the Aquila Group of Funds, you may call us at 800-437-1020 or visit our web site at www.aquilafunds.com.