Policy in Detail

CENTER OF THE AMERICAN EXPERIMENT

August 2, 2013 Number 12

Minnesota taxpayers to pay higher borrowing costs because of pension debt

By Kim Crockett

If you work in the financial sector, you are aware that public pensions, public debt and municipal bankruptcies like Detroit are making headlines hour by hour. After years of warnings from economists and free market policy organizations like ours, the costly consequences of bad public policy are becoming clear. The question is, are voters paying attention?

Last week, Moody's Investor Service announced that it had downgraded the City of Virginia and on Monday night Minneapolis was downgraded from AAA down to a respectable but lower Aa1 rating.[1] (S&P and Fitch continue to give Minneapolis their top score.) Mayor Rybak worked hard and very publicly to recover that AAA rating from Moody's and touted the achievement and the debt payment savings widely. It is unlikely that the downgrade will get the same publicity.

Moody's takes a new approach to pension debt

These downgrades have been anticipated for some time; Moody's has been signaling since last July that it was going to take a very different approach to pension liabilities and that the new approach would result in downgrades for cities across the nation.

"Pension obligations represent a growing source of budgetary pressure for many governments. However, the manner in which these obligations are reported varies widely, and we believe liabilities are underreported from a balance sheet perspective," said Timothy Blake, a Moody's Managing Director. "The purpose of the adjustments is to provide greater transparency and comparability in pension liability measures for use in credit analysis."

1 Moody's, News Release, "Rating Action: Moody's downgrades City of Virginia's (MN) GO to Baa1 from A2; affects $13M in debt," July 25, 2013, available at http://www.moodys.com/research/Moodys-downgrades-City-of-Virginias-MN-GO-to-Baa1-from--PR_278669; and Moody's, News Release, "Rating Action: Moody's downgrades to Aa1 from Aaa, Minneapolis' (MN) outstanding GOULT debt; outlook revised to stable," July 29, 2013, available at http://www.moodys.com/research/Moodys-downgrades-to-Aa1-from-Aaa-Minneapolis-MN-outstanding-GOULT--PR_278876.

Moody's identified several adjustments to reported pension information including two I have talked about many times:

- Accrued actuarial liabilities will be adjusted based on a high-grade long-term corporate bond index discount rate (5.5% for 2010 and 2011) instead of the outlier rate of 8.0% to 8.5% that Minnesota persists in using despite a national shift toward a more attainable and reasonable assumption; and

- A common (and much shorter) amortization period of 17 years to pay off unfunded liabilities will be used instead of the current 30 years used by Minnesota. This is Moody's way of saying that while you can kick the can down the road, the road has to be shorter. Otherwise the unfunded liability is shifted to future generations, which violates basic pension funding principles.

Minneapolis and Virginia under the microscope

Out of the 8,000 plus local governments rated by Moody's, Minneapolis and Virginia were placed "under review" along with just 27 other local governments (including Chicago) last April when Moody's announced a new approach to analyzing pensions.[2]

"The local governments whose ratings have been placed on review were determined to be **significant outliers** in their current rating category," according to Moody's release.[3] The list of 29 local governments constituted less than 1% of local governments with general obligation or equivalent ratings.

But the problem is not isolated to these two cities—or just to Moody's. Just last month, Tom Steward from Watchdog.org reported that the bond ratings for **thirty-one cities** across Minnesota have slipped since January of 2012.[4]

And the conversation about the need for U.S. pension reform continues across the globe.

The Economist dedicated its front page this week to "The Unsteady States of America: Why the pensions nightmare is only just beginning," and said that "America's whole public sector still operates in a financial never-never land."[5] The editors say that just like Europe a few years back, we are in a state of denial and that Detroit's woes are like "a flashing warning light on America's fiscal dashboard."

What is the solution?

While I disagree with the editors that a tax increase has to be part of the overall solution, I am gratified that *The Economist* has joined the chorus calling for a shift to defined contribution plans and abandoning the "accounting tricks" that have obscured the pension crisis from public view.

In a related article in *The Economist* about the long-term problem of how to fund generous pension and health-care promises that are no longer affordable (if they ever really were), the authors noted that the Detroit bankruptcy will help answer the question, "When politicians promise too much to creditors and pensioners, who ends up footing the bill?"[6]

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2 Moody's, News Release, "Announcement: Moody's announces new approach to analyzing state, local government pensions; 29 local governments placed under review," April 17, 2013, available at http://www.moodys.com/research/Moodys-announces-new-approach-to-analyzing-state-local-government-pensions--PR_271186.

3 Id. (emphasis added).

4 Tom Steward, "'Alarming' trend: 31 MN cities credit downgraded since 2012," Watchdog.org Minnesota Bureau, June 27, 2013, at http://watchdog.org/92896/alarming-trend-31-mn-cities-credit-downgraded-since-2012/. For a complete list of affected cities, see Downgraded Minnesota Cities, Watchdog.org Minnesota Bureau, at http://watchdog.wpengine.netdna-cdn.com/wp-content/blogs.dir/1/files/2013/06/MinnesotaCitiesDowngrade.pdf.

5 "The Unsteady States of America: Why the pensions nightmare is only just beginning," *The Economist* (July 27, 2013), available at http://www.economist.com/news/leaders/21582258-it-not-just-detroit-american-cities-and-states-must-promise-less-or-face-disaster.

6 "Who pays the bill?," *The Economist* (July 27, 2013), available at http://www.economist.com/news/united-

Will there finally be a political price?

Well we know it is NOT the politicians who will pay the fiscal price but perhaps voters will wake up and make elected officials, and their appointees, pay a political price if they continue to ignore this growing fiscal mess. We must recruit and elect serious, brave people who are prepared to take the necessary steps to solve the problem while it is still manageable.

In an email notifying the city council of Moody's decision to downgrade the city's rating, Minneapolis Chief Financial Officer Kevin Carpenter, wrote "The new methodology is overly simplistic and puts too much emphasis on long-term pension obligations."

Bad news for Mayor Rybak and the taxpayers of Minneapolis

In the end, it does not matter what CFO Carpenter thinks if Moody's and the numbers disagree. Moody's noted the city's "outsized adjusted net pension liability of 4.3 times fiscal 2012 operating revenues" as one of its major concerns.

Moody's also noted that Minneapolis is much too dependent on the state for cash. The City receives almost 8% of its budget ($64 million) from Minnesota's taxpayers and spends almost 10% of its budget on debt service. We dug into the **Minneapolis budget** and found that 10% of every tax dollar goes toward closed pensions funds (they have all been merged into state funds which require big cash payments) and 8% of every tax dollar goes to capital and debt service.[7] Principal and interest payments on the general obligation debt cost taxpayers $110 to $130 million dollars (or about twice what state taxpayers give the city in LGA support). Every city is going to have some debt but this is too high. If the city had lower debt payments, the money could go instead toward roads, police and parks.

How will municipalities interpret the wake-up call?

The downgrading of dozens of cities, including the City of Lakes, will get the attention of the well-financed lobby of Minnesota's cities, counties and school districts. While pension policy is set at the state level, it is municipalities who are going to pay the higher budgetary price along with hard working taxpayers and public employees if our elected officials at the state level continue to kick this old can down the road. The question is, how will the municipal bureaucrats react?

One would think that the sobering news from Detroit and Moody's new approach would result in some belt-tightening but here is my concern: Cities and counties already have the statutory right to bond for pensions *without a referendum*.[8] Interestingly, Minneapolis is the only city I know of that has taken advantage of this bad statute.

What if instead of answering Moody's with a general tightening of the belt, municipalities instead just go around taxpayers by bonding to pay for the current pension system? Or instead of supporting pension reform, they continue to avoid the issue?

As always, in a democracy the answer lies with an educated and active public holding elected officials accountable. But it is tough for voters to do their job if municipalities can avoid the scrutiny of a referendum.

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states/21582282-pensioners-are-pushing-many-cities-and-states-towards-financial-crisis-who-pays-bill.

7 City of Minneapolis, *2013 City of Minneapolis Budget in Brief*, available at http://www.ci.minneapolis.mn.us/www/groups/public/@finance/documents/webcontent/wcms1p-103722.pdf.

8 Minn. Stat. § 475.52 Subd. 6; and Minn. Stat. § 475.58 Subd. 1 (7) and (10).

Understanding Moody's role

Moody's has shined a bright light on unfunded pension liabilities and the accounting tricks used to obscure the size of the pension problem. It has an important but limited role to play in the debate over pension reform. I think the new approach to analyzing pensions will mark a historical turn in the national debate and I fully expect other agencies like Standard & Poor's to follow their bold lead. Moody's, which is a publicly traded bond credit rating business, was not, however, performing a public service. It was protecting its investors and doing its job—which is to analyze and help price the ability of a bond issuer to meet its debt obligations.

Moody's is not a public policy organization nor is it a reliable ally in our quest for free markets and limited government. For example, just after Moody's downgraded Minneapolis, it upgraded the State of Minnesota's rating outlook from negative to stable. The summary and reasons given are revealing:

> Minnesota's rating outlook has been revised to stable reflecting the state's strong financial management that has resulted in improved revenue performance, replenishment of budget reserves, and budget balancing solutions that are largely recurring.[9]

Allow me a rough interpretation: Moody's does not care that the state raised over $2 billion in new taxes to address a deficit of $627 million without making any effort to reform how the state budgets and spends. Nor does Moody's care that the projected deficit shrank from billions to millions because of tough, and in some cases, one time budget measures like the school shift. So long as debt is paid on time and in full, Moody's is agnostic on how it gets done.

But thanks to a functioning bond marketplace—and the leadership of Moody's in trying to properly price the costs of pension liabilities—the case for fundamental pension reform is clearer today. ■

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9 Moody's, News Release, "Rating Action: Moody's revises Minnesota's outlook to stable; assigns Aa1 to G.O. bonds Series 2013 A, B, and C," July 30, 2013, available at http://www.moodys.com/research/Moodys-revises-Minnesotas-outlook-to-stable-assigns-Aa1-to-GO--PR_278882.

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