LORD ABBETT

Economic Insights

Visit us at www.lordabbett.com for more Economic Insights by Milton Ezrati

Municipal Finance: Some Positive Signs

August 27, 2012

Milton Ezrati, *Partner, Senior Economist and Market Strategist*

State and local government finances remain precarious. The degree of trouble varies from place to place, of course, but generally it will take decades for states and cities to put their finances in anything like good order. It is, in fact, a good bet that no middle-aged person today will live to see such an event. One wag has suggested that the yet unborn will not live to see such a day. But if such cynicism carries truth, the immediate outlook can nonetheless anticipate some modest relief, at least enough to ease some of the strains under which state and local governments have labored and enough to improve investment performance in the area as well as on the overall economic picture.

The fundamental financial problems are well known. Profligate spending and unreasonable pension promises have placed states and cities in an untenable financial predicament. Three years into this supposed recovery, many still struggle to balance their budgets, which, as of last measure, still average a composite deficit of $130 billion. On top of this, states and cities still face huge unfunded pension and healthcare liabilities. Officially, this funding shortfall amounts to some $757 billion; but this estimate assumes much higher investment returns than are generally considered likely. The huge California Public Employees Retirement System (CalPERS), for example, currently assumes a constant 7.5% annual investment return in its assets. Last year, the system had a 1.0% return on its investments. Matters will look worse when the new Governmental Accounting Standards Board (GASB) rules demand more conservative return assumptions. The Pew Center on the States estimates that then estimates of unfunded liabilities will climb to $2.0 trillion. The research outfit State Budget Solutions puts that figure at $4.6 trillion. Whatever the exact figure — and if the politicians understate, the research outfits no doubt inflate in an effort to attract journalistic attention — the true unfunded amount is undisputedly burdensome.

But bad as these financial fundamentals will likely remain, a pickup in revenues still promises marginal relief. According to Commerce Department data, income tax receipts to states and cities have grown 7.0% during the last 18 months. Sales tax revenues have risen some 6.0%, and even property tax receipts have moved upward, by some 3.5%. Also encouraging is that the pace of growth has largely accelerated. During the most recent six months, income tax receipts have risen at a 10.5% annual rate, sales taxes at a 7.0% annual rate, and property taxes at a 2.0% rate. These increased cash flows offer ample reason to conclude that the worst financial pressure has passed. The fundamentals will, of course, continue to impose financial and operating constraints, including layoffs and hiring restrictions. But the intensity of these constraints going forward should dissipate and, consequently, so should the drag they have imposed to date on this already slow cyclical recovery.

Though this growth in tax revenues has gone on for a while, it is only now that it can offer states and cities a measure of relief. Their problem for the last 18 months has come from a shortfall in federal transfers. The federal government, having channeled huge flows toward states and cities in its 2009 stimulus package, has since 2011 begun to unwind that posture. Federal flows have slowed throughout this time, dropping almost 15% and denying state and local governments some $200 billion in revenue flows. Against this, the tax receipt gains of $62.9 billion have offered only a minor counterbalance. Net cash flows have fallen by almost $140 billion.

But now this unfortunate situation seems to have run its course. Federal transfer dollars have just about returned to levels that prevailed prior to the stimulus surge, suggesting that they will now likely stabilize. Meanwhile, the accelerating pattern of tax receipts promises to continue to add still more to state and city cash flows. If state and city managers are wise, they will resist the temptation to spend all this new net flows and instead will set some aside to fund their pension and healthcare liabilities and to reserve against future setbacks. Even if they do act with prudence, however, the increasing net revenue flow will free them from the intense need to cut back that has clearly prevailed for the last 18-plus months.

Recent jobs data may offer a glimpse at just such an effect. Whereas states and cities have cut staff by some 11,000 a month on average during the 12 months ended this past May, in June and July such cuts averaged only 7,000 a month. Two months prove little, of course. The change could easily be statistical fluke. But the shifting situation of state and local finances nonetheless suggests such moderation going forward with the overall economic relief it implies.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

The opinions in the preceding economic commentary are as of the date of publication, are subject to change based on subsequent developments, and may not reflect the views of the firm as a whole. This material is not intended to be relied upon as a forecast, research, or investment advice regarding a particular investment or the markets in general. Nor is it intended to predict or depict performance of any investment. This document is prepared based on information Lord Abbett deems reliable; however, Lord Abbett does not warrant the accuracy and completeness of the information. Consult a financial advisor on the strategy best for you.

Investors should carefully consider the investment objectives, risks, charges, and expenses of the Lord Abbett funds. This and other important information is contained in a fund's summary prospectus and/or prospectus. To obtain a prospectus or summary prospectus on any Lord Abbett mutual fund, contact your investment professional, Lord Abbett Distributor LLC at (888) 522-2388 or visit us at www.lordabbett.com. Read the prospectus carefully before you invest.

Website: www.lordabbett.com

NOT FDIC INSURED—NO BANK GUARANTEES—MAY LOSE VALUE

LORD ABBETT®

Lord Abbett mutual fund shares are distributed by: LORD ABBETT DISTRIBUTOR LLC • 90 Hudson Street • Jersey City, New Jersey 07302-3973