Municipal Securities Research

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Municipal Commentary

Populism, Pensions and Municipal Distress

An activist in Scranton, Pa. is circulating a petition that the city should file for bankruptcy. This is the first time we have seen a ballot measure tied to bankruptcy. While the petition may not make it to the ballot, its existence is perhaps a reflection of frustration with the city's chronic fiscal problems as well as the general trend to greater populism in government. We present a discussion of Scranton's problems as a case study of similar issues facing other municipalities such as underfunded pensions, lagging economic growth and stretched taxpayers. Scranton's new administration has embarked on several significant positive changes, however, which should provide some relief (and perhaps opportunities for adventurous investors) and which we discuss below.

(We note at the outset that only Scranton and Allentown in Pennsylvania have permission to pass an ordinance through the citizen initiative process. Certain "third class" cities in Pennsylvania have this right as well, but qualifying a petition is a tough process (15 days to achieve 20% of the last election's eligible voters' signatures, on site at the municipal clerk's office).

A Changing Economic Profile

Once a thriving city of 140,000, now pushing 75,000, Scranton was a hub for coal and steel production and home of Lackawanna Iron and Steel at the turn of the 19th century. The city and region produced rail track for the budding U.S. railroad system at that time. As the steel industry modernized, moved West and found its way to other countries, communities in Pennsylvania (and Ohio and West Virginia) suffered economic loss. The state created Act 47 in 1987 to help former steel towns deal with economic loss and, in particular, manage labor arbitration awards in a strongly unionized political culture. Scranton entered Act 47 in 1992.

A key part of the program is a requirement for a distressed city to write a Recovery Plan (not unlike a similar requirement in bankruptcy). When negotiating collective bargaining contracts, a plan could offer protection by capping raises and benefits to fit within the plan. This approach worked for some years for Scranton, until the firefighters' union sued. After many years and many appeals, the Pennsylvania Supreme Court decided in 2011 that Act 47 does not, in fact, provide protection for arbitration awards under Act 111 for police and fire. The city was faced with a requirement to pay $16 million of back pay and $7.6 million retirement benefits. The court also ordered interest at 6% for each day that passed without repayment. The city council attempted to file bankruptcy in 2011 but was unsuccessful. Unfortunately, years of disagreement among the elected officials and lack of funds to meet the back pay decision resulted in substantially higher amounts owed.

Also in 2011 the city council voted to lower property taxes to provide relief for residents, but which also intensified the city's budget problems. (Why council and executive actions that do not comply with a recovery plan are not constrained by Act 47 is a mystery.) Some may recall the headlines in 2012 when Mayor Chris Doherty, facing a cash squeeze, temporarily paid employees at the minimum wage (including public safety personnel). The council also decided not to pay on a guaranteed Parking Authority loan and as a result, short term borrowing to alleviate the city's cash crunch was closed off.

In 2012, 14 municipalities across the state had been in the program more than 10 years with some, like Scranton, in the program for more than 20. Eventually the legislature passed SB1321, which required Act 111 arbitration awards to comply with a municipality's Financial Recovery Plan but this was too late to help Scranton.

Enter GASB 67/68

It is little surprise that through this period of distress the city did not make sufficient payments into its pension and OPEB systems. Until recently, there was little transparency for the long-term pension and retiree health obligations. The city's 2014 audit incorporates the new pension accounting standards in terms of showing a measure of the "unfunded liability" on the balance sheet. As a result, there was a negative adjustment to the 2013 balance sheet of $149 million. This audit shows total government activity assets were $146 million, while liabilities totaled $375 million. The pension adjustment was based on an 8% investment rate of return. On these assumptions, the police plan is 33% funded, the firefighters plan is 18% funded and the non-uniform is 29% funded. The city also has an estimated unfunded liability for non-pension post-retirement benefits of $184 million (not yet fully reflected).

The new accounting rules as Scranton has applied them, offer some additional insight. The city's "net money-weighted rate of return" on the pension was 6.57%. Compared with the assumed 8%, the difference produces additional "deferred outflow of resources" totaling $754,093. Based on long-term expected earnings on the pension assets, the city expects a return of 3.73%, which is presented purely as information to the reader. On the liability side, GASB rules now require presentation of scenarios if the discount rate used were to be 1 percent less and 1 percent more than assumed — that is 7% and 9%. On a 7% scenario, net pension liability would increase $22.7 million.

The auditors gave the city a "qualified opinion" as the GASB rules require a blended discount rate if the system is expected to deplete assets — such rate is a blend of the expected long term earnings rate to the extent there are assets to support and a high grade municipal rate for the period of time assets are expected to be depleted. The commonwealth's audit report shows that the police officers' plan has five years of assets that can fund benefits, less than three years for the firemen's plan and a bit more than three years for non-uniformed employees. Scranton, as we mentioned uses an 8% discount and not a blended rate, hence the qualified opinion. (This calculation assumes no further contributions or earnings. Nevertheless the situation is dire.)

The Good News

In July 2016, the city passed a 0.75% commuter tax on non-resident income (in accordance with the revisions to Act 47). Revenues are to be earmarked for the city's pension plan. According to Moody's, city's consultants estimated the tax could generate about $5.1 million annual revenues, compared with Moody's analysis of $19 million required annually to amortize the city's net pension liability. (Recall that Moody's uses a corporate discount rate to standardize pension liabilities across municipalities in its analyses; a rate that is quite a bit lower than the city's.)

In addition, the city pursued a public-private-partnership (P3) approach for its troubled Parking Authority which will monetize the authority's assets. As of today, the city is no longer is responsible for the Parking Authority debt. The city is also in the process of successfully privatizing its sewer system. Like many other older industrial cities suffering decline, the city's sewer system is in need of major repairs and under mandate to comply with environmental standards. The state Public Utilities Commission approved the sale of the system on Oct. 6, 2016 to Pennsylvania American Water Company. Additional approvals are still ahead before the sale may take place. The State Department of Environmental Protection must grant a permit to discharge treated sewage into the Lackawanna River. A hearing is scheduled for the beginning of November. The US EPA, the US Department of Justice and a federal judge must approve an amended consent decree mandating sewer system upgrades. However, the sale could bring in $195 million — the city would get $95 million which it expects to target to pension plans. The city of Dunmore, which the Scranton sewer system serves would get $24 million.

What Else?

At the end of June the city's redevelopment authority was able to sell $29.81 million tax exempt and $7.92 million taxable lease debt with an S&P BB rating to make a $30.9 million back payment to police and fire, make a contribution to the retirement plans and refund 2008 bonds. At the end of August, the city went to market again with $32.8 million general obligation bonds mainly to refund Parking Authority debt and make capital improvements. In addition, to effect the P3 and attain an upfront payment for the city, the Scranton-Lackawanna Health and Welfare Authority issued a limited offering of about $39.5 million which resulted in a consideration to the city of about $32 million for the parking and meter system. The senior lien debt in this offering was rated BB+ S&P.

These positive changes are not yet reflected in the city's finances, but should result in improvement over the next year. The city's "Recovery Plan Coordinator" expects the city to be in a position to exit Act 47 in August 2017.

Lessons Learned

Other municipalities in Pennsylvania and elsewhere share some of Scranton's characteristics that ultimately lead to fiscal distress and in the worst case insolvency:

First, there is often a major adverse economic shift coupled with long-term difficulty making the hat switch on "stranded costs".

For communities in Pennsylvania it was decline of the coal and steel industry coupled with a strong labor union political culture that made it difficult for officials to tighten the belt. Detroit and other Michigan communities also, faced industrial decline and legacy costs from a by-gone era. For the troubled communities in California, there was a different factor. The common thread among San Bernardino, Stockton, Vallejo (and Atwater as well) were the loss of military bases that once provided population and economic vitality. For Atlantic City, the loss of four major casinos mortally harmed the tax base. For Puerto Rico, the loss of the pharmaceutical tax benefit in 2006 was one of the major changes that accelerated decline.

Second, the nature of response to the economic adversity is key to maintaining fiscal health. (There's no surprise here.)
Through Detroit's decline, the city continued to offer enhancements to the pension plan. (Retroactive benefits, by definition, are never pre-funded.) Recall that Detroit's pension had an annuity program that paid the greater of 8% (the pension's discount rate) or that year's earning rate... and in lean years took funds from the pension corpus. (A claw-back of some of these excess payments was part of the bankruptcy recovery plan.) Atlantic City continued to borrow to pay settlements on lower tax assessments, thereby increasing fixed costs on a shrunken tax base. Stockton too, and certainly Puerto Rico, fell into over-borrowing in the face of economic decline.

Stranded Costs

In the electric utility world when nuclear power plants had major cost overruns and less costly sources of power emerged, companies were faced with "stranded costs". One could apply a similar concept to these urban legacy issues. While many companies wrote down the non-performing assets (hard to do in the municipal context) in other cases some of the stranded costs were spread through rates across many customers as part of the workout. In Pennsylvania, the state gives aid to municipalities for their pensions, through the Public Employee Retirement Commission (PERC). (As part of this year's state budget cuts, the Commission was eliminated and absorbed into the Auditor General's office. The Auditor General has created the "Municipal Pension Reporting Program" and transferred over the various functions from PERC.) The delayed budget left municipalities without their pension aid for some time, but the allocations were finally announced Oct. 5, 2016.

Act 47 offers help to distressed municipalities as well. Michigan's Act 4 and New Jersey's Department of Community Affairs oversee local budgets and in some distressed cases offer grants, aid and oversight. The new Act 47 includes disincorporation, if a distressed city fails to exit that status within five years (with a three-year extension permitted) or face receivership and possibly disincorporation if deemed unviable. Disincorporation however, only applies to those municipalities that have been under Act 47 and do not provide police or fire services — which significantly limits the number of municipalities that might fall into this category. In our view, consolidating services across municipalities could offer savings and combining retirement plans may provide help as well.

Interestingly, Pennsylvania (and Illinois) have what seems to be an excessive number of governments — 4,905 and 6,968 respectively...ahead of populous California, according to the Census 2012 survey. Pennsylvania alone has 3,200 pension plans. Quite simply, having so many entities is costly, in our view. As of the Auditor General's Aug. 29, 2016 report there were 13 municipalities with severely distressed pension plans. These are plans that have less than 50% funding. Of these, four have greater than $1 million liability with the city of Philadelphia the largest among the group (45% funded with $10.8 billion total liabilities) and Scranton is next (24% funded; $209 million total liabilities). The city of Chester, Tullytown Borough and Colwyn Borough are each 49% funded with $119.1 million, $5.8 million and $1.5 million total liabilities respectively.

A Case for Optimism

Scranton's efforts to work out the back-pay agreement, get out from under the guarantee for the parking system debt and facilitate repairs for its aging sewer system through privatization are steps in the right direction. Proceeds should bolster the drained pension funds. The city is county seat, has higher education and medical facilities in its base that anchor the community. The city's efforts resemble the kinds of workout solutions found in bankruptcy, but here without bankruptcy. Harrisburg followed a similar workout path. But the third leg, as it is for other distressed municipalities, is further economic development. There are a few bright lights of innovation in older industrial cities to point to. Advanced materials manufacture and 3-D printing are providing new jobs and economic value to depressed places such as Schenectady, N.Y. and Youngstown, Ohio.[1] Activities like these, along with P3's, privatization of assets and functions, sensible tax policies (and we would argue, re-negotiated benefit packages and perhaps consolidation of small municipalities) over the long term may help older cities like Scranton grow out of their pension and fiscal woes.

[1] We recommend: *The Smartest Places on Earth, Why Rustbelts are the Emerging Hotspots of Global Innovation* by Antoine van Agtmael and Fred Bakker, Public Affairs, New York, 2016.

Additional information is available on request.

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