Recession Readiness

Webinar Presentation:
The Hutchins Center on Fiscal and Monetary Policy
The Brookings Institution

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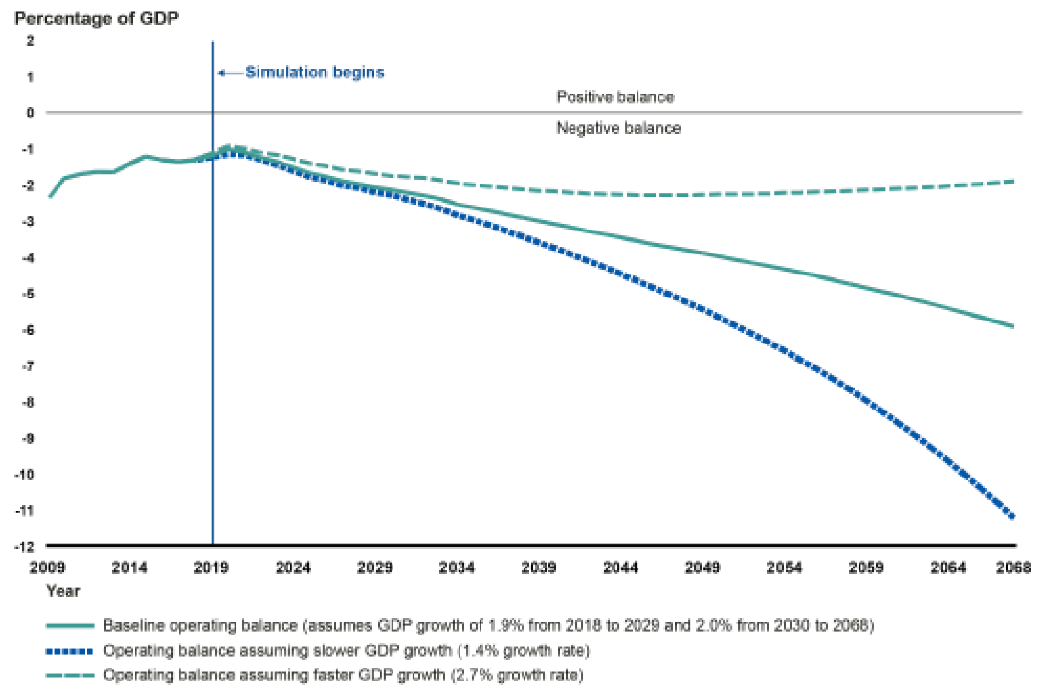
In the Aggregate: Structural Fiscal Challenges and Economic Sensitivity

- State and local government finances are sensitive to the broader economy, but the challenges are not just cyclical
- The U.S. Government Accountability Office (GAO) has developed a simulation model for the state and local sector as an entirety, projecting significant, long-term fiscal gaps absent corrective action, due largely to:
  - Near-flat revenues as % of GDP
  - Healthcare costs (Medicaid, employees, retirees) rising faster than the overall economy
  - Pension funding pressures
- ***In a weaker economy, these structural challenges intensify***

Figure 8: State and Local Government Sector Operating Balance under Alternative Gross Domestic Product (GDP) Growth Paths, 2009 through 2068



Source: GAO analysis of data from the Agency for Healthcare Research and Quality, Bloomberg, Board of Governors of the Federal Reserve System, Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, Centers for Medicare & Medicaid Services, Congressional Budget Office, and the Social Security Administration. | GAO-20-269SP

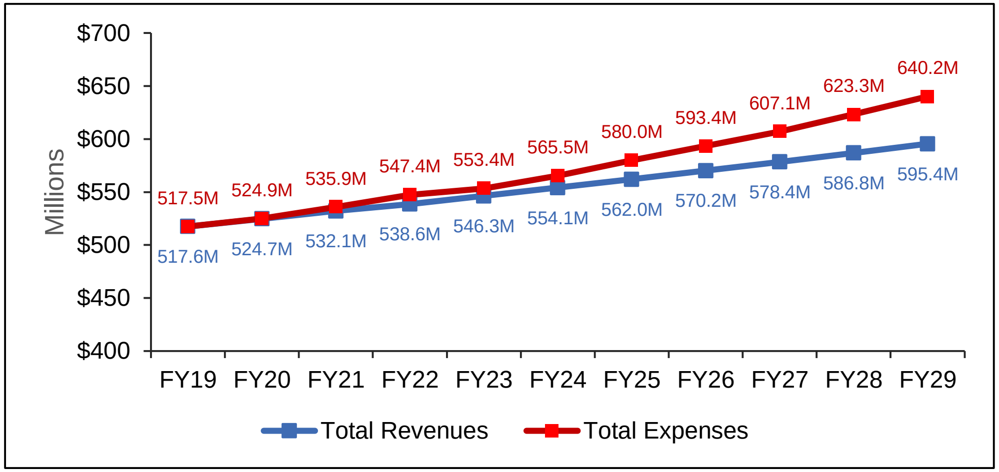
Note: For our alternative simulations reflecting slower and faster real GDP growth, we used the OASDI Trustees' high- and low-cost projections of real GDP growth for the entire simulation period.

Source: United States Government Accountability Office, "State and Local Governments' Fiscal Outlook: 2019 Update" (December 2019)

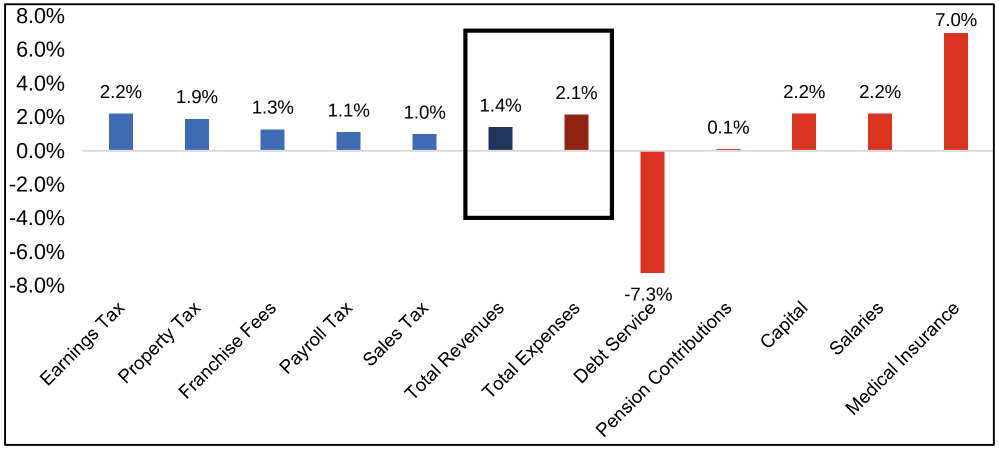
In the Particular: Budget Drivers and Trajectories Can Vary Significantly

- Recognized best practice: 5-10 year **long-range financial plan** to create a framework for fiscal sustainability
- Typically evaluates key budget drivers and policy parameters through a **baseline** analysis
- Focuses on recurring revenues and expenditures and structural budget position ("carry forward")
- Assesses and addresses liabilities and long-term needs (e.g. infrastructure, unfunded retiree benefits, tax policy)
- Can be a valuable tool to develop strategies and gain buy-in for bending the curves, closing any gaps, and carving out new resources
- Also the starting point to **stress test** for recession readiness

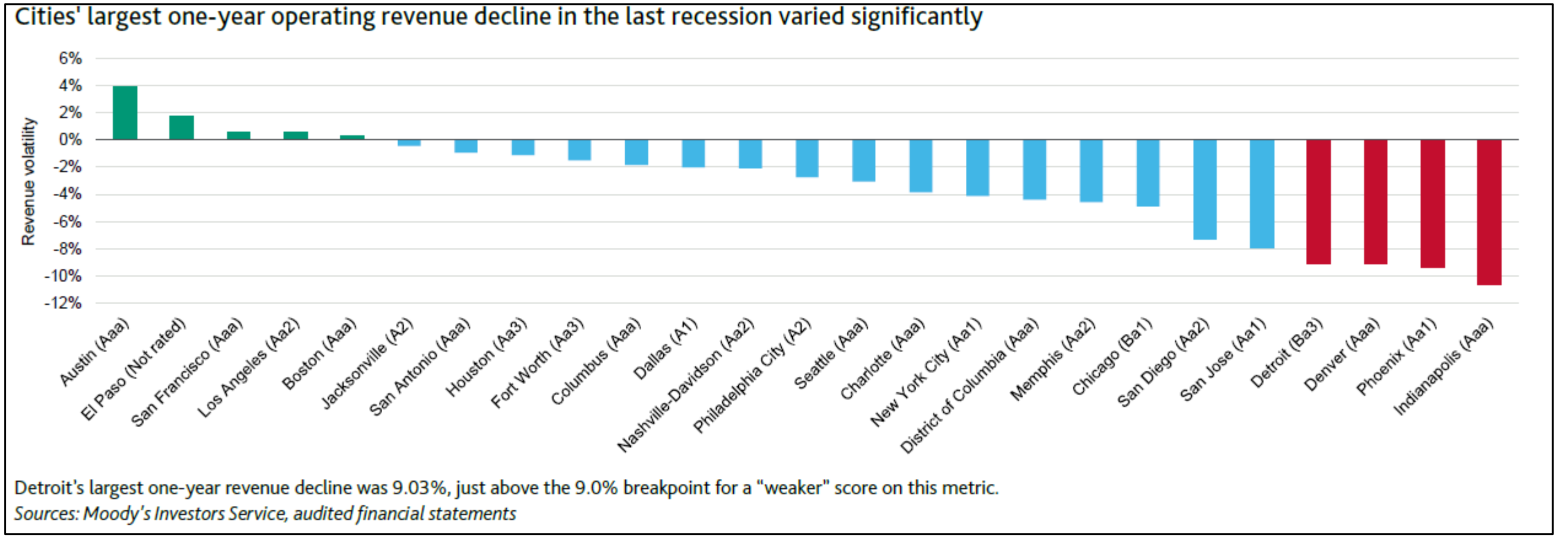
General Fund Projections: FY2019-FY2029



Projected CAGR for Major Budget Drivers: FY2019-FY2029

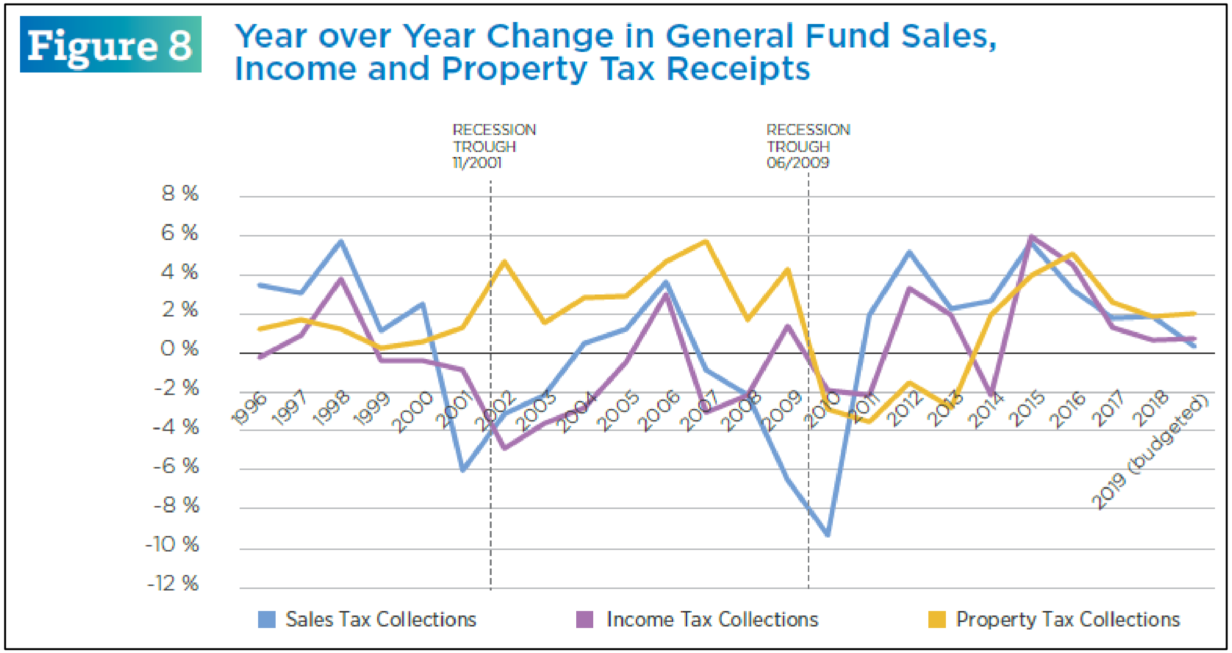


Stress Test: Revenues



Detroit's largest one-year revenue decline was 9.03%, just above the 9.0% breakpoint for a "weaker" score on this metric.
Sources: Moody's Investors Service, audited financial statements

Sources: Moody's Investors Service, "Strong reserves, financial flexibility position most large US cities to weather a recession;" National League of Cities, "City Fiscal Conditions" (2019)



Stress Test: Operating Expenditures

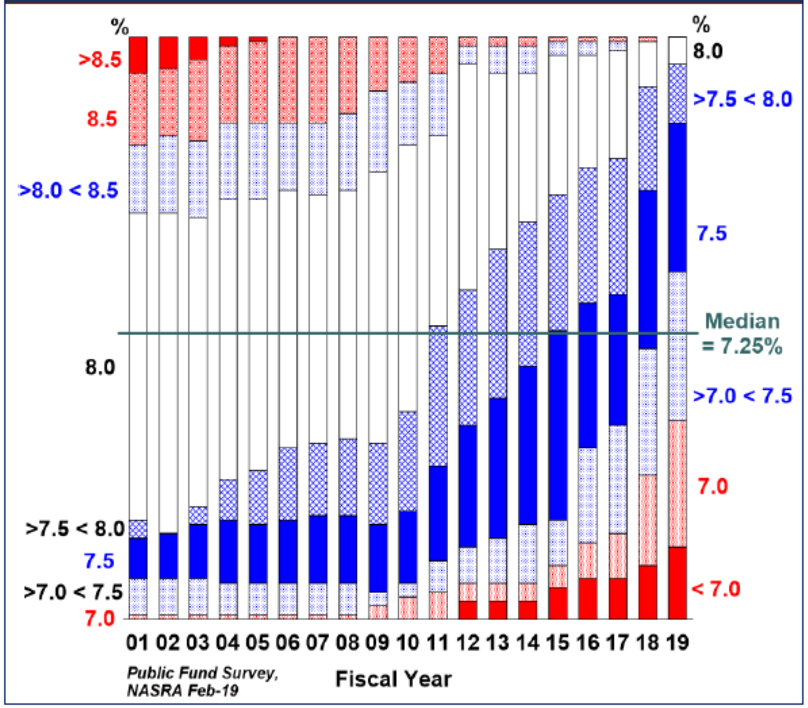
Total Expenditures = Fixed Costs + [Level of Service * Cost Per Unit of Service]

- **How would service demands change in a recession?**
  - Greater demand for social services and safety nets
  - Some growth-related service pressures might decline (e.g., building permit inspections)
  - Are certain discretionary services and studies likely to go on hold?
- **How might costs per unit of service change?**
  - Wage pressures could moderate. How much flexibility (If under collective bargaining, when do contracts expire? Are there reopeners?)? How to evaluate and address?
  - Healthcare inflation? Workers' compensation?
  - Are any major contracted services coming up for bid? Is that just a general concern or are there economic sensitivities with pricing?
- **What are the fixed cost constraints?**
  - Are they truly fixed? Even if not economically sensitive, are the prospective trends clear?

Stress Test: Fixed Costs and Liabilities

- **Declining pension investment returns in a downturn would increase employer contributions (eventually)**
  - Impact and timing will depend on multiple factors, for example: dependence on investment returns, assumed rate of return, smoothing method for investment returns, AVR lag to budget year, amortization method (open/closed, level dollar or level % of pay) and period, potentially offsetting changes in payroll growth, etc.
- Other Post-Employment Benefit (OPEB) funding, benefit design and risk exposure
- Debt burden and structure
- Capital Improvement Program (CIP) and related (fleet, equipment) needs
- Other non-debt liabilities, such as:
  - Internal service fund condition
  - Workers' compensation reserves
- Other fixed costs (e.g. maintenance of effort commitments)?

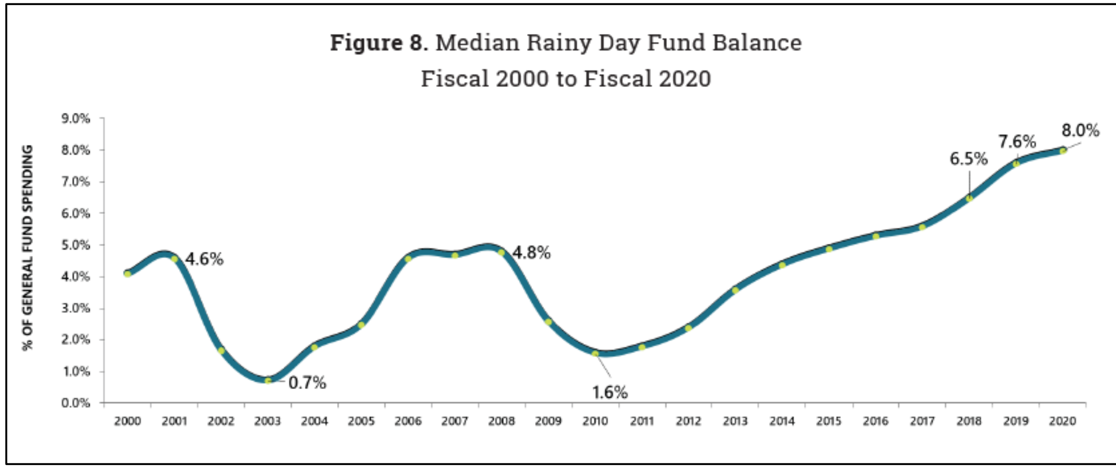
Figure 4: Change in Distribution of Public Pension Investment Return Assumptions, FY 01 to FY 19

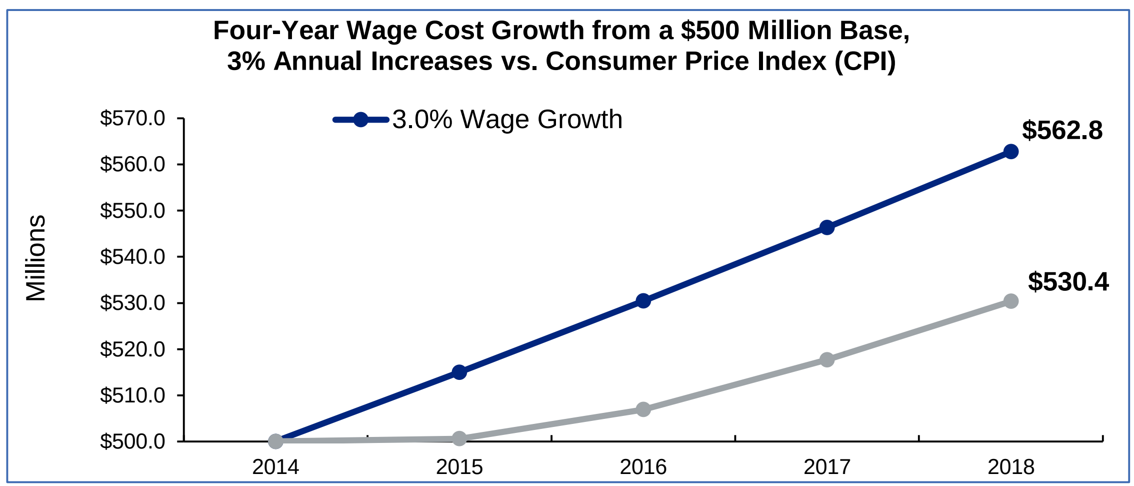


Source: National Association of State Retirement Administrators (NASRA) Issue Brief (Updated February 2019)

Post-Stress Test: Now What?

- **Calibrate and size reserve needs**
  - Existing policy
  - Current reserve levels
  - Risk-based resizing based on exposure analysis?
- **Establish spending parameters for addressing pent up demands**
  - Workforce agreements / policies
  - New services
- **Comprehensive Recession Readiness Action Plan** to position key budget drivers and reduce overall risk





Sources: National Association of State Budget Officers (NASBO) Fall 2019 Fiscal Survey of the States; CPI growth rates from the Bureau of Labor Statistics, CPI-All Urban current series, 2014 Annual to 2018 Annual, not seasonally adjusted

Recession Readiness Checklist

Stress Test

- ❑ Develop a baseline long-range forecast
- ❑ Identify downturn scenario(s) – moderate, severe
- ❑ Analyze revenue volatility – scale and timing for key line items
- ❑ Analyze expenditure sensitivity – fixed costs, service demands, unit costs
- ❑ Evaluate reserve levels
- ❑ Evaluate the condition of internal services funds and any special reserves
- ❑ Review capital needs, fleet, and equipment condition
- ❑ Assess debt mix and structure with a municipal advisor

Action Plan for Sustainability

- ❑ Establish future spending parameters
- ❑ Calibrate and size reserve needs
- ❑ Position revenues sustainably through tax and fee policies and potential adjustments
- ❑ Explore rebalancing employee total compensation to improve competitiveness and reduce risk exposure
- ❑ Evaluate and develop options to improve efficiency and manage costs
- ❑ Invest in productivity improvements (e.g., energy efficiency, fleet renewal, technology)
- ❑ Address retiree benefit funding and risk exposure
- ❑ Plan for capital program sustainability
- ❑ Review debt-financing approach and policies with a municipal advisor
- ❑ Ensure that internal services funds and any special reserves are appropriately funded

Overall Approach

- ❑ Communicate to Build Stakeholder Buy-in pfm