Eaton Vance
Investment Managers

Strategies for Taxes
Seeking tax-efficient income and equity

Eaton Vance
State of the States: How Do They Rank?

October 2015

Prepared by the Eaton Vance Municipal Insight Committee

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Summary: State of the states

Our credit outlook for most states is **stable**.

- Many states are structurally balanced and building reserves.

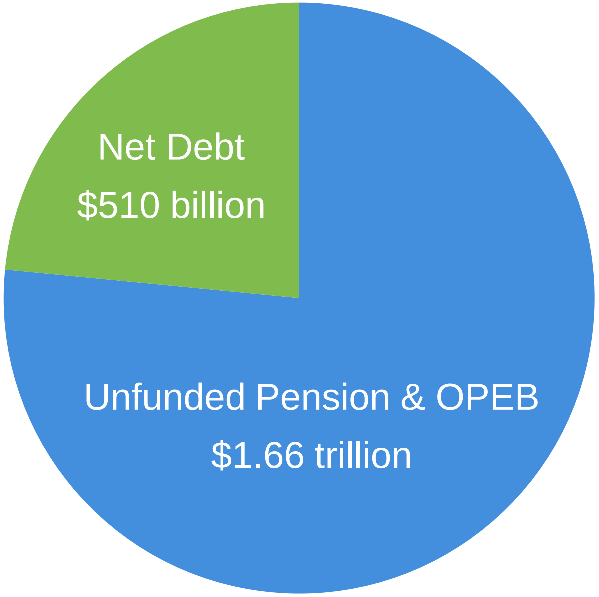
However, some states appear to be **challenged**.

- Some states are structurally imbalanced, are not fully funding their pension obligations, have thin financial reserves and are using one-time revenue sources to balance budgets.

Why are some states challenged?

Debt, unfunded pensions and other post employment benefit (OPEB) liabilities have been a dominant story for many U.S. states over the past several years.

State unfunded pension and OPEB liabilities are more than ***three times larger*** than state debt burdens.



For more on the challenges of unfunded pensions and OPEB, please see the **Appendix**

Source: Debt is net tax supported debt from Moody's June 2015. Unfunded pension liabilities from State CAFRs. States' share of estimated pension liabilities are based upon the states' share of the total state and local liabilities as per Moody's "Adjusted Net Pension Liabilities Show Improvement" (November 2014) and Eaton Vance assumptions. States' pension plan discount rates from 2014 State CAFRs. Eaton Vance then applied a 5.5% discount rate to pension liabilities, based on Moody's Adjustments to U.S. State and Local Government Reported Pension Data, July 2, 2012, where for each 1% difference between 5.5% and a plan's discount rate, the actuarial accrued liability increased by 13%. OPEB liabilities from State CAFRs. ***Importantly***, the states' unfunded OPEB liability has not been adjusted for the states share of the total state and local OPEB liability, which could result in the states' OPEB liability being overstated.

Why are some states challenged?

Although important, debt and unfunded liabilities represent only **one aspect** of municipal credit quality.

We think an evaluation of the credit quality of a municipal issuer should include many additional important **quantitative** and **qualitative** factors, such as:

- Financial performance.
- Economy and wealth.
- Budgetary outlook and flexibility.

How we rank each of the states and Puerto Rico

This report presents the ranking of the states and Puerto Rico based on Eaton Vance's proprietary ratings methodology, which includes both **quantitative and qualitative factors**.

Quantitative factors included in the methodology cover a number of general categories important to state analysis:

- Economy and wealth.
- Financial performance.
- Debt.
- Unfunded retirement obligations.

Qualitative factors include:

- Projected budget shortfalls or surpluses.
- Historical record of meeting projections.
- Pension or OPEB reform initiatives.
- Success of proposals to increase revenues.
- Success of proposals to decrease expenditures.

Important quantitative factors in our methodology

Debt, adjusted unfunded pension liability and unfunded OPEB liability as a percentage of gross state product

- A very high level of debt or very significant unfunded retirement obligations can cut into a state's budget, reducing the amount of resources available.

Percentage of pension annual required contributions (ARC)

- A low contribution percentage will lead to increasing net pension obligations over time.

Adjusted pension liability funded ratio

- A low pension funded ratio indicates that a state may need to invest more money into its pension plans to meet these eventual obligations, reducing flexibility for other spending.

General fund balance as a percentage of revenues

- A high general fund balance signifies that a state has adequate financial resources to mitigate current and future financial risks.

Important quantitative factors in our methodology

Governmental fund liquidity

- High levels of liquidity ensure a state can make the payments it needs to make on time, without the need for short-term borrowing.

State unemployment rate

- Low unemployment tends to correlate with higher economic growth, productivity and increasing state revenues from taxes.

Median household income

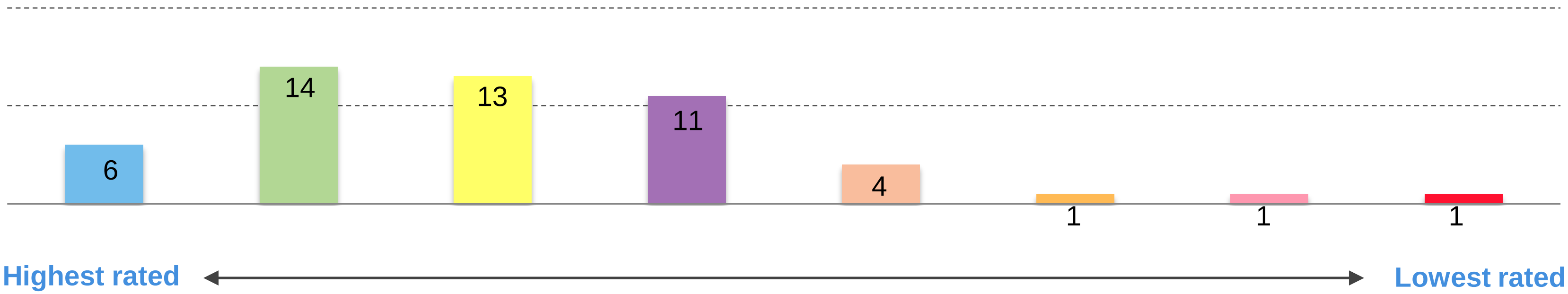
- When adjusted for cost of living, wealthier states tend to have higher revenue-raising flexibility and more economic activity.

Important notes about our rankings

- Rankings are on a **scale of 1 to 51**, with 1 being regarded as most positive and 51 being viewed as most negative.

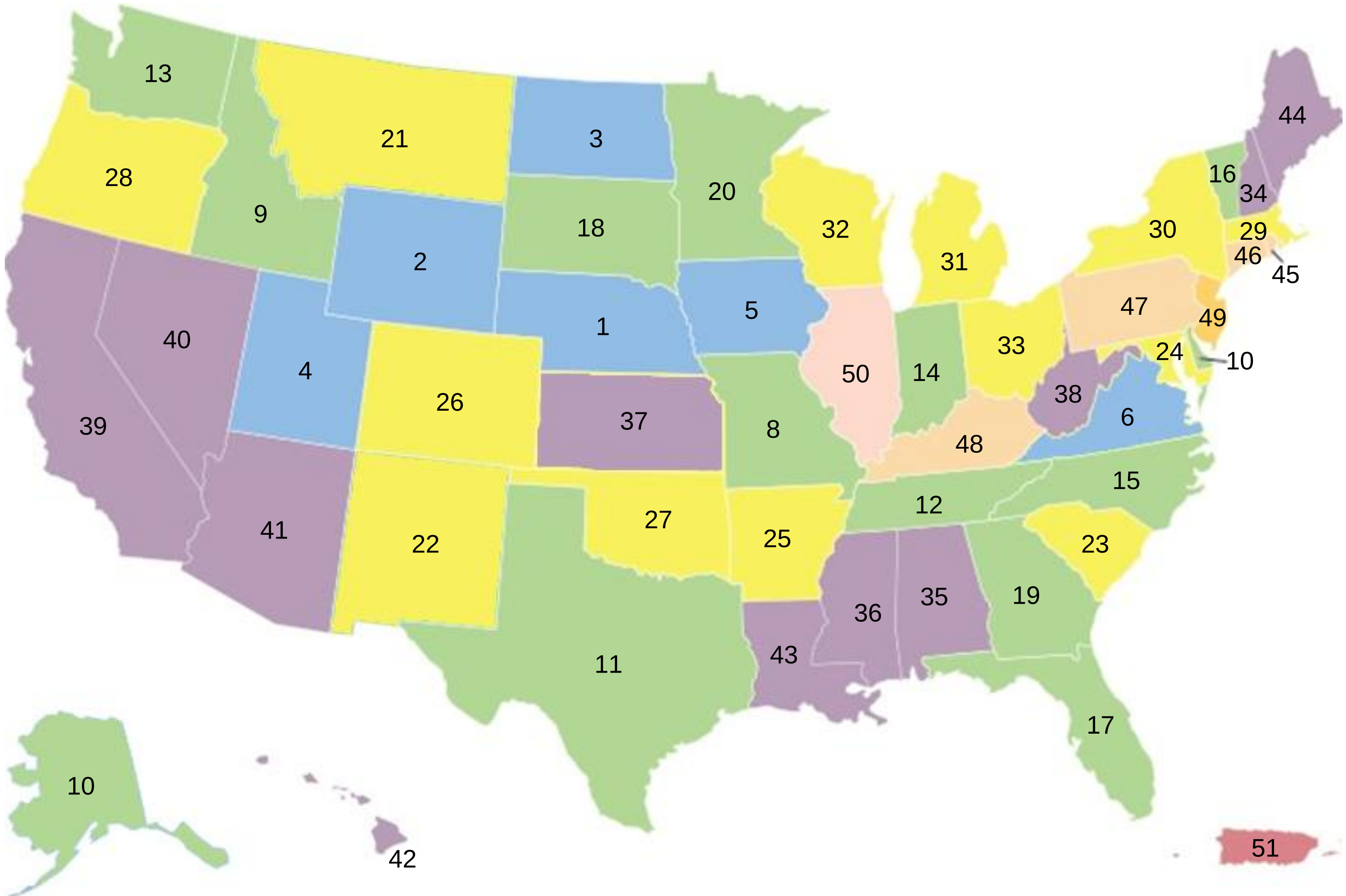
- Although we don't provide Eaton Vance's proprietary ratings score for each state, **many states score very closely together**.

- We have grouped states using **eight color codes**, as large differences in ranking on a 1-51 scale may not necessarily reflect differences in credit quality.



- States that are in the same color-coded group should be considered **very similar in credit quality** to each other.

Overview: How do the states and Puerto Rico rank?



Results: How do they rank?

Strategies for Taxes

		Debt, Adjusted Pension & OPEB as a % of GDP		Average ARC Contributed % 2010-2014		Adjusted Pension Liability-Funded Ratio		General Fund Balance as a % of Revenues		Governmental Funds Liquidity (Days Cash)		State Unemployment Rate		Median Household Income	
Rank	State	Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank
1	Nebraska	0.6%	(1)	94.5%	(23)	64.1%	(14)	30.6%	(5)	181	(5)	2.9%	(1)	$ 55,431	(12)
2	Wyoming	5.8%	(12)	85.5%	(31)	60.9%	(19)	134.4%	(2)	1931	(2)	4.2%	(10)	$ 64,000	(3)
3	North Dakota	6.6%	(14)	64.6%	(47)	48.2%	(39)	133.7%	(3)	773	(3)	2.9%	(2)	$ 54,666	(15)
4	Utah	4.2%	(6)	100.0%	(9)	67.3%	(12)	15.7%	(19)	154	(8)	3.6%	(4)	$ 64,686	(2)
5	Iowa	2.5%	(2)	93.0%	(24)	65.5%	(13)	18.6%	(17)	71	(26)	4.0%	(8)	$ 56,832	(8)
6	Virginia	6.5%	(13)	64.8%	(46)	54.9%	(26)	3.5%	(39)	49	(34)	4.9%	(17)	$ 66,243	(1)
7	Missouri	7.1%	(17)	98.3%	(16)	60.9%	(18)	6.8%	(34)	56	(30)	5.7%	(28)	$ 51,235	(24)
8	Idaho	3.5%	(4)	97.3%	(18)	73.9%	(7)	31.1%	(4)	174	(7)	4.2%	(12)	$ 52,389	(21)
9	Delaware	17.9%	(40)	98.3%	(17)	73.4%	(8)	30.5%	(6)	105	(12)	5.0%	(19)	$ 56,161	(10)
10	Alaska	38.5%	(50)	90.6%	(29)	45.3%	(44)	255.8%	(1)	2510	(1)	6.7%	(45)	$ 54,314	(17)
11	Texas	11.3%	(30)	78.8%	(38)	57.1%	(22)	19.3%	(16)	90	(18)	4.5%	(16)	$ 55,836	(11)
12	Tennessee	5.7%	(11)	100.0%	(9)	74.3%	(5)	11.1%	(23)	51	(32)	6.3%	(39)	$ 48,947	(30)
13	Washington	8.0%	(22)	67.2%	(45)	82.0%	(2)	6.8%	(33)	92	(15)	5.9%	(32)	$ 54,533	(16)
14	Indiana	7.7%	(21)	96.7%	(20)	58.1%	(20)	24.8%	(10)	86	(22)	5.5%	(26)	$ 53,949	(18)
15	North Carolina	8.3%	(23)	97.2%	(19)	78.2%	(4)	4.3%	(37)	32	(45)	5.7%	(27)	$ 48,019	(32)
16	Vermont	18.6%	(43)	107.1%	(1)	54.6%	(29)	9.4%	(26)	36	(41)	3.8%	(6)	$ 42,642	(46)
17	Florida	4.6%	(7)	82.5%	(36)	67.7%	(11)	20.5%	(15)	78	(24)	5.7%	(30)	$ 45,761	(39)
18	South Dakota	3.1%	(3)	104.2%	(2)	79.4%	(3)	25.6%	(9)	175	(6)	3.5%	(3)	$ 50,099	(28)
19	Georgia	9.0%	(24)	100.0%	(8)	63.3%	(16)	13.2%	(22)	62	(28)	6.5%	(42)	$ 52,101	(23)
20	Minnesota	12.1%	(32)	76.3%	(41)	55.6%	(24)	8.9%	(27)	107	(11)	3.8%	(5)	$ 58,706	(5)
21	Montana	6.8%	(16)	77.8%	(39)	57.5%	(21)	22.1%	(13)	270	(4)	4.3%	(13)	$ 46,051	(38)
22	New Mexico	11.1%	(29)	92.1%	(25)	63.0%	(17)	14.2%	(20)	73	(25)	6.3%	(38)	$ 47,635	(36)
23	South Carolina	12.0%	(31)	100.0%	(9)	50.3%	(35)	29.6%	(7)	89	(19)	6.6%	(44)	$ 45,388	(41)
24	Maryland	16.0%	(39)	75.6%	(42)	52.9%	(33)	4.3%	(36)	17	(50)	5.5%	(25)	$ 60,352	(4)
25	Arkansas	7.7%	(19)	96.5%	(21)	63.5%	(15)	23.9%	(11)	88	(21)	5.7%	(28)	$ 44,274	(44)
26	Colorado	7.7%	(20)	79.8%	(37)	44.1%	(47)	6.1%	(35)	50	(33)	4.3%	(14)	$ 58,414	(6)
27	Oklahoma	7.2%	(18)	88.5%	(30)	56.1%	(23)	21.9%	(14)	142	(9)	4.2%	(11)	$ 50,486	(27)

Results: How do they rank?

Strategies for Taxes

		Debt, Adjusted Pension & OPEB as a % of GDP		Average ARC Contributed % 2010-2014		Adjusted Pension Liability-Funded Ratio		General Fund Balance as a % of Revenues		Governmental Funds Liquidity (Days Cash)		State Unemployment Rate		Median Household Income	
Rank	State	Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank	Value	Rank
28	Oregon	5.6%	(10)	85.4%	(32)	74.2%	(6)	10.1%	(24)	93	(14)	6.1%	(37)	$ 38,507	(50)
29	Massachusetts	21.2%	(44)	83.0%	(34)	47.1%	(41)	8.7%	(30)	29	(46)	5.1%	(20)	$ 47,691	(34)
30	New York	10.6%	(27)	98.8%	(15)	70.4%	(9)	-1.2%	(45)	35	(43)	5.8%	(31)	$ 42,717	(45)
31	Michigan	10.6%	(28)	83.0%	(35)	45.2%	(45)	7.1%	(31)	34	(44)	6.0%	(33)	$ 52,931	(19)
32	Wisconsin	3.9%	(5)	102.4%	(3)	99.9%	(1)	-5.7%	(47)	27	(47)	4.9%	(18)	$ 52,841	(20)
33	Ohio	10.3%	(25)	64.6%	(48)	54.8%	(27)	18.2%	(18)	68	(27)	5.2%	(22)	$ 52,205	(22)
34	New Hampshire	6.8%	(15)	100.0%	(9)	51.3%	(34)	8.8%	(28)	42	(39)	3.9%	(7)	$ 54,804	(14)
35	Alabama	10.5%	(26)	100.0%	(9)	49.8%	(36)	8.8%	(29)	112	(10)	6.1%	(35)	$ 47,663	(35)
36	Mississippi	15.6%	(38)	100.4%	(7)	46.0%	(43)	26.6%	(8)	81	(23)	7.0%	(49)	$ 45,033	(42)
37	Kansas	14.4%	(36)	73.5%	(43)	45.2%	(46)	0.0%	(41)	48	(35)	4.4%	(15)	$ 56,636	(9)
38	West Virginia	18.0%	(41)	100.5%	(6)	53.4%	(31)	-0.5%	(43)	89	(19)	6.7%	(46)	$ 39,781	(49)
39	California	13.8%	(35)	71.3%	(44)	55.2%	(25)	-7.1%	(49)	43	(37)	6.8%	(48)	$ 45,019	(43)
40	Nevada	4.9%	(9)	91.0%	(28)	54.0%	(30)	4.1%	(38)	91	(17)	7.1%	(50)	$ 47,789	(33)
41	Arizona	4.6%	(8)	100.5%	(5)	53.0%	(32)	0.1%	(40)	42	(38)	6.4%	(41)	$ 49,199	(29)
42	Hawaii	32.2%	(48)	91.6%	(26)	47.5%	(40)	23.8%	(12)	92	(15)	4.0%	(9)	$ 40,755	(48)
43	Louisiana	18.6%	(42)	91.5%	(27)	54.8%	(28)	13.5%	(21)	102	(13)	6.7%	(47)	$ 47,335	(37)
44	Maine	12.8%	(33)	101.0%	(4)	68.5%	(10)	-6.7%	(48)	20	(49)	5.1%	(21)	$ 41,097	(47)
45	Rhode Island	14.8%	(37)	99.9%	(14)	49.6%	(37)	7.0%	(32)	48	(36)	6.5%	(43)	$ 45,709	(40)
46	Connecticut	34.1%	(49)	95.6%	(22)	38.3%	(48)	-0.2%	(42)	15	(51)	6.1%	(34)	$ 50,564	(25)
47	Pennsylvania	13.7%	(34)	42.4%	(49)	48.5%	(38)	-1.1%	(44)	53	(31)	5.4%	(23)	$ 50,541	(26)
48	Kentucky	30.3%	(46)	77.0%	(40)	38.3%	(48)	-1.4%	(46)	37	(40)	5.4%	(24)	$ 48,708	(31)
49	New Jersey	30.9%	(47)	32.8%	(50)	46.6%	(42)	9.8%	(25)	25	(48)	6.3%	(40)	$ 55,075	(13)
50	Illinois	29.5%	(45)	83.5%	(33)	31.6%	(50)	-8.0%	(50)	59	(29)	6.1%	(35)	$ 58,188	(7)
51	Puerto Rico	88.6%	(51)	32.8%	(51)	7.3%	(51)	-23.1%	(51)	36	(42)	12.7%	(51)	$ 23,032	(51)

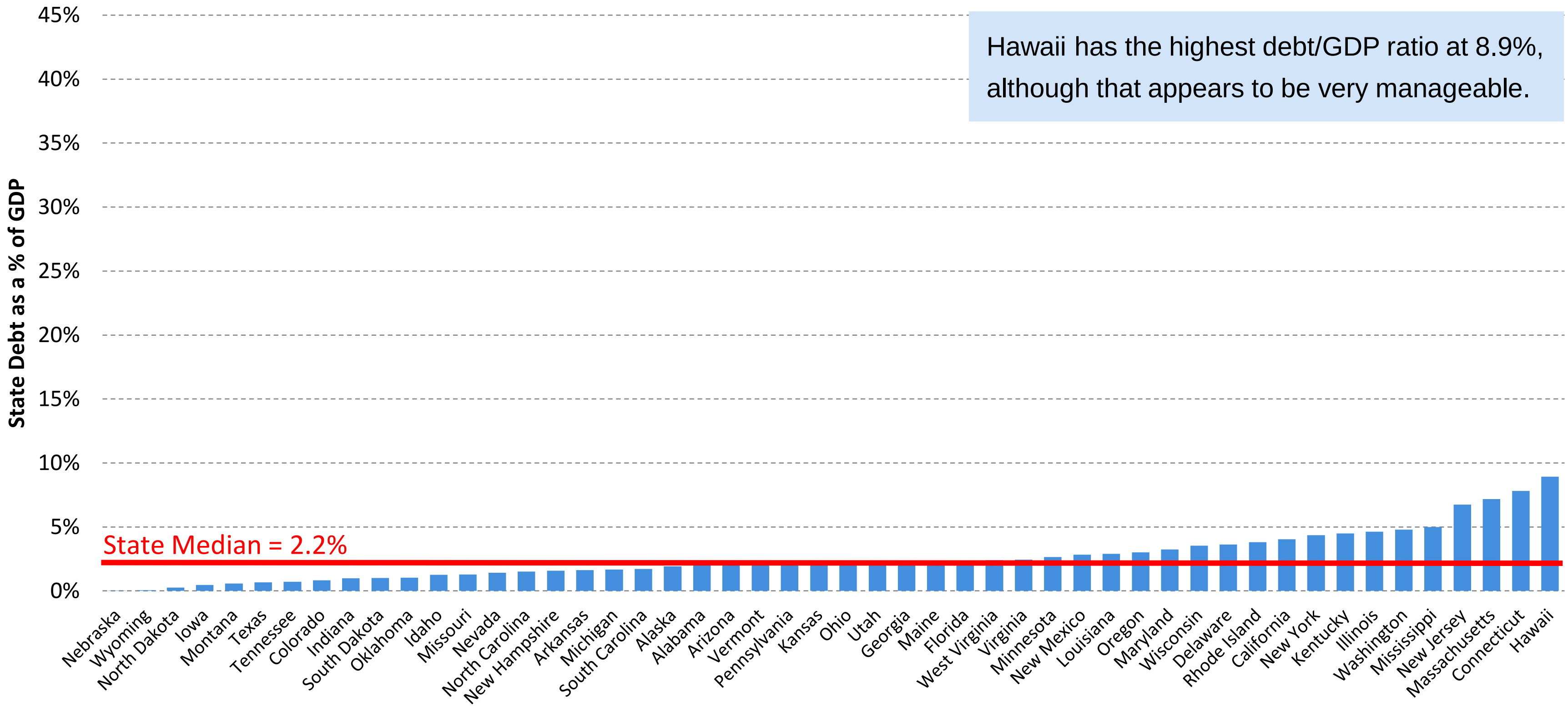
A guide to reviewing the state of the states

The following pages include in-depth charts that help compare the states based on the credit quality factors that are incorporated in Eaton Vance's ratings methodology.

1. How are the states managing their **debt load**?
2. How heavy are **debt and unfunded pension burdens** on the states?
3. Which states are most pressured by **debt, pension and OPEB liabilities**?
4. How do debt, pension and OPEB loads compare to **annual revenues**?
5. Which state budgets can handle **debt, pension and OPEB expenses**?
6. Which states are not fully funding their **pension contributions**?
7. Which state **pensions** are the most **underfunded**?
8. How much **cushion** do states have to mitigate **financial risks**?
9. How much **liquidity** does each state have?
10. Which states are battling **high unemployment**?
11. Which states have the **wealthiest households**?
12. How much **flexibility** do states have to raise **taxes**?
13. Which states fall short in terms of **economic growth**?
14. Which states have the highest **population growth**?

1. How are the states managing their debt load?

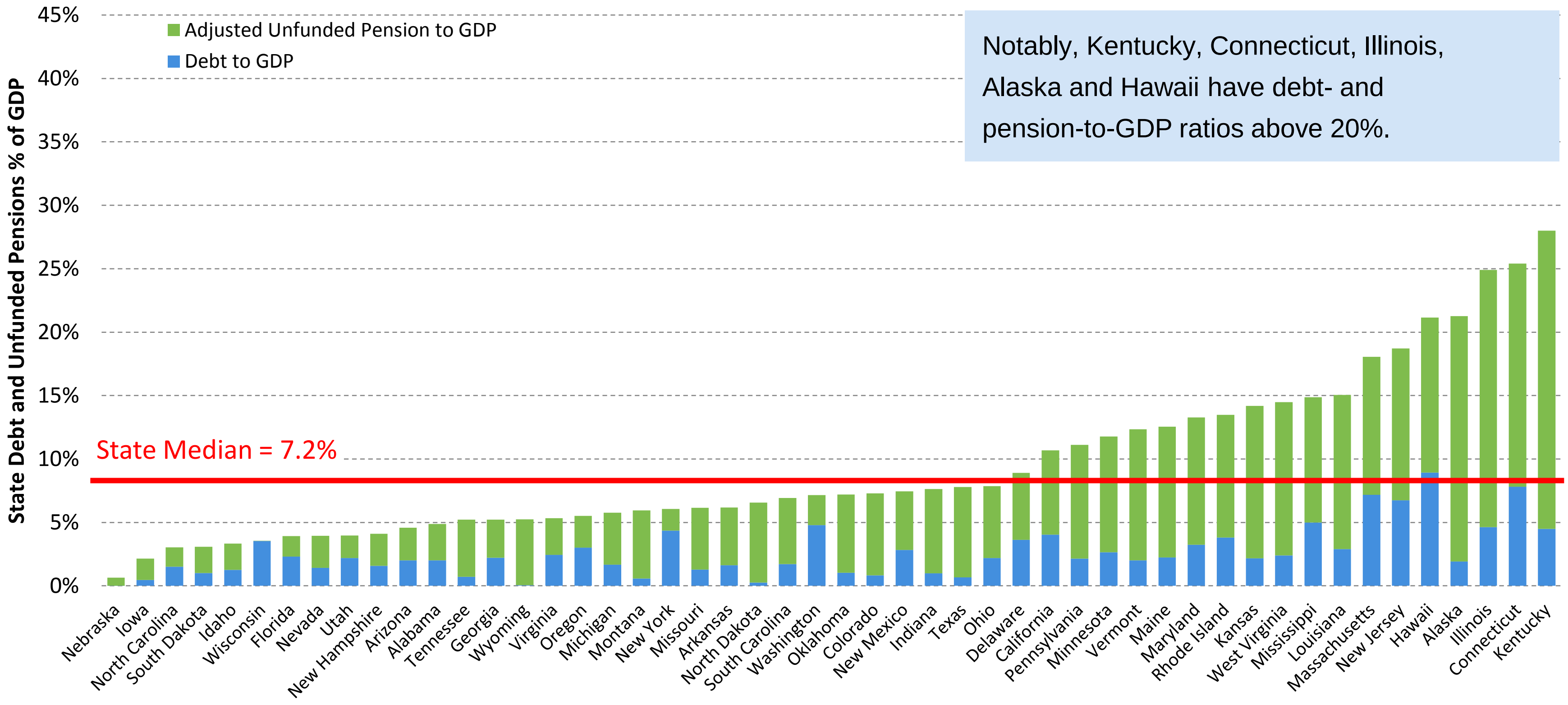
Many states have curtailed borrowing after the Great Recession. Combined with increasing state GDP, this has resulted in state debt (as a % of GDP) remaining low.



Source: Debt is net tax supported debt from Moody's State Debt Medians Report, June 2015. GDP from the Bureau of Economic Analysis 2014 advanced estimates.

2. How heavy are debt and unfunded pension burdens on the states?

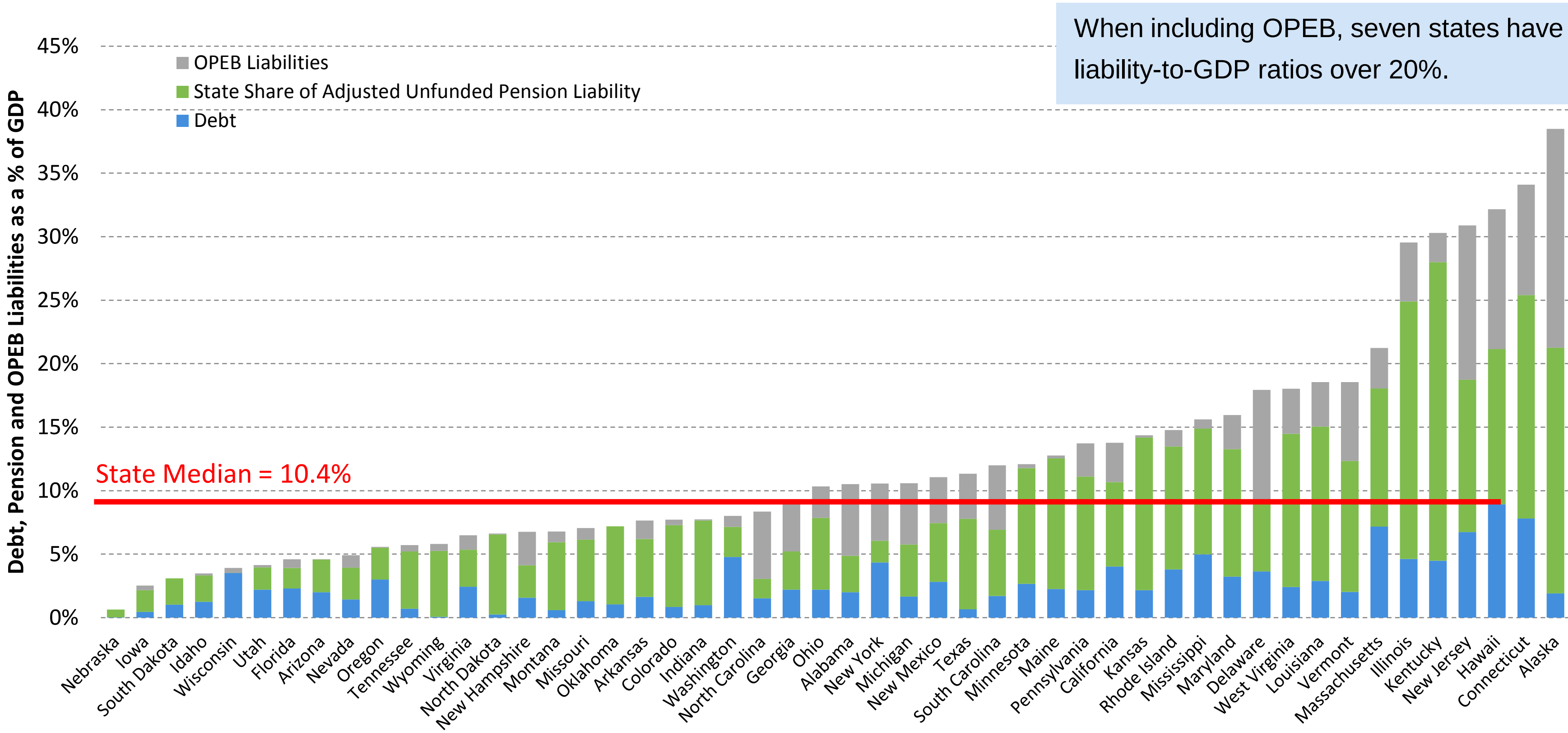
Most states have manageable burdens and, due to GDP growth and pension reforms, the median has ***declined*** from 8.3% in 2011 to 7.2% in 2014.



Source: Debt is net tax supported debt from Moody's June 2015. Unfunded pension liabilities from 2014 State Comprehensive annual financial reports (CAFRs). States' share of estimated pension liabilities are based upon the states' share of the total state and local liabilities as per Moody's "Adjusted Net Pension Liabilities Show Improvement" (November 2014) and Eaton Vance assumptions. GDP from the Bureau of Economic Analysis 2014 advanced estimates. States' pension plan discount rates from 2014 State CAFRs. Eaton Vance then applied a 5.5% discount rate to pension liabilities, based on Moody's Adjustments to US State and Local Government Reported Pension Data, July 2, 2012, where for each 1% difference between 5.5% and a plan's discount rate, the actuarial accrued liability increased by 13%.

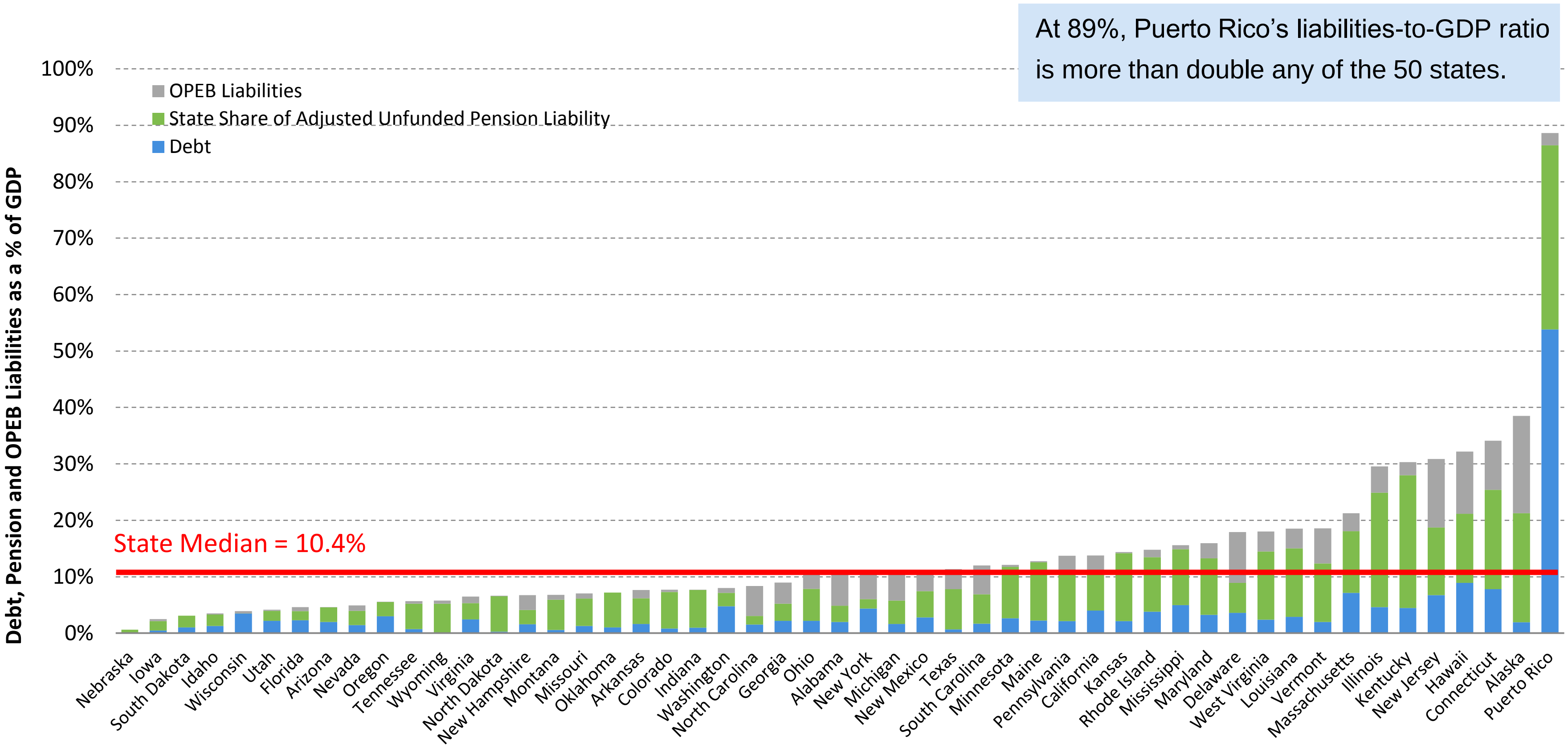
3. Which states are most pressured by debt, pension and OPEB liabilities?

Including large unfunded OPEB, most states maintain manageable burdens, and the State median has ***declined*** from 11.5% in 2011 to 10.4% in 2014



Source: Debt is net tax supported debt from Moody's June 2015. Unfunded pension liabilities from State CAFRs as of June 30, 2014. States' share of estimated pension liabilities are based upon the states' share of the total state and local liabilities as per Moody's "Adjusted Net Pension Liabilities Show Improvement" (November 2014) and Eaton Vance assumptions. GDP from the Bureau of Economic Analysis 2014 advanced estimates. States' pension plan discount rates from 2014 State CAFRs. Eaton Vance then applied a 5.5% discount rate to pension liabilities, based on Moody's Adjustments to US State and Local Government Reported Pension Data, July 2, 2012, where for each 1% difference between 5.5% and a plan's discount rate, the actuarial accrued liability increased by 13%. OPEB liabilities from State CAFRs. ***Importantly***, the states' unfunded OPEB liability has not been adjusted for the states' share of the total state and local OPEB liability, which could result in the states' OPEB liability being overstated.

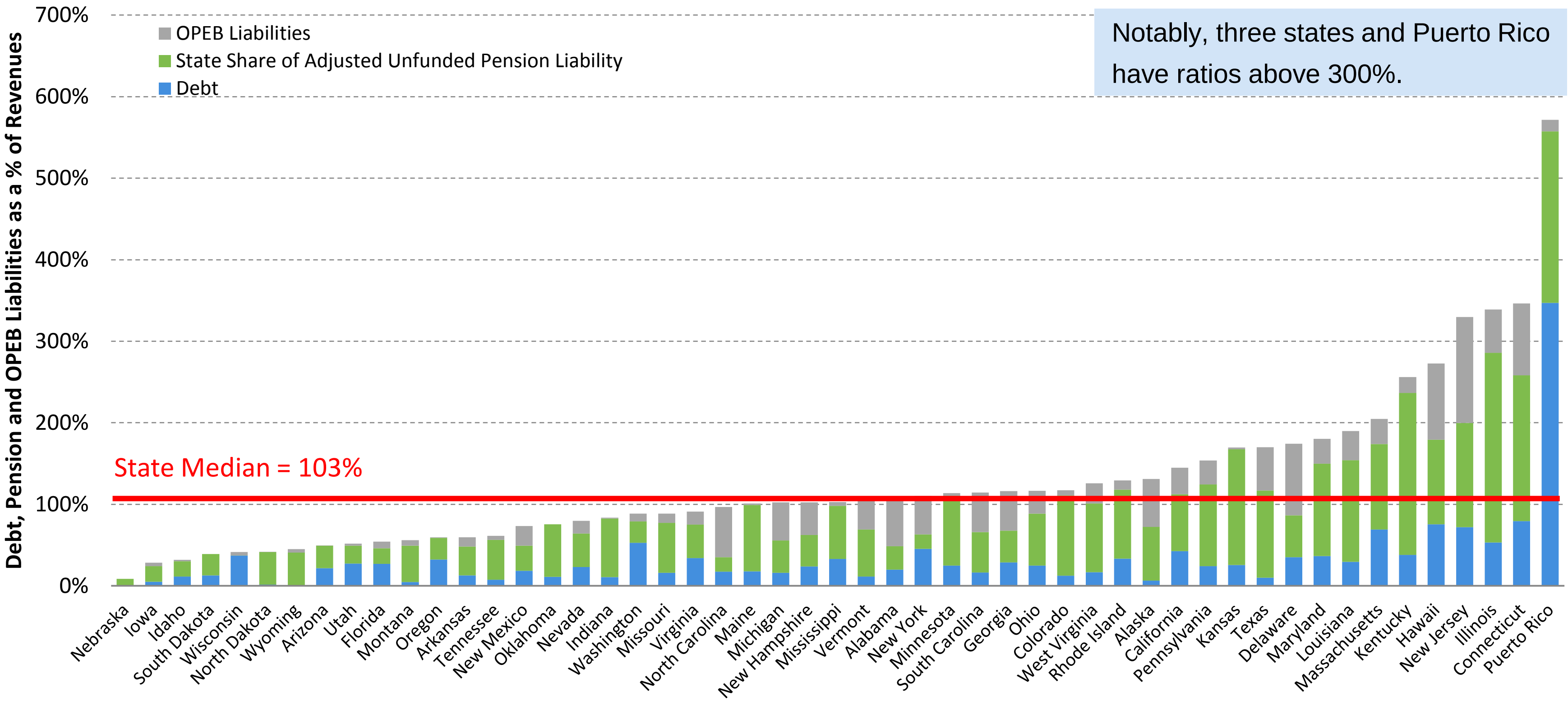
Not a surprise: Puerto Rico remains a *significant* outlier



Source: Debt is net tax supported debt from Moody's June 2015. Unfunded pension liabilities from State CAFRs as of June 30, 2014. States' share of estimated pension liabilities are based upon the states' share of the total state and local liabilities as per Moody's "Adjusted Net Pension Liabilities Show Improvement" (November 2014) and Eaton Vance assumptions. GDP from the Bureau of Economic Analysis 2014 advanced estimates. States' pension plan discount rates from 2014 State CAFRs. Eaton Vance then applied a 5.5% discount rate to pension liabilities, based on Moody's Adjustments to US State and Local Government Reported Pension Data, July 2, 2012, where for each 1% difference between 5.5% and a plan's discount rate, the actuarial accrued liability increased by 13%. Puerto Rico GDP from The World Bank. OPEB liabilities from State CAFRs and Puerto Rico CAFR. ***Importantly***, the states' unfunded OPEB liability has not been adjusted for the states' share of the total state and local OPEB liability, which could result in the states' OPEB liability being overstated.

4. How do debt, pension and OPEB loads compare to annual revenues?

Much like a home mortgage, this measures the states' outstanding debt to annual income.

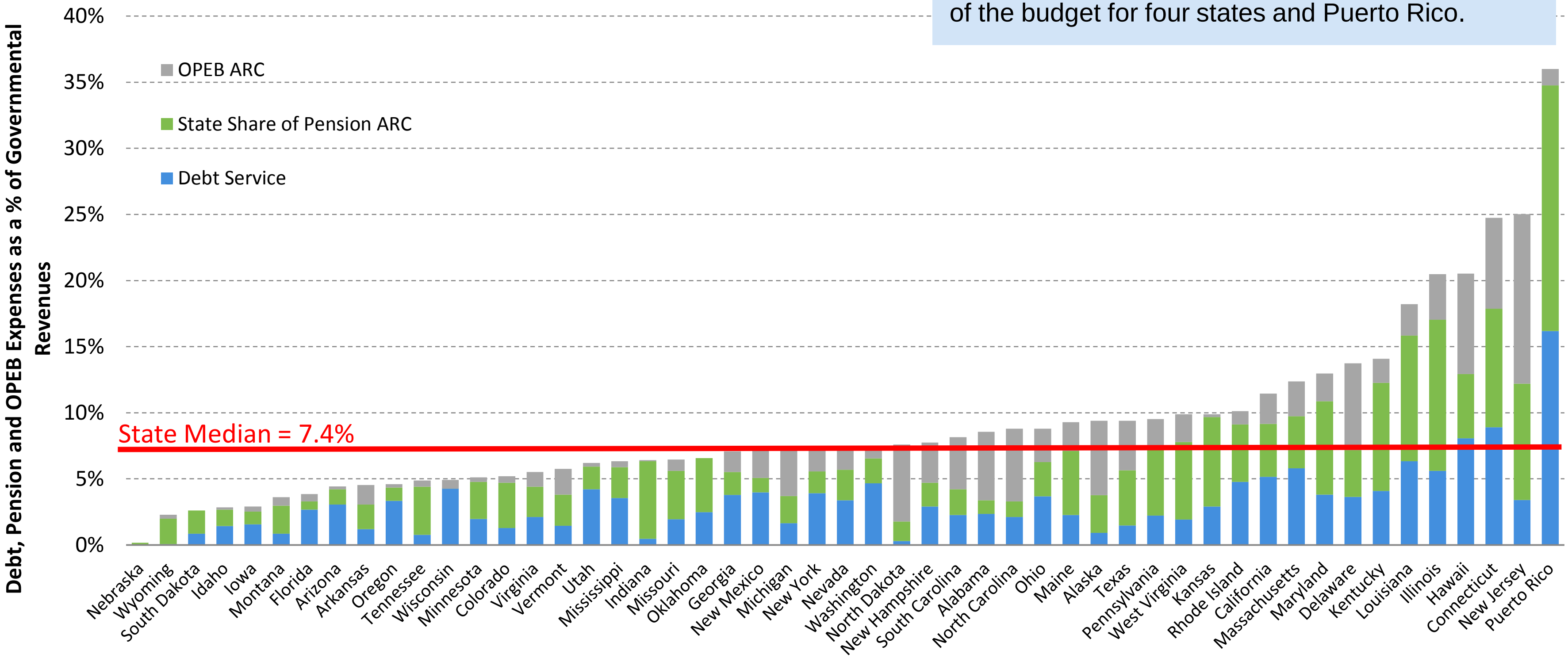


Source: Debt is net tax supported debt from Moody's June 2015. Unfunded pension liabilities from State CAFRs as of June 30, 2014. States' share of estimated pension liabilities are based upon the states' share of the total state and local liabilities as per Moody's "Adjusted Net Pension Liabilities Show Improvement" (November 2014) and Eaton Vance assumptions. States' pension plan discount rates from 2014 State CAFRs. Eaton Vance then applied a 5.5% discount rate to pension liabilities, based on Moody's Adjustments to US State and Local Government Reported Pension Data, July 2, 2012, where for each 1% difference between 5.5% and a plan's discount rate, the actuarial accrued liability increased by 13%. OPEB liabilities from State CAFRs and Puerto Rico CAFR. Annual revenues from State CAFRs, ***Importantly***, the states' unfunded OPEB liability has not been adjusted for the states' share of the total state and local OPEB liability, which could result in the states' OPEB liability being overstated.

5. Which state budgets can handle debt, pension and OPEB expenses?

Most states are in good shape, but for some states these expenses, if paid in full, could crowd out other spending initiatives.

These historical liabilities consume more than 20% of the budget for four states and Puerto Rico.

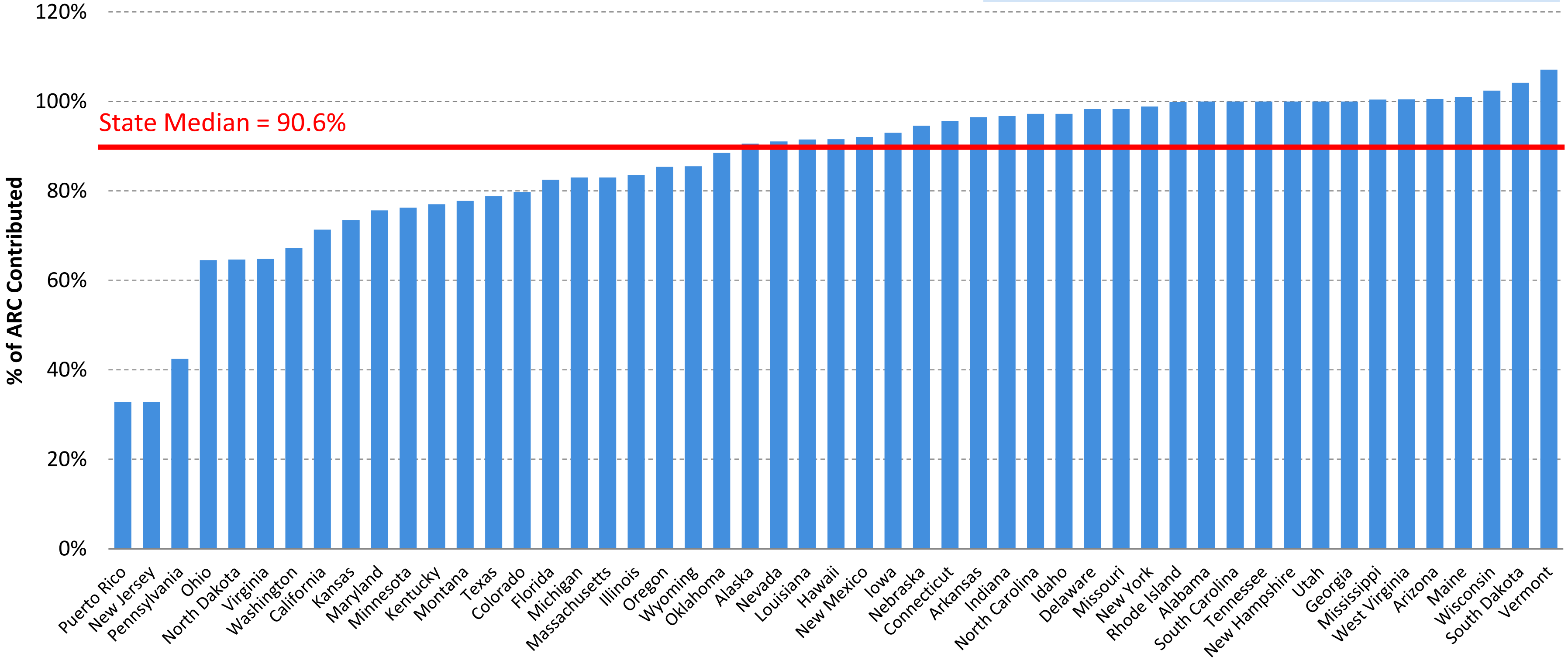


Source: Debt Service, Pension ARCs and OPEB ARCs are all from 2014 State CAFRs and Puerto Rico CAFR. States' share of pension ARC is based upon the states' share of the total state and local liabilities as per Moody's "Adjusted Net Pension Liabilities Show Improvement" (November 2014) and Eaton Vance assumptions. ***Importantly***, the states' unfunded OPEB liability has not been adjusted for the states' share of the total state and local OPEB liability, which could result in the states' OPEB ARCs being overstated.

6. Which states are not fully funding their pension contributions?

If a state does not fully fund its pension annual required contributions (ARC), then it is not in fiscal balance. Consistently underfunding the ARC will drive unfunded pension liabilities higher.

From 2010 to 2014, six states and Puerto Rico contributed less than 70% of the ARC.

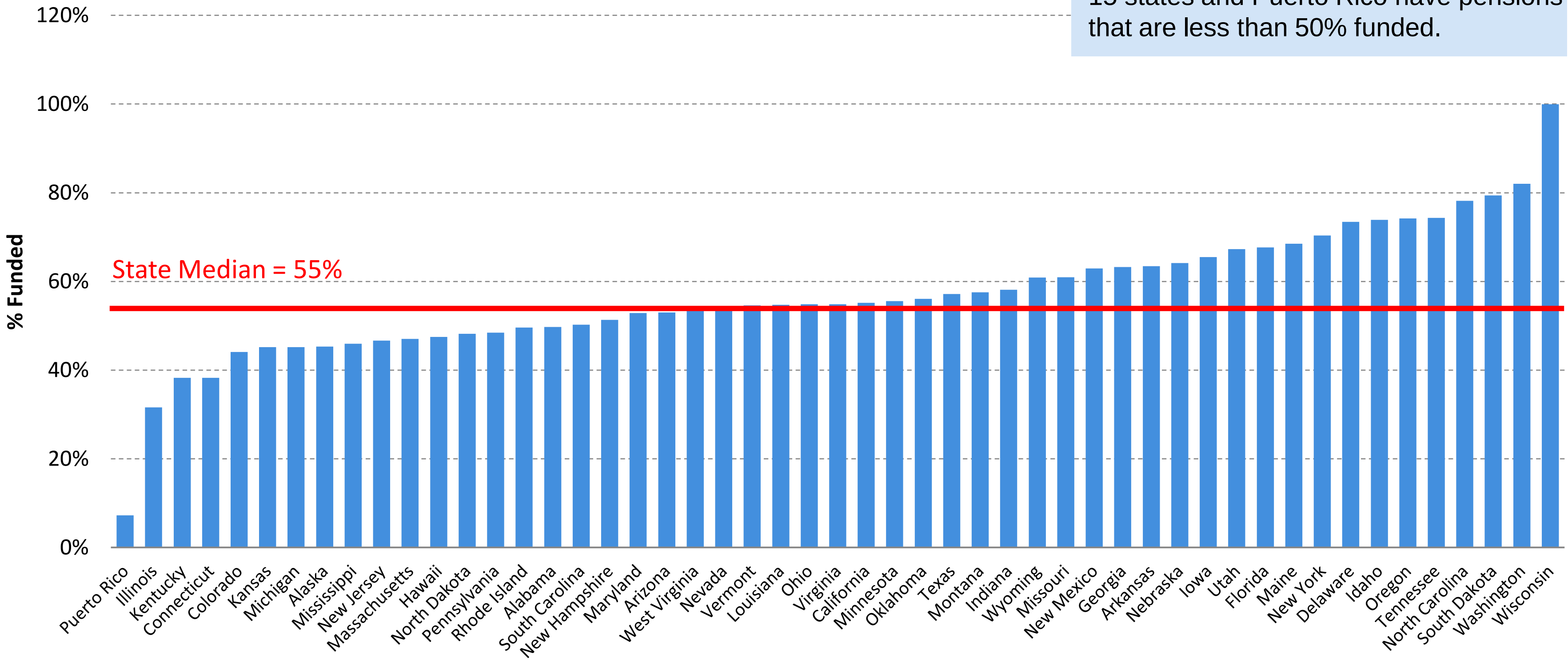


Source: Percent of ARC contributed 2010-2012 from PEW Center on the States "The Fiscal Health of State Pension Plans: Funding Gap Continues to Grow" (March 2014). 2013 ARC contributed % from State CAFRs as of June 30, 2013. 2014 ARC contributed % from State CAFRs as of June 30, 2014

7. Which state pensions are the most underfunded?

Adjusted pension liability-funded ratio measures whether a state may need to invest more money into its pension plans to meet these eventual obligations, reducing flexibility for other spending.

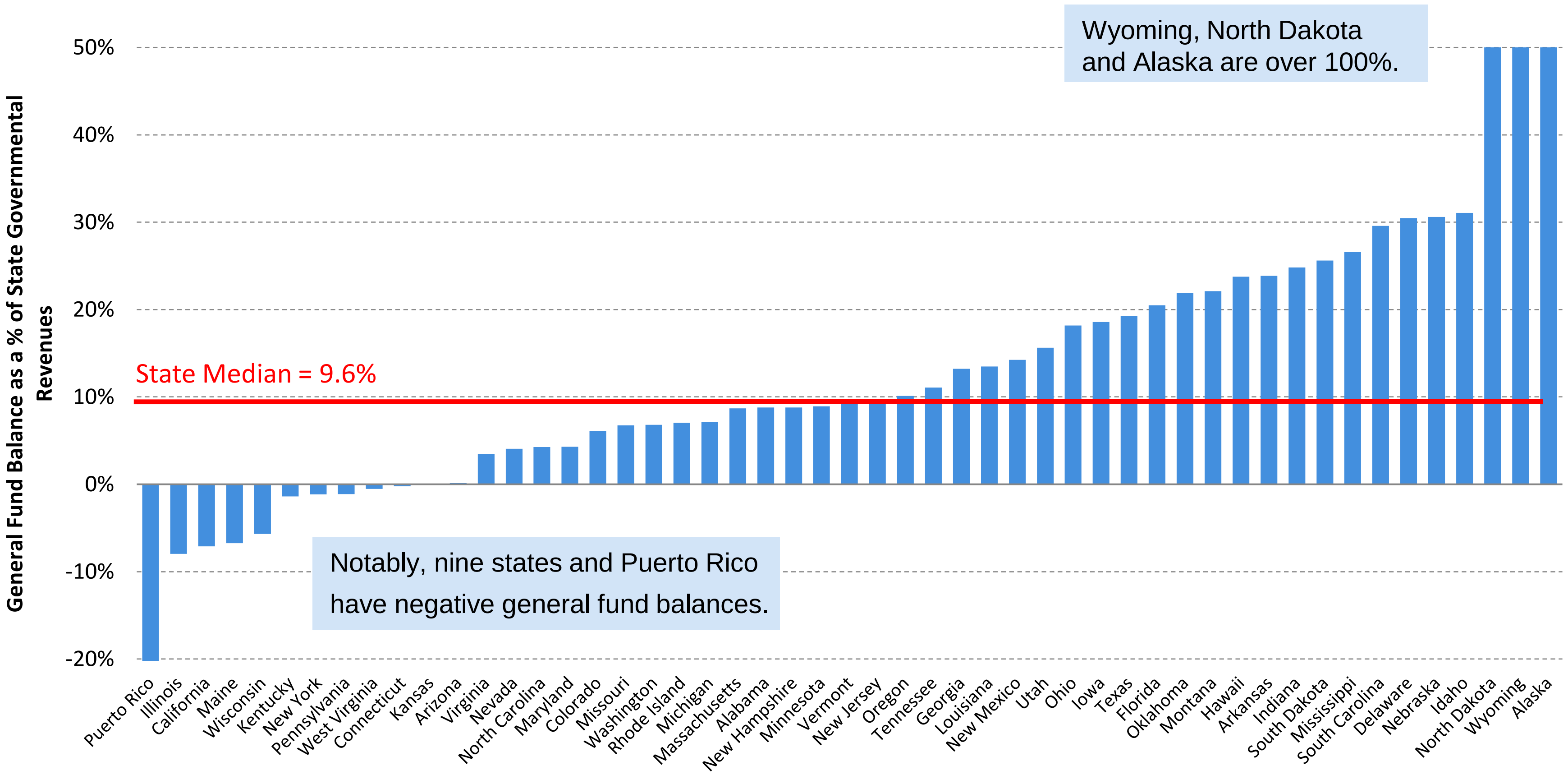
15 states and Puerto Rico have pensions that are less than 50% funded.



Source: Pension plan asset and liability data from State CAFRs as of June 30, 2014. Eaton Vance then applied a 5.5% discount rate to pension liabilities, based on Moody's Adjustments to US State and Local Government Reported Pension Data, July 2, 2012, where for each 1% difference between 5.5% and a plan's discount rate, the actuarial accrued liability increased by 13%. The resulting adjusted funded ratio is the plan's assets divided by its adjusted liabilities.

8. How much cushion do states have to mitigate financial risks?

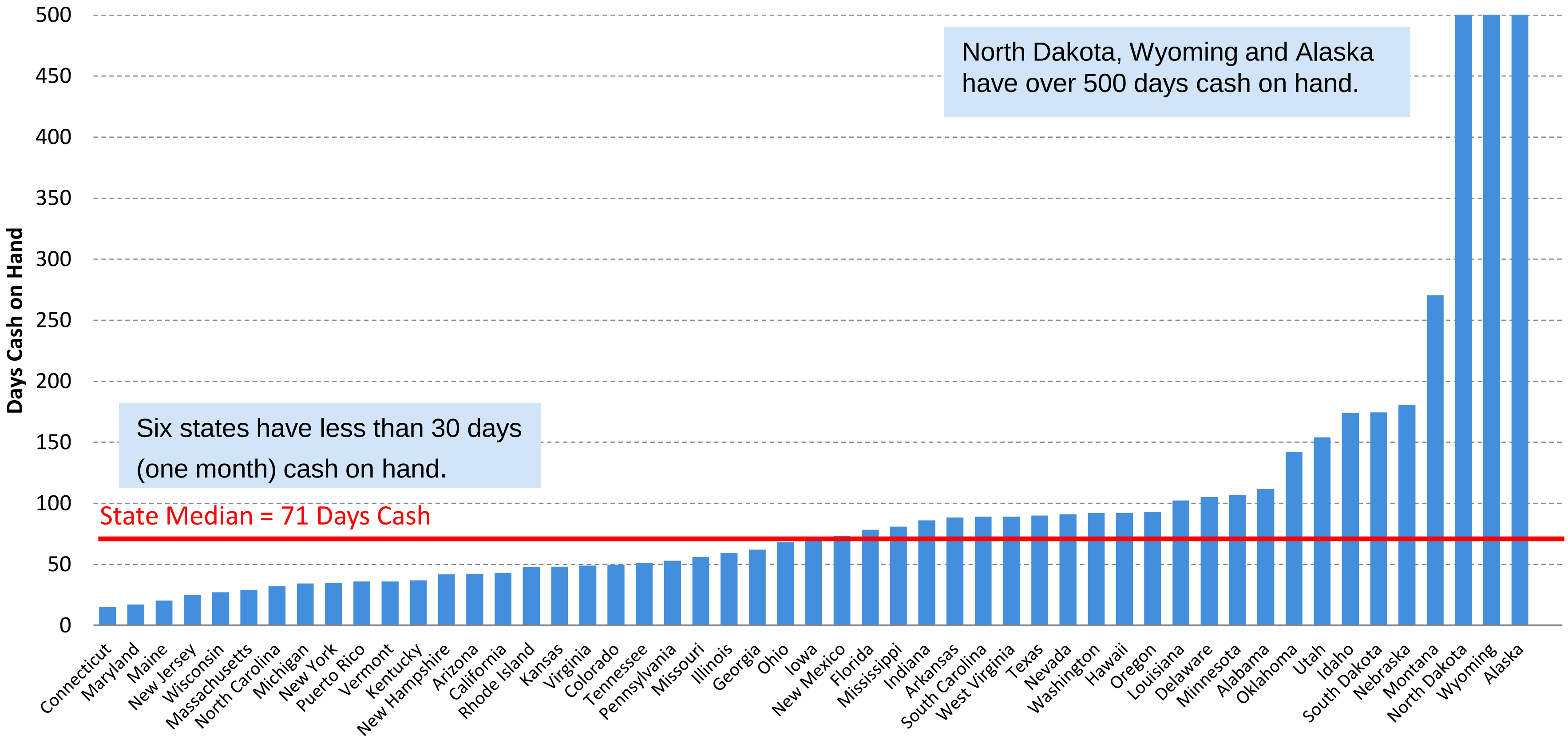
A high general fund balance (as a % of annual revenues) signifies that a state has adequate financial resources to mitigate current and future financial risks.



Source: General Fund Balances and Revenues from State CAFRs as of June 30, 2014.

9. How much liquidity does each state have?

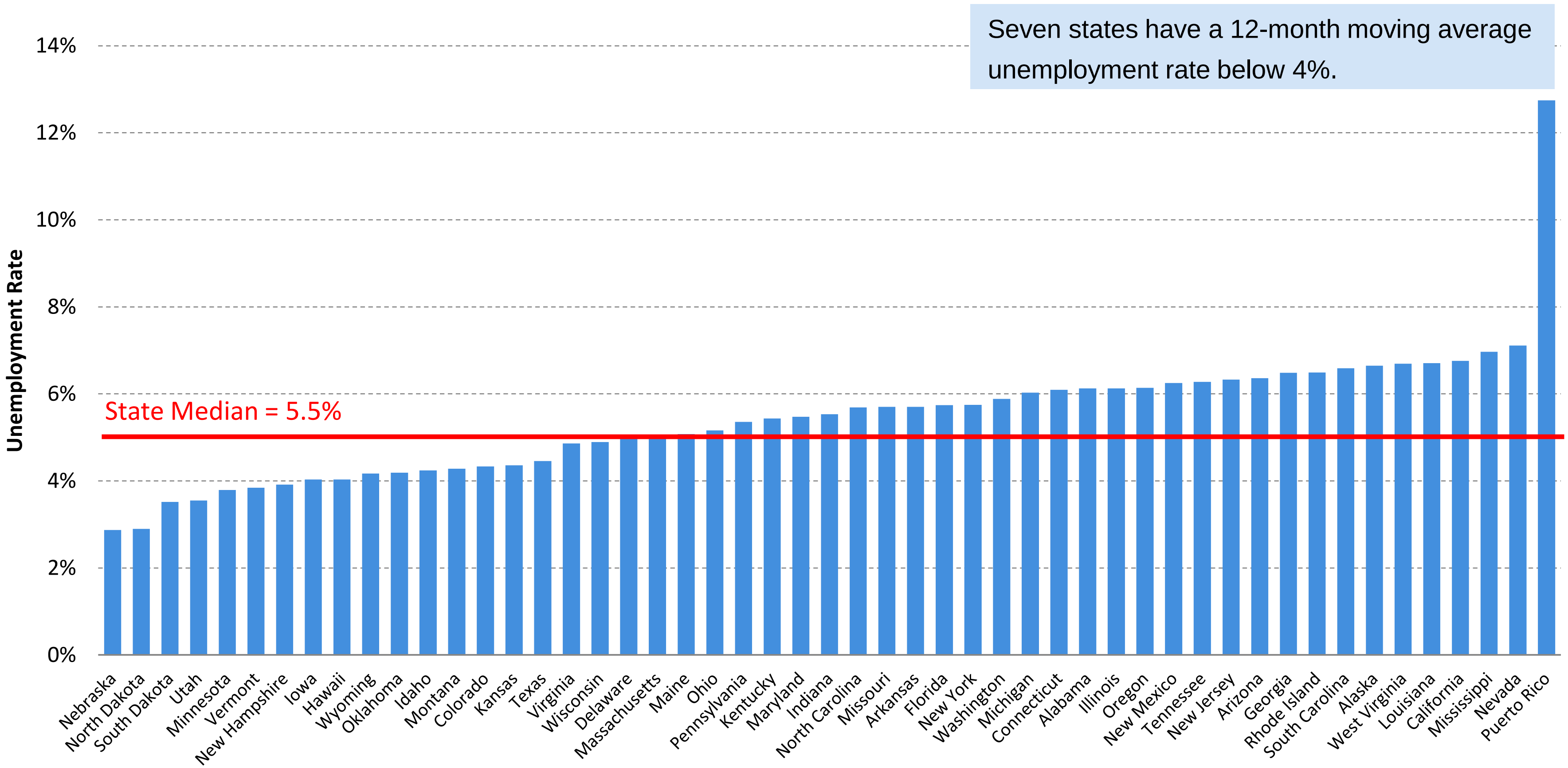
Governmental funds liquidity (in days cash on hand) measures whether a state can make payments on time without the need for short-term borrowing. High levels of liquidity ensure a state can make these payments.



Source: Governmental Funds liquidity from State CAFRs as of June 30, 2014. Days cash on hand is calculated as cash available in the governmental funds divided by annual governmental fund expenditures, and then multiplied by 365.

10. Which states are battling high unemployment?

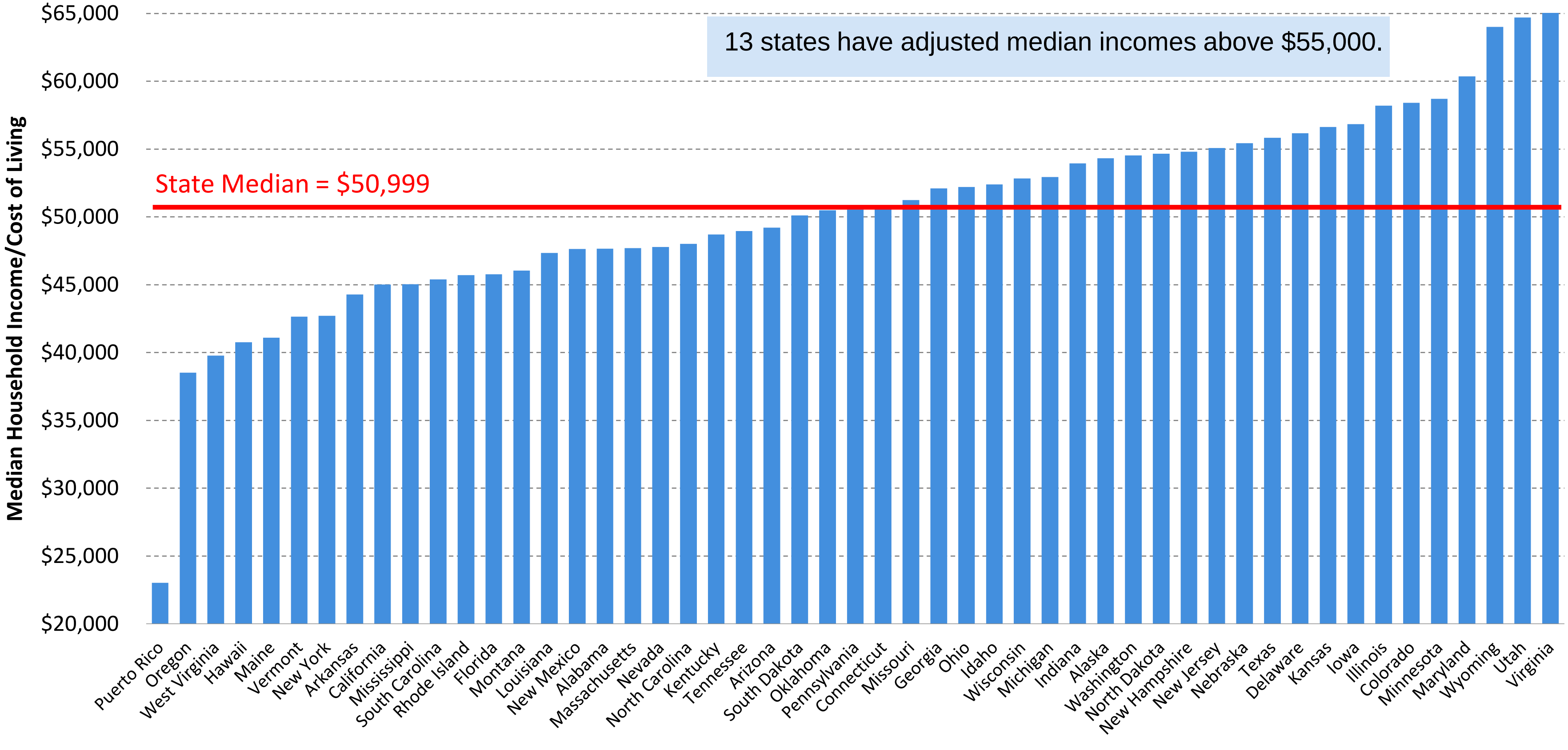
The 12-month moving average unemployment rate is a general measure of the health of a state's economy and labor force.



Source: Unemployment rates for the past 12 months from BLS, as of August 2015.

11. Which states have the wealthiest households?

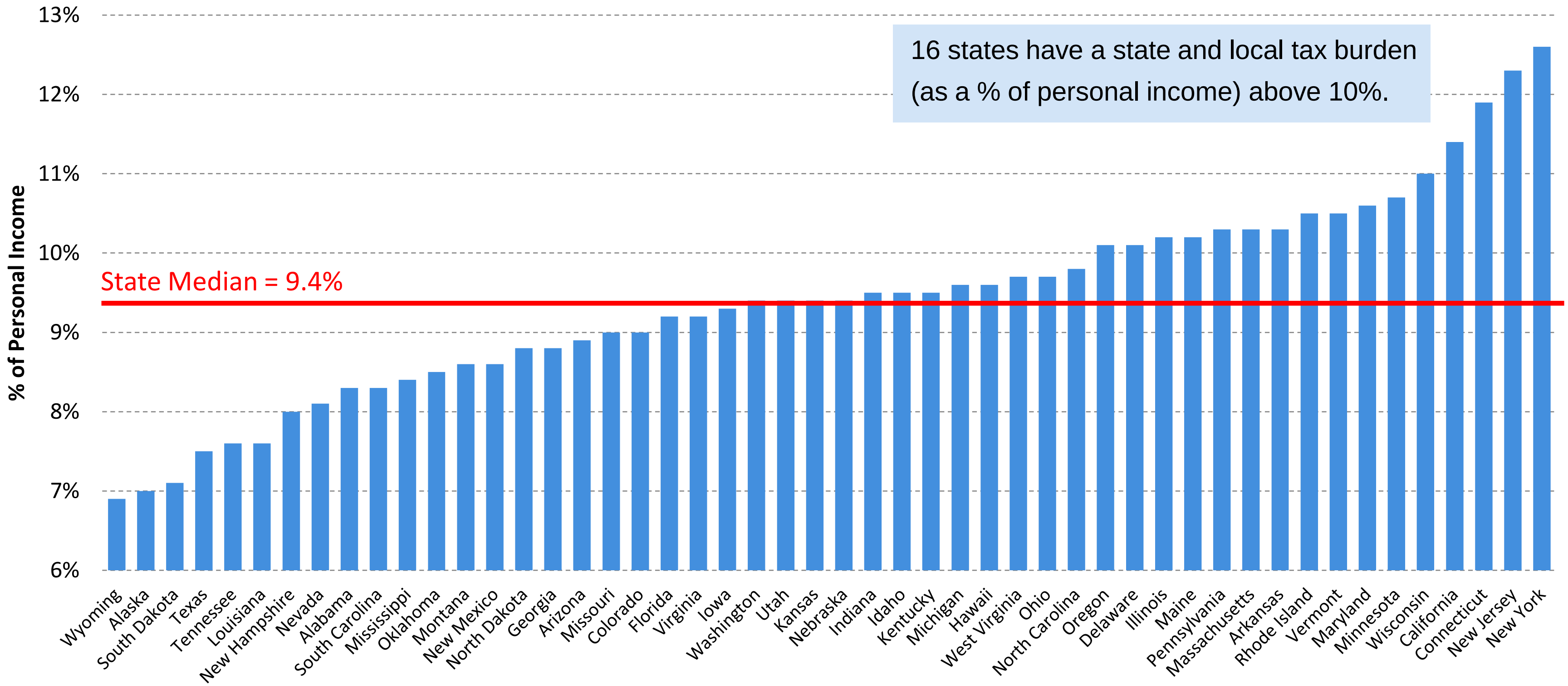
Median household income (adjusted for cost of living) is one measure of the strength of a state's tax base.



Source: Median Household Incomes from Census Bureau 2013 one-year estimates. Cost-of-living adjustment from the Missouri Economic Research and Information Center, Q2 2015 data. To adjust for cost of living, we divide the median household by the cost-of-living index value, which is given as a % of the U.S. average. Puerto Rico cost-of-living adjustment from numbeo.com cost-of-living index.

12. How much flexibility do states have to raise taxes?

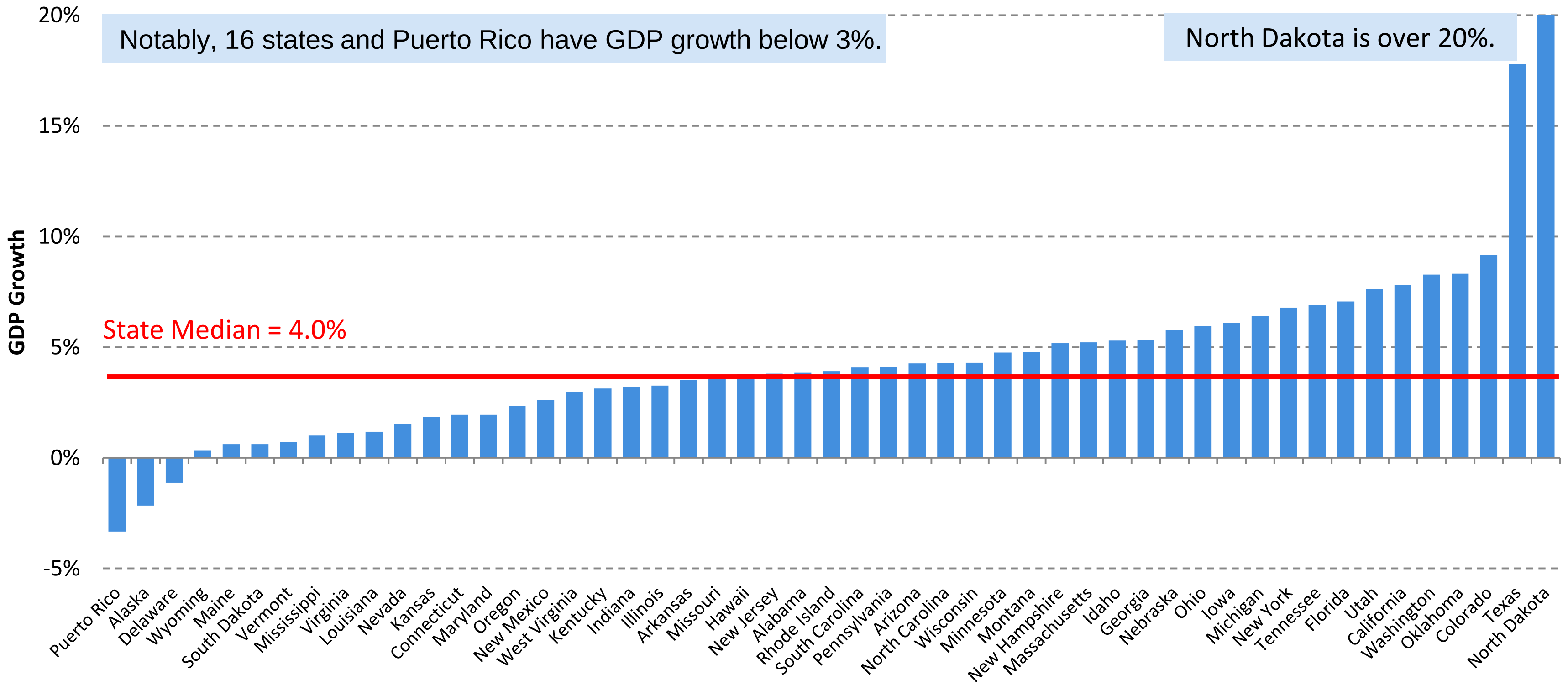
State and local tax burden (as a % of personal income) can help measure the flexibility a state has to increase taxes to generate additional revenue.



Source: Tax burdens as a percent of personal income from taxfoundation.org published April 2014, data as of FY 2011. Tax burden information was unavailable for Puerto Rico.

13. Which states fall short in terms of economic growth?

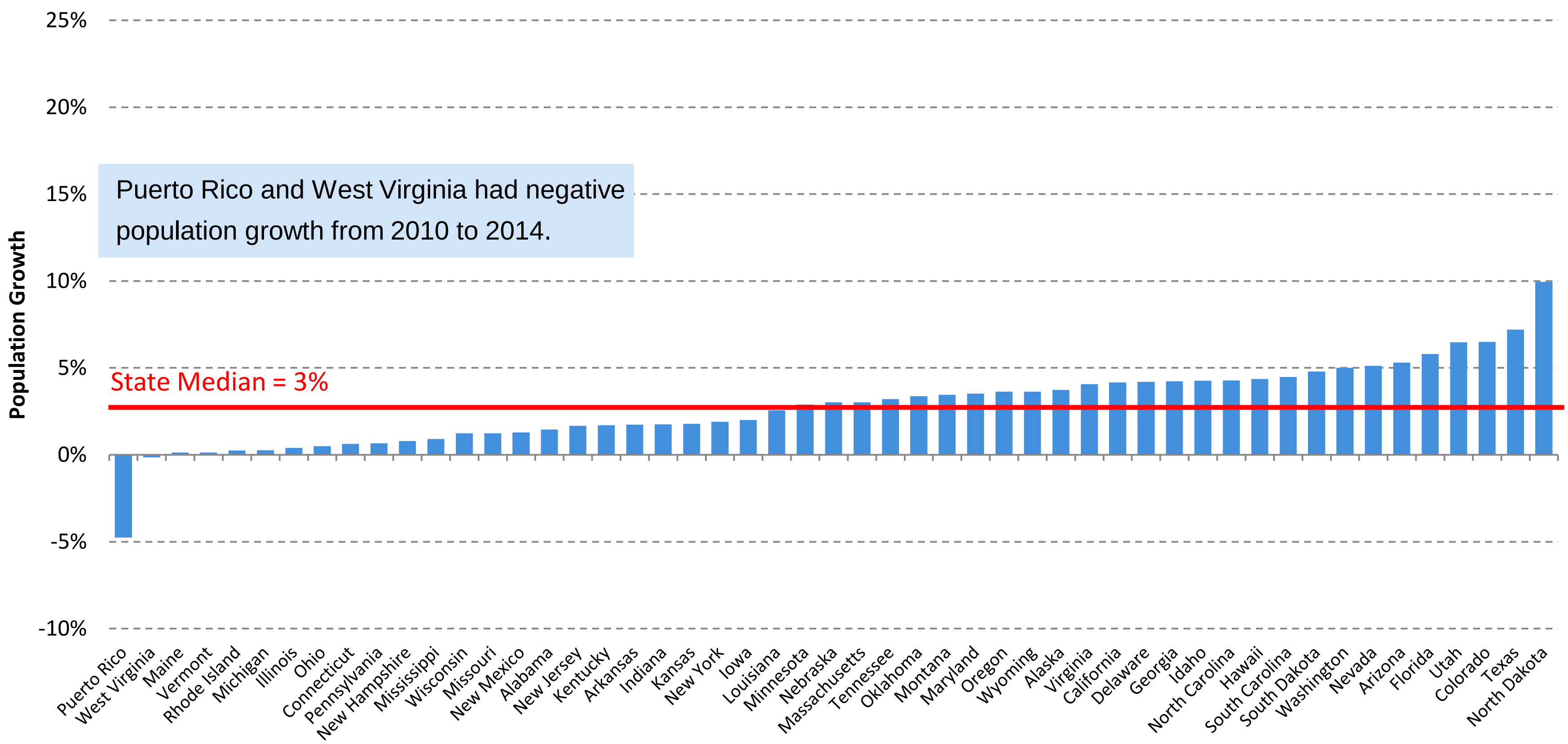
Real state GDP growth (from 2011 to 2014) provides a measure of the health of the economy in each state.



Source: Real GDP growth from 2011-2014 from the Bureau of Economic Analysis 2014 advanced estimates. Puerto Rico GDP from the World Bank.

14. Which states have the highest population growth?

State population growth (2010 to 2014) provides a measure of how desirable a state is to live in, which may impact revenue trends, but also may influence infrastructure spending.



Source: Population growth from Census Bureau 2014 population estimates and 2010 census.

The state of the states: Conclusion

While we have focused on state data in this presentation, there are **over 40,000** different local general obligation (GO) and essential service credits.

- In some highly ranked states, there are certain local issuers that may pose a credit risk.
- Conversely, in some low-ranking states, certain local issuers may exhibit strong credit characteristics.

Independent, professional credit research is now more important than ever to successfully navigating the vast, disparate municipal bond market.

Appendix

- Why unfunded **pension liabilities** are so important.
- Unfunded **OPEB liabilities**: the elephant in the room.
- Examining the **lowest ranked states**:
  - Puerto Rico
  - Illinois
  - New Jersey
  - Kentucky
  - Pennsylvania
  - Connecticut
- What would it take to **fix the gaps?**

Why unfunded pension liabilities are so important

Analyzing unfunded pension liabilities will remain a key component to understanding municipal credit quality.

Governmental Accounting Standards Board (GASB) revised accounting changes related to reporting requirements for public employee pensions plans, which will likely lead to increased scrutiny. The changes that will have the biggest impact include:

- A reduction in the pension plans discount rate. **This change will serve to increase the unfunded pension liability.**

- The requirement that governments report their net pension liabilities on their balance sheets as opposed to simply in the notes of the financial statements. **This change will make the unfunded pension liabilities more visible.**

- Pension plans must use the fair value of pension assets, as opposed to smoothed values, to determine net pension liabilities. Since state and local pension assets hit a new high of $3.78 trillion on December 31, 2014, which compares to a prerecession high of $3.2 trillion (NASRA), **this change will likely lead to increased asset values for most pension plans.**

Why unfunded pension liabilities are so important

- Increased pension and OPEB funding is pressuring municipal cash flows and has resulted in, and we believe will likely continue to result in, **meaningful downgrades of municipal bonds**.

- Pension and OPEB benefits are typically protected by the Federal Constitution's Contract Clause (and in some cases by state constitutional protections), so **changing future benefits can be challenging**.

- On the positive side, many states have been addressing these liabilities. Since 2009, **48 states have made changes to pension plans**, some multiple times.[1]

  - **2009** – 10 states
  - **2010** – 21 states
  - **2011** – 32 states
  - **2012** – 10 states
  - **2013** – 5 states and Puerto Rico
  - **2014** – 2 states

[1] Source: National Conference of State Legislatures, 2014.

Unfunded OPEB liabilities: the elephant in the room

Other post employment benefits (OPEB) liabilities are a critical factor in assessing municipal credit quality.

- In May 2014, Governmental Accounting Standards Board (GASB) proposed that governments recognize their net OPEB liabilities on the face of their financial statements, which will make OPEB liabilities much more visible.

- Historically, the common belief was that OPEB liabilities could easily be restructured outside of bankruptcy. However, recent rulings should make investors realize that **OPEB liabilities are a more permanent obligation than previously thought.**

  - On July 3, 2014, The Supreme Court Of The State Of Illinois ruled that, "The State's provision of health insurance premium subsidies for retirees," is protected by the Illinois Constitution and **cannot be diminished or impaired**.

  - The State of Hawaii in 2010 ruled that health insurance subsidies were constitutionally protected.

  - While numerous factors drove Detroit, MI into bankruptcy in 2013, the city's unfunded OPEB liability of $4.3 billion was its **single largest liability** at the time of its filing. In fact, Detroit's OPEB liability was 1.7x greater than its total debt.

The bottom 6: Why do these states rank so low?

Puerto Rico (#51)

The shrinking economy coupled with growing fixed costs has evaporated Puerto Rico’s liquidity and financial flexibility.

- Puerto Rico has been in a recession since 2006.
- Businesses continue to leave following the phaseout in 2006 of U.S. federal tax breaks that generally eliminated the U.S. tax on income related to U.S. corporations from island operations.
- Electricity costs three times the U.S. average.
- Population has declined 5.2% over the last 10 years to 3.6 million residents.

Lack of capital market access:

- In July 2015, the governor of Puerto Rico announced that the island’s debt was unpayable. At that time he formed a Working Group, whose task was to come up with a restructuring plan for the Commonwealth’s debt.
- Puerto Rico’s Working Group’s report shows the Commonwealth is facing a $27.8 billion financing gap from fiscal year 2016 to 2020 without implementing any corrective actions. In a best-case scenario, with significant corrective actions (revenue increases and expense cuts), the working group estimates the financing gap could only decline to $14 billion.
- The Commonwealth and GDB defaulted on the payment of the Public Finance Corporation appropriation debt in August.
- Based on the Commonwealth’s cash flow forecasts, the Commonwealth’s liquidity will fall to negative $204 million in December 2015 and by June 2016 cash will fall further to negative $511 million.

The bottom 6: Why do these states rank so low?

Illinois (#50)

Years of political gridlock have resulted in an inability to pass long-term tax extensions and properly address significant legacy liabilities.

- Illinois faces a projected $5 billion budget GAP for 2016 and as of early October 2015 an approved fiscal 2016 budget had not yet been approved budget.
- Given the political stalemate, the state's backlog of bills is projected to increase to over $8.5 billion or over 25% of the 2016 budget.
- Pension reform is a critical long-term issue. The Illinois Pension system is the weakest funded among the all 50 states and the IL Supreme Court ruled that the constitutional protection provided to pensions also applies to retiree health care subsidies.
- Costs of the constitutionally protected pensions are increasing about 6.5% a year.
- A history of structurally unbalanced budgets has led to the deterioration of the state's finances and credit quality.
- Based on the current 2016 budget gap, the state is $5 billion short of funding operations and meeting the statutory pension contribution requirement, which is still short of the actuarially required contribution.
- Combined with underfunding of pension and OPEB ARC in 2014, the total shortfall for the state is $7.8 billion.
- Sales tax and Income tax make up the majority of all state-collected revenues, at over 70% of the total.
- To close the gap, including full funding of pensions and OPEB, would require a 74% increase in the sales tax, a 37% increase in the effective income tax or a 25% increase in some combination of the two revenue sources.
- Currently, the sales tax rate in the state is 6.25%, and the income tax rate is a flat 3.75%.

The bottom 6: Why do these states rank so low?

New Jersey (#49)

Narrow reserves and growing fixed costs.

- Very low liquidity of just 25 days cash is well-below the 50-state average of 177 days, and provides very little operating flexibility.
- Pension-funded ratio of just 47% in FY 2014 for a $66 billion unfunded liability, which represents 128% of revenues. More importantly, the state has been both unable and unwilling to fund annual required pension contributions, meeting just 33% of the ARC in 2014, and averaging only 32.8% over the past five years. Attempts in the legislature to raise taxes to meet the obligation have been vetoed.
- Debt continues to grow, up to a per capita debt burden of $4,138 (47th highest).
- Fixed costs (annual debt service, pension and OPEB costs) to revenues of 25% is second only to Puerto Rico. Pension and OPEB fixed costs alone accounted for 77% of the increase in spending in the 2016 budget, crowding out other necessary spending.
- New Jersey's economy continues to lag the nation.
- Based on year-end estimates for 2015, the state expects revenues to fall $259 million short of expenditures.
- Combined with underfunding of pension and OPEB ARCs, the total shortfall for the state is just shy of $8.0 billion.
- Sales tax and Income tax make up the majority of all state-collected revenues, at over two-thirds of the total.
- To close the gap, including full funding of pension and OPEB, would require a 90% increase in the sales tax, a 65% increase in the effective income tax or a 38% increase in some combination of the two revenue sources.
- Currently, the sales tax rate in the state is 7.0%, and the top income tax rate is 8.97%.

The bottom 6: Why do these states rank so low?

Kentucky (#48)

Poorly funded pensions and pressured financial position.

- Pensions are only 38% funded, which is the 48th worst in the nation. The unfunded liability of $44.3 billion is a high 198.7% of revenues.
- The Commonwealth failed to pass any meaningful pension reform in the 2015 legislative session, which is especially needed for the Kentucky Teachers' Retirement System.
- Weak financial position. 2014 reserve levels fell to negative 1.4%. Low liquidity of 37 days cash on hand. The Commonwealth has been unable to replenish the rainy day fund since the recession.
- High debt burden including pensions and OPEB at 30.3% of GDP, amongst the highest in the country.
- Kentucky's GDP growth was been below average from 2011 to 2014.
- Based on year-end estimates for 2015, the state expects balanced operations. However, this does not include full funding of pension and OPEB ARCs.
- Adding in the underfunding of pension and OPEB ARCs, the total shortfall for the state is $529 million.
- Sales tax and income tax make up the majority of all state collected revenues, at over 80% of the total.
- To close the gap, including full funding of OPEB, would require a 17% increase in the sales tax, a 14% increase in the effective income tax or an 8% increase in some combination of the two revenue sources.
- Currently, the sales tax rate in the state is 6.0%, and the top income tax rate is 6.0%.

The bottom 6: Why do these states rank so low?

Pennsylvania (#47)

Late 2016 budget and pressured financial position.

- The Democratic governor and Republican legislature have failed to pass a budget for fiscal year 2016, which began on August 1. The two sides disagree on how to balance the budget. Governor Wolf wants to increase personal income taxes and create a new natural gas severance tax. Republicans are opposed to any tax increases and believe there are other ways to balance the budget. The Commonwealth faces a $2.3 billion budget gap for 2016.
- The Commonwealth does not have a temporary budget in place, meaning public schools and social service agencies are feeling the pain of no state funding.
- Pensions are only 48% funded, ranking the state 38th in the nation. The unfunded liability of $59.4 billion is 100.39% of revenues.
- Weak financial position. 2014 reserve levels fell to negative 1.14%. Low liquidity of 53 days cash on hand. The Commonwealth has been unable to replenish the rainy day fund since the recession.
- Elevated but manageable debt burden in comparison to the other states. Debt including pensions and OPEBs is 13.73% of GDP, ranked 34th in the country.
- Based on the current 2016 budget gap, the state is $2.3 billion short of funding operations and meeting the full pension contribution requirement.
- Combined with underfunding of OPEB ARC (pension ARC is fully funded in the current budget proposal) the total shortfall for the state is $2.7 billion.
- Sales tax and Income tax make up the majority of all state-collected revenues, at over two-thirds of the total.
- To close the gap, including full funding of OPEB, would require a 30% increase in the sales tax, a 24% increase in the effective income tax or a 13% increase in some combination of the two revenue sources.
- Currently, the sales tax rate in the state is 6.0%, and the income tax is a flat 3.07%.

The bottom 6: Why do these states rank so low?

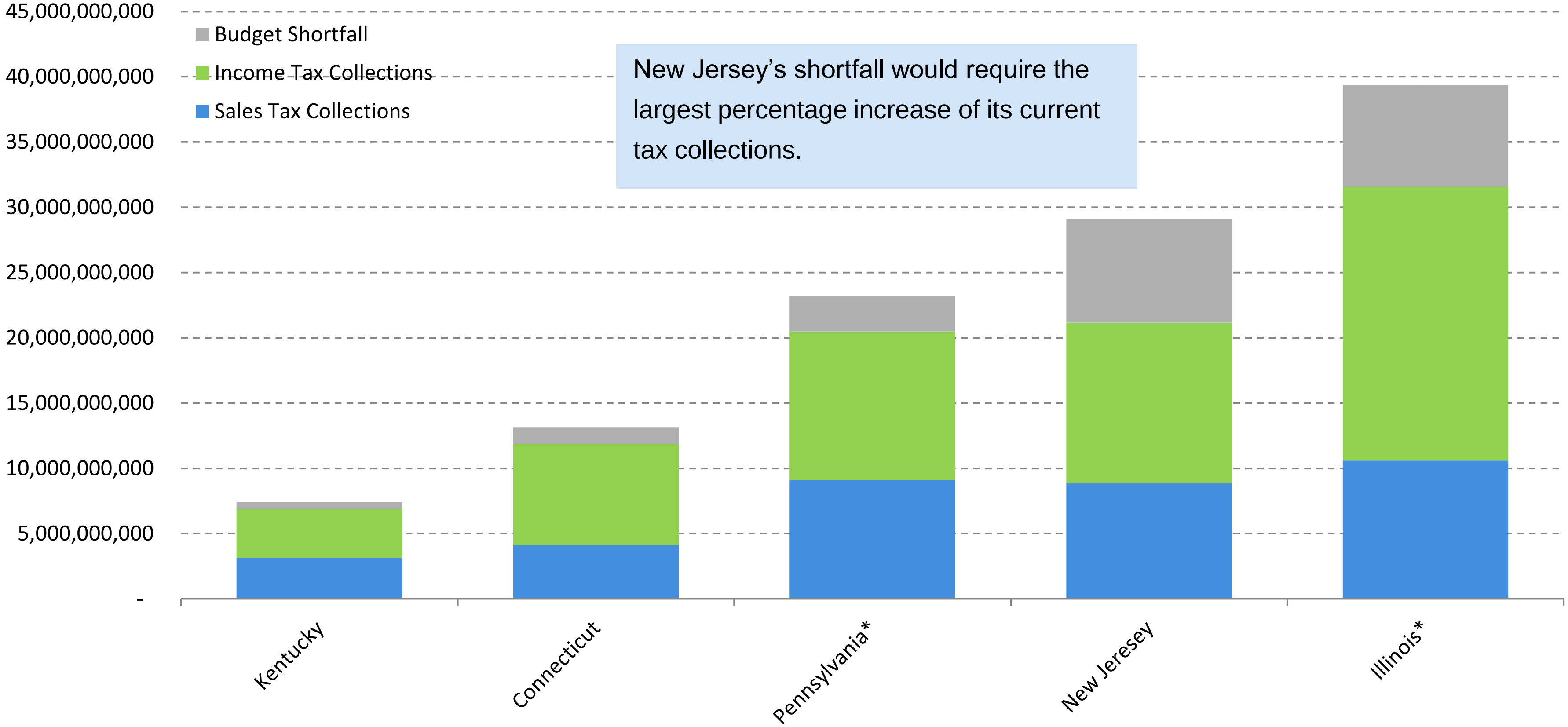
Connecticut (#46)

Sluggish economic growth since 2010, well behind the national median.

- Years of underfunding the pension funds along with poor investment performance on pension assets has resulted in one of the worst-funded pension plans among the 50 states (38% funded, $44.6 billion unfunded liability representing 179% of revenues).
- Some recent pension reforms, but without further reform, pension and OPEB payments will continue to require a greater percentage of the state's annual budget.
- Some of the debt burden is the result of funding public school capital costs at the state level vs local level, as many other states do. Factoring this in, the state has a very high financial burden ((debt + unfunded pension + OPEB)/GDP) ranked 49 out of 50 states.
- The lowest liquidity of all 50 states, with only 15 days cash on hand, severely limits flexibility.
- Based on year-end estimates for 2015, the state expects revenues to fall $70.9 million short of expenditures.
- Combined with underfunding of OPEB ARC (pension ARC is fully funded) the total shortfall for the state is $1.24 billion.
- Sales tax and income tax make up the majority of all state-collected revenues, at over 80% of the total.
- To close the gap, including full funding of OPEB, would require a 30% increase in the sales tax, a 16% increase in the effective income tax or a 10% increase in some combination of the two revenue sources.
- Currently, the sales tax rate in the state is 6.35%, and the top income tax rate is 6.7%.

What would it take to fix the gaps?

Some states require much larger increases in revenues than others, relative to current collections. Ability to raise taxes is an important consideration, as some of these states already have above-average tax burdens.



Notes: "Budget Shortfall" refers to the estimated deficit in 2015 for each state plus the difference between pension contributions and pension ARC and OPEB contributions and OPEB ARC in 2014. *For Illinois and Pennsylvania, since budgets have not yet been passed for 2016, we use the available 2016 budget gap rather than the estimated 2015 results.

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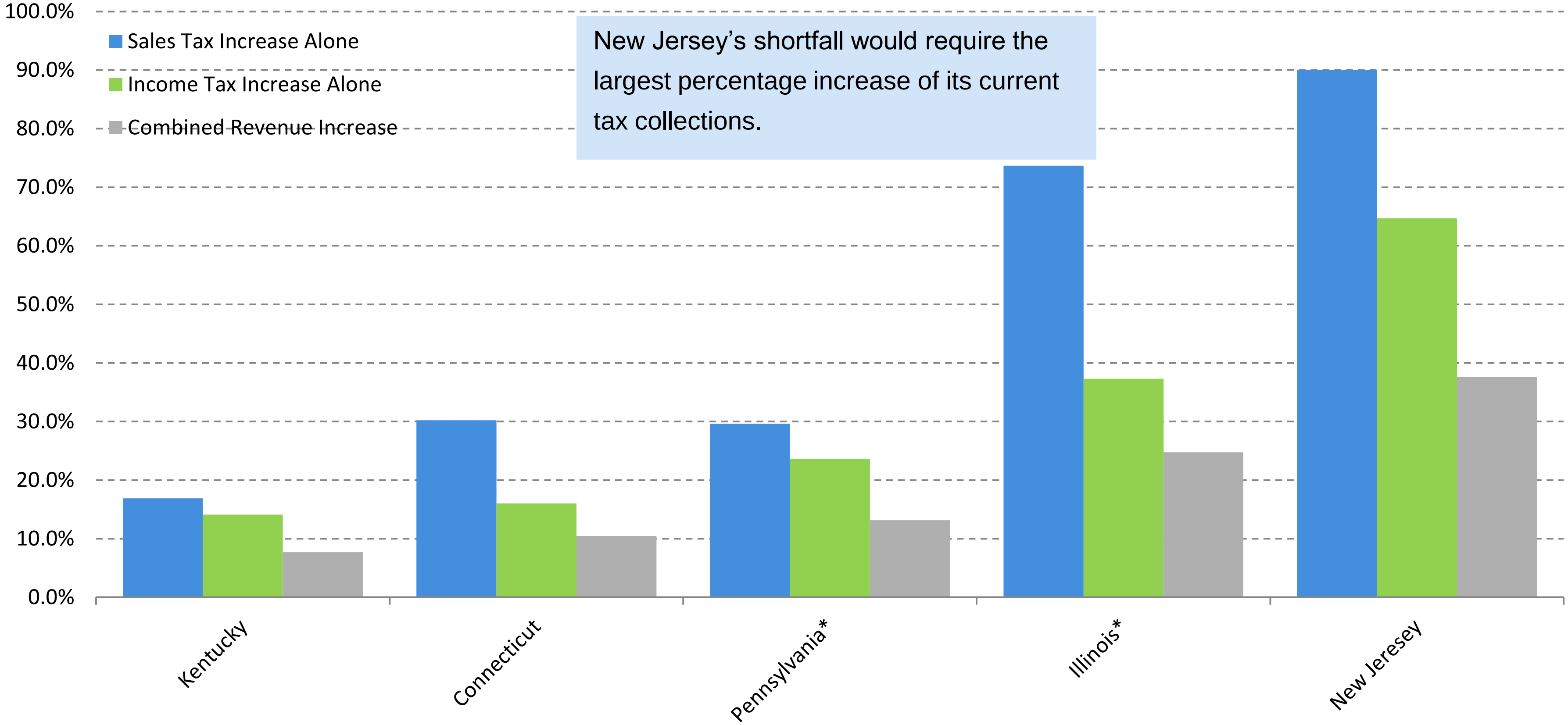

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