Are You Ready for the Next Economic Downturn?

Building Financial Sustainability and Resilience

Michigan Municipal Executives
2018 Winter Institute

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Why Worry?

- The statewide unemployment rate for Michigan as of December 2017 was only 4.7% (p), down from double digits for December 2008 through September 2011 and a peak of 14.9% in June 2009

- Michigan is now entering its ninth year of economic recovery, having created an average of 70,500 net job additions per year from the previous recession's low point in the summer quarter of 2009 to summer 2017. The annual growth rate over this period of 1.7% outpaced the nation's 1.5%

- In the most recent University of Michigan forecast, further gains are projected of 41,900 jobs during 2017, 40,900 in 2018, and 52,200 in 2019

Source: Bureau of Labor Statistics; University of Michigan Research Seminar in Quantitative Economics Michigan Forecast (11/17/2017)

Where We Are Now:

FIVE PREMISES

1. The Start of the Next Downturn is Now Closer Than the End of the Last One

- The current expansion phase of the business cycle began more than eight years ago, after the recession bottomed out in June 2009
- **104 months and counting** as of February 2018
- Last five expansion phases (trough to peak):

START/END	DURATION
November 2001 – December 2007	73 months
March 1991 – March 2001	120 months
November 1982 – July 1990	92 months
July 1980 – July 1981	12 months
March 1975 – January 1980	58 months

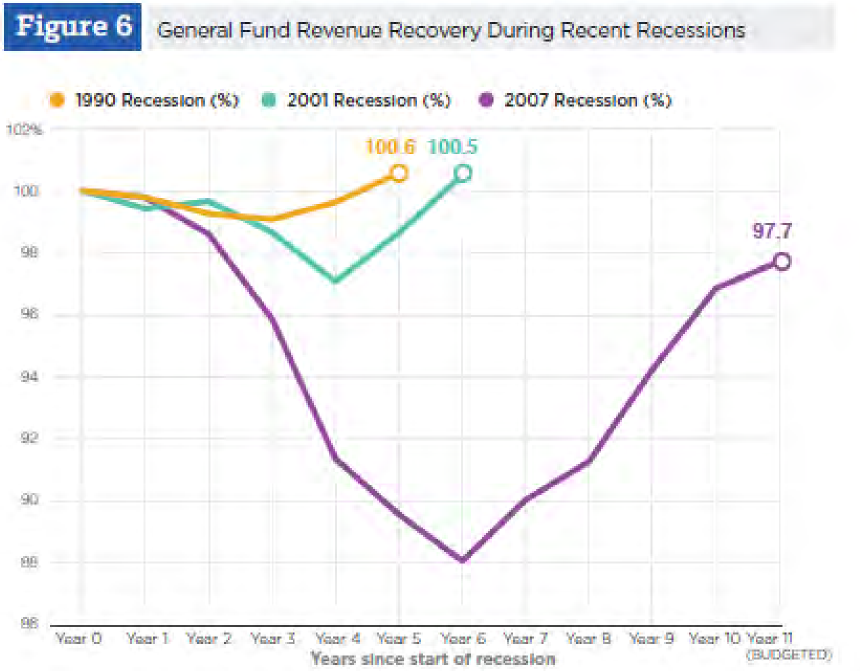
- Average 1945-2009 (11 cycles): **58.4 months**
- Range: 12 to 120 months

Source: National Bureau of Economic Research (NBER)

2. The Good Old Days Have Not Returned

- Recent analysis by the National League of Cities found that city General Fund revenues as of 2017 were still less than 98% of pre-recession (2006) levels in constant dollar terms

- Per U-M forecaster Michael McWilliams: *"It bears noting that the state had over 300,000 more employed in 2000 than it does today... The labor participation rate has drifted down further since the end of last year, meaning that a substantial part of the drop in the state's unemployment rate came from Michiganders exiting the labor force rather than finding jobs."*

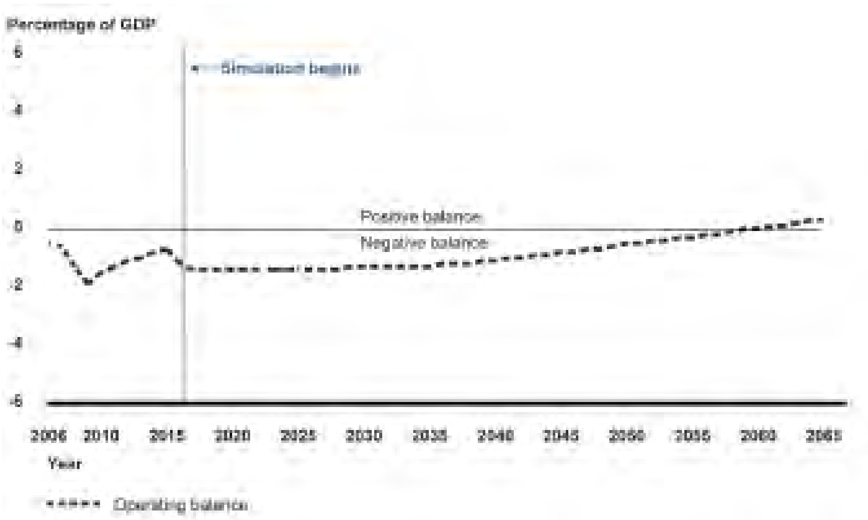


Source: "City Fiscal Conditions 2017," National League of Cities (September 2017), Detroit Free Press (November 17, 2017)

3. Structural Fiscal Challenges Will Persist

- Ongoing public sector fiscal challenges are not just cyclical, and few public employers will simply grow their way out of such pressures
- The U.S. Government Accountability Office (GAO) has developed a simulation model for the state and local sector as an entirety, projecting significant fiscal gaps absent corrective action, due largely to:
  - Flat revenues as % of GDP
  - Healthcare and retiree costs rising faster than the overall economy
- GAO calculated that closing the structural gap would require action equivalent to a [3.3% cut]() in state and local government recurring expenditures every year

State and Local Operating Balance Measure, as a Percentage of Gross Domestic Product (GDP)



Source: United States Government Accountability Office, “State and Local Governments’ Fiscal Outlook: December 2016 Update”

4. Scrutiny and Expectations Have Increased

- GASB has put pensions and OPEB on the balance sheets
- The rating agencies have all increased focus on retiree benefits, with the recent Moody's analytic methodology for assessing pension liabilities and a **doubling** of the weight their analysis assigns to debt and pensions (from 10% to 20%)
- Meanwhile, taxpayers remain constrained by sometimes tepid wage growth, and the disconnect between public and private sector compensation approaches adds to the pressures around governmental retiree benefits:
  - By 2014, only an estimated 2% U.S. private industry workers had a traditional DB pension only (with another 11% in both DB and DC plans)

Source: Moody's Investors Service. (2013, April 17). *Adjustments to U.S. State and Local Government Reported Pension Data; EBRI*

5. Pent-up Demands Have Surfaced

- **From the workforce**, to make up for containment and concessions during the downturn
- **From the public, operating departments, and elected officials** to restore and enhance services
- **To address deferred and growing infrastructure needs**
- **To meet changing IT demands** (mobility, access) and opportunities

Managing competing expectations and goals from operating departments, labor, Councils/Boards, and the public – while positioning for long-term fiscal stability – is a major challenge and concern for public sector managers in this period of recovery and growth

Summary: Where We Are

1. The start of the next downturn is now closer than the end of the last one
2. The good old days have <u>not</u> returned (“New Stable”)
3. Structural fiscal challenges will persist
4. Scrutiny and expectations have increased
5. Pent-up demands have surfaced

Five Things To Consider Doing Now

"Plan for what it is difficult while it is easy..."

Five Key Areas to Address

to Position for Enhanced Sustainability

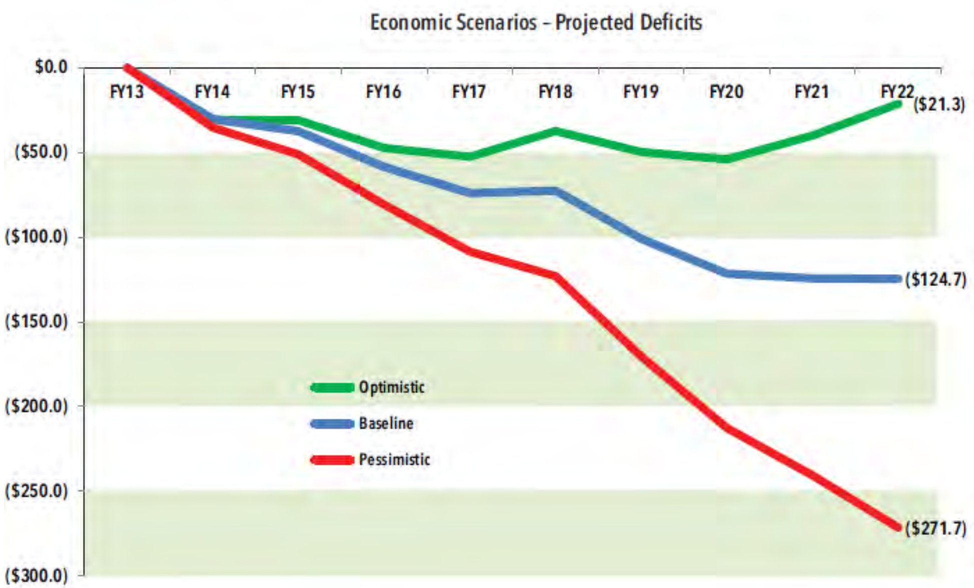
1. Establish a multi-year financial planning framework (or enhance what you have)
2. Strengthen reserves and overall financial policies/practices
3. Rebalance the total compensation portfolio
4. Strengthen pension/OPEB and other liability funding (and liability management)
5. Invest in infrastructure renewal and replacement

The Emanuel Doctrine Revisited

"You never want a ~~serious crisis~~ good recovery to go to waste"

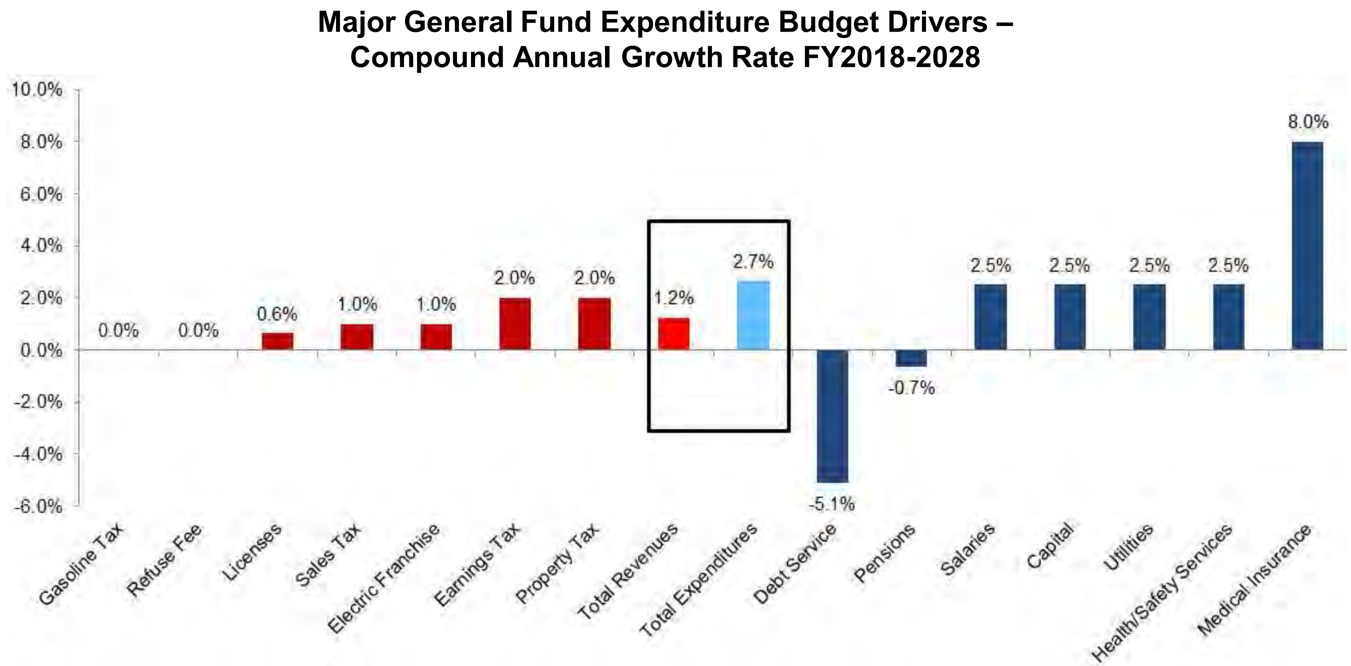
1. Long-Range Financial Plan

Defining the Challenges



- Develop a 5-10 year financial plan to create a framework for forward-looking policies
- Evaluate key budget drivers and policy parameters
- Identify the "as is" gaps (**clarity**)
- Address liabilities and long-term needs (e.g. infrastructure, tax policy)
- Determine the costs of key priorities and incorporate them into a financial planning model
- **Stress test** the plan under alternative economic scenarios, and to provide "pre-mortems"

1. Long-Range Financial Plan



- Develop strategies to address key budget drivers, bend the curves, close the gaps, and carve out new resources
- Establish parameters for addressing pent up demands
- Communicate the plan and gain buy-in from all levels of the organization (**accountability**)

2. Reserves and Overall Financial Policies

Reserve policies: What should reserves be to meet the financial needs of the future?

- **Target levels**
  - Risk analysis
    - Revenues
    - Expenditures
    - Emergencies
- **When to draw down?**
- **Replenishment?**

2. Reserves and Overall Financial Policies

Other Key Policies/Practices

- Use of non-recurring revenues
- Use of volatile revenues (e.g., MA and CA excess capital gains policies)
- Contingency budgeting (e.g., DE 98% rule)
- Revenue estimation
- Tax policy / Tax incentives review
- Fees and charges
- Debt policy
- Liability funding (more later)
- Capital vs. Operating (more later)

3. Rebalancing Total Compensation

- Competitiveness in attracting and retaining a qualified workforce
- Affordability and sustainability: cost and ***risk exposure***
- Goals and values as an employer

Competitiveness?

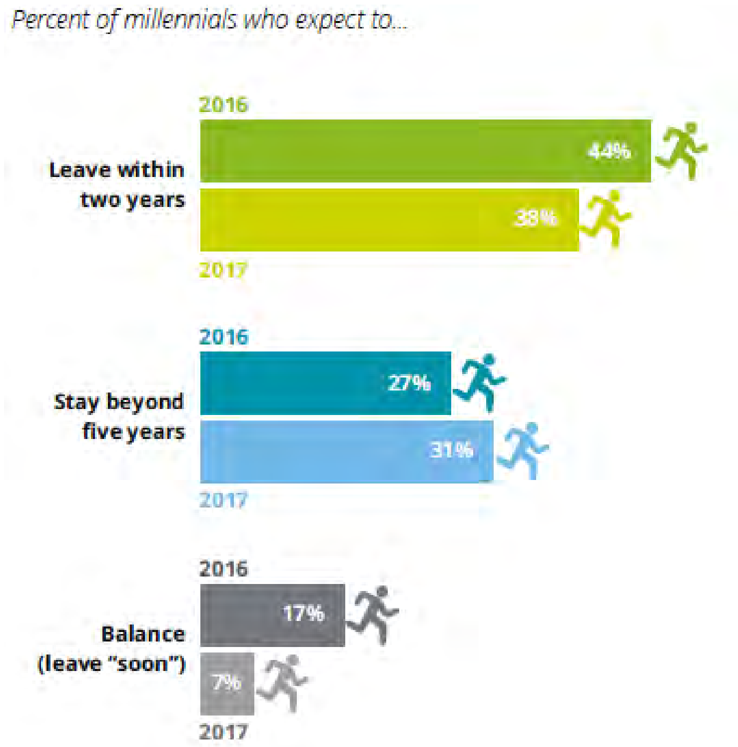
- All recruitment and retention is not alike
  - Generations generalized:

BOOMERS	GEN X	GEN Y - MILLENNIALS
1946-1964	1965-1976	1977-1990
Became institutions	Mistrust institutions	Irrelevance of institutions
TV	PC	Web/Phones
Have technology	Use technology	Assume technology
Task-focused	Multi-task	Multi-task fast
Ozzie and Harriet	Latch-key kids	Nurtured

Source: Futurist.com

Competitiveness for Millennials

- No gold watches: still expect to shift jobs often, and look forward to it (although maybe not as much?)
- Looking for flexibility and work-life balance
- Seeking ongoing challenges, excitement, impact
- Enjoy a sociable workplace
- **Environmentally** conscious
- Technologically savvy
- Anti-bureaucratic
- Want to make a difference



Source: The 2017 Deloitte Millennial Survey

"Defined-benefit programs are designed to reward only those with lengthy stays within a particular political geography. These programs discourage mobility within the workforce. My peers in the private sector have a lot more flexibility to move around."

– Fiscal Policy Analyst, Maricopa County, AZ (age 32); *Governing* magazine

For a somewhat different perspective, albeit still one that shows less than one-quarter of millennials with the same employer for more than five years, see: "Millennials aren't job-hopping any faster than Generation X did", Pew Research Center (April 19, 2017)

3. Rebalancing Total Compensation

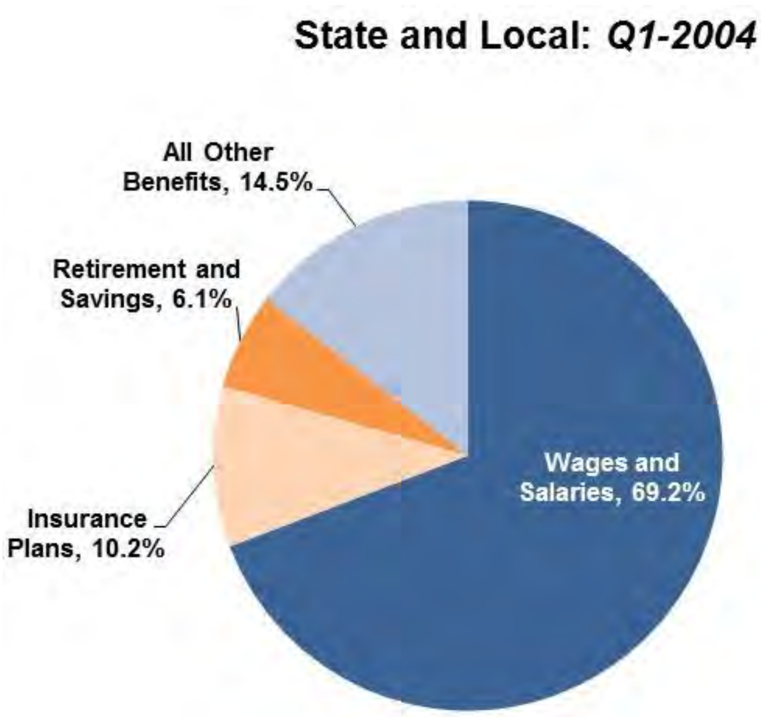
Compensation component	Civilian workers[1]	Private industry	State and local government
Wages and salaries	68.3%	69.6%	62.6%
Benefits	31.7	30.4	37.4
Paid leave	7.0	6.9	7.5
Supplemental pay	3.1	3.6	1.0
Insurance	8.7	8.0	11.9
Health	8.3	7.5	11.6
Retirement and savings	5.5	4.1	11.4
Defined benefit	3.5	1.9	10.6
Defined contribution	2.0	2.2	0.8
Legally required	7.4	7.8	5.6

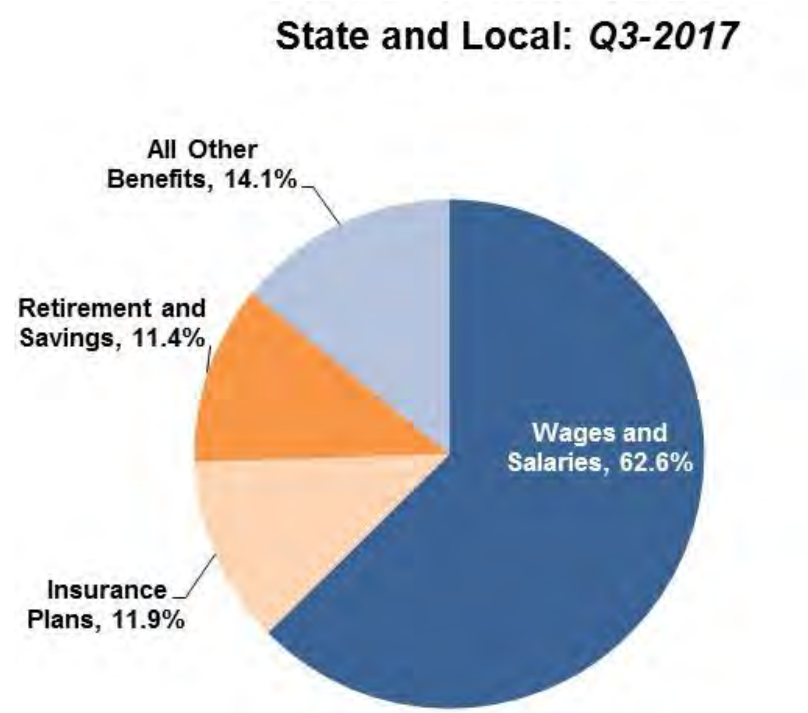
[1] Includes workers in the private nonfarm economy except those in private households, and workers in the public sector, except the federal government.

Source: Bureau of Labor Statistics, Employer Costs for Employee Compensation - September 2017 (12/15/2017)

Rebalancing the Portfolio

Employer Costs for Employee Compensation





Source: Bureau of Labor Statistics, Employer Costs for Employee Compensation

4. Funding Liabilities

- **Pensions**
  - Funding now distinct from accounting, requiring a sound funding policy
  - Funding should be actuarially sound and maintain intergenerational equity
  - Discipline, stability
- **OPEB**
  - Liability management
  - Projected future cost curves
  - Trust establishment/funding
- **Other Liabilities**
  - Risk Management Fund
  - Other fund deficits?

General Considerations

- How quickly to target full funding?
- Are there options to change benefits to reduce costs, and how likely is it to get these adopted?

4. Funding Liabilities: What's a Healthy Level?

- Is 80% the magic number?
- Likely derived from the standard for determining a private sector plan to be "at risk" under the Pension Protection Act
- For governments, funding ratios should be evaluated in the context of:
  - The business cycle
  - Financial condition and capacity
  - Investment approach

"The funded ratio is most meaningful when viewed together with other relevant information. Other factors that might be considered in assessing the fiscal soundness of a pension plan include:

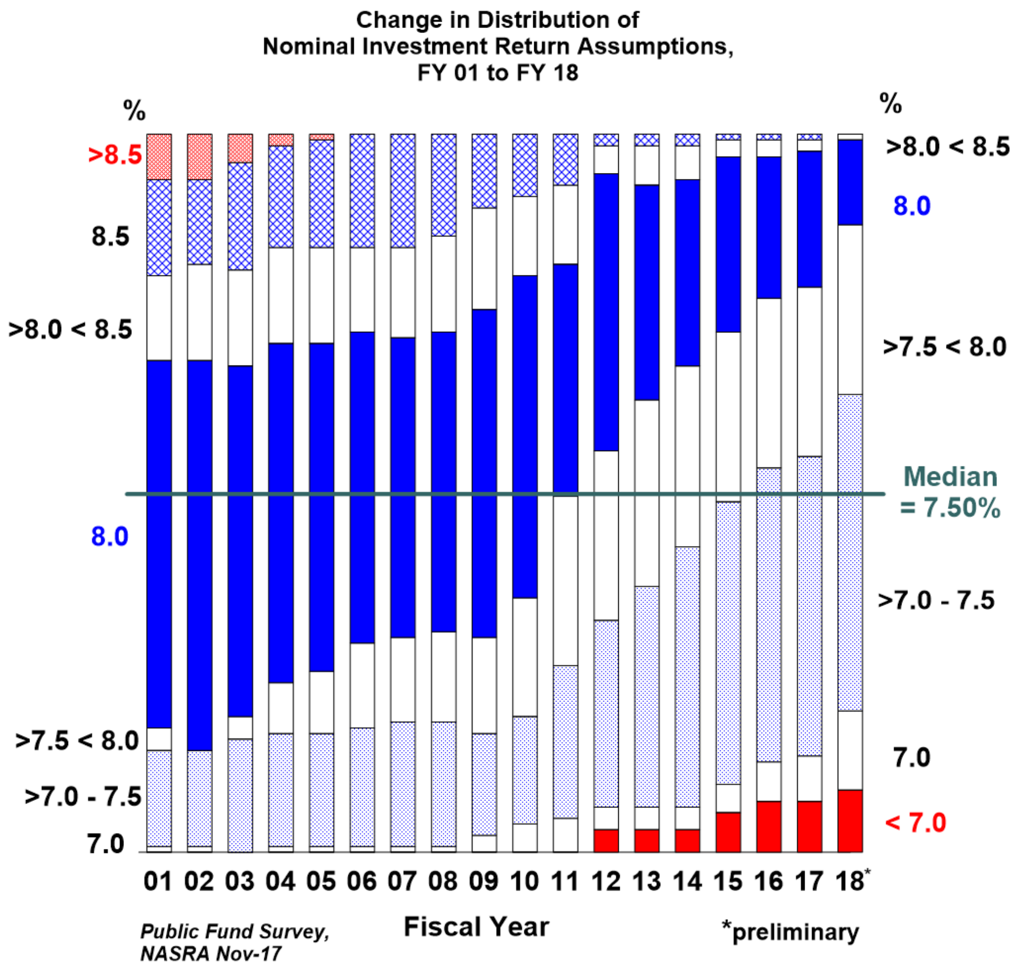
- Size of the pension obligation relative to the financial size (as measured by revenue, assets, or payroll) of the plan sponsor.
- Financial health (as measured by level of debt, cash flow, profit or budget surplus) of the plan sponsor.
- Funding or contribution policy and whether contributions actually are made according to the plan's policy.
- Investment strategy, including the level of investment volatility risk and the possible effect on contribution levels.

Each of these factors should be examined over several years and in light of the economic environment."

Source: "The 80% Pension Standards Myth," American Academy of Actuaries, Issue Brief, July 2012

4. Funding Liabilities

Review of (De-Risking) Actuarial Assumptions



Key Actuarial Assumptions:

- Investment return
- Actuarial method
- Amortization method
- Amortization periods
- Smoothing
- Mortality and other plan experience
- COLAs
- Payroll growth

5. Infrastructure Investment

- **Facilities/Infrastructure Renewal and Replacement**
  - Condition assessment
  - Maintenance standards
  - Cost estimates
  - Financing plans
    - Pay-go? Dedicated funds

- **Capital v. Operating Budget**
  - Time for a clean-up?

5. Infrastructure Investment

- **Technology/Productivity Investment**
  - Not just IT, also:
    - energy efficiency
    - improved fleet/equipment
  - ROI and benefits realization
  - Capitalizing a Productivity (Revolving) Fund

Stakeholder Buy-in

- **Consider a pre-mortem**
  - What bad things will happen if you are not successful in implementing a financial plan and policies? Again, stress test.
  - Be able to tie the success of your plan to the success of the various stakeholders
- **Communicate, communicate, communicate**
  - Work to gain buy-in before you settle on a final set of initiatives to push
  - Include a variety of stakeholders in the discussion (Council/Board, chief executive, department heads, labor groups)
  - Be flexible and open to all options
- **Be transparent, accurate, and open to feedback**

Sustainability, Flexibility, Resiliency

Actions to Consider During Recovery (not one-size-fits all)

- Long-range planning framework
- Rebuild reserves / Strengthen reserve policies
- Review/codify financial policies/practices:
  - Use of non-recurring revenues
  - Use of volatile revenues
  - Contingency budgeting
  - Revenue estimation
  - Tax policy / incentives review
  - Fees and charges
  - Debt policy
- Rebalance the compensation portfolio
- Pension funding policy / actuarial assumptions
- OPEB funding
- Address any other liabilities
- Infrastructure investment
  - Condition assessment
  - Pay go
  - Capital v. operating budget "clean up"
- Technology / productivity investment

Thank You

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