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State and City Budget Blues: Pressures Keep Piling Up.

NEW YORK — It's not just Detroit and Puerto Rico with financial problems.

The pressure is rising on local governments around the country that are struggling with big pension obligations and other debts. Five states need to put aside more than 25 percent of their annual tax revenues just to pay pensions and other debts, an untenable amount, according to a recent study by the nonprofit Center for Retirement Research. For major cities, debt costs above 40 percent of revenue are typically an unmanageable burden, and the report counts eight of them.

Overall, U.S. state pension plans are underfunded by at least $1 trillion, various experts and credit rating agencies say. And that funding hole will almost certainly hurt taxpayers, government workers and bondholders.

"It's getting harder to sweep these problems under the rug," says Tracy Gordon, a senior fellow with the Urban-Brookings Tax Policy Center.

After taking into account health care and other debt obligations, states like Hawaii, Kentucky and Massachusetts and cities like Houston and San Jose, California, are all above thresholds that the Center for Retirement Research considers worrisome.

For many years, politicians hoped to make up for the funding gaps by getting strong returns from investments in stocks, bonds and hedge funds, says Gordon. But the typical public pension plan had a return of just 0.5 percent for the fiscal year that ended in June, according to credit-rating agency Moody's.

That has increased the risk for a major crisis at municipalities with outsize debt payment, says Lisa Washburn, a managing director for Municipal Market Analytics, a municipal bond research firm. "This is a liability that they are going to have to come to terms with eventually, and the longer they delay coming to terms with it, the worse it's going to be."

How you might be affected depends on your relationship to the location in question:

— You're a bond holder.

For muni bond investors, the chief worry is a default. But despite the dramatic headlines, investors who hold state-issued bonds until they mature have little to fear. "You can expect to be repaid," says Washburn. If your state's debt rating is downgraded, however, you may find that your bond is worth less if you need to sell it before maturity.

Those who hold the bonds of struggling cities overburdened with debt, however, have cause for concern. "States have sovereign ability to do just about anything they want, so they have a very wide array of options to pursue," says Alan Schankel, a municipal bond strategist at Janney Capital Markets. "Depending on the level of oversight, cities and counties have much less flexibility. And many of them are dependent on state aid."

When a city files for bankruptcy, judges sometimes allow payments to be curtailed to muni bondholders. That's what happened in Detroit and Stockton, California. Moreover, severe budget problems at the state government level can also have a trickle-down effect leading to less support for schools and hospitals supported by the state, which also issue municipal bonds.

— You're an employee.

The good news for public service workers is that, in some states, pension payments are guaranteed by law. And even in places where they may not be, legislators tend to be sympathetic to pension holders.

Now for the bad news: If things get really bad, you still might find your benefits thwacked. Detroit workers, for example, had their pensions cut when the city filed for bankruptcy. A more likely situation is that you'll be the victim of pension "reform," which could involve an increase to your annual contribution rate or fewer cost-of-living salary bumps. You may also see cutbacks in other benefits, such as health care, which are easier for states and cities to enact. Rhode Island suspended cost-of-living adjustments for retirees in 2011 and introduced a 401(k)-like funding system for current state workers, for example.

— You're a taxpayer.

A simple way for states to boost their sagging budgets is to increase taxes. A sales tax increase along with an income tax increase on wealthy residents helped California pull out of its massive budget hole from the Great Recession, for example. Simple, though, doesn't mean easy. Politicians are often reluctant to increases taxes on their watch. "Politically, that's just very hard to do," says Washburn.

Other places have tried different tactics to boost revenues. A few years ago, Kansas tried cutting taxes in hopes that it would boost its economy and lead to eventual gains in income tax revenue, for example. Unfortunately, the state still recently had a projected $290 billion shortfall.

Instead of raising taxes, states sometimes cut back services in order to save money. "Maybe the Department of Motor Vehicles is open five days a week instead of six," says Schankel. The challenge is that if too many services are cut, residents will become disenchanted with the community and move elsewhere. That only exacerbates the revenue problem.

It all shows how no single approach will lift local governments out of their troubles. One thing, however, is clear, says Gordon: "Someone has to be left holding the bag."

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