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OUTLOOK

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State government – US

State outlook revised to negative as coronavirus impact deepens

The outlook for US state governments has changed to negative from stable as the coronavirus shutdowns precipitates a severe economic downturn and subsequent recovery that will challenge state credit strength. The likely prolonged recovery will lead states to employ a variety of measures to manage their finances which may lead to weaker reserves and increased leverage, which will be affected by state-to-state variation in the speed and pace of recovery. These measures will take place in an environment of rising fixed costs and potential popular and legislative resistance to some budget-balancing actions. Emergency federal actions so far do not provide funding to help states fill gaps in revenue collections, but additional financial assistance for that purpose would help support state credit quality. States themselves have strong powers to make budgetary adjustments through cuts, revenue increases and shifting costs to lower levels of government, but the historic crisis will substantially test the options.

» **The coronavirus-driven economic downturn will extend beyond widespread business reopenings across the country**. The crisis has created tremendous uncertainty for businesses and households, reducing incomes, consumer confidence and spending and thereby creating a negative operating environment for state governments. Even with a rebound in 2021, we project that US real GDP will trail the 2019 level. As a result, state revenue will not start growing again until state fiscal year 2022 and not return to fiscal 2019 levels for several years. Most states' fiscal years end June 30.

» **Some state actions to counter the downturn will increase the sector's leverage and diminish its record reserves.** Balancing state budgets, a requirement for most states, will pose a challenge, especially given the speed and severity with which the crisis has taken hold. States have many levers to pull to respond to economic shocks, though some will result in weakened credit profiles after the crisis passes. Most states built reserves to record levels in the years following the last recession and many will likely use that cushion in conjunction with other spending reductions to help cope with the pandemic. Actions such as deficit borrowing, payment delays, postponing spending and use of non-recurring resources outside of rainy day funds are also likely. These actions will likely become more prevalent if a longer downturn makes revenue recovery more difficult for states to balance budgets with recurring actions. Resistance to balancing measures, such as those that would increase taxes or deepen social risks, raise the prospect of weakened balance sheets and prolonged structural imbalances.

» **High fixed costs will reduce flexibility for some states**. During the recent economic expansion, state revenue growth outstripped growth in fixed costs (pensions, retiree health benefits and debt service). In fiscal 2018, fixed costs averaged 11% of state own-source revenue after growing 16% since fiscal 2014, with even more rapid growth on a "tread water" basis.[1] Poor performance of equity markets relative to actuarial assumptions in 2020 will further hike pension liabilities. With state revenue receding, fixed costs will soak up a greater portion of available revenues and force budget adjustments in other areas. Some states with especially high fixed costs, such as Connecticut (A1 stable), Illinois (Baa3 negative) and New Jersey (A3 negative), will face an additional impediment to maintaining credit quality in the absence of other avenues for balancing budgets.

» **Emergency federal aid is not yet earmarked to replace lost revenue**. To date, nearly all emergency federal aid for states is aimed at reimbursing governments for coronavirus-related expenses, including about $10 billion per quarter in enhanced federal matching payments for Medicaid. Additional aid designed to replace revenue lost because of the crisis is under discussion in Congress, but is uncertain. In 2009 as the economy slid into recession, the American Recovery and Reinvestment Act explicitly directed $256 billion, or about 2% of GDP, to support state spending on services and infrastructure (see Exhibit). Federal aid is estimated by the Center for Budget and Policy Priorities to have filled about 30% to 40% of state budget gaps from fiscal 2009 to 2011.

Exhibit 1

Federal assistance to states in 2009 American Recovery and Reinvestment Act surpassed $250 billion

Program	Amount (billions)
Medicaid	$93
State Fiscal Stabilization Fund	$54
Build America Bond subsidy	$30
Highways and bridges	$28
Elementary and secondary education	$25
Transit	$8
Rail	$8
TANF	$5
Weatherization assistance grants	$5
Total	**$256**

TANF stands for Temporary Assistance for Needy Families
Source: US Government Accountability Office

» **The innate strengths of state credit will buttress the sector's ability to manage through the cycle**. States are well-positioned to withstand the challenges posed by increasing economic costs from the coronavirus. Typically, the state sector is characterized by well-diversified economies, strong liquidity, robust market access and low debt with few bullet maturities or other market risks. In addition, states have strong powers to adjust spending and raise revenue and are able to take actions such as deferring capital spending and reducing aid to lower levels of government.

» **What could change the outlook**. The outlook could shift to stable if efforts to contain and treat the virus and develop a vaccinate proceed more rapidly and improve the speed and strength of an economic recovery. Substantial federal aid directed to offset state revenue declines could also lead to a return to a stable outlook.

This outlook represents our forward-looking view on credit conditions in the sector over the next 12 to 18 months. This sectorwide outlook, however, does not imply the likelihood or direction of rating actions for individual issuers.

Moody's related publications

Outlook

» 2020 outlook stable with continued revenue growth and record reserve levels, December 3, 2019

Sector In-Depth

» Revenue recovery from coronavirus hit will lag GDP revival, prolonging budget woes, April 24, 2020

Endnotes

1 "Tread water" refers to pension contributions that cover interest on the year's initial unfunded liability plus the additional liability accrued during the year (service cost). Many states do not make annual contributions sufficient to meet this standard.

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