States Sector Well-Positioned to Meet Challenges

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Each January we take the opportunity to assess the fiscal health of the states. Since 45 states operate on a July 1st to June 30th timeline, the start of a calendar year allows us to look back at the recently completed fiscal cycle, evaluate current progress, and consider challenges for the upcoming year. Given the outbreak of the pandemic last March, this year's exercise is particularly difficult, since budget plans and forecasts were scrapped, tax collections were delayed, and emergency spending needs emerged. Despite the many unknowns and continually-shifting landscape, we remain constructive on state credit.

Nearly all states are required to prepare and maintain a balanced budget that centers on the primary operating fund, the General Fund. The two primary sources of discretionary revenue are personal income and sales taxes, which together, on average, represent 75% of General Fund receipts. As the crisis began to unfold last March, officials took prudent actions and lowered revenue outlooks for 2020 and 2021. Yet, revenue declines do not appear as severe as originally feared, for a number of reasons. First and foremost, the federal government released an unprecedented level of stimulus into the U.S. economy, including direct aid to the states. Generous unemployment benefits supported consumer spending and by extension, sales tax receipts. In addition, job losses centered on lower-wage paying industries, while higher-wage earners, responsible for the bulk of personal income tax collections, largely remained employed. Lastly, equity market returns rebounded strongly in 2020, in turn, boosting capital gains and personal income taxes, particularly in wealthier states. In its Fall 2020 Survey, the National Association of Budget Officers (NASBO) indicated of the 40 polled, 24 states reported fiscal 2021 revenue collections (to date) that either exceeded or matched initial projections, a promising sign that budget officers set reasonable expectations.

In keeping with efforts to maintain balanced budgets, administrators took swift action to trim spending in response to lower revenues. Although the pandemic did not begin to unfold (for most) until the final quarter of fiscal 2020, NASBO reports 19 states executed some measure of spending cuts before year end. Enacted budgets for fiscal 2021 totaled $893 billion, a 5.5% reduction from preliminary proposals, and the first pull back in state spending in over a decade. Whereas K-12 education and Medicaid programs account for more than half of discretionary state spending, education programs including public colleges and universities suffered the brunt of the budget axe, as Medicaid and social service demands are projected to increase in a weaker economy. Federal assistance under the Coronavirus Aid, Relief, and Economic Security (CARES) Act included direct aid to states along with an increased federal share of Medicaid costs, thereby alleviating some of the expenditure pressures linked to the pandemic. It is important to remember that debt service claims only a small portion of state expenditures, representing on average less than 4% of operating budgets. Unlike the U.S. Treasury and corporate borrowers, new money debt issuance by the states has been somewhat muted in recent years, given a more cautious stance following the Great Recession and the recognition of other sizeable long-term liabilities, specifically retiree benefits.

Early fiscal responses to the pandemic have centered on curtailment of expenses, application of stimulus funds, short-term borrowing to offset delayed tax filings, and use of reserves. Fortunately, following a decade of economic expansion, the sector entered the crisis with healthy reserves of more than $130 billion, representing 13% of General Fund budgets. NASBO reports 30 states expect to draw on accumulated balances in 2020 and, or 2021. Few states have turned to revenue measures to close budget gaps, but the longer the downturn persists, the greater likelihood of tax hikes in some jurisdictions. Although the latest federal stimulus package does not include direct aid to the sector, many of its provisions will benefit state coffers including direct payments to individuals, extension of unemployment benefits, grants for schools, higher education, and mass transit, along with funding for healthcare providers. President-elect Biden has indicated interest in introducing additional stimulus proposals upon taking office.

Despite the many uncertainties of the current health crisis, we remain confident in the ability of states to manage the challenges ahead. The restoration of fiscal stability will be uneven across the sector, yet all states possess a number of tools to maintain structural balance and remain current on debt obligations. We are encouraged by the proactive steps taken to date and expect prudent efforts to continue going forward.