Core Strengths Resilient Despite Slower Economic Growth

Fitch’s Sector Outlook: Stable

Fitch Ratings maintains its stable outlook for U.S. states and local governments in 2020, reflecting core credit strengths in both sectors. Overall, Fitch believes that states and local governments will be able to adjust to anticipated challenges including ongoing revenue volatility, continued demands for infrastructure investment, and projected slower economic growth.

Rating Outlook: Stable

Fitch expects most U.S. states and local governments to maintain Stable Rating Outlooks through 2020 despite our forecast for slower economic growth at both the national and global levels. All states have Stable Rating Outlooks. Approximately 96% of local government Rating Outlooks are Stable.

Rating Distribution Weighting:

Ratings in the tax-supported sectors continue to be high, reflecting the sectors’ core strengths. Only three U.S. states are rated below the ‘AA’ category — Connecticut, Illinois, and New Jersey — and 80% of local governments are rated in the top two rating categories.

What to Watch

- State revenues will remain somewhat volatile given lingering effects of recent federal tax policy changes. Fitch’s expectations for slower national economic growth also complicate the revenue forecasting process. Local governments that rely on property tax revenues are less exposed to this volatility concern.
- Housing supply and affordability is a growing issue facing all levels of government, particularly in and around major cities.
- K-12 spending will continue to be a primary pressure point for states and school districts.
- Infrastructure funding remains key, particularly given the pending expiration of the federal surface transportation authorization act and growing demand in areas like climate resiliency.
- The upcoming federal election cycle will drive vigorous debate on potentially significant policy shifts, but Fitch anticipates very limited action given the current split government.
- Core state and local credit strengths, including budgetary control and moderate long-term liabilities, will remain intact. Reserve balances for local governments continue to grow.
- Fitch expects stability for most states in 2020, but a handful are more likely to have credit-relevant developments, specifically: AK, IL, and KY.
What to Watch — State Revenue Volatility and Slowing Economic Growth
Fitch and other market observers have noted considerable volatility in state revenues over the past several years, particularly since implementation of the December 2017 federal tax legislation (commonly referred to as the Tax Cuts and Jobs Act, or TCJA). We anticipate that unpredictability will continue into 2020, though at a smaller scale, as states and taxpayers have now had two years to adjust to the new federal tax framework and its pass-through effects for states. The June 2018 U.S. Supreme Court’s Wayfair decision has also affected both state and local governments’ sales tax collections, though the magnitude is difficult to fully assess. Fitch’s expectation of slowing national economic growth further complicates the revenue outlook. The agency’s December 2019 Global Economic Outlook forecasts U.S. GDP growth at 1.7% in 2020, which would be the lowest level since 2011.

Local governments that depend on state funding — primarily school districts and counties — would be most at risk if state revenues proved especially volatile in the upcoming year. Property taxes are fairly well insulated from the immediate effect of changes in economic growth, given the lag between changes in home prices and property tax levies.

What to Watch - Housing Supply and Affordability
Fitch’s U.S. RMBS Sustainable Home Price Report (Third-Quarter 2019) indicates that home prices in most regions appear to be valued in line with long-term sustainable levels, with overvaluation largely concentrated in Texas, Florida and California. According to the U.S. Department of Housing and Urban Development, half of all people experiencing homelessness in 2018 were in those three states plus Washington. State and local governments are increasingly expressing concerns about the lack of affordable housing and a need to address homelessness. These concerns are especially notable in and around the nation’s large cities, where physical and policy constraints on new construction make addressing the supply gap difficult. All levels of government are increasingly stepping up to provide affordable options for residents.

What to Watch - Pressure on School Funding
Teacher labor actions, including strikes, continue to be a significant stressor for school districts, maintaining pressure on both states and local district officials to increase or reallocate funding. The focus has primarily been on traditional issues — increased wages and benefits for teachers. However, this year’s strikes in Los Angeles and Chicago indicate that labor demands are broadening to include issues not directly tied to teacher headcount and compensation, such as increased health and social work services. The 2018 U.S. Supreme Court decision in the Janus case, which was widely expected to limit the power of public sector collective bargaining, does not seem to be affecting the strength of teachers’ unions thus far.

U.S. Economic Forecast

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F – Forecast.
Source: Fitch Ratings.
What to Watch — Addressing Infrastructure Demands Remains a Challenge

The inadequacy of current infrastructure funding continues to be a concern despite continuing efforts from states and local governments to address the challenges. Transportation is a key focus. Fitch estimates 34 states have taken actions to raise new revenues, or re-allocate existing ones, for transportation since 2013. The vast majority have increased gas taxes, which are states’ primary means of funding transportation needs. Federal funding is also a critical source of transportation funding for states and local governments, and the September 30, 2020 expiration of the current five-year federal surface transportation act (Fixing America's Surface Transportation, or FAST) creates some uncertainty.

States to Watch in 2020

Fitch identifies 3 states where developments in 2020 could have implications for credit quality. Alaska and Illinois both face potential constitutional amendments that could alter Fitch’s assessments of credit quality. Kentucky will have a gubernatorial transition as it deals with ongoing budgetary challenges.

Alaska will face key questions on gubernatorial proposals, which may weaken operating flexibility. Fitch expects the governor will continue to seek a full dividend payment for residents and legislative approval for a set of constitutional amendments, constraining operating flexibility. The legislature will continue to discuss constitutional amendments the governor proposed earlier this year, which, if enacted, could weaken the state’s budgetary operating flexibility and negatively affect Alaska’s Issuer Default Rating (IDR).

Illinois voters will decide in November on a constitutional amendment to allow a graduated individual income tax. The credit implications depend on whether Illinois uses any increased revenues to address structural budget challenges, or if the state can adequately adjust its budget to work toward structural balance if the amendment fails.

Kentucky’s new Democratic governor will need to work with the Republican-controlled legislature to address persistent budgetary challenges with enactment of a new biennial budget due in the first half of 2020. Kentucky has made fiscal progress in recent years, and Fitch’s view on the IDR will be shaped by the commonwealth’s ability to maintain structural spending commitments, most notably for pensions, while continuing to reduce reliance on non-recurring budget measures. This could prove challenging if the political environment deteriorates.
What to Watch — Major Federal Policy Shifts Unlikely Until 2021 (Maybe)

Given divided control in Congress, Fitch does not anticipate significant changes in federal policy that would materially affect state and local governments’ credit quality in 2020. The administration has and will continue to drive certain policy decisions unilaterally such as trade policy, but the implications for state and local government credit quality should remain modest. Medicaid, given its large and growing role in state budgets, is one area where executive and even state actions bear watching. Idaho, Nebraska, and Utah voters all approved ballot measures to expand Medicaid in 2018 but have yet to implement them. Oklahoma voters may decide on a similar ballot initiative in November 2020. Also, the federal administration will release guidance soon on how states could implement Medicaid block grants or per capita caps. Tennessee recently submitted a proposal to convert most of its Medicaid funding to what it calls a modified block grant approach, which, if approved, would make it the first state to use such a system.

As the presidential and congressional campaigns approach in November, Fitch anticipates vigorous debate and ramped up rhetoric around major changes in areas such as tax and health care policy. Actual changes are unlikely in 2020 and their likelihood in 2021 will be driven by the post-election political climate, including whether Congress and the presidency are aligned.

What to Watch — Stable Growth in Local Government General Fund Reserves

Local governments’ available general fund balances relative to spending continue to grow. The Fitch Analytical Stress Test (FAST) model confirms the stabilizing effect of property-tax-heavy revenues on volatility, as results indicate that a 1% decline in GDP would have a generally limited effect on revenues. These solid reserves provide a strong buffer against the potential effect of recession; Fitch assesses more than 70% of local governments as having financial resilience at the ‘aaa’ level. Fitch expects slow but continued economic growth along with manageable expenditure pressures to result in stability in 2020.
Outlooks and Related Research

2020 Outlooks
Global Economic Outlook (December 2019)
U.S. Housing Affordability - Defining the Gaps (September 2019)
2019 State Pension Update - Liabilities Drop in Latest Survey (December 2019)

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