

U.S. States 2024 Outlook: Credit Stability Endures In Unstable Times

January 4, 2024

Sector View: Stable

Robust reserve positions and strong management controls will allow states to brace for slower economic growth and softening revenues in fiscal 2024. States' credit fundamentals appear resilient, but fiscal 2025 budget discussions will likely center on managing increasing costs, waning federal support, and changes in tax policy potentially further straining revenues.

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What We're Watching -- U.S. States



Elections

The Presidential election, Congressional elections, and 11 gubernatorial elections could swing governmental budget and policy priorities.



Tax structures

Strong revenues and federal stimulus led many states to cut taxes to further spur growth. Will forecasts hold should the economy slow?



Labor shortages

With low unemployment forecast, state employers will be pressured to keep wages and benefits competitive.



Inflation

While receding, currently high cost of living could continue to affect consumer sentiment and thus consumption taxes.



Event risks

Geopolitical uncertainties, cyber attacks, and extreme weather events will continue to pressure management. Cost and availability of insurance are emerging pressures.



Demographics

The aging U.S. population and ongoing migrant crisis will add to service delivery and benefit costs for governments.

Source: S&P Global Ratings.
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U.S. states: By the numbers

\$430 bil.

Excess household savings remaining from stimulus



9.7%

50-state OPEB funded ratio

Up vs 2022

73.6%

50-state pension funded ratio

Down vs 2022

0

States with negative outlooks

6

States with positive outlooks

13.5%

Aggregate 50-state rainy day funds to general fund spending,

+4.9% 10 years ago



11.8 mil.

Medicaid enrollees disenrolled through Dec. 1, 2023

-12.5% drop from the April 2023 peak



Approx.

\$1,010

Net state tax-supported debt per capita



1.3 : 1

Jobs open per job seeker*



*As of November 2023. OPEB--Other postemployment benefits. Sources: S&P Global Ratings, S&P Global Ratings Economics, Bureau of Labor Statistics, National Assn. of State Budget Officers, Kaiser Family Foundation. Copyright © 2024 by Standard & Poor's Financial Services LLC. All rights reserved.

What's Behind Our Sector View?

Although the economy is forecast to underperform its 2.0% potential growth rate in 2024 and again in 2025, according to S&P Global Ratings' economists (table 1), U.S. states overall have many strengths, which lends to credit stability in the short term, including high reserves, a history of balanced budgets, and lessening fixed-cost obligations (see "Economic Research: Economic Outlook U.S. Q1 2024: Cooling Off But Not Breaking," published Nov. 27, 2023). For the second year in a row, January begins with no states having a negative outlook and six having a positive outlook. But again, the macroeconomic uncertainties, demographic trends, and revenue forecasting challenges are tempering the potential for broad positive expectations, which, in our view, counterbalances the outlook trend and thus, we maintain our stable sector view.

States remain in strong fiscal condition. States continue to benefit from the pandemic recovery and capital funds the federal government has allocated to them. These stimulus funds are mostly used or earmarked, and the remaining aid will be spent by the 2026 deadline, providing both internal liquidity in the short term and funds for capital requirements in the long term. States used most of the recovery money for one-time items and not recurring expenditures or programs. Capital projects funded from stimulus are being deployed over the current and next few fiscal years to accelerate ongoing capital program initiatives, while often replacing or reducing planned debt issuance with pay-as-you-go funding. Although the impact of a potential fiscal cliff caused by the depletion of federal aid is a current topic in the market, S&P Global Ratings views the coming change for direct state credit quality as more of a gradual slope rather than an impending fiscal cliff.

Budgetary pressure points are beginning to appear. States are experiencing revenue shortfalls, with some meaningfully off from forecast. Should this trend continue with a projected underperforming economy, revenue deficits could force austerity measures or use of reserves. In the past few fiscal years, most states have made changes to tax rates in personal and corporate income or sales taxes, with most of those actions being cuts. If these cuts don't generate the projected revenues, further structural issues could arise. The revenue side, though, is not the only part of budgetary balance that could be pressured. Inflation, as well as the wages and benefits granted in recent fiscal years, will manifest in current costs and out-year expenditure estimates. Medicaid state-share costs are increasing with the elimination of pandemic-related enhanced federal medical assistance percentage (eFMAP) that stepped down to zero as of January 2024. These costs will keep adding expenditure pressure in 2024 as states continue with eligibility redetermination, for many, through the current fiscal year-end. Furthermore, the longer-term trends of an aging population shifting service needs, increased costs from extreme weather events, and rising frequency of cyber attacks will all continue to affect state budgetary decision-making. How each state manages collection trend changes, cost increases, and economic conditions will drive credit discussions in 2024.

Table 1

S&P Global Ratings' U.S. economic forecast -- Select data points

As of November 2023

	2021	2022	2023f	2024f	2025f
Real GDP (Year % change)	5.8	1.9	2.4	1.5	1.4
Real consumer spending (Year % change)	8.4	2.5	2.2	1.8	1.6
Core CPI (Year % change)	3.6	6.2	4.8	2.8	2.3
Unemployment rate (%)	5.4	3.6	3.7	4.3	4.6
West Texas Intermediate (\$/bbl)	68.40	94.90	80.00	80.00	80.00
Henry Hub (\$/bbl)	3.90	6.50	2.50	3.00	3.50
Housing starts (mil.)	1.6	1.6	1.4	1.3	1.4

f--Forecast. bbl--Barrel.

Sector Top Trends

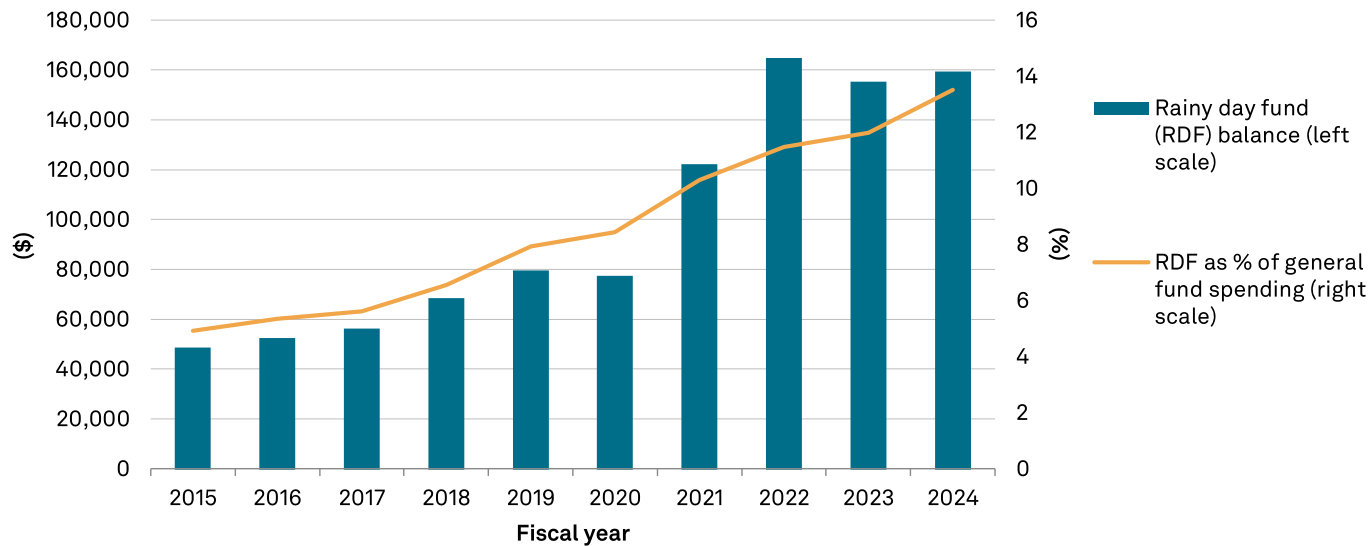
Record-high reserves will cushion credit stability. Revenues are beginning to show signs of weakening, but some states are still beating fiscal 2024 revenue targets to date and overall states are in great fiscal shape. According to the latest National Association of State Budget Officers' data, states have an aggregate rainy-day fund balance of 13.5% of total general fund spending, and many have other resources as well (i.e., general fund surpluses or other balances not formally reserved in rainy day funds (see chart 3). Our view is that most states have high levels of reserves and other resources, which should provide a liquidity credit cushion for the coming year and beyond.

The Urban Institute reports that state revenues on an inflation-adjusted basis are down 4.6% in the first quarter of fiscal 2024. Should this continue, the pace at which inflation erodes purchasing power could have an impact on service delivery levels. As revenues slow, increasing benefit and entitlement costs and unbudgeted costs such as funding asylum seekers/migrant shelter and

care expenses will affect spending decisions and future budgets. We're watching how and when the high reserve balances might be drawn down. Using a reserve is not an automatic credit negative. If a state has the wherewithal to build a rainy-day balance in the good times, for use in the bad times, then its use can be viewed as just a management action. Should a reserve fund be drawn upon, we analyze why and how the draw will be used, when the state will expect to replenish the balance, or where the rainy-day balance will normalize.

Chart 1

State rainy-day funds' growth in the past decade

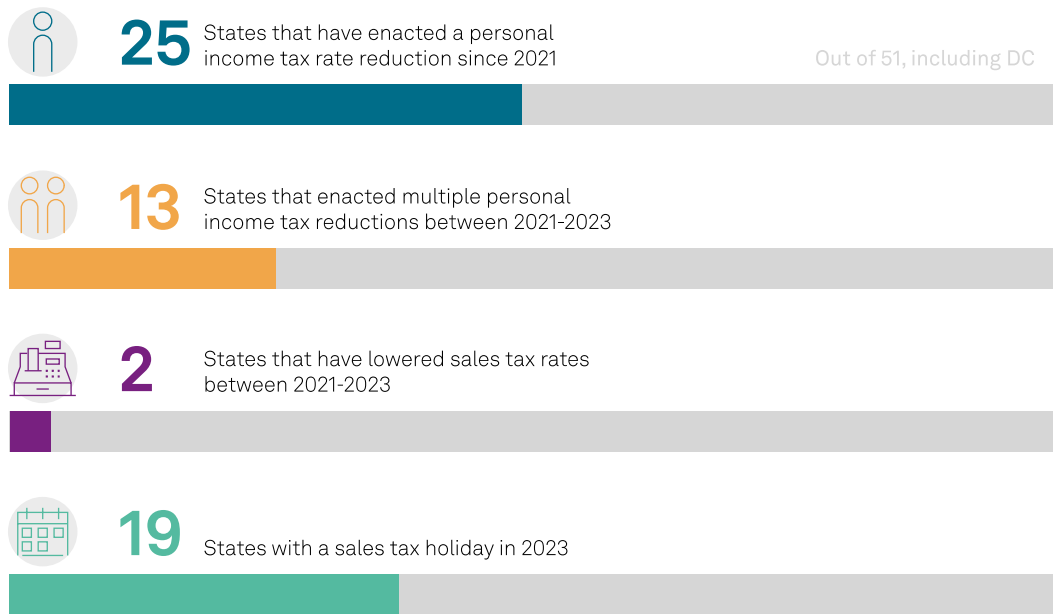


Source: National Assn. of State Budget Officers.
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State tax cuts could create pressures if the economy weakens. Thanks to stronger-than-projected growth across many revenue streams in the past few years, most states have passed tax cuts or relief in some form. A total of 25 states have reduced personal income tax (PIT) rates since 2021, and some lowered rates multiple times between 2021-2023 (see chart 2). More state tax cuts become effective or phase-in in 2024, with further bills likely to be considered before an active state legislature election period. Cuts are often approved with the goal of furthering economic development in a lower tax environment, but the timing of certain tax cuts--namely PIT--could prove untimely and compound revenue softness if economic conditions weaken. Ongoing management of expenditures with post-tax cut revenues will be important for maintaining credit quality, as a mismatch between slowing revenue growth expectations and anticipated expenditures could result in budget imbalance.

Chart 2

By the numbers: A look at recent income and sales tax relief

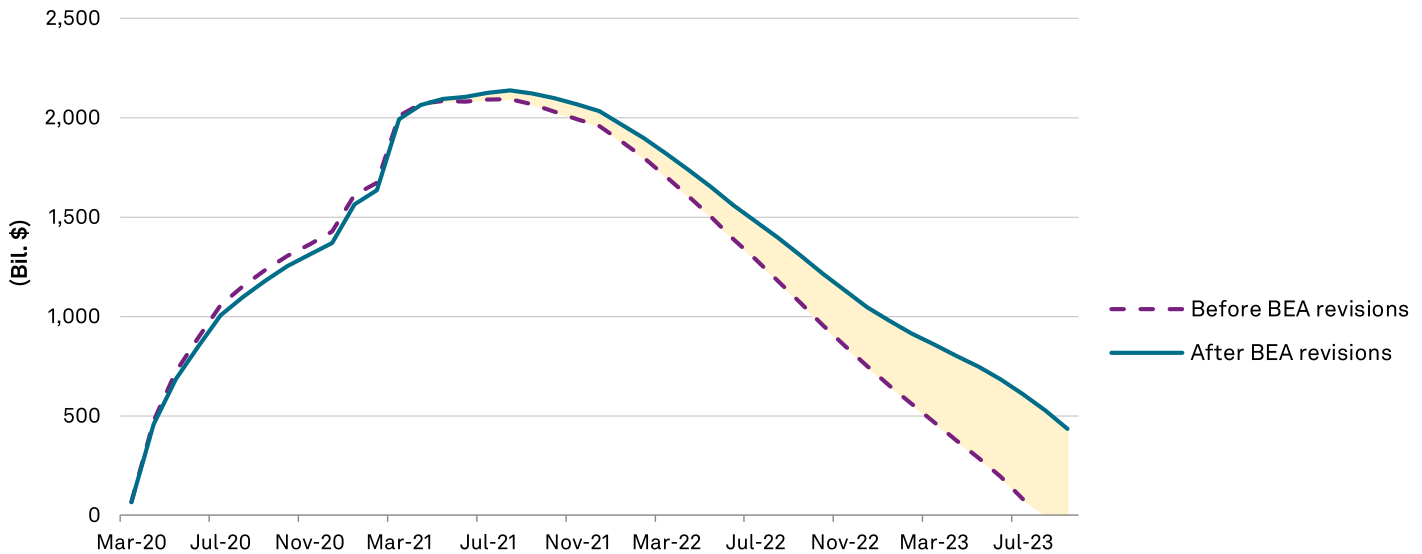


Sources: Federation of Tax Administrators, S&P Global Ratings.
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Consumer spending continues to support sales tax revenues. The strength of spending by the American consumer has resulted in strong sales tax revenues in the past couple of years, but year-to-date fiscal 2024 collections are beginning to show this resilience softening. With higher energy prices and household "fixed" expenditures (for example, student loan payments and health insurance costs) persisting, we could see eroding disposable income and discretionary spending dampening consumption-based tax revenues over the near term. However, in September 2023, the Bureau of Economic Analysis revised its household cumulative excess savings and identified \$430 billion still remaining from the surplus built up during the pandemic. Although most of this is being held by the top half of the income brackets, it should provide a spending cushion into 2024.

Chart 3

Cumulative excess savings in U.S. revised higher after data revisions



Note: Solid line is based on BEA data revisions; Excess savings is calculated based on counterfactual trend 48 months prior to March 2020; Shaded area depicts the difference between revised data and pre-revision estimate.

Sources: San Francisco Fed, Bureau of Economic Analysis, S&P Global Ratings calculations.

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Sales taxes are also influenced by corporate spending. Although businesses face higher costs of capital, which will lower capital expenditures and hiring, the continued deployment of funds from the Infrastructure Investment and Jobs Act, the CHIPS and Science Act, and the Inflation Reduction Act will spur investment into 2025. All these could further support consumption-based tax collections, particularly in states that regularly announce electric vehicle and battery factories, semiconductor plants, and large-scale broadband investments.

Federal policy uncertainty could lead to state budget pressures. We expect continued federal policy uncertainty due to partisan discord in 2024. Early in the year, ongoing federal budget debates will likely bring government shutdown risks back to the forefront. Should a federal shutdown occur, it could have revenue impacts for states. Later in the year, the focus will be the November elections, both nationally and locally, where 11 states will hold gubernatorial elections. At the state level, 85% of all House of Representatives seats and 65% of Senate seats will be up for election in November 2024, which could also shape state policy decisions in subsequent years. Regardless of election outcomes, federal policy is unlikely to be as generous to states in the future as it was the past three years. One place where federal policy has been credit supportive is in transit, particularly where state support often aids the transportation agencies with recurring and emergency funding. Following the federal largesse shown during the pandemic to transit agencies, some systems might be left with a fiscal cliff until ridership returns or new funding sources found. In these situations, transit agencies might look to states for help backfilling the lost federal resources, and where large transit systems are key to regional economies, there could be pressure

on those states to provide such support.

At the national level, the cost to service the current federal debt is rising and bringing an increasing focus on the absolute level of the national debt. Higher-for-longer interest rates exacerbate the situation. Given healthier fiscal conditions in many states than at the federal government, there's a greater likelihood that cuts in federal programs aiding states could be considered should federal priorities shift. Because of the disparate nature of state service levels, differing reliance on federal funding, and varying management capabilities and financial flexibility across the sector, we believe the effects on credit quality resulting from any federal fiscal reductions in general will likely be uneven. We expect states will know in advance about changes to federal funding arrangements, thereby allowing time for adjustments. Nevertheless, depending on the timing and magnitude of changes, these adjustments could be painful for states due to balanced budget requirements. And if painful for state budget decisions, the ability states have to push fiscal problems down to local municipalities could lead to shared pain throughout levels of government.

Lower Medicaid reimbursement rates and disenrollment decisions will be a budget and policy challenge. The primary flow of funds from the federal government to states is in the Medicaid program and we expect state-share cost increases for Medicaid will continue. On Jan. 1, 2024, all Medicaid reimbursement rates returned to unenhanced levels as the pandemic-related eFMAP stepped down to zero. At the beginning of fiscal 2024, there were 89.7 million Americans, or more than 1 in 4, in a Medicaid program. Along with the rate step-down, states can disenroll those who are no longer eligible for the benefits. Most states, though, don't expect to complete the corresponding eligibility redeterminations until later in 2024, and along with the increased share associated with the eFMAP elimination, there could be additional costs associated with that mismatch. As health care cost inflation has historically risen at a faster rate than the consumer price index, the increasing state share could pressure budgets as well.

Higher insurance costs will add to expenditure pressure. Health insurance (including Medicaid coverage) is among the insurance types facing increased costs. Cyber insurance has reportedly become more expensive and coverage was limited in the past year, leaving some issuers to drop policies and self-insure. In regions exposed to severe weather events, property and casualty insurance is also either becoming more expensive or providers are simply not offering new coverage. This could have impacts on property values and on catastrophe bonds issued by states. The upfront costs of all insurance cost increases could have budget impacts, but also the limited post-event support could begin to slow recovery efforts following large-scale events.

Worker shortages continue to pressure budgets, but generative AI could help. Governments of all levels report that workforce challenges remain. In both fiscal 2023 and 2024 budgets, nearly every state adopted wage and benefit provisions designed to retain and attract workers, but shortages remain common in public safety, corrections, nursing, and social work positions. These pay incentives appear to be working, as the U.S. Bureau of Labor Statistics reported that November 2023 marked the 20th consecutive month of increase in aggregate state and local employment, with total employment near the February 2020 peak. The hiring success, coupled with compensation and benefit increases, will have out-year budget implications and we're watching the fiscal 2025 budget proposals to see the significance of these actions.

Because of the worker shortage and higher costs of new employees, many state are turning to technology solutions, including artificial intelligence, to fill gaps in state workforces or improve productivity of those remaining. In October 2023, the Biden Administration issued an executive order on using artificial intelligence in government, focusing on safety, equity, and innovation; as

this new technology is deployed, many states already have similar legislation. To date, governmental use has primarily been internal decision-making analysis and enhancing self-service customer engagement, but over time it could help with case management and service delivery for various government roles. We're monitoring how this developing technology could control costs and alleviate workforce shortages, but it's too early to tell the long-term impact.

Pension and OPEB pressures remain where plans are not fully funded. Through the pandemic, states maintained better funding discipline, which has resulted in an overall strengthening of the long-term funding progress and a lessening of the risks associated with statewide pension plans. Pension and other postemployment benefits (OPEB) liabilities are not evenly distributed by state, with many having well-funded statewide plans. Pension risks remain for some, though, and OPEB are largely being funded on a pay-as-you-go basis, meaning pension and OPEB funding and risk management will remain key components of our fixed-cost analysis. S&P Global Ratings' annual survey shows state pension funded ratios slipped in 2022, improving asset performance for the fiscal year ended June 30, 2023, and a continuing focus on funding discipline will likely support near-term positive funding progress. Still, absent prudent risk management over time, a confluence of factors, structural demographic shifts including an aging population, and medical cost growth could add budgetary pressure tied to pension and OPEB funding in the long term. (For more information, see "U.S. State Pension And OPEBs: Funding Progress Is Likely To Pick Up In 2023 After Slipping In 2022," published Sept. 7, 2023.)

State mineral royalty revenues might slow from recent strength. The past two years have been favorable for credit quality in states that receive revenues from federally distributed mineral royalties (primarily associated with leasing of lands and production for oil and gas). Payments, according to Federal Funds Information for States, have increased 117% since fiscal 2021. In fiscal 2023, the federal government distributed over \$4.7 billion in such payments to 32 states. With our baseline view that broader U.S. economic growth is cooling, recent outsize growth for mineral-producing states (primarily, oil and natural gas activities) could be unlikely beyond the short term. In S&P Global Ratings' view, strong balance sheets and prudent budgetary management should help blunt the potential downside to the broader U.S. economy and preserve overall credit quality. Although we do not expect a sharp pull-back in oil exploration and production, mineral-producing states might need to realign forecast expectations and assess if tighter spending controls and further upkeep of high reserves is necessary to guard against a potential strain on their economies and revenues. (For more information, see "Economic Momentum Expected To Wane For Mineral-Producing U.S. States As Tailwinds Abate," published Aug. 3, 2023.)

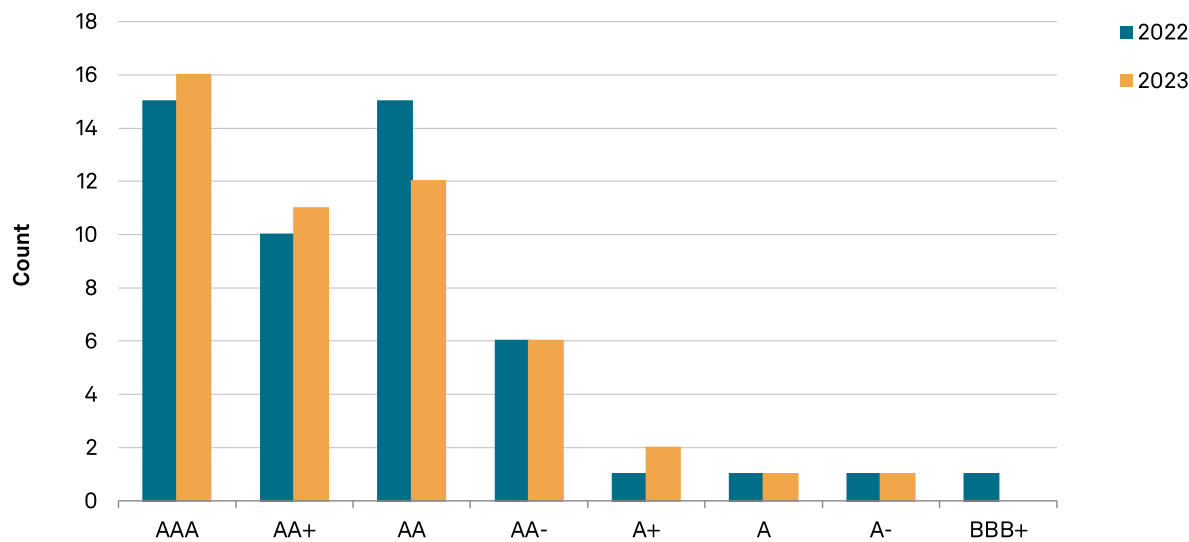
Rating Performance

For the second year in a row, most outlook revisions and rating actions were positive. We enter 2024 with six state general obligation (GO) ratings having positive outlooks and none having a negative outlook. In fact, no states had a negative outlook in the past 18 months, a particularly long period without enough downward pressure to revise an outlook. We upgraded five states in 2023 (see chart 5), following three in 2022, reflecting strengthened pension discipline and improved balances, as well as replenished reserves. The six states currently carrying positive rating outlooks are Alaska, Kansas, Louisiana, New Hampshire, Oklahoma, and Pennsylvania, reflecting changing long-term practices in reserve levels as well as continued budget management practices. We revised the outlook on California to stable from positive following

recent revenue shortfalls. Missouri and Montana defeased all of their GO debt: Montana defeased all of its debt and has no public issuer credit rating.

Chart 4

State rating distributions



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Table 2

State GO rating actions in 2023

State	Date	Action	Rating	Outlook
Missouri	Feb. 9	Initial rating	AAA (ICR)	Stable
Illinois	Feb. 23	Upgrade	A-	Stable
Kansas	Feb. 28	Outlook revision	AA- (ICR)	Positive
Louisiana	Mar. 31	Outlook revision	AA-	Positive
New Jersey	Apr. 12	Upgrade	A	Stable
Massachusetts	Apr. 14	Upgrade	AA+	Stable
Kentucky	Jun. 29	Upgrade	A+ (ICR)	Stable
Oklahoma	Jul. 20	Outlook revision	AA	Positive
Pennsylvania	Sep. 22	Outlook revision	A+	Positive
Montana	Nov. 14	Rating withdrawn	NR	--
Ohio	Dec. 8	Upgrade	AAA	Stable
California	Dec. 14	Outlook revision	AA-	Stable

ICR--Issuer credit rating. NR--Not rated.

Related Research

History Of U.S. State Ratings, Dec. 15, 2023

This report does not constitute a rating action.

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