State budgets hit a bumpy COVID-19 road—analyzing municipal credit pressures

For most US governors, June typically brings political fireworks when state legislatures hammer out final budgets for the next fiscal year. Given the COVID-19 recession and plummeting tax revenues, quite a few governors face hard budget choices this year. Put simply, governors must apply spending cuts or new taxes in ways that won’t degrade the long-term viability of their economies—the engine that drives public services—or risk squeezing access to municipal bond markets. As bond investors, this paper reviews our recent COVID-19 credit research, explaining why some states face mounting credit pressures from high fixed costs and shallow emergency reserves, whereas other states with more diversified economies and strong financial management should fare better post COVID-19.

In the wake of the COVID-19 pandemic, US governors have grabbed the media spotlight. After issuing lockdown procedures and more recently guidelines on re-opening businesses, public awareness of the role governors play in state economies has risen sharply. It’s nothing new, however, for our muni bond team. Evaluating the willingness of governors to make tough financial decisions is a key factor in our credit research, which gauges bond risks. Whereas some buyers of state-issued bonds might not blink if bond yields are tempting enough, our COVID-19 credit analysis helps ensure we are appropriately compensated for risks in states where governors may have chronically shortchanged budgets and degraded financial resiliency.

With regard to credit risks, it’s important to state upfront that despite the COVID-19 recession, states aren’t heading toward bankruptcy. Under current federal law, states can’t file for bankruptcy—granting authorization would require new legislation at the federal level. That said, we think mounting credit pressures could mean ratings reductions for some states if more federal funding doesn’t materialize from the US Congress this summer. Some states were ill-prepared to weather a normal cyclical downturn, let alone the dramatic economic shock of COVID-19. A downgrade could increase borrowing costs for states already weighed down by pension liabilities and meager rainy-day reserves. To a degree, this year’s muni market performance already reflects the variability of credit pressures among states, as we show later in our credit analysis in Exhibit 4.

To gauge the credit pressures from COVID-19 (and record low oil prices) that are bearing down on state budgets, our team analyzes four key components, as outlined in Exhibit 1, that can

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<tr>
<th>Revenue and Economic Diversity</th>
<th>Rainy-Day Reserves</th>
<th>Fixed Costs</th>
<th>Political Leadership</th>
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<td>We measure the degree of exposure to sales and personal income taxes, which can be more volatile during the COVID-19 recession. We analyze a state’s economic exposure to at-risk sectors: oil and gas, tourism, retail and transportation. Professional and business services sectors can offer a counterbalance to record low oil prices and COVID-19 lockdowns. Since the 2008 financial crisis, many states have amassed large fiscal cushions in rainy-day reserves and other investment pools which can help plug budget shortfalls. But there are some outliers: states like Illinois and New Jersey have very little in emergency reserves. Some states with large reserves, like Alaska, can still come up short because their revenues are prone to volatile downturns; Alaska’s revenues are largely petroleum-based. Underfunded pensions (where liabilities far outstrip assets) often require big annual infusions from tax revenues regardless of economic downturns. The same holds true for fixed retiree health care costs. High fixed costs can degrade budget flexibility and long-term financial resiliency, leading to a downgrade. Outstanding debt obligations can grow even larger after a credit downgrade. We analyze a governor’s legal authority to balance budgets during downturns, which is partly shaped by a state’s legislative rules on executive orders, and whether a governor’s party has a majority in Congress. Over and above the legal ability to make tough budget choices is a governor’s political willingness to balance spending cuts and/or new taxes in ways that won’t jeopardize long-term financial resiliency.</td>
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Source: Franklin Templeton Fixed Income Research.

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impact a state’s financial and economic resiliency. Our research combines quantitative metrics—for example, the diversity of tax revenues, exposure to at-risk sectors like tourism and the size of “rainy day” reserves—and qualitative measures that consider the strength of a governor’s ability to implement hard choices like spending cuts or new taxes.

Our COVID-19 credit analysis tells us states like New Jersey face relatively high credit pressures compared with states like North Carolina and Texas, which enjoy higher financial resiliency and economic diversity, as shown in Exhibit 2. Even states like New York—which came into this crisis with far more financial resiliency than states like Illinois—now face tough budget choices. With tax receipts already down 12.4% and state unemployment over 11% and climbing, New York Governor Andrew Cuomo’s enacted budget proposes US$10.1 billion in budget cuts, largely to public schools and state Medicaid health care—two of the largest budget items in most states.1

Before offering bite-sized summaries of our credit risk assessment across five states including New York and California, we walk through the four key components of our COVID-19 credit-pressure analysis. We start with the diversity of a state’s tax revenues, and the concentration of a state’s economic exposure to at-risk sectors like oil and gas, transportation, tourism and retail.

It’s important to note here that fresh unemployment data and revised state budgets are ongoing and coming fast. State governors and legislative offices are busy analyzing new economic projections and releasing revised estimates of revenue shortfalls. The credit views presented here are as of the published date and are subject to change, especially if more federal funding to states is approved this summer.

Revenue and economic diversity
As a whole, state governments rely on personal income and sales taxes for most of their tax revenues (with some notable exceptions). With US unemployment now at 14.7%—the highest since the 1930s Great Depression—and most retail shops and restaurants still closed or slowly getting back to normal, tax revenues have slumped dramatically and blown a hole through state budgets. Case in point: California Governor Gavin Newsom released a COVID-19 budget analysis showing a US$54.3 billion shortfall through the summer of 2021, rendering his recent January budget proposal inoperative. To fix this deficit, Newsom thinks everything needs to be on the table—spending cuts, higher taxes and a plea for more federal help.

Understanding the composition of a state’s tax revenues is a key component of our credit-pressure analysis. For starters, not all states rely as heavily on sales and personal income taxes as states like New York and California do. Texas and Nevada, for example, don’t have personal income taxes. That doesn’t mean, however, that they’re in the free and clear from the COVID-19 recession. Nevada’s outsized exposure to tourism and gambling in Las Vegas and Lake Tahoe has hit sales tax revenues relatively hard. On the other hand, sales taxes in Texas have fared somewhat better given its more diverse economy and looser shelter-in-place restrictions compared to states like New York.

Other states get by with fewer sales and income taxes by relying more on “severance” taxes that come from the extraction of natural resources like oil, gas, coal, timber and fish. But here too, this doesn’t immunize state budgets from shortfalls. Given record-low oil prices, Alaska’s petroleum-based revenues have dropped significantly this year. Despite its large backup reserves and less reliance on income and sales taxes compared to states like California, Alaska’s credit was downgraded in early May.

As Alaska illustrates, tax diversity is inextricably linked with a state’s overall economic diversity, which forms another component of our credit-pressure analysis. Because New York City and its boroughs have been the epicenter of US-based COVID-19 infections, New York State is projecting sharp declines in sales and income tax revenues due to shelter-in-place restrictions. That said, New York City is also an international hub for financial services companies and a growing cadre of information and technology firms. These businesses largely remain up and running with more employees working from home.
Technology and professional services sectors provide diversity in Texas, which some investors mistakenly view solely as an oil and gas economy. Metropolitan areas like Austin, San Antonio and Houston have seen strong growth outside the energy sector over the past two decades, offering welcome economic resiliency from a credit risk perspective.

**Federal help and rainy-day reserves**

Unlike the federal government, US governors can’t print money, and a majority are obliged to balance their budgets annually by state law. Without more federal funds over and above the recent CARES Act, US governors are now signaling major cuts to key services, including public K-12 schools and colleges as well as social safety nets like Medicaid. To help fill their COVID-19 budget gaps, the National Governors Association has called for another US$500 billion in federal funding relief, and a consortium of governors including California’s Newsom recently suggested US$1 trillion. We are monitoring these proposals as they work their way through the US Congress.

Some states, however, are better equipped to weather the COVID-19 downturn than others. Over the recent 10-year economic expansion, many governors steadily grew their rainy-day reserves. Designed for unexpected shocks, states can tap these reserves to soften the need for severe and sudden spending cuts or tax hikes to balance budgets. A vital budget resource to offset volatile tax revenues, our team tracks rainy-day reserves quite closely, as do bond rating agencies. For example, last year after California increased its rainy-day reserves to the largest in that state’s history—US$16.5 billion—Fitch upgraded California’s rating, citing its improved ability to manage future downturns.²

Given the size of its budget, California’s rainy-day reserves for fiscal 2019 could cover that state’s operating costs for 52.8 days, according to new research by the Pew Charitable Trusts, as shown in Exhibit 3.³ While states like Alaska and North Dakota had more than 100 days’ worth of operating costs in reserves, five states had less than a week’s worth in reserve for fiscal 2019: Kentucky (4 days), New Jersey (3.9 days), Pennsylvania (0.3 days), Illinois (a few hours), and Kansas which hasn’t funded their reserves. These states have markedly less flexibility in balancing their budgets during the COVID-19 recession.

It’s worth mentioning here that many states maintain reserves outside their rainy-day funds, which can also offset budget shortfalls and bolster liquidity. Pennsylvania, for example, traditionally dips into the state treasurer’s investment pool to

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**Exhibit 3. 34 states’ rainy-day funds surpass pre-recession levels**

Days each state could run on rainy-day funds, fiscal year 2019

Source: Pew analysis of data from the National Association of State Budget Officers.
New York acts with little room for maneuvering. Summaries below, some governors face extraordinary balancing obligations to avoid politically sensitive cuts, degrade gimmicks that simply kick the can, like short-changing long-term pension obligations to avoid politically sensitive cuts, degrade long-term financial flexibility. As we explain in our five state summaries below, some governors face extraordinary balancing acts with little room for maneuvering.

High fixed costs
On the back of 10 years of steady economic growth, there remains a wide gap between states like South Dakota and Wyoming, which maintain relatively well-funded public pensions, and states like Illinois, where pension liabilities have mushroomed to outstrip assets and drive up annual fixed costs. This dilemma stems from a legacy of poor policy choices. By not consistently setting aside money for pension contributions, states like New Jersey, Kentucky, Connecticut and Illinois are shackled with relatively high pension costs. Add to that the costs from existing debt obligations and retiree health care, and total fixed costs can hamstring a governor’s budget flexibility during downturns. For states like Illinois and New Jersey with almost no budgetary cushions from rainy-day reserves, high fixed costs substantially increase the difficulty of balancing budgets, in our view.

Political leadership
Although much of our credit research is quantitative, qualitative measures of a governor’s leadership ability also play a role. Examples of strong leadership have been on full display during the COVID-19 pandemic. By balancing the need for public safety through shelter-in-place orders with the long-term viability of their state economies, Ohio governor Mike DeWine and New York’s Andrew Cuomo have enjoyed sky-high approval ratings from their constituents. The cruel nature of this COVID-19 recession is that during a time when the public is looking to social safety nets, it’s also the time when state tax revenues are shrinking dramatically. Legally obligated to balance state budgets, governors recognize some spending cuts are necessary—though the scope is shaped by the size of reserves, fixed costs and a state’s economic exposure to hard-hit sectors like tourism.

Ultimately, as credit analysts we’re looking for smart budget compromises that don’t jeopardize a state’s credit quality. Budget gimmicks that simply kick the can, like short-changing long-term pension obligations to avoid politically sensitive cuts, degrade long-term financial flexibility. As we explain in our five state summaries below, some governors face extraordinary balancing acts with little room for maneuvering.

New York
The Empire State came into the COVID-19 crisis just slightly ahead of states like New Jersey and Pennsylvania in terms of overall financial preparedness, but far behind states like Texas and North Carolina. New York’s fixed costs are manageable in our view, due to relatively well-funded pensions and a small but decent rainy-day fund of reserves. That said, New York has also been at the epicenter of US-based COVID-19 cases. The state’s shelter-in-place restrictions have meant fast and large declines in revenues. New York’s economy is somewhat buttressed by exposure to the international financial services industry and information and technology jobs where most employees continue to work from home. But there’s no escaping the hard budget blows from expected declines in high-income bonuses and wages this year.

Cuomo announced an initial round of US$10 billion in spending cuts from the US$177 billion state budget enacted in April, with no new taxes on the horizon. These cuts, which include health care via Medicaid, K-12 schools and public transit, have caused some negative headlines; nevertheless, Cuomo has retained fairly strong public approval given his widely admired COVID-19 updates. By state law, Cuomo can implement further across-the-board cuts (excluding debt service) if revenue shortfalls turn out worse than projected. Given New York’s legal ability to adjust spending, its manageable fixed costs and strong political leadership, we think the state has the tools to manage the COVID-19 crisis without jeopardizing its credit ratings.

New Jersey
Governor Phil Murphy came into the COVID-19 crisis with more headwinds than his next-door neighbor New York. New Jersey had made its first deposit of US$421 million to its rainy-day fund in 2019 since draining it dry during the last recession. Fixed costs are also relatively high due to its underfunded pensions, which the state must continue increasing funding to each year (partially through a lottery pledge) or risk a credit downgrade. Given New Jersey’s proximity to the COVID-19 epicenter, it has the second-highest number of reported COVID-19 cases. The state’s 2019 road is that during a time when the public is looking to social safety nets, it’s also the time when state tax revenues are shrinking dramatically. Legally obligated to balance state budgets, governors recognize some spending cuts are necessary—though the scope is shaped by the size of reserves, fixed costs and a state’s economic exposure to hard-hit sectors like tourism.

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Our team is scrutinizing New Jersey’s monthly revenue reports and other financial reporting to look for realistically estimated revenue shortfalls and a willingness to adjust spending accordingly. With roughly US$1 billion in reserves outside its rainy-day fund and mandatory funding increases for its pensions, balancing New Jersey’s budget without increasing long-term debt will be quite tricky for Murphy—though absolutely necessary to maintain the state’s bond rating.
Pennsylvania

Governor Tom Wolf’s state came into the COVID-19 crisis with modestly improved credit quality. Pennsylvania had made its largest contribution in decades to its rainy-day fund of US$317 million after the close of fiscal 2019. But its overall reserves remain small relative to the state’s operating budget, and higher fixed costs from some underfunded pensions reduces Wolfs’ budget flexibility. In the wake of COVID-19 revenue shortfalls, Wolf recently submitted a piecemeal, no-new-taxes budget that carries full-year money for public schools and state-supported universities, debt service and school pension obligations. The state’s other budget items, including billions to social services, are only funded through November 2020. If the US Congress doesn’t produce additional aid, tough budget choices will come right on the heels of this year’s November elections.

Although Wolf’s shelter-in-place policies have sparked some controversy in different counties, we believe Pennsylvania remains on track to re-open safely on a regional basis. Overall, the state has markedly fewer reported COVID-19 cases compared with hotspots in neighboring New York and New Jersey. Economically, the state is fairly diversified as it’s been moving into health care, education and technology primarily driven by strong growth in Philadelphia and Pittsburgh. Demographics are a bit weaker given the state’s aging population and increasing Medicaid costs. Given the state’s lack of reserves and high fixed costs, we are keen to see if Wolf can shepherd a conservative budget through in a timely manner as we approach November.

California

In terms of rainy-day funds, California entered the COVID-19 crisis with nearly US$20 billion in reserves plus another US$2 billion of surplus that it can tap to cushion the blow from revenue shortfalls. But with state unemployment now expected to peak at a jaw-dropping 24.5%, Gavin Newsom is projecting an expected US$54.3 billion shortfall. The governor’s May budget proposal recommends widespread budget cuts and some revenue enhancements; certain cuts could be reinstated if more federal resources become available, giving Newsom some flexibility. While Newsom’s broad-based approach to balancing the budget is welcome, he’s reversed course on some prudent fiscal initiatives started in prior years. One example is recommending that deposits previously intended for California’s pension systems be used instead to defray current costs. While helpful this year, this move degrades longer term pension savings. Additionally, the state is recommending it not increase the pension contributions that the California State Teachers’ Retirement System (CalSTRS) is allowed to make under law. Aside from these short-sighted moves, we think California’s large and diverse economy offers resilience. While shelter-in-place policies have increased unemployment significantly, we expect that trend to reverse once the state reopens, supporting a gradual economic recovery.

Texas

With ample rainy-day reserves of US$11.5 billion, manageable fixed costs, below-average debt levels and Governor Greg Abbott’s penchant for strong budgetary practices, we think Texas offers a high degree of economic and financial resiliency during the COVID-19 recession. The state’s favorable tax climate and sunny weather has been a magnet for attracting new businesses—Texas enjoys the second highest net migration into the state in the country—which have helped diversify its economy away from oil and gas. With strong growth in professional and business services, we think these sectors could offset the impact from recent oil price declines. Because Texas doesn’t levy a personal income tax, it may avoid some of the near-term cash flow issues other states are experiencing from tax filing delays into July. As far as re-opening for business, mobility trends from Apple in early May suggested Texans were already getting out and about in their cars before official shelter-in-place restrictions were lifted—driving trends were just 12% below baseline averages at the start of May compared with 60% below average in April.

Upcoming budget battles

As we move into peak budget season—most states’ fiscal years (but not all) end June 30th—we think sparks could fly when the budget rubber hits the COVID-19 road during June negotiations. Budget battles are already notorious for headline risks as state legislatures quarrel out in the open through local news outlets. Given the shock of COVID-19 and prospects of more help from the US Congress, these budget skirmishes are already making national headlines this year.

Exhibit 4. State muni bond performance reflects COVID-19 credit pressures

<table>
<thead>
<tr>
<th>May 2020</th>
<th>YTD Return %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alaska</td>
<td>-4%</td>
</tr>
<tr>
<td>California</td>
<td>-3%</td>
</tr>
<tr>
<td>Illinois</td>
<td>-2%</td>
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<tr>
<td>New Jersey</td>
<td>0%</td>
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<tr>
<td>New York</td>
<td>-1%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>-2%</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>-3%</td>
</tr>
<tr>
<td>Texas</td>
<td>-4%</td>
</tr>
</tbody>
</table>

Source: Bloomberg Barclays Municipal Bond Index. Indexes are unmanaged, and one cannot invest directly in an index. There is no assurance that any estimate, forecast or projection will be realized. Past performance is not an indicator or guarantee of future results. See www.franklintempletondatasources.com for additional data provider information.
Although we think further muni bond market volatility is likely this year, we also recognize that many states entered this pandemic with replenished rainy-day reserves, helping governors balance their budgets for 2020 and fiscal year 2021. That said, individual states with higher fixed costs, lower reserves, and more exposure to COVID-19 infections could face ratings downgrades. Indeed, those expected scenarios are already playing out in the muni bond market, where states with lower financial flexibility, like New Jersey and Illinois, are underperforming Texas and California, as shown in Exhibit 4. As always, our muni team will be sifting through prodigious levels of noise this budget season, with an eye towards steering clear of unnecessary risks that aren’t properly compensated.

Endnotes

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest rate movements, a municipal bond portfolio’s yield and value will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the portfolio’s value may decline. Investments in lower-rated bonds include higher risk of default and loss of principal. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond’s issuer, insurer or guarantor, may affect the bond’s value.
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