
Your State is Probably Facing a New Dawn of Public Finance Problems.

U.S. states have entered a new era characterized by chronic budget stress. For the past 130 years, states have mostly been financially resilient through a range of economic conditions. In fact, no state has defaulted on its debt since Arkansas in the 1930s. This long period of relative calm may have lulled some people into complacency when it comes to state finances. It shouldn't have.

S&P Global Ratings has been evaluating the creditworthiness of U.S. states and municipalities since 1940. We now see a profound shift unfolding in states such as Illinois, Kentucky, and New Jersey, whose pension systems are funded at distressed levels. The pervasiveness of budget pressures in these and other states is inconsistent with a mature national economic expansion and signals real credit stress. Our recent negative rating actions on several states' debt reflect this. Since January 2016, we have issued 11 state credit rating downgrades and just two upgrades.

Nevertheless, the states continue to benefit from certain inherent advantages that result in mostly high credit ratings. Among these are self-imposed controls against financial excess, such as balanced-budget requirements and limits on borrowing. We shouldn't forget that states adopted these restraints in response to a series of debt crises from 1840 through the 1880s.

To this day, these fiscal institutions remain important pillars underneath states' credit standings. The states' co-sovereign status and fiscal integration with the federal government has also protected them in tough economic times. Now, however, demographic and macroeconomic shifts are creating stress that, for some states, render these institutions inadequate.

Low oil prices explain the fiscal gaps for the leading energy states like Alaska and North Dakota. But slower revenue growth, declining worker-to-beneficiary ratios in state retirement systems, and rising Medicaid enrollments are widespread and have meant that fiscal stress is no longer confined to recessionary times. This stress is leading states to forego crucially needed investment in infrastructure and higher education.

There is an asymmetry to the new era for state finances. While the budgetary gains to states during the current expansion have been subdued, recent downdrafts have been severe. In the aggregate, from 1951 through 2001, state tax revenues never posted year-over-year declines, but have done so three times in just the past 15 years.

The most dramatic decline was also the most recent, when in 2009 revenues plunged 8.5 percent. Furthermore, we believe states can expect to largely go it alone the next time a recession strikes. In our view, it's unlikely that in a downturn the current Congress would deliver enhanced aid to states via Medicaid as previous Congresses did in response to the last two recessions.

Large unfunded pension and retiree health care liabilities will also continue to squeeze state finances. The aging population and low gains in productivity imply a federal funds rate that — even after the expected round of tightening monetary policy — is low by historic norms. Yet most states still assume investment rates of return in the range of seven to eight percent, incentivizing greater risk taking, which brings with it greater risk of underperformance.

Recent equity market appreciation and various business sentiment readings indicating improved confidence offer a reasonable basis for near-term optimism. But even a burst of federal fiscal stimulus and deregulatory zeal is likely to lift gross domestic product growth (GDP) growth only temporarily considering the structural headwinds facing the U.S. economy. Therefore, whatever pace of expansion materializes in 2017 or 2018, we expect economic growth will revert to around two percent over the long term.

Not all states will stumble on this more challenging landscape. Those that have maintained pension funding discipline and consistently sought balance between revenues and spending will fare best. The strongest states will also likely expand their efforts at pension reform to cover retiree health care, which will become more important as time goes on.

With the potential for less countercyclical federal aid, states will need larger budget reserves and fiscal policy guided by a goal of aligning spending with revenue. Healthy budget reserves, balanced fiscal operations, and funding discipline vis-à-vis long-term liabilities will help any state better withstand the effects of protracted slow growth. A review of our rating actions over the past two to three years bears this out and shows that state credit quality has already begun to diverge along these lines.

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