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Fitch: State and Local ARPA Uses Illustrate Broad Budgetary Flexibility

Fitch Ratings-New York-18 January 2022: Initial allocations of the $350 billion in direct aid available via the Coronavirus State and Local Fiscal Recovery Funds (SLFRF) to state and local governments under the American Rescue Plan Act (ARPA) reflect the law's wide discretion and governments' generally robust ability to manage budgets, says Fitch Ratings. Many state and local governments are adjusting budgets to minimize potential credit risks of relying on one-time federal aid for operating support. Additionally, the majority of SLFRF remains unspent, providing governments with an important fiscal cushion.

Data regarding SLFRF appropriations remains difficult to compare accurately across jurisdictions with official reports somewhat dated. Fitch reviewed spending plans filed with the US Treasury Department (Treasury) last summer and ARPA spending compilations from the National Conference of State Legislatures, National Association of State Budget Officers, Council of State Governments and the Center on Budget and Policy Priorities. Additional data will become available following upcoming federal reporting deadlines on Jan. 31 (states and large locals) and April 30 (all others). Local government SLFRF allocation trends will be difficult to assess until then.

Fitch estimates approximately half of states' SLFRF funds have been programmed. A much smaller share has actually been spent, with most allocations spanning multiple years. Approximately 70% of the total $350 billion has been distributed by Treasury, with the remainder expected in 1H22. The final SLFRF rule published on Jan. 6 is largely consistent with the interim rule released last spring. Restrictions against directly using SLFRF for debt repayment and reserve replenishment remain in place.

Despite strong economic and fiscal recoveries, states have allocated between $10 billion to $20 billion for 'revenue replacement', the largest category to date of the four primary ARPA-authorized uses. Treasury guidance allows revenue replacement to cover any government services, a very broad authorization, and also allows for streamlined reporting and compliance with this designation. One-time revenue replacement poses the risk of creating fiscal cliffs for state and local governments if it directly funds recurring operating needs.

In many cases governments allocating SLFRF for revenue replacement are separately forecasting budget surpluses or significant one-time expenditures, thereby mitigating credit risk. Given the flexibility of revenue replacement uses, governments can apply SLFRF dollars to operating needs and subsequently apply state-source revenues to other uses, such as debt repayment or reserves.

California and Illinois are among the states that allocated the most toward revenue replacement, $8.6 billion and $2.0 billion, respectively, with California projecting large surpluses over the next few years and Illinois budgeting to use state dollars to pay down liabilities. California's Legislative Analyst Office projected operating surpluses of $3 billion to $8 billion annually through fiscal 2026 in its November 2021 fiscal outlook report. Illinois' fiscal 2022 enacted budget includes $1 billion to pay down federal pandemic loans, which the state completed earlier this month, and $900 million to repay interfund borrowing.

Up to 10 states have not made any allocations of SLFRF funds, as is the case with many local governments, and most allocated funds have not actually been spent. While Fitch anticipates continued economic and revenue growth in 2022 in the US, pandemic uncertainty and inflation remain downside risks, and the fiscal cushion provided by unallocated or unspent SLFRF will support state and local governments' fiscal resilience in the near term.

Disputes around SLFRF use, including lawsuits against Treasury's rule prohibiting the use of SLFRF to fund tax cuts and the federal government's challenge of Arizona's allocation of funds in ways that may conflict with federal public health guidance for schools, are not expected to affect credit as SLFRF funding is not a key rating driver for most governments.

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