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Fitch: Federal Spending Cuts Push More Fiscal Risk to State, Local Governments

Fitch Ratings-New York-07 November 2025: State and local governments are increasingly assuming fiscal responsibilities that have typically been shouldered by the federal government. This could amplify pressures during periods of fiscal stress and increase state and local government credit risk, Fitch Ratings says in its new report.

Trump administration and congressional policy initiatives, as well as long-term challenges to the U.S. sovereign's finances, are resulting in a transferring fiscal obligations and risks to state and local governments.

States with the lowest levels of financial resilience are likely to be the most vulnerable to rating transition if the federal and state/local relationship substantially and permanently shifts. Robust dedicated operating reserves relative to annual budgets most clearly demonstrate states' financial resilience and provide a key credit risk mitigant.

The 2025 tax and spending bill introduces significant changes to SNAP cost-sharing requirements and changes to states' ability to levy provider taxes for Medicaid that will directly impact state budgets. Federal spending reductions under the law start out modestly and grow over multiple years, according to the Congressional Budget Office's analysis. This gives states time to plan budgets accordingly, although states will have less flexibility in a lower growth or recessionary environment.

Significant changes to the scale of federal FEMA aid would increase credit risk for state and local governments at a time when billion-dollar natural disasters are increasing in frequency and cost. State and local governments have flexibility to manage increased costs following natural disasters while awaiting federal reimbursement, but federal support can be important to maintaining long-term fiscal and credit stability. A Fitch analysis found that Louisiana, Hawaii and Florida have the highest levels of federal disaster aid relative to their economies.

The U.S.'s fiscal challenges — with general government debt reaching 124.6% of GDP by 2027 — may limit its capacity to provide meaningful countercyclical support to states and municipalities during a downturn.