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Fitch: Deficit Borrowing in Crisis Recovery Neutral to Negative for U.S. States & Locals

Fitch Ratings-New York-03 June 2020: More frequent use of non-structural measures such as deficit financing to offset the rapid and severe decline in revenues triggered by the coronavirus pandemic and related containment measures is likely for state and local governments, according to Fitch Ratings. Whether such measures will affect an issuer's credit quality will depend on the ability to regain financial resilience once recovery takes hold and on any long-lasting impact on gap-closing ability (comprised of revenue-raising ability, expenditure flexibility and reserves) and the long-term liability burden (debt and pension obligations relative to personal income). For rating stability, budgeting decisions must both effectively address the near-term crisis and be sustainable through future economic cycles.

If deficit financing is used as part of a comprehensive plan to protect fiscal stability and does not meaningfully affect the burden of long-term liabilities on an entity's budget and overall resource base, Fitch will view it as neutral to credit quality. However, Fitch envisions negative rating impact if the ability to rebuild financial resilience post-debt issuance is unclear — for example, the issuer becomes reliant on debt for operating needs on a regular basis or is not able to begin replenishing reserves once the recovery is under way — or if the debt makes the long-term liability burden more restrictive.

Short-term borrowing for timing mismatches between receipts and disbursements typically does not affect Fitch's view of long-term credit quality and is not considered deficit financing. However, Fitch does not believe that short-term borrowing will be an effective mitigant to the pandemic-related revenue declines because lost revenues are unlikely to be fully recouped over the term of the borrowing, making long-term deficit financing more likely.

Since the onset of the pandemic early in 2020, U.S. state and local governments have developed and revised budgets in anticipation of immediate and significant declines in revenues that are now beginning to show. Given the rapid and dramatic shift in revenue receipt — many entities that are now seeing severe declines experienced above-budget revenues prior to the onset of the pandemic — near-term measures to preserve liquidity and maintain essential services are necessarily different from those used in an expansion or even a moderate downturn.

Tools available vary depending on legal and practical constraints and include revenue-raising measures, expenditure reductions, use of reserves and long- and short-term borrowing. Long-term borrowing for operating needs, or deficit financing, is rare among the typically highly-rated issuers in Fitch's portfolio of U.S. state and local governments as it is perceived by many issuers as a last resort due to the costs to future budgets and potential impact on ratings.

While deficit financing is likely to remain uncommon among U.S. state and local governments, it is used regularly by other sub-national governments internationally as a means to address fiscal and economic downturns. For example, Canadian provinces, which are highly-rated by Fitch and operate in a federalism framework with some similarities to U.S. states, have regularly issued operating debt to manage service reductions and provide economic and fiscal stimulus during downturns and then paid it down during economic expansions. Canadian provinces typically bear more responsibility for service delivery and economic oversight than U.S. states.

New York City (Issuer Default Rating AA/Negative), Illinois (BBB-/Negative) and New Jersey (A-/Negative) are among the largest Fitch-rated state and local governments considering sizable deficit financings in order to address the anticipated severe fiscal implications of the coronavirus pandemic. Fitch will review each issuer's budget mitigation actions individually and will assess deficit financing in the context of the entity's overall strategy for addressing the current unprecedented situation. We recognize the difficult trade-offs most issuers now face between increasing their debt burden and employing other budget-balancing tools including tax increases or reductions in key services. Each decision will affect longer-term economic and fiscal recovery, and Fitch will assess the impact of these decisions on credit quality accordingly.

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