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Fitch: ARPA Interim Rule Limits Credit Positives for States and Locals

Fitch Ratings-New York-18 May 2021: The US Treasury's recent guidance on how US states and local governments can spend the $350 billion of direct American Rescue Plan Act (ARPA) aid will limit their ability to use ARPA to unwind nonrecurring budgetary actions, including deficit borrowing undertaken in 2020 to compensate for pandemic-related revenue declines, Fitch Ratings says. The Treasury's Interim Final Rule for the Coronavirus State and Local Fiscal Recovery Funds (FRF) prohibits using the funds for debt service and reserve replenishment, tempering the positive rating momentum from the FRF for some credits on Negative Outlook.

Eligible uses are still fairly broad. Virtually all general infrastructure is also eligible up to the amount of a government's revenue losses relative to a pre-pandemic growth trajectory, which is assumed to be 4.1% annually from fiscal 2019. Authorization for water, sewer and broadband infrastructure projects is broader, allowed up to each government's full FRF allocation. The rule allows operating uses, including restoring government staffing to pre-pandemic levels, and public health and safety payroll costs. Fitch considers application of one-time FRF for recurring operating needs as a credit negative that could create a fiscal cliff.

The interim final rule is effective immediately but is likely to be amended in the next several months after the Treasury evaluates comments. Given the extensive documentation around the FRF, many governments will need time to evaluate the rule, submit comments and await revisions. Some, such as Kentucky, already enacted legislation laying out their plans. Kentucky proposes using half its FRF for repayment of a loan from the Federal Unemployment Account (FUA), broadband expansion, and drinking water and wastewater infrastructure. All three are explicitly eligible uses.

The rule prohibits repayment of debt service or reserve fund replenishment, which complicates planning and hampers restoration of fiscal resilience for Illinois (BBB-/Negative) and New Jersey (A-/Negative), which both expressed interest in using the funds to pay down liabilities. The Treasury specifically requests feedback on whether the debt service prohibition should be reconsidered. Fitch notes the allowance of FRF to repay prior FUA loans contrasts with the Treasury's preference that governments use FRF for prospective uses rather than to reimburse prior spending.

Illinois' comptroller has already submitted comments urging the Treasury to allow the state to use part of its $8.100 billion FRF allocation to repay short-term borrowing undertaken to support operations during the pandemic, including $2.175 billion in outstanding loans from the Federal Reserve's Municipal Liquidity Facility.

According to the National Conference of State Legislatures, nearly half of states planned or implemented reserve draws during the pandemic and many local governments did the same. Strong revenue growth has allowed many governments to avoid such draws or restore them, but overall reserves remain below pre-pandemic levels. The Treasury's prohibition on using FRF to restore this key element of financial resilience may leave some governments in a weaker position should tax revenues not be as robust as forecast over the medium term.

The ARPA statute indicates FRF may not be used for standalone direct pension contributions and tax cuts. The rule goes into extensive detail on the tax cut prohibition, which applies only to states, implying the Treasury will be particularly vigilant in monitoring it. Thirteen states have filed a federal lawsuit challenging the tax cut provision as a violation of states' sovereignty.

ARPA also included a separate $10 billion Coronavirus Capital Projects Fund to be distributed to states, territories and tribal governments. The Treasury anticipates releasing detailed guidance on this fund before the summer.

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