
Fitch: US Debt Ceiling Policy Actions Consequential for Public Finance Credit

Fitch Ratings-New York-15 February 2023: Fitch Ratings believes the U.S. government is likely to raise or suspend the debt limit to avoid default. However, the way it resolves the latest debt ceiling impasse could affect the risk profiles of Fitch-rated states, local governments, and US public finance (USPF) revenue-supported entities. Federal budgets directly support a wide range of functions carried out by states and local governments, and broader federal spending is meaningful to the economic activity that underpins the credit quality of USPF issuers.

If resolution of the debt ceiling materially reduces federal spending, USPF credits could be directly affected over time, especially those that rely on federal funding for healthcare services, housing subsidies and grants, higher education grants and student loans, and other programs. Medicare and Medicaid cuts would be particularly consequential given their size and relative importance for healthcare institutions and state governments. Medicaid (a joint federal-state program) comprises roughly one-third of total state budgets, while Medicare and Medicaid combined are more than one-half of the payor mix for hospitals.

All USPF sectors would be exposed to the wider ramifications of reduced federal spending, which would gradually reverberate through economic activity and could weigh on future tax collections and revenues. The U.S. Treasury Department estimates federal spending averaged approximately one-fifth of total GDP in the five years before the pandemic. Significant federal fiscal consolidation could have meaningful effects on overall economic activity.

Most USPF ratings assume sufficient flexibility to respond to reduced federal funding. The ability of state and local governments to respond to direct cuts, primarily with their own spending cuts, reflects their significant autonomy within the U.S. federal structure. States benefit from strong legal and fiscal powers enshrined in the U.S. Constitution, and states in turn delegate substantial fiscal powers to local governments. Local governments bear the added risk of absorbing potential state tightening that could follow federal cuts, although they typically have broad budgetary tools and reserves to cushion unforeseen developments. Many states and local governments currently benefit from unusually high reserves and solid liquidity given multiple rounds of pandemic-related federal economic stimulus and generally prudent fiscal management.

Revenue-supported entities are also generally well-positioned to absorb the effects of reduced federal funding. Cuts to Medicaid and Medicare would add to fiscal challenges for not-for-profit hospitals. However, hospitals and health systems generally have rating flexibility due to significant balance sheet cushion, a hallmark rating strength of the sector, and the generally lower reimbursement levels from both Medicare and Medicaid compared to commercial payors.

A prolonged impasse marked by heightened brinksmanship and risk of default cannot be ruled out. In this scenario, higher uncertainty could have more serious economic consequences. While Fitch's USPF ratings anticipate normal economic cycles, if debt ceiling uncertainty triggers a sharp and deep downturn, they would be subject to greater transition risk.

Most USPF ratings are not explicitly tied to the U.S. sovereign rating ('AAA'/Stable) except when bond repayment depends on federal agencies or instruments. Negative rating action on the U.S. sovereign would likely result in negative action on ratings with direct links to, or dependence on, the sovereign rating unless other factors mitigate the exposure.

Bonds linked to the sovereign rating include municipal housing bonds currently rated 'AAA' and secured entirely, or predominately, by Fannie Mae and Freddie Mac mortgage-backed securities, pre-refunded municipal bonds where escrowed funds deposited with a trustee to advance refund the bonds are invested in U.S. government obligations, and bonds fully enhanced by FHLB letters of credit. Ratings on pre-refunded municipal bonds depend on the rating assigned to U.S. treasuries or other bonds guaranteed by federal agencies.

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