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The Risk of a US Recession Is Rising. Here's What That Means for States' Credit Outlook.

- **State credit quality is less favorable, Conning report says**
- **Texas gets top ranking this year, surpassing Florida**

The rising possibility of a recession threatens US states' credit quality, according to a new report.

As economic conditions soften the state's credit picture is less favorable, said Conning & Co. in its annual report analyzing the credit health of all 50 states released on Tuesday. The investment firm lowered the municipal sector's outlook to "declining" from stable.

"The inflation that supports sales-tax revenues will likely wane, and personal income taxes will probably decline with the labor market worsening," Karel Citroen, head of municipal research at Conning, a Hartford, Connecticut-based firm that manages over $7 billion of municipal bonds for clients, wrote in the report.

States have benefited significantly from robust tax collections and the unprecedented inflow of hundreds of billions of dollars from federal pandemic aid, pushing their financial reserves to all-time highs, and increasing pension, as well as other post-employment benefit contributions in 2022. Balances in rainy-day funds hit all-time highs in 37 states and their combined savings reached a record $134.5 billion by the end of fiscal 2022, according to data from the National Association of State Budget Officers.

The federal government provided nearly $200 billion in direct aid to states under the $1.9 trillion American Rescue Plan legislation, which boosted the fiscal strength of states and offset some of the tax-revenue shortfalls that plagued major cities as the shift to remote work turned residents away from urban centers.

However, tighter Federal Reserve monetary policy and tapering Covid-19 aid may reduce tax-revenue growth and could diminish state credit quality during the upcoming fiscal year, according to Conning.

"States in most cases have a constitutional obligation to balance their budget when they are being put together," Citroen said in an interview. "But when revenues fall short of expectations, it's difficult to cut expenditures on the fly, so states might have to tap into their reserves."

State Creditworthiness

According to Conning's report, Texas received the highest credit quality ranking this year and unseated Florida for the No. 1 ranking.

"Texas is a perfect example of a state that really diversified over the last 10 years away from natural resources and was able to attract tech and health care firms," Citroen said.

Texas outperformed in GDP per capita, the report said, adding that the Lone Star State and Florida, now second, benefited from strong economies and population growth. South Dakota, Tennessee and Idaho rounded out the top five states for credit quality.

Utah, which held the highest ranking for the three years prior to 2022, fell to its lowest rank since 2015, due in part to rising home prices. California slipped 14 spots to No. 42 from last year's rankings on tax-revenue declines.

Some states that benefited from migration during the Covid-era are now staring down significant infrastructure spending and pension obligations that could present challenges to their fiscal strength in the event of a recession.

"It's good when people move to an area because it brings in more tax collections as people spend and buy homes. But it drives up home prices and at some point the local municipality or the state needs to provide additional services as well," Citroen said.

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