States Demonstrate Resilience As Cash Falls Short

June 30, 2020

PRIMARY CREDIT ANALYST

Carol H Spain
Chicago
(1) 312-233-7095
carol.spain
@spglobal.com

SECONDARY CONTACT

Geoffrey E Buswick
Boston
(1) 617-530-8311
geoffrey.buswick
@spglobal.com

Key Takeaways

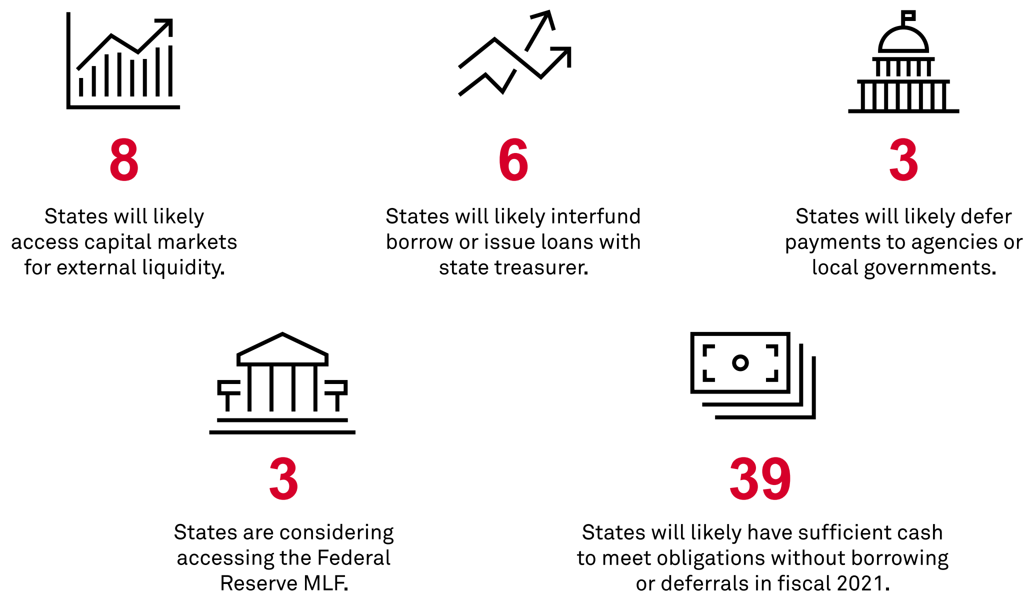
- We have seen a notable uptick in short-term borrowing by states and payment deferrals to address sudden shortfalls.
- A majority of states will likely have sufficient cash to weather revenue declines through fiscal 2021.
- Short-term borrowing can make sense when states lack the internal cash resources to meet current obligations and deficits are temporary.
- Cash shortfalls signal fiscal stress when they become structural challenges.

As the COVID-19 pandemic wreaks havoc on revenue, S&P Global Ratings has observed that states are grappling with how to manage cash flow. Early forecasts indicate that state revenue declines will likely surpass the 11.6% drop during the Great Recession, exceeding the 8.0% median state rainy day fund balance. Many states extended tax-filing deadlines to July from April to provide taxpayer relief, exacerbating cash-flow pressures. At the same time, they are absorbing significant unbudgeted pandemic-related costs. Although the Coronavirus Aid, Relief, and Economic Security (CARES) Act funds help offset pandemic-related expenses, the federal government has yet to provide support to offset lost tax revenue.

Drawing on reserves or slashing spending isn't always sufficient, timely, or the most prudent tool states have to address cash shortfalls. Even in the best of times, states can experience cash deficits because required disbursements occur evenly throughout the year but they receive a majority of revenue later in the fiscal year. To manage the routine ebb and flow of cash balances, some states might temporarily tap rainy day or other available funds or borrow internally. Some maintain standing lines of credit with either banks or state investment pools, engage in direct bank loans, or access capital markets to issue revenue anticipation notes (RANs).

S&P Global Ratings has seen a notable uptick in short-term borrowing and payment deferrals to address sudden shortfalls, but a majority of states will likely have enough cash to weather fiscal 2020-2021 budget challenges. To date, states have had sufficient liquidity to meet priority obligations given strong market access and a high degree of sovereignty over expenditures. If additional federal aid does not materialize, we believe many states might need to increase deficit borrowing.

States Use Cash-Flow Management Tools During COVID-19 Recession



Source: S&P Global Ratings' state survey as of June 26, 2020.

States Borrow, Delay Payments During COVID-19 Recession

Short-term borrowing can make sense when states lack the internal cash resources to meet current obligations and deficits are temporary. In this recession, many states view cash deficits as temporary given the likely influx of receipts after July tax-filing dates and pending economic recovery. Budget cuts often occur over the course of the fiscal year rather than as upfront savings, and some states might opt to delay painful cuts if revenue is likely to recover or they anticipate federal aid. For example, in June 2020, New York State (AA+/Stable) issued $3.5 billion of personal income tax subordinate RANs. S&P Global Ratings doesn't view the debt as an indicator of fiscal distress but rather as a means to buy time until New York receives delayed income tax receipts and can effectuate planned budget cuts.

Given the current low interest rate environment, borrowing is a low-cost option for most states, and we understand that the CARES Act considers interest and issuance costs as eligible expenses. States with weaker credit quality, however, have less favorable market access. In May 2020, the Federal Reserve temporarily established the $500 billion Municipal Liquidity Facility (MLF) as a lender of last resort to states and local governments. If faced with unfavorable market conditions, the MLF will purchase state anticipation notes with maturities of up to three years at a penalty rate. This option could be attractive for states expecting a longer recovery period, but most legally prohibit cash-flow or deficit borrowing beyond a fiscal year. So far, only Illinois (BBB-/Negative) has used the MLF for a $1.2 billion short-term borrowing that it will repay within a year. If market conditions deteriorate, the MLF could become more critical.

The current downturn has inspired other novel borrowing approaches. As of June 2020, New Jersey (A-/Negative) had fully drawn down a renegotiated external bank revolving credit facility for $1.5 billion. New Jersey statutes prohibit the state from cash-flow borrowing across fiscal years. To get around the statute, New Jersey extended its fiscal year three months to Sept. 30, which allowed it to renegotiate a cash-flow facility to extend past the former fiscal year-end.

Another less conventional cash management tool is to defer vendor payments or disbursements to agencies or local governments. California's (AA-/Stable) budget proposal includes a large deferral of school funding, which will improve the state's fiscal results, although it could result in school districts needing to borrow or dip into savings to cover the delayed revenue. New Jersey's budget proposal also defers appropriations normally occurring from September into October, which helps its cash in the short term, but would likely compel it to access external debt markets for liquidity purposes in October. While Illinois hasn't formalized upcoming payment deferrals, it maintains a bill backlog to various vendors that will likely grow over the next year.

Cash Deficits As Harbingers Of Distress

Cash shortfalls signal fiscal stress when they become structural challenges. One factor S&P Global Ratings considers is whether the state will have the capacity to repay the loan or make the deferred payment without creating another structural budget gap. Examples include if a temporary line of credit were to become an annual budget item or if the state were to issue long-term bonds to repay short-term notes. We also look at the size of cash shortfalls relative to the budget and the extent to which a state relies on capital markets to meet priority payments. Signs of significant distress, or a noninvestment-grade rating, include if a state were to approach the legal or practical limit of borrowing, or if market access is only available from nontraditional lenders or at interest rates or terms that could further impair capacity or willingness to meet financial commitments.

This report does not constitute a rating action.