



Federal Help Wanted: Municipalities Face Fiscal Uncertainties



U.S. election could impact ailing municipal budgets.

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Municipal bond markets have largely recovered from the sharp, liquidity-driven sell-off that occurred at the height of the market's response to coronavirus-induced economic damage.

However, the magnitude of the potential revenue shortfalls that state and local governments will suffer, while still uncertain in many instances, could set the stage for meaningful spending cuts in government employment, education budgets, and other services. These austerity measures would weigh on the U.S. economic recovery.

The outlook for state and local government relief funding will be highly dependent upon the next presidential administration's agenda. Democratic nominee Joe Biden has indicated that, as president, he would prioritize a substantial increase in federal aid for state and local governments. Given President Donald Trump's current position in stimulus negotiations, his second-term administration would be less likely to seek significant state and local relief.

But the balance of power in the Senate will determine the extent to which the next president can implement his agenda. A Republican majority (the status quo) would likely approve less



Katie Deal

Washington Analyst
U.S. Equity Division

funding for state and local governments than if Democrats held a Senate majority.

Municipal Budgets Crunched by the Coronavirus

T. Rowe Price's team of municipal credit analysts think that many state and local governments were reasonably well prepared for an economic contraction, having used the lengthy economic recovery that followed the 2008–2009 financial crisis to improve their fiscal health and build up reserves in rainy day funds.

Nevertheless, the sharp economic contraction has created significant uncertainty for state and local governments as they seek to address existing revenue losses and estimate future declines—key factors in planning their budgets for the 2021 fiscal year, which began on July 1 for many jurisdictions.

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Recent estimates from the Center on Budget Policy and Priorities put state-level revenue declines at about 10% for fiscal 2020 and more than 20% for fiscal 2021. States whose tax revenues rely heavily on industries that have suffered significant disruptions—tourism and oil and gas production, for example—face the biggest challenges.

States have responded by drawing down reserves, cash flow borrowing, cutting expenses, and identifying new sources of revenue where possible. Data from the Bureau of Labor Statistics indicate that state and local government payrolls shed more than 1 million jobs from March to the end of August.

Not every municipal issuer is well equipped to cope with the strains on their cash flows. Although default rates in the municipal bond market are likely to remain much lower than in other fixed income asset classes, credit analysts at T. Rowe Price have said that investors should expect an uptick in defaults, primarily among two groups: smaller issuers and those in the high yield segment of the market.

Postelection Relief?

The Federal Reserve’s creation of a Municipal Liquidity Facility as a backstop for issuers facing near-term

challenges contributed to the sharp recovery in muni bond yields. However, without federal support to offset lower revenue, states would likely need to cut costs further to right-size their budgets.

During Senate negotiations on a fourth round of federal stimulus, Democrats were strong advocates for direct aid to support state and local governments, suggesting that a Biden administration would push for similar measures as part of its effort to heal the economic damage from the coronavirus pandemic.

Based on Trump’s and the Republican Party’s resistance to providing relief without stringent restrictions, direct relief for state and local governments would be less likely if Trump were to win a second term. However, further economic damage could make Republicans more amenable to passing a larger stimulus bill after the election, especially if job losses deepen.

No matter which presidential candidate wins the election, the content, timing, and amount of any future stimulus package to address state and local budget shortfalls remains uncertain. In our view, the balance of power in the Senate will determine the scope and size of any federal relief for municipalities.

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