2025

STATE AND LOCAL FISCAL FACTS

An Update on the Fiscal Condition of State and Local Governments

Fiscal Condition of State and Local Governments

In the past few years, the fiscal conditions of state and local governments have stabilized, but improvements have been uneven. While challenges remain, officials have been taking steps to replenish rainy day funds and address long term structural imbalances.

State Finances [1]

Recent trends in state fiscal conditions reflect a continued return to a more "normal" budget environment, following multiple years of widespread, substantial surpluses and record-setting revenue growth. In the current state fiscal environment, new money is limited, revenue collections are performing close to states' forecasts, and reserves in most states are on track to record modest growth. While some variation exists, states overall are in a sound fiscal position with stable revenue outlooks and rainy-day funds at or near all-time highs. However, expenditure pressures are, in many cases, outpacing revenue growth. Coupled with expiring federal pandemic-era aid, state budgets will be tighter looking ahead.

In fiscal year 2024, total state spending (state and federal funds combined) continued to stabilize following pandemic-related increases. Total state spending increased 6.2 percent in FY 2024, growing moderately for a third consecutive year, following record growth in 2021. While states' own funds (general funds and other state funds combined) continued to grow strongly in FY 2024, federal funds to states have leveled off following rapid growth. The recent slowdown is largely due to states having already expended most of federal COVID-19 aid and the expiration of federal Medicaid funding. Federal funds to states grew 2.0 percent in FY 2024 after declining 4.1 percent in FY 2023.

Meanwhile, state general fund spending in FY 2025 enacted budgets is expected to record a slight annual decline of 0.3 percent after three consecutive years of robust expenditure growth. Those substantial increases, including in fiscal 2024, were largely driven by sizable one-time expenditures of surplus funds that are expected to lessen in fiscal 2025. Despite the aggregate decrease, 31 states are projecting general fund spending increases in fiscal 2025 based on enacted budgets and the median annual growth rate for the 50 states is an increase of 1.9 percent.

On the revenue side, growth in tax collections continues to stabilize as receipts come more in line

with states' revenue forecasts and growth rates reflect recently enacted tax cuts. General fund revenue is projected to grow 1.9 percent in FY 2025, following similarly modest growth in FY 2024 and an annual revenue decline in FY 2023. This recent slowdown in revenue following record-breaking growth in FY 2021 and FY 2022 was expected by states and built into their budgets. The vast majority of states recorded revenue surpluses in FY 2023 and most states reported collections for FY 2024 came in ahead of original estimates as well.

Most states are projected to end FY 2025 with larger rainy day fund balances than the previous year, building on substantial increases in reserves in recent years. The median rainy day fund balance as a percentage of general fund expenditures has grown every year since the aftermath of the Great Recession in FY2011, and states are expecting to continue this streak, with a median balance projected at 14.4 percent at the end of FY 2025 according to enacted budgets. Total balances, meanwhile, declined in FY 2024 and are expected to do so again in FY 2025 as states spend down prior-year unanticipated surpluses that have accumulated in their general fund ending balances. States spending down a portion of their large balances is to be expected and in line with routine budget practice, with many states directing these surplus funds to one-time investments.

City Finances [2]

City fiscal conditions show that municipalities are making the necessary shifts to continue to meet the fiduciary duty of local officials and the fiscal needs of their community. General fund expenditures, including the three largest categories of public safety, public health and recreation, saw a notable surge in 2023, due to increased fund reserves, conservative spending during the peak of the COVID-19 pandemic and substantial federal support in the forms of the CARES and American Rescue Plan Acts (ARPA) alongside the Bipartisan Infrastructure Law. COVID-era emergency aid programs, most significantly the State and Local Fiscal Recovery Fund Program, have had a transformative impact in communities and have been a lifeline for municipalities, cushioning the blow from the COVID-19 fiscal shock.

Both property and sales tax receipts increased in 2023 over the previous fiscal year mainly because of high home values and because businesses in many states continued revenue growth trends after the reopening of the economy. Income tax collections, while overshadowed by steeper increases in property and sales taxes, also experienced positive 1.5 percent growth in 2023 (in 2017 constant dollars), due to a healthy job market and the lowest unemployment rates in more than 50 years.

However, as we move into 2025, a decline in general fund revenue is anticipated, due to the expiration of pandemic-related emergency programs and the normalization of the post-pandemic economy. Cities' options are often hamstrung by tax and expenditure limits (TELs). TELs are state-imposed, and occasionally voter-imposed, restrictions on the ability of local governments to raise taxes or other revenues, or restrictions on how to spend those funds. As a result of

restrictions on tax revenues and other local financing tools, cities can either cut services or increase the fees charged for services which places greater financial burden on businesses and residents.

These fluctuations underscore the challenges cities face in maintaining sustainable revenue streams in the midst of shifting economic conditions.

County Finances

Counties invest nearly $743 billion annually to provide essential services such as public safety, infrastructure, healthcare and workforce development.[3] Counties also serve as the backbone of local economies, ensuring that businesses can thrive, workers can find jobs and communities remain resilient.

Recognizing counties' critical role in economic stability and recovery, the federal government made two historic investments in county governments through the Coronavirus Aid, Relief and Economic Security (CARES) Act and the American Rescue Plan Act (ARPA). CARES established the $150 billion Coronavirus Relief Fund (CRF) to support state and local governments in addressing the COVID-19 pandemic. Counties with populations over 500,000 received direct allocations, while others relied on state governments for funding distribution. ARPA established the State and Local Fiscal Recovery Fund (SLFRF), which provided a $65.1 billion direct investment in county governments to strengthen local economies, improve infrastructure and maintain essential services. Over the past four years, counties have strategically deployed these funds to reinforce their long-term capacity to meet growing demands, enhance public services and attract additional investments.

Growing Demand and Structural Constraints in Counties

Counties are economic engines, generating revenue and reinvesting it into their communities. According to a 2024 NACo survey, three-quarters (72 percent) of counties reported increased revenues between January 2021 and December 2023. However, as local economies expand, the demand for county services has risen even faster—with 85 percent of counties reporting an increase in service demand and 86 percent citing insufficient funding and/or workforce shortages as barriers to meeting community needs.[4]

Counties generate over two-thirds (68 percent) of their own revenue yet operate under a complex and often restrictive fiscal structure.[5] The primary source of revenue—property taxes—accounts for 38 percent of county-generated funds, but 44 states impose limitations on counties' ability to increase property tax revenues. Additionally, while 31 states allow counties to impose a local sales tax, these taxes are often restricted by rate limits, with the average capped

at 1.55 percent.[6]

To maintain financial flexibility and reduce the tax burden on residents, counties increasingly rely on fees and service charges, which now comprise 27 percent of all county-generated revenue.[7] Together with county taxes, these revenues help fund critical investments in infrastructure, housing, transportation, and business development, ensuring counties remain fiscally strong while supporting long-term economic growth.

Municipal Bankruptcy [8]

Municipal bankruptcy, while often headline grabbing, is rare and not an option for most municipalities. Fiscal stress in these cases usually stems from long-standing economic challengesand unique circumstances.

- Bankruptcy is not a legal option for sovereign entities. States have taxing authority and are constitutionally or statutorily required to balance their budgets.
- States determine whether their political subdivisions may pursue bankruptcy in the event of insolvency. Only 12 states authorize Chapter IX bankruptcy filings for their general-purpose governments, and another 12 states conditionally authorize such filings. Twenty-six states either have no Chapter IX authorization or prohibit such filings.
- Bankruptcies remain rare and are a last resort for eligible municipal governments.
- Chapter IX of the federal Bankruptcy Code does not provide for any federal financial assistance, and filing under this section of the law is not a request for federal funding

Federal Role in the Intergovernmental Partnership

America's system of federalism divides governing responsibilities between the federal government and state and local governments. The Tenth Amendment of the Constitution affirms this principle, stating "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." State and local governments play a vital role in this intergovernmental partnership, directly serving the needs of communities by addressing critical issues such as economic development, infrastructure, education, and public safety.

State and local governments are actively working to address fiscal challenges, including modernizing revenue systems, managing rising healthcare costs, and meeting growing pension obligations. Unnecessary federal mandates or preemptions can hinder the ability of state and local governments to effectively serve our constituents and undermine the balance of power envisioned by our Founding Fathers in the Constitution. These mandates and federal intervention often force difficult choices, requiring cuts to essential local services to comply with federal

requirements. We believe a more collaborative approach, one that includes consultation and addresses the financial impact on state and local governments, is essential for effective governance.

Municipal Bonds

Municipal securities are predominantly issued by state and local governments for governmental infrastructure and capital needs purposes, such as the construction or improvement of schools, streets, highways, hospitals, bridges, water and sewer systems, ports, airports and other public works. The volume of municipal bonds issued in 2024 was nearly $500 billion, a record high.

Between 2014 and 2024, states, counties, and other localities invested $3.5 trillion in infrastructure through tax-exempt municipal bonds; the federal government provided almost $1.5 trillion.[9]

On average, between 10-12,000 municipal issuances are completed each year.

The principal and interest paid on municipal bonds is a small and well-protected share of state and municipal budgets:

- Debt service is typically only about 5 percent of the general fund budgets of state and municipal governments.
- Either under standard practice or as required by law or ordinance, debt service most often must be paid first before covering all other expenses of state and municipal governments.
- Municipal securities are considered to be second only to Treasuries in risk level as an investment instrument. The recovery rate of payment for governmental debt far exceeds the corporate recovery rate.

Types of Debt and Default

Municipal debt takes two forms: General Obligation, or GO debt, backed by the full faith and credit of a general-purpose government like a state, city, or county; and Non-GO debt issued by governments and special entities that is usually backed by a specific revenue source (special taxes, fees, or loan payments) associated with the enterprise or borrower.

There are two types of defaults: First, the more minor “technical default,” where a covenant in the bond agreement is violated, but there is no payment missed and the structure of the bond is the same and second, defaults where a bond payment is missed, or in the rare event when debt is restructured at a loss to investors.

Historically, municipal bonds have had lower average cumulative default rates than global corporates overall and by like rating category. Since 2014, the average cumulative default rate

for municipal bonds was 0.06% compared to 8.16% default rate for corporate bonds.[10]

- In the double-A rating category to which the majority of municipal ratings were assigned, average cumulative default rates are much lower for municipal bonds than for corporate bonds with the same double-A symbol. [11]
- There has been only one state that has defaulted on its debt in the past century, and in that case bondholders ultimately were paid in full.

Federal Tax Exemption

The federal tax exemption for municipal bonds is an effective, efficient, and successful way for state and local governments to finance infrastructure. Municipal securities existed prior to the formation of the federal income tax in 1913. Since then, the federal Internal Revenue Code has exempted municipal bond interest from federal taxation. Over the past twenty years, the federal exemption has saved state and local governments on average 150-200 basis points in additional interest expenses and we expect that to be near 210 basis points in the years ahead.[12] In 2024 alone, state and local governments saved over $9 billion in additional interest expense through the federal tax exemption.[13] Many states also exempt from taxation the interest earned from municipal securities when their residents purchase bonds within their state. Because of the reciprocal immunity principle between the federal government and state and local governments, state and local governments are prohibited from taxing the interest on bonds issued by the federal government.

Beginning in 2018 state and local governments could no longer use tax-exempt bonds to advance refund outstanding bonds as a result of the 2017 Tax Cuts and Jobs Acts. Before that, tax-exempt advance refundings helped state and local government take advantage of favorable interest rate environments, which resulted in reduced debt service costs, the freeing up of resources to be used for other important purposes, and a reduction in taxpayer and ratepayer burdens. Advance refundings helped issuers save more than $14 billion from 2012 - 2017.

State and Local Pensions [14]

Although some state and local government pension trusts are fully funded with enough assets for current pension obligations, there are concerns about the extent of underfunding in certain jurisdictions. In most cases, increases in contributions, or modifications to employee eligibility and benefits, or both, will be sufficient to remedy the underfunding problem.[15]

Governance and Reforms

State and local government retirement systems are established and regulated by state statutes; subject to fiduciary, investment and administrative laws and benefit protections; and overseen by elected officials, regulators and independent boards to ensure they are managed responsibly and transparently. In many cases, plans are further subject to local governing policies,

ordinances and oversight. Federal regulation is neither needed nor warranted, and public retirement systems do not seek federal financial assistance. State and local governments have and continue to take steps to strengthen their pension reserves and operate under a long-term time horizon. Since the Global Financial Crisis, every state has made changes to pension benefit levels, financing arrangements, or both, often multiple times. Many local governments have made similar reforms to their plans.[16] None required federal intervention.

Pension Finances

Public employees and their employers contribute to their pensions during employees' working years. Assets are held in trust and invested in broadly diversified portfolios to prefund the cost of pension benefits for over 15 million working and 12 million retired employees of state and local government.[17] As of September 30, 2024, state and local retirement trusts held $6.25 trillion in assets.[18] These assets are invested using a long-term horizon, and nearly all benefits are paid out not as a lump sum, but as monthly distributions in retirement.

Public employees typically are required to contribute 5 to 10 percent of their wages to their state or local pension. Most states have increased required employee contribution rates in response to economic and market changes over the last fifteen years.[19]

For most state and local governments, retirement systems remain a relatively small portion of their budget. For the nation as a whole, the portion of combined state and local government spending dedicated to retirement system contributions is 5.1 percent.[20] Current pension spending levels vary widely and are sufficient for some entities and insufficient for others. In recent years, some states that previously failed to make adequate contributions to their pension plans have significantly improved their contribution efforts.

Funded levels—the degree to which a plan has accrued assets to date to pay projected long-term benefits for current and future retirees—vary widely. Although a number of pension plans are near or above 100 percent advance-funded, on average, the funded level in FY2023 was 76 percent, and 13 percent of plans were less than 60 percent funded.[21] Aggregate public pension funding levels have improved in recent years, and the number of plans with a funding level below 60 percent has dropped notably.

All state retirement systems have reduced their investment return assumption following the Global Financial Crisis. The average investment return assumption for FY2023 is 6.91 percent[22] and actual returns have met or exceeded this assumption for the 1-, 5-, 10-, 20-, and 30-year periods ending December 31, 2024.

Essentially all major pension systems are focused on transparent reporting and disclosure. They have formal funding policies, and develop annual comprehensive financial reports, summary plan descriptions and actuarial valuations based on national standards. Evaluations of how assumptions have matched experience are typically performed every five years.[23]

Endnotes:

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