2026

STATE AND LOCAL FISCAL FACTS

An Update on the Fiscal Condition of State and Local Governments

National Governors Association

NCSL Celebrating 50 Years

The Council of State Governments

National Association of Counties NACo

NLC National League of Cities — A Century of Strengthening Cities

ICMA International City/County Management Association

The United States Conference of Mayors

Government Finance Officers Association

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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]

States are in a stable fiscal position but face tighter budget conditions ahead amidst continued slow revenue growth, increasing spending pressures, and declining federal funds.

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 outpacing revenue growth in a growing number of states, especially in years beyond the current budget cycle. This dynamic, coupled with the winddown of pandemic-era federal aid, recent reductions to some federal grants, and scheduled federal funding changes under the One Big Beautiful Bill Act (OBBBA), is leading to tighter state budget conditions and will require states to make difficult decisions.

In recent years, total state spending (state and federal funds combined) has continued to stabilize following pandemic-related increases. Total state spending increased 5.7 percent in fiscal 2025, growing moderately for a fourth consecutive year, following record growth in 2021. States' own funds (general funds and other state funds combined) and federal funds increased at similar rates in FY 2025, with state funds growing 5.7 percent and federal funds growing 5.5 percent.

In FY 2026 enacted budgets, state general fund spending is projected to record a slight annual increase of 1.3 percent after four consecutive years of annual expenditure growth of at least 6 percent. General fund spending increases in recent years have been largely driven by sizable one-time expenditures of surplus funds that are expected to lessen in FY 2026 and beyond. On a median basis, general fund spending is estimated to grow just 0.2 percent in FY 2026, with 23 states projecting year-over-year declines. In another sign of tightening, a growing number of states reported using targeted cuts and eliminating vacancies and/or hiring freezes in their enacted budgets for FY 2026.

Smaller spending increases and targeted budgetary actions reflect states' efforts to align spending with slower revenue growth. General fund revenue in FY 2026 is projected to grow just 0.3 percent on a median basis. This follows annual general fund revenue growth on a median basis between 1 and 3 percent in FY 2023 through FY 2025. Slower revenue growth in recent years, which followed record-breaking increases in FY 2021 and FY 2022, can be attributed to slower economic growth and lower inflation coupled with the impacts of recently adopted tax cuts at the state level.

Most states are projected to end FY 2026 with larger rainy day fund balances than the previous year, building on substantial increases in reserves in recent years. While the median rainy day fund balance as a percentage of general fund expenditures declined in FY 2025 for the first time since the aftermath of the Great Recession, this was the result of expenditures growing faster than reserves for the average state rather than a reflection of widespread use of rainy day funds. The median balance as a percentage of general fund spending is expected to tick back up to 14.4 percent in FY 2026. Total balances, meanwhile, are expected to continue declining as states spend down prior-year unanticipated surpluses that accumulated in their general fund ending balances. States spending down a portion of their large ending 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 in 2025 reflected a shift from post-pandemic recovery to a more restrained and uncertain budget environment. While cities continue to meet community needs, the expiration of federal emergency programs and slowing revenue growth are tightening fiscal conditions.

General fund expenditures rose sharply in FY2024, supported by strong reserves, conservative pandemic-era spending, and substantial federal aid through the CARES Act, American Rescue Plan Act's (ARPA) State and Local Fiscal Recovery Fund and the Bipartisan Infrastructure Law. By FY2025, however, spending growth has leveled off as cities adjust to reduced federal support and rising costs.

Revenue trends mirror this transition. Property and income taxes saw strong gains in 2024 due to strong housing demand and labor markets, but both are expected to stabilize in 2025. Sales tax revenues have flattened as consumer spending returns to pre-pandemic patterns. As a result, only 52 percent of finance officers report being better able to meet their FY2025 needs than in FY2024, and just 45 percent feel optimistic about FY2026.

State-imposed tax and expenditure limits (TELs) continue to constrain local fiscal flexibility, often forcing cities to either reduce services or increase fees. External pressures are also emerging: nearly half of surveyed cities report tariff-related procurement challenges, and many are monitoring potential changes to the municipal bond tax exemption, which could significantly raise borrowing costs and delay infrastructure projects.

Despite these headwinds, cities are adapting—reassessing priorities, exploring alternative financing, and planning for a more constrained fiscal landscape.

County Finances [3]

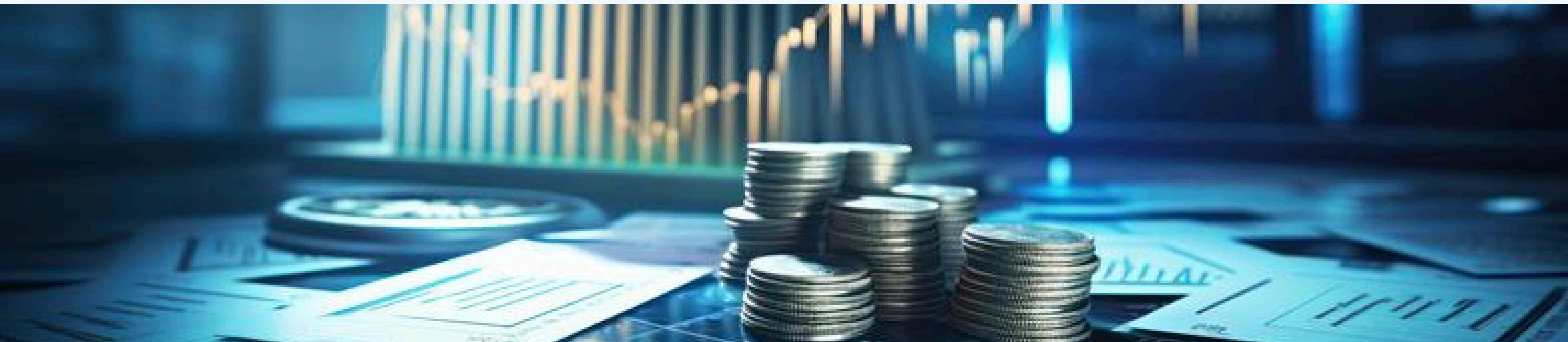
County fiscal conditions reflect a stable but constrained environment, shaped by state-imposed revenue limits, rising service costs, and shifting intergovernmental funding.

Counties collectively generate over $775 billion annually from a wide variety of sources, raising approximately 68 percent of their own revenue through local taxes, charges, and fees. Property taxes remain the dominant revenue source, providing over $200 billion per year, while sales taxes contribute $70 billion and charges and fees generate $142 billion. The remaining 32 percent of county revenue comes from federal, state, and other local governments — totaling $247 billion in intergovernmental transfers each year.

Despite this scale, county fiscal flexibility is heavily constrained by state law. Forty-four states impose limits on county property tax authority, and only 31 states permit counties to levy any form of local sales tax, almost always with restrictions. In 2025, 21 states imposed substantial restrictions on county finance authority, leaving many counties with limited ability to adjust revenues in response to rising costs or service demands.

In a growing trend across the nation, the National Association of Counties (NACo) estimates in a preliminary forthcoming 2026 report that actions by state legislatures have resulted in one hundred fifteen property tax actions in thirty-four states and the District of Columbia from 2020 to 2025 resulting in a reduction of tax revenue projected to be approximately $11.91 billion in Fiscal Year 2026-27 and $11.94 billion the following year. Property tax and other discretionary provide direct, tangible benefits to communities for core mandated services that include health & human services, zoning and development, elections, schools, public amenities, public safety, and infrastructure projects. Nearly all states set significant limits on counties' ability to raise revenue through property taxes with thirty-one states imposing multiple limits such as property tax exemptions relief, credits, refunds, assessments, reductions, incentives and increased limits all lowering the value of a taxable property.

These structural constraints are compounded by growing expenditure pressures. Counties invest over $740 billion annually, led by health and human services ($194 billion), justice and public safety ($124 billion), education ($121 billion), and transportation ($60 billion). As federal pandemic-era aid winds down and state funding formulas tighten, counties with limited revenue authority face difficult tradeoffs between service levels and fiscal sustainability.



Municipal Bankruptcy [4]

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 2025 was nearly $580 billion, a decrease from the previous high set in 2016 of $445 billion, and a 13% increase in issuance over 2024. [5] While the total par value of the tax-exempt municipal bond market grows to $3.5 trillion in 2025, {6} the federal government's contribution to public infrastructure has remained unchanged for over 20 years.[7}

On average, 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: (1) 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 (2) defaults where a bond payment is missed, or in the rare event when debt is restructured at a loss to investors.

Since Congress added Chapter 9 to the federal bankruptcy code in the 1930's, approximately 700 entities have filed under this provision. In contrast, commercial Chapter 11 filings typically exceed 5,000 annually [8] The majority of rated defaulted bonds were issued by not-for-profit hospitals or housing project financings, not including debt issued by Puerto Rico, a territory with debt default subject to the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA), a US Federal Law.

Historically, municipal bonds have had lower average cumulative default rates than global corporates overall and by like rating category. Since 2007, the average 5-year default rate for municipal bonds was 0.08, compared to 6.94% default rate for corporate bonds. [9]

- 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. [10]
- 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. [11] In 2025 alone, with over $3.5 trillion underpinning state and local infrastructure, taxpayers saved over $73 billion in additional interest expense through the federal tax exemption.[12] 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.

As a result of the 2017 tax reform law, beginning in 2018 state and local governments could no longer use tax-exempt bonds to advance refund outstanding bonds. 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 [13]

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.[14] None required federal intervention.

Pension Finances

State and local government retirement systems distribute more than $400 billion annually to more than 12 million retired public employees and their survivors that reside in virtually every city and town in the nation. 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 employees of state and local government. [15] As of September 30, 2025, state and local retirement trusts held $6.7 trillion in assets. [16] These assets are invested using a long-term horizon, and nearly all benefits are paid as monthly distributions in retirement, not as a lump sum. Public employees typically are required to contribute 5 to 10 percent of their wages to their state or local pension. Since the Global Financial Crisis, most states have increased required employee contribution rates. [17]

For most state and local governments, retirement systems remain a relatively small portion of their budget. Nationwide, the portion of combined state and local government spending dedicated to retirement system contributions is 5.1 percent.[18] Current pension spending levels vary widely and are sufficient for some entities and insufficient for others. [19] 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 some pension plans are near or above 100 percent advance-funded, the average funded level in FY24 was 77 percent, and over 20 percent of plans were more than 90 percent funded. [20] 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.

Many public plans have moved toward more conservative actuarial methods and assumptions. For example, all state retirement systems have reduced their investment return assumption following the Global Financial Crisis. The average investment return assumption for FY24 was 6.91 percent [21} and actual returns have met or exceeded this assumption for the 1-, 3-, 5-, 10-, 20-, and 30-year periods ending December 31, 2025. [22]

It is important to note that 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]

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