PUBLIC SECTOR SERVICES

Assessing the State and Local Government Fiscal Outlook

Synopsis

While many state and local governments have weathered the COVID-19 pandemic in good financial shape, they face a variety of uncertainties and challenges going forward — including a rapidly approaching federal funding cliff. This set of circumstances provides governments with a unique opportunity in 2024 to step back and comprehensively evaluate their fiscal resources, needs and risks. An A&M fiscal health assessment can provide valuable insight into a government's fiscal condition and inform a financial sustainability plan that funds major service priorities and financial obligations on a long-term basis.

A Shifting Economic Environment

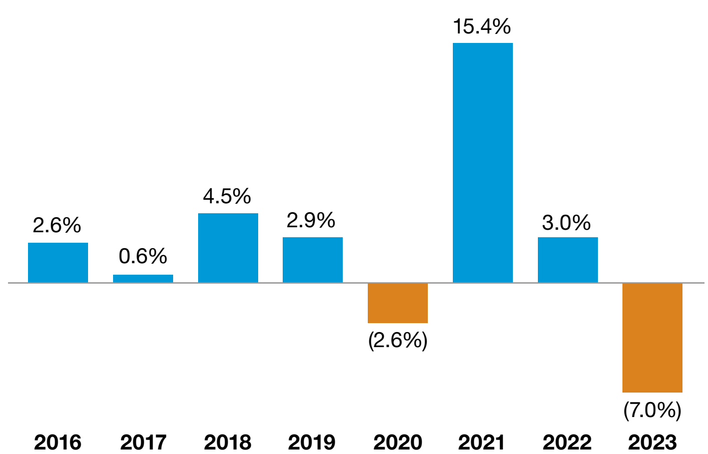
The latest employment and inflation data have increased the odds of a “soft landing” for the U.S economy, but recent economic volatility means the outlook remains uncertain, particularly with regards to consumer demand. A downturn in employment and other taxable economic activity, either now or in the future, could quickly sap the financial reserves that governments have been able to build up in recent years.

State and local revenues surged during the pandemic as a result of one-time federal stimulus spending, rapid increases in housing prices and a temporary shift in consumer spending from nontaxable services to taxable goods. **The major revenue sources that state and local governments rely on, however, are now flattening out or declining:**

- **Income tax** revenues have fallen significantly across the country. In many cases, this is a result of policy decisions by states to cut taxes, but investment market losses have also been a contributing factor. In urban areas, local income taxes have declined as a result of the shift from traditional office environments to remote and hybrid work.
- **Sales tax** revenue growth has flattened out as the shift from purchases of nontaxable services to taxable goods during the pandemic reverses itself.
- **Property taxes**, the largest revenue source for most local governments, are stable in most areas but are a lagging indicator of real estate market activity and may decline if higher mortgage interest rates persist and eventually cause housing prices to weaken, or if the shift to remote and hybrid work causes commercial office space valuations to fall.

Annual Change in Total State and Local Government Tax Revenues

July-June Fiscal Year, Adjusted for U.S. Consumer Price Index



Source: U.S. Census Bureau

On the expenditure side of the ledger, state and local governments face an array of short- and long-term pressures that have been impacted by the pandemic and its economic effects, as outlined below.

State and Local Government Expenditure Pressures	
Operating Costs • While inflation has come down from the major spike that occurred from 2021 into 2022, state and local governments face lagging cost increases as multi-year labor agreements and contracts for goods and services expire and are renegotiated. • As the largest category of expenditures for most governments, labor costs are particularly challenging as a tight labor market makes recruitment and retention for high-demand positions more difficult, public sector unions seek to make up for lost purchasing power in recent years, and employee health care costs continue to rise.	**Capital Investment Needs** • While the federal Infrastructure Investment and Jobs Act provides a much-needed short-term investment boost, additional long-term financial investment will be needed to make up for decades of underinvestment in water and sewer systems and transportation infrastructure, and to make the sizable forward-looking investments needed in clean energy production and broadband infrastructure. • Higher interest rates for municipal borrowing, rapid increases in construction costs, and shortages in qualified workers have made addressing capital investment needs even more expensive.
Information Technology • Critical IT support systems demonstrated weaknesses as case volumes spiked during the pandemic. Investments will be needed to strengthen or replace legacy IT systems. • Many governments have experienced difficulty filling vacancies in both professional and back-office positions, highlighting the need for investment in technology that can streamline key processes. The rise of generative AI is creating new opportunities, and risks, for the use of technology to gain efficiencies.	**Retirement Liabilities** • While 2023 delivered positive investment gains for public retirement systems, the majority of state and local governments still have substantial unfunded liabilities they're paying down over time. • Further, negative investment results from market volatility in previous years are still being phased in under actuarial smoothing practices, potentially increasing the actuarially determined contributions that governments need to build into their annual operating budgets.
Service Gaps • In many cases, the pandemic highlighted and exacerbated the need for additional public services and supports in areas like mental health, housing and workforce development. State and local governments that have opted to use temporary federal funds to bolster those services to their residents will be interested in identifying existing or new financial resources that can be utilized to continue those efforts.	

A Critical Year for Flexible Federal Funding

The $350 billion in State and Local Fiscal Recovery Funds (SLFRF) provided under the federal American Rescue Plan Act (ARPA) have been a boon for state and local governments across the country. These funds have helped offset revenue losses caused by the pandemic to allow essential government services to continue uninterrupted, created the opportunity to make investments in programs to support local economic recoveries and provide health and human service support to residents, and allowed governments to catch up on infrastructure investments and equipment purchases. **Key deadlines for the use of SLFRF funds, however, are now rapidly approaching:**

- SLFRF funds must be fully **obligated** by December 31, 2024.
- SLFRF funds must be fully **expended** by December 31, 2026.

The recent Interim Final Rule issued by the U.S. Department of Treasury regarding the definition of "obligation" does not provide a great deal of flexibility for the first deadline:

- With very limited exceptions for administrative costs related to SLFRF funds, governments must place orders for property and services and enter into contracts, subawards or similar transactions by the end of the year. **Simply having funds appropriated or programmed for specific purposes won't be sufficient.**
- Additionally, there are significant restrictions on the use of SLFRF funds for employee payroll beyond December 31, 2024, limited to employees whose time is spent complying with federal funds reporting and administrative requirements.

Financial data submitted by state and local governments to the U.S. Department of Treasury indicate that, as of September 30, 2023, just roughly half of SLFRF funds had been spent and at least one of every four dollars received had not yet been obligated.

> ***Absent an adjustment to federal guidance, in less than 12 months state and local governments leaders need to ensure that all of their SLFRF funds are fully obligated to avoid returning a portion of the funds to the U.S. Department of Treasury.***

State and Local Fiscal Recovery Funds

Spending Status as of September 30, 2023

$350.0 Billion Received

Source: U.S. Department of Treasury

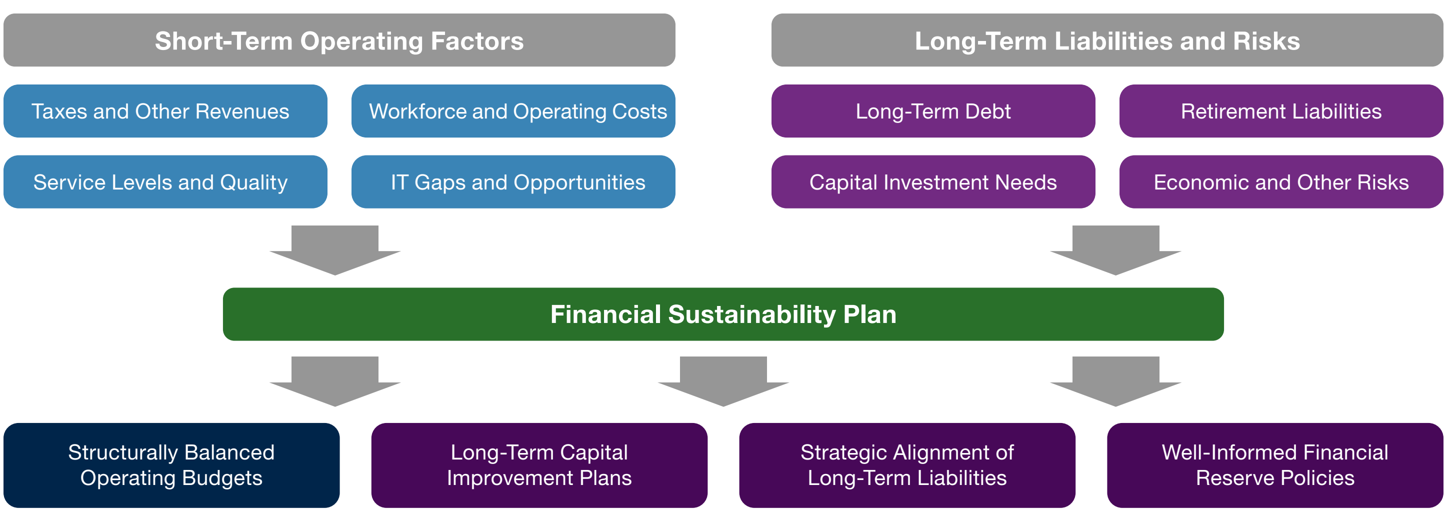
Government leaders will not only need to fully allocate SLFRF funds and enter into contracts and purchase agreements for SLFRF funds that not yet been obligated by the end of 2024, but also assess whether existing SLFRF-funded programs can meet the 2026 federal spending deadline and, if not, repurpose those funds for other uses. In some cases, use of the more flexible Revenue Loss provisions created under the 2022 Final Rule SLFRF funds may allow a government to strategically address financial liabilities.

How A&M Can Help

The confluence of the shifting economic environment and the first SLFRF funding deadline create a unique opportunity for state and local governments to comprehensively assess their long-term financial outlooks and establish a holistic financial plan going forward. While such an effort will be critical for governments that were forced to utilize SLFRF funds to backfill their base operating budgets and are facing an imminent “fiscal cliff,” all governments can benefit from a periodic review and realignment of their financial outlooks.

Compounding the challenges described here is the national shortage in government accounting and finance staff. As state and local governments work to fill vacancies to keep day-to-day financial operations functioning effectively, they may not have the capacity to comprehensively assess the government’s financial outlook and confront these challenges and risks on their own.

Creating a Financial Sustainability Plan



> ***With a fiscal health assessment conducted over just a one- to two-month period, professionals at Alvarez & Marsal can utilize their extensive experience helping governments tackle financial challenges to identify both short-term and long-term financial shortfalls and opportunities. This assessment informs the creation of a long-term financial sustainability plan that utilizes remaining SLFRF funds strategically and supports the construction of structurally sound budgets for 2025 and beyond.***

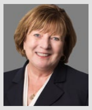
Based on our long track record of assisting state and local governments with financial planning and transformation, A&M offers a range of services to address financial and operational gaps identified as part of a fiscal health assessment, including the following:

- **Revenue Management:** We review collections and audit processes to improve tax yield, enhance cash flow and optimize the overall tax function.
- **Finance, Accounting and Compliance:** We remove roadblocks that prevent timely financial reporting and design key controls to manage risk and remediate drivers of control failures.
- **Federal Funds Management:** We help public agencies navigate a complex federal funds management and financial reporting environment through proactive strategy and planning.
- **Long-Term Financial Planning:** We identify recurring revenue enhancement and cost reduction initiatives to build sustainable financial plans.
- **Talent, Operations and People:** We analyze the size and composition of the workforce to align leadership, talent and culture, to support emerging needs and improve performance.
- **Organizational and Shared Services:** We identify common functions across agencies that could be consolidated within a government or delivered more effectively in partnership with external service organizations.
- **Digital and Technology Solutions:** We identify opportunities for utilizing automation or expanding the use of technology to improve effectiveness and reduce costs.
- **Strategic Procurement:** We utilize proven strategic sourcing methodologies to drive savings and improve quality.
- **Capital Planning:** We design and implement processes, tools, technologies and appropriate governance for the successful development, evaluation and execution of capital projects.

A&M's Public Sector Experience

In 2003, A&M launched its Public Sector Services (PSS) practice to meet the unique needs of federal, state and city governments, as well as school districts, state education agencies, institutions of higher education and other education and non-profit organizations. Since then, PSS has completed over 400 projects for more than 200 different public sector clients in nearly all 50 states.

Contacts



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ABOUT OMNIA PARTNERS, PUBLIC SECTOR

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Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) for leadership, action and results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services. When conventional approaches are not enough to create transformation and drive change, clients seek our deep expertise and ability to deliver practical solutions to their unique problems.

With over 9,000 people providing services across six continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, leverage A&M's restructuring heritage to help companies act decisively, catapult growth and accelerate results. We are experienced operators, world-class consultants, former regulators and industry authorities with a shared commitment to telling clients what's really needed for turning change into a strategic business asset, managing risk and unlocking value at every stage of growth.

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