

U.S. Municipal Bond Market

If Taxes Go Higher, Demand for Municipals Will Also Rise

Summary

- States such as New Jersey, California, and New York have been considering taxes on the wealthy to help close budget gaps.
- Demand for municipal bonds has been strong since the Tax Cuts and Jobs Act of 2017, and that demand has continued in recent months. This week, investors added another \$2.3 billion to municipal mutual funds. This was the 14th consecutive week of positive flows where investors have in total allocated \$21.4 billion into municipal funds.
- We expect demand for tax-exempt municipal bonds will rise if or when taxes go higher.

Higher Taxes May be Required to Help Plug an Almost \$1 Trillion Budget Hole

U.S. states are projected to possess a \$555 billion (revised down from \$650 billion) budget gap over three years, according to a recent revision by the Center on Budget and Policy Priorities.¹ Cities anticipate a \$360 billion revenue shortfall according to a National League of Cities report.² A report released yesterday also by the National League of Cities highlighted that it took city budgets about 12 years to recover to their pre-2007 positions.³ This time around the hole could be even deeper for some without tax hikes.

The current financial situation is more than strained for state and local governments around the country. On top of that, this new COVID-19 reality is proving to be especially difficult for entities that were structurally imbalanced before March 2020.

New Jersey Governor Cannot Commit to Leave Taxes Alone

The state of New Jersey is one of the lowest rated states in the U.S. This morning, New Jersey Gov. Phil Murphy appeared on CNBC Melissa Lee and explained four methods the state will use to revamp its budget:⁴

- First, the state will borrow a lot. The N.J. Supreme Court just approved the state's ability to borrow \$10 billion;⁵
- Second, the state plans to cut expenses;
- Also, N.J. will raise revenue (means "increase taxes") to address inequities from the pandemic, including a millionaire's tax;
- Gov. Murphy also called on Congress to act on another round of COVID-19 relief.⁶

During the interview, Gov. Murphy stressed Congress needs to act on relief for state and local governments. However, the governor was not able to commit to not raising taxes after he was asked if taxes could remain level if federal state relief materialized. For several years Gov. Murphy has supported the millionaire's tax policy. And polling also supports a hike on millionaires, showing the tax hike is favored by 72%.⁷

California Lawmakers Offer Multiple Millionaire Tax Proposals

Even though California regained its structural balance in the last decade,⁸ it has not been immune to the significant COVID-19 impact. In fact, California has been one of the hardest hit states from a fiscal perspective.

Please see disclosure starting on page 3.

Tom Kozlik

Head of Municipal Strategy & Credit
214.859.9439
tom.kozlik@hilltopsecurities.com

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Last week, an attempt to generate revenue from high earners to fund government and help pay for aid to schools failed, but a new proposal was introduced this week. The new plan would, “levy a 0.4% tax on Californians with a net worth of \$30 million or more. The legislation would affect about 30,000 residents, less than 1% of Californians and generate \$7.5 billion for schools and the state’s social safety net.”⁹ Top earners in California already pay the highest state income tax rate nationwide according to data from the Tax Foundation.¹⁰

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Lawmakers Also Propose to Tax the Wealthy in New York State

Even before the COVID-19 pandemic, lawmakers were scrambling to find a way to close New York state’s \$6 billion budget gap, the largest since the Great Recession. Ron Deutsch, executive director of the Fiscal Policy Institute said pre-pandemic, “New York should ask our billionaires and millionaires to pay a little more so we can eliminate our budget gap, create a fairer tax system and fund the starved services so many New Yorkers depend on.”¹¹

The fiscal fallout from COVID-19 has been fierce across New York state. A multi-year budget gap of \$60 billion is now expected with a \$13 billion or 14% shortfall in FY21.¹² New York lawmakers, including Gov. Andrew Cuomo, have been waiting to see what type of relief Washington, D.C. lawmakers are willing to make available. Already, a collection of 100 New York State Senate and Assembly members have signed a pledge to refuse to allow state budget cuts without a tax hike on New York’s wealthy.¹³

Higher Taxes Will Drive Demand for Tax-Exempt Municipal Bonds

In addition to the above-mentioned proposals, at some point it is likely conversations about bringing the federal budget closer to balance will recommence. If these efforts to raise taxes are successful, we believe it could drive demand higher for tax-exempt municipal bonds. And, keep in mind there is an increased scarcity factor for investors to now consider. This was caused by the less and less tax-exempt bonds available from a higher and higher amount of municipal bonds that are being issued on a taxable basis.

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The demand for tax-exempt bonds is likely to increase because the interest they earn is not subject to federal income tax. In some cases, they are not subject to state or local tax either, but this potential feature differs depending upon circumstances.

We Have Seen Significant Demand for Municipals in 2019 and 2020

This week investors added another \$2.3 billion to municipal mutual funds. This was the 14th consecutive week of positive flows where investors have in total allocated \$21.4 billion into municipal funds.

Last year flows into municipal funds were positive every week. Investors put in a total of \$65 billion into municipal funds. To date, investors have distributed a net positive amount of \$6.5 billion in 2020, which is lower because about \$31 billion flowed out of municipal funds in March and the beginning of April.

The desire for the tax-exemption advantage has likely been one of the drivers of this consistent municipal demand. We saw the demand escalate after the implementation of the Tax Cuts and Jobs Act of 2017 and demand has kept up. Keep in mind the 2017 Act really did two things that impacted the supply and demand relationship. It eliminated the use of tax-exempt bonds for advance refundings, thus reducing the supply of tax-exempt bonds, and it capped the state and local government tax deduction, effectively creating a selective tax hike. This likely increased the demand side.

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¹ McNichol, Elizabeth and Michael Leachman; [States Continue to Face Large Shortfalls Due to COVID-19 Effects](#); Center on Budget and Policy Priorities; July 7, 2020.

² [Cities Anticipate \\$360 Billion Revenue Shortfall](#); National League of Cities; May 14, 2020.

³ [City Fiscal Conditions, 2020](#); National League of Cities; August 13, 2020.

⁴ Squawk Box, @SquawkCNBC; Twitter Post; Aug. 14, 2020 7:59AM; <https://twitter.com/SquawkCNBC/status/1294257300413263872>

⁵ Reitmeyer, John; [NJ Supreme Court Says Gov. Murphy Can Borrow Billions Without Voter Approval. But There's a Restriction](#); NJSpotlight; August 12, 2020.

⁶ Squawk Box, @SquawkCNBC; Twitter Post; Aug. 14, 2020 7:59AM; <https://twitter.com/SquawkCNBC/status/1294257300413263872>

⁷ Hernandez, Joe; [Third time's the charm? Murphy floats N.J. tax hike on millionaires again](#); WHYY PBS; Feb 20, 2020.

⁸ Please see more in: Kozlik, Tom; [The U.S. Municipal Bond Market in 2020, in the Last Decade, and in the Next](#); HilltopSecurities; December 18, 2019; page 7.

⁹ Wiley, Hannah; [California Democrats pushing 2 plans to tax rich in coronavirus downturn](#); The Sacramento Bee; August 13, 2020.

¹⁰ Loughead, Katherine; [State Individual Income Tax Rates and Brackets for 2020](#); Tax Foundation; Feb 4, 2020.

¹¹ McDonough, Annie; [What Should be Done About New York's \\$6.1 Billion Budget Gap?](#); City&State New York; Jan 5, 2020.

¹² [New York State Division of Budget Announces Release of the FY2021 Enacted State Budget Financial Plan](#); New York State Division of Budget; April 25, 2020.

¹³ Slattery, Denis; [New York lawmakers embrace tax the rich plan to avoid spending cuts post coronavirus](#); NY Daily News; June 18, 2020.

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