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COVID-19 DISRUPTS MUNICIPALITIES—WILL TAXING MILLIONAIRES ACCELERATE OUTMIGRATION?

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In June of 2020, we published a credit research paper appraising the ability of state governments to withstand the pandemic's upheavals. At the time, we thought rating reductions were likely if more direct federal funding for states didn't materialize. Although that stimulus didn't arrive, by September the two biggest credit-rating firms had only downgraded about 1% of the muni borrowers they rate.[1] Apart from some high-profile downgrades (including New York and New Jersey in late fall) the muni credit markets finished 2020 buoyed by breakthrough vaccines and signs that state and local tax collections were better than anticipated. That said, many governors still face tough choices when it comes to budget shortfalls: they must either raise revenues, cut spending, or both. In this paper, we explain why tax revenues have rallied unexpectedly for California, and begin to explore if working remotely will accelerate outmigration from New York City.

New York Governor Andrew Cuomo didn't mince words last April. In the wake of budget shortfalls triggered by COVID-19, Cuomo promised to cut state spending by $8.2 billion. It wasn't an idle threat. Lawmakers in the Albany capital gave Cuomo unilateral authority to make broad cuts based on projected revenue shortfalls. Because raising taxes was off the table, the only way to avoid spending cuts was either direct federal aid to replace lost revenues, or if revenues turned out better than forecast.[2] Fast-forward to January 2021, and Cuomo is now contemplating an approach New Jersey recently adopted: raising taxes.

PROGRESSIVE TAX INCREASES

Back in September, New Jersey Governor Phil Murphy convinced state lawmakers to implement a progressive tax increase on residents earning $1 million or more. By raising the state's top marginal rate from 8.97% to 10.75%, New Jersey now has one of the highest personal income tax rates, trailing just California (13.3%) and Hawaii (11%),

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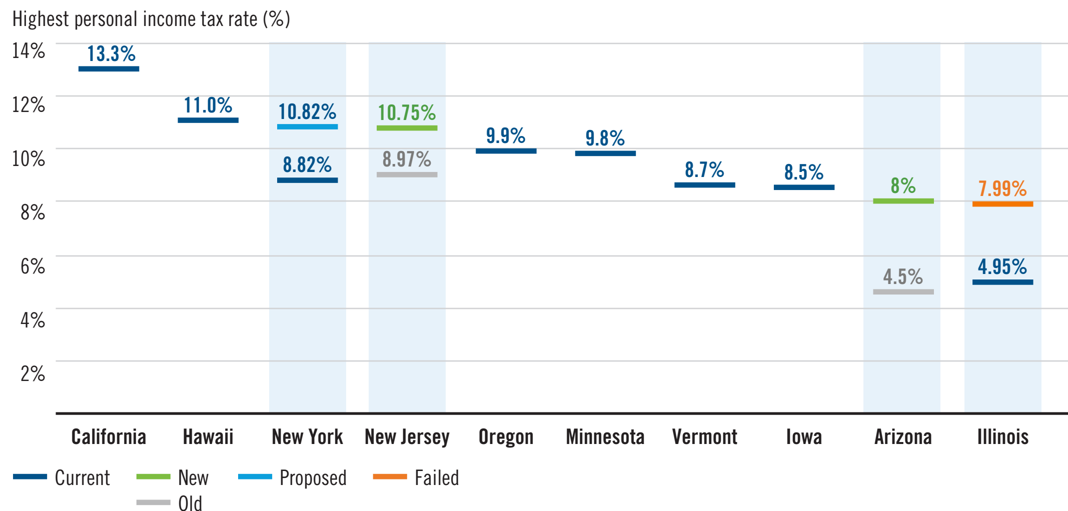
as shown in Exhibit 1. That tax hike, however, wasn't enough to hold off a credit downgrade in early November, due to the state's hefty structural deficit. Following the downgrade, New Jersey issued an emergency $4 billion COVID-19 bond to help close the state's budget gap. Driven partly by scant tax-free muni supplies, New Jersey's one-of-a-kind bond was nearly 10 times oversubscribed. Given low rates, many issuers could refinance tax-exempt bonds with taxable munis and still achieve lower yield—doubling taxable muni issuance to $140 billion in 2020.[3]

TOP-RATE INCOME TAXES

Exhibit 1: New wealth taxes gain traction

As of January 2021



Sources: Tax Foundation, state comprehensive annual financial reports.

Like Murphy, Illinois Governor Jay Pritzker was hoping a progressive tax increase would give him breathing room to tackle a structural deficit much larger than New Jersey's. By replacing a flat 4.95% income tax with a graduated six-bracket system, Pritzker wanted to increase the top rate to 7.99% for joint filers earning over a million, while reducing taxes on low-income earners to 4.75%. Voters rejected the proposal in November, leaving Illinois on the precipice of a junk rating.

Given the tepid reaction to Pritzker's tax proposal, why is Cuomo considering raising taxes on New York's wealthiest? One reason is his $8.2 billion spending cut never fully materialized. Instead, Cuomo withheld approximately $2.9 billion in aid to local governments temporarily, hoping the cuts wouldn't become permanent if federal aid materialized. Would raising New York's top income tax rate solve Cuomo's budget shortfall? Let's start by reviewing California's progressive tax structure to see how the Golden State weathered the COVID-19 storm last year.

SUNNY CALIFORNIA

Amid frustrations over a slow vaccine rollout, Governor Gavin Newsom delivered some welcome budget news in early January 2021: California had an unexpected $15 billion surplus. Back in June 2020, state lawmakers were bracing for much worse. After passing a skinnier budget that included funding cuts and payment delays, Newsom's finance team projected a future $8.7 billion deficit if COVID-19 infections forced more lockdowns.[4] So how do we explain the $23.7 billion spread between the anticipated deficit and California's surprise surplus? One answer lies in the stark K-shaped recovery that has disproportionally benefited America's wealthiest.

For employees in high-wage industries like finance and information management, technologies like Zoom and Microsoft Teams meant they kept working safely from home through the pandemic without skipping a beat. With the combo of high-income work flexibility and California's progressive income tax structure—the Golden State relies on the rich more than most other states—California ended up receiving more income-tax withholdings during the last nine months of 2020 compared with all of 2019.[5]

Just as Zoom-like technology buttressed revenues from high-income workers, so too have online retailers stabilized state revenues from sales taxes. Although COVID-19 closed revenue generators like Disneyland, millions of home-bound families helped pick up the slack by shopping online. In a stroke of great timing, Newsom had recently signed a new internet law in April 2019 requiring online marketplaces like Amazon to collect California sales taxes. That law sprang from a 2018 US Supreme Court case—South Dakota vs. Wayfair, the online home-goods store—allowing states to charge taxes on internet sales. One interesting caveat: two states with sales taxes—Florida and Missouri—still don't collect sales tax from all on-line retailers because they haven't passed similar laws.

THE COVID-19 WEALTH GAP

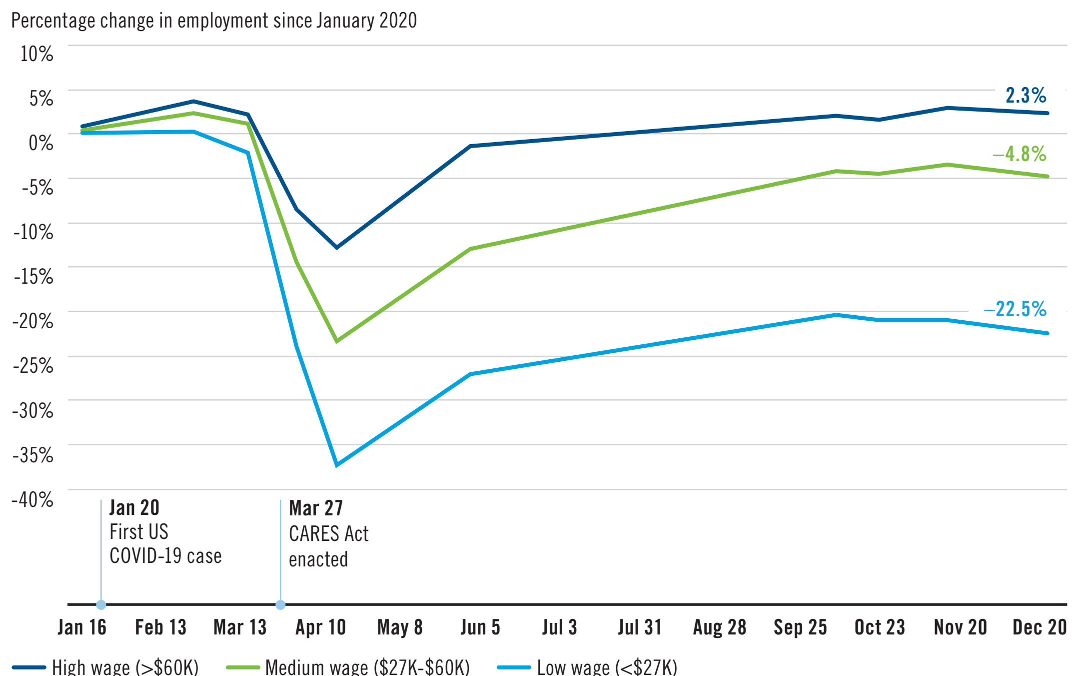
If California's top earners got through 2020 relatively unscathed financially, it's quite a different picture at the other end of the economic spectrum. Because COVID-19 continues to hammer lower-income workers in service sectors like hospitality, employment among the bottom quartile of American earners—those making less than $27,000 a year—remains 22.5% below January 2020 levels, as shown in Exhibit 2. For Americans making above $60,000, unemployment has largely dissipated.

Although direct federal aid didn't materialize to offset state revenue shortfalls, other stimulus from Washington, D.C., helped blunt state tax blows. For example, California received over $11 billion in reimbursements for a range of public health costs via the

COVID-19 K-SHAPED RECOVERY

Exhibit 2: Unemployment remains high among low-wage workers

January 16, 2020–December 20, 2020



Sources: Opportunity Insights Economic Tracker, Tracktherecovery.org.

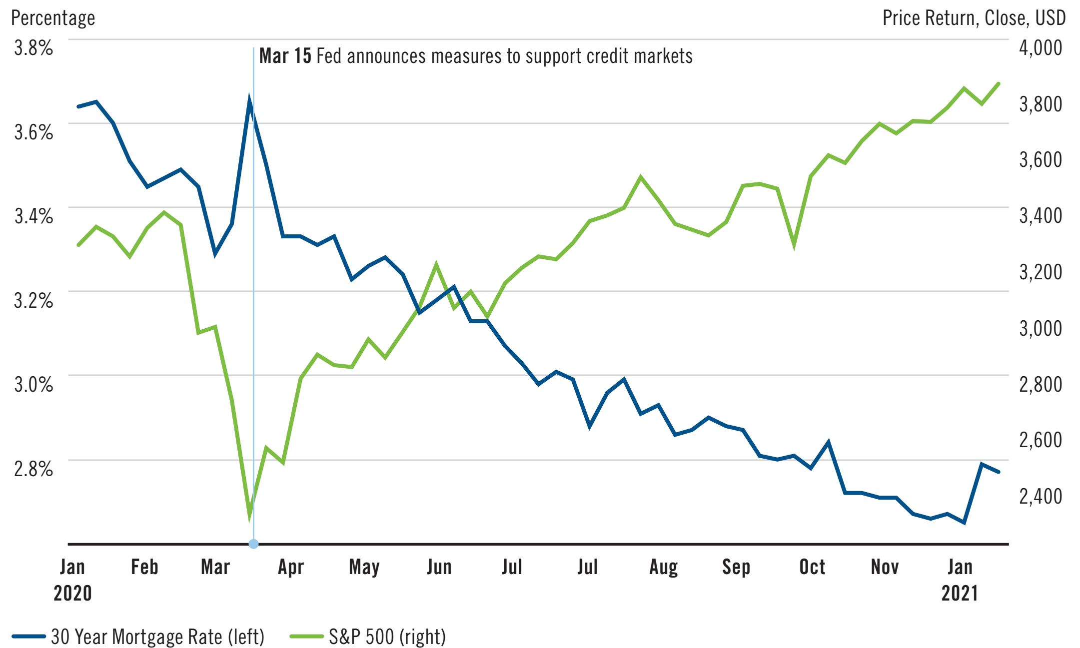
national Coronavirus Relief Funds.[6] On top of that, states that tax unemployment benefits got an indirect lift from the CARES Act which boosted weekly unemployment benefits by $600 through July 2020. December's COVID aid package includes a smaller $300 weekly enhancement through mid-March 2021.

To be clear, California doesn't tax unemployment benefits, so that particular federal stimulus didn't help Governor Newsom. But don't feel sorry for him. California benefited spectacularly from the Federal Reserve's (Fed's) bazooka-like COVID-19 measures, including slashing benchmark rates to zero last March. As shown in Exhibit 3, the Fed's move helped supercharge stock markets—technology shares like Tesla in particular—producing a record $18.5 billion in capital gains tax revenues for California last year.[7]

FED'S BAZOOKA-LIKE POLICY

Exhibit 3: Stocks rally and mortgage rates plunge after central bank's move

January 2020 to January 2021



Sources: Freddie Mac, S&P Dow Jones Indices, Macrobond.

That same Fed action also drove 30-year mortgages to the lowest rate on record. Homeowners with good credit scores have refinanced at the fastest rate in two decades, allowing millions to cut their monthly payments.[8] And yet, as some upper-income households bought second homes to escape cities, 35% of California residents are living in households where eviction or foreclosure in the next two months is somewhat or very likely.[9] In key ways, the Fed's monetary policy helped the wealthiest rebound fastest, exacerbating what some economists consider "pathological" levels of income and wealth inequality.[10]

TARGETED SPENDING

Pouring through Newsom's new budget, it's clear the Governor recognizes some California residents are suffering disproportionally under COVID-19. With remote learning, low-income schoolchildren are failing in record numbers. Many working-class families are trapped by high unemployment rates and face possible eviction. Rather than wait till summer when Sacramento lawmakers typically reconcile budget disagreements, Newsom is asking for an immediate $5 billion to reopen schools by spring, aid struggling businesses and distribute $600 cash payments to low-income families.

At this early stage of the budget process, making a granular credit assessment of Newsom's spending priorities is premature. Quite a lot can change for the better between now and July 1 when California's next fiscal year starts. For example, if elements of President Joe Biden's COVID-19 relief plan get through Congress, it could eliminate the need for Newsom's direct COVID-19 payments, freeing up $2.4 billion that California can use for other long-term priorities. But there are also wildcards to consider. Infectious disease experts fear the more lethal and infectious B.1.1.7 variant of COVID-19 could be "a perfect storm" that re-scrambles California's budget priorities.[11] On a brighter note, by summer, the COVID-19 vaccine program could jumpstart service sectors like hospitality. If so, low-income workers could experience the same upward trajectory higher wage earners did last year.

ECONOMIC SUSTAINABILITY

If a granular budget appraisal is off the table for now, we think a high-level critique is warranted along two dimensions. The first relates to California's near-term economic sustainability amidst COVID-19 uncertainties. The second concerns long-term credit quality in the wake of migration trends.

Newsom has $34 billion beyond what he needs to balance California's budget, of which $22 billion is going back into rainy-day reserves. The main reason to do this, he's told reporters, is the current surplus could be fleeting. We agree. But what Newsom doesn't reveal is that he's legally obligated to replenish California's reserves. And in fact, he's only adhering to the bare minimum of what the state constitution stipulates. Given the uncertainties around the vaccine rollout and the potential economic catastrophe from the B.1.1.7 variant, we would prefer to see the state government transfer even more surplus into emergency reserves. From a credit perspective, such a move would reflect a more sustainable budget mindset given looming COVID-19 uncertainties. It's a prudent approach that former Governor Jerry Brown deployed quite often, and to great effect.

OUTMIGRATION ACCELERATES

Just as COVID-19 propelled the Fed to lower interest rates, the pandemic is forcing governors and mayors to grapple with the outmigration of taxpayers from some cities and states. In an ominous sign for the high-flying San Francisco Bay Area economy, the region recently saw negative net migration for the first time in over a decade.[12] In 2018 it lost 54,000 residents to other US states while international migration added just 45,000. To be clear, overall population growth was positive that year (net 21,000) due to a natural increase from new births. However, adult taxpayers and companies are indeed moving out, and for several reasons: astronomical rents, too much street crime, traffic congestion and high taxes.[13]

As municipal bond investors, demographics and migration trends (such as tax flight) have always been part of our forward-looking credit analysis. Because COVID-19 has the potential to accelerate outmigration—we'll get a sharper picture after last year's income tax filings—we plan to release an analysis of state and city outmigration in the spring. As a preview, we believe the Bay Area economy can remain a powerful economic magnet, attracting and retaining large clusters of high-growth knowledge industries. Doing so, however, requires adapting to new realities, such as office activities being redistributed between other California cities and other states.

One of the Bay Area's biggest hurdles is overcoming the chronic failure to build enough new housing at moderate prices. On the theme of work mobility and housing costs, we turn next to New York's ongoing budget challenges, and a growing Yes-In-My-Back Yard (YIMBY) movement that aims to crush New York City's housing crisis.

LIFE IN THE BIG APPLE

If bond investors left Newsom's budget meeting with some optimism, some had whiplash listening to Andrew Cuomo's 2022 budget proposal eleven days later. Instead of a surprise surplus, Cuomo pointed to a $15 billion deficit and issued a stern ultimatum: if the US Congress fails to give New York a direct aid package equaling $15 billion exactly, deep spending cuts and a new wealth tax will ensue. With the state legislature set to present its own budget proposal in the coming weeks, the prospect of raising taxes on the rich will be a lightning rod issue. Many of New York City's wealthiest families already work remotely, either from second homes outside the city or from different states like Florida. A new 2022 tax on the rich would be a strange way to say, "welcome back to Manhattan."

TAX THE ULTRARICH

A closer look at Cuomo's budget shortfall reveals a fuzzy picture. To start, New York's December tax receipts overshot projections by $1.4 billion. That and other revenues helped whittle down a previously projected $8 billion deficit to under $5 billion for the current 2021 fiscal year. It's the next 2022 fiscal year, which starts this April, where Cuomo's budget office is projecting a $10 billion deficit. Without direct federal aid to fill these two gaps, Cuomo is proposing a combo of spending cuts and postponing a middle-class tax cut, along with new revenues (adult-use cannabis and mobile gambling) and a temporary three-year "surcharge" on New York's top earners.

The wealth tax is generating a lot of heat, in part because Cuomo has long been a staunch opponent of taxing New York's wealthiest any higher. Currently, the top 2% of the state's highest earners pay roughly half of New York's income taxes.[14] Hiking taxes might give families who recently left Manhattan another reason not to come back, and potentially kick-start deep structural (i.e., permanent) spending reforms. That said, it is important to recognize this tax applies to roughly 4,400 tax filers and only for the next three tax years. What's more, by pre-paying all three years of the surcharge in advance, taxpayers would be fully reimbursed. Let's break this down.

As shown in Exhibit 4, the highest surcharge of 2.00% applies to a tiny sliver of New Yorkers making over $100 million annually. By using progressive tax tiers, families earning between $5 and $10 million would only see a 0.50% tax increase. All combined,

NEW YORK'S ULTRA-RICH TAX

Exhibit 4: Three-year progressive surcharge on New York's wealthiest residents

As of January 2021

Proposed New Tax Brackets (Earnings, USD)	Current State Income Tax Rate	Proposed Temporary Surcharge	Proposed State Tax Rate	New York City (NYC) tax rate	Combined NY State + NYC Tax Rate
$5–$10 million	8.82%	0.50%	9.32%	3.87%	13.19%
$10–$25 million	8.82%	1.00%	9.82%	3.87%	13.68%
$25–$50 million	8.82%	1.50%	10.32%	3.87%	14.19%
$50–$100 million	8.82%	1.75%	10.57%	3.87%	14.44%
$100 million and up	8.82%	2.00%	10.82%	3.87%	14.69%

Source: Klopott, F. "Executive Budget Proposal" NYS Division of Budget. January 2021.

the high-income surcharge for the 2021 tax year would generate $1.5 billion of new revenues, tapering down to $1.4 billion and $1.2 billion in the 2022 and 2023 tax years.[15] For residents willing to prepay their 2022 and 2023 surcharges when they file their 2021 taxes, they would be fully reimbursed via tax deductions during the 2024 and 2025 tax years.

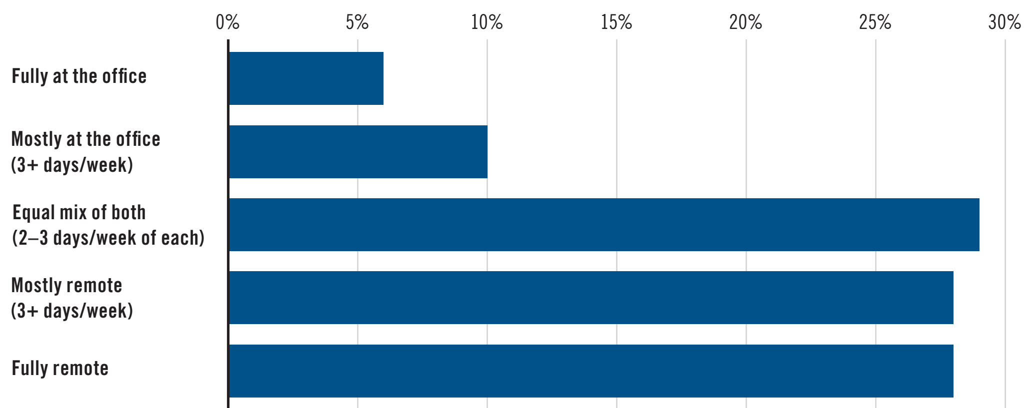
COVID-19 OUTMIGRATION

At this stage it's unclear if New York will pass a new high-income tax into law in March. But there is another certainty: the pandemic has shifted how Americans view working remotely and the benefits of flexible mobility, as shown in Exhibit 5. This could accelerate outmigration for cities like the Big Apple.

WORKING REMOTELY PARADIGM SHIFT

Exhibit 5: Post-COVID-19 more employees want to work remotely

June 16, 2020–August 7, 2020



Source: CBRE Workforce Sentiment Survey, 10K responses.

Trying to predict how pronounced outmigration might eventually become is tricky. While 2020 certainly gave wealthy families ample reasons to leave urban centers, the unique social and cultural institutions that New York City offers will likely pull some families back, as will premier schools for parents grooming their children for ivy-league colleges. Before COVID-19 hit, New York City was home to 30,000 families earning at least $1 million a year who listed a combined 31,137 children on their tax filings in 2018.[16] We'll be monitoring the situation closely, as will Andrew Cuomo.

THE 15-MINUTE CITY

For all the hand-wringing over tax flight, urban policy experts have identified an equally destructive phenomenon crippling dynamic "superstar cities" like New York City: sky-high housing prices and overburdened infrastructure.[17] Blessed with above-average per capita gross domestic product driven by knowledge clusters in finance (New York) and high tech (San Francisco), these cities are victims of their own success as demand has vastly outstripped housing supply. Despite offering higher incomes, these cities will continue growing more slowly and even shrink unless they do two things: build higher-density affordable housing, and fund modern infrastructure that enables car-free access (walking, e-bike, subway, bus) to jobs, friends and family, and basic services.

Momentum behind the "15-minute city" concept has recently accelerated through backing by an influential Bloomberg consortium of mayors (known as the C40) representing 96 of the world's largest cities.[18] Consider Melbourne, Australia, which resembles sprawling US cities built around cars like Houston, Texas. As a C40 member, Melbourne's Lord

Mayor Sally Cap says her C40 colleagues are leveraging the shock of COVID-19 to shift transportation policies and infrastructure spending to widen pedestrian walkways, incorporate bike lanes and modernize outdated zoning laws.[19]

Another intriguing trend picking up steam in New York City is the YIMBY movement that aims to build high-density affordable housing in expensive neighborhoods like SoHo and Gowanus in Brooklyn. As a grass-roots movement comprised of highly educated, well-paid millennials, the main roadblocks include byzantine zoning laws and fierce opposition from New York's wealthiest residents who don't like change. Mayor Bill DeBlasio's administration has given its full support to the movement and is currently pushing for an 8,000-unit development (3,000 of them affordable) in Gowanus.[20]

BOND MARKET (OVER)REACTIONS

In the wake of the K-shaped COVID-19 recovery, a catastrophic-looking economic downturn has turned out better than expected for some state and local governments. Because bond markets often overreact to five-alarm headlines, our credit analysts sometimes spot good muni opportunities even in states we've been critical towards. That window of opportunity opened early last year for Illinois, a state that we believe has chronically short-changed its budgets. A similar opportunity happened for New York last October, when fears of urban outmigration dislocated spreads and performance from its underlying credit fundamentals.

Looking ahead, we expect more windows will open, given uncertainties over the vaccine program and prospects of more lethal COVID-19 variants. For us, navigating muni bond markets during 2021 will require a closer look at the scope of Biden's COVID-19 relief package, along with his build-back-better infrastructure program which could be $2 trillion in size. Tax flight and outmigration remain volatile and hard to predict, requiring deeper analysis that we will publish and share with current and future clients over the months to come.

Endnotes

1. Source: Braun, M. "Muni-Bond Downgrades Rare Even With Few Spared Pandemic's Blows," *Bloomberg*, September 14, 2020.
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