NORTHERN TRUST
ASSET MANAGEMENT

MUNICIPAL BONDS: 2023 U.S. STATES OUTLOOK

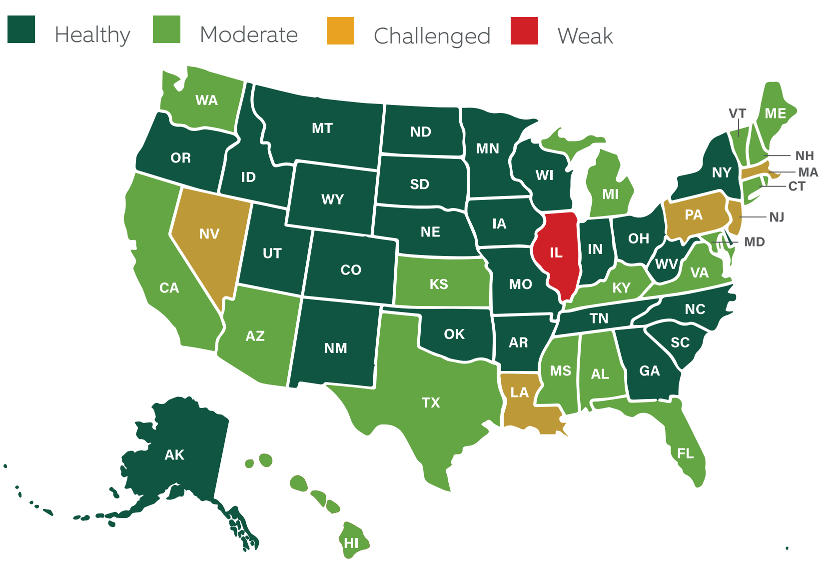
STATES RESILIENT BECAUSE OF RECORD RESERVES, OUTPERFORMING REVENUES AND SUBSTANTIAL FEDERAL AID

The 2023 fiscal year will start July 1 with states well-positioned due to record fiscal year 2022 revenues and accumulated reserves, as well as federal aid. However, states should begin normalizing spending in the coming year, particularly in light of potential equity market losses, inflation-related rising costs, anticipated slower growth and the absence of new extraordinary federal stimulus. The vast majority of states have prepared to manage this transition with continued resiliency (see Exhibit 1), supporting a stable credit outlook for $375+ billion of state-issued municipal bonds.

EXHIBIT 1: RECORD RESERVES AND REVENUE DRIVE RESILIENCY

The vast majority of states remain resilient. Only Illinois is categorized as "weak." Louisiana, Massachusetts, Nevada, New Jersey and Pennsylvania are "challenged."

States' Resiliency for Fiscal Year 2023



Sources: Northern Trust Asset Management; National Association of State Budget Officers; state budget reports; Moody's Investors Service; U.S. Census Bureau. Resiliency considers historic revenue volatility measured against budget practices, fixed obligations, reserves, economic trends and overall fiscal flexibility.

Key Takeaways

- With strong reserves and pandemic federal aid, states generally are entering the fiscal year beginning July 1 in healthy financial condition.
- Slowing economic growth and less federal support on the horizon may challenge some states to find alternative funding to maintain healthy budgets.
- All states are well-positioned to meet debt obligations in the near term, supporting strength in the overall municipal credit market.

HEALTHY BUDGETS FOR 2023

Generally, states expect balanced budgets for the fiscal year 2023, despite likely moderating economic growth. Many states are budgeting for flat to modest revenue growth, with some calling for a pullback from fiscal year 2022's record tax collections — particularly in corporate taxes.

The National Association of State Budget Officers Annual Survey reports projected 2023 revenue growth at a median 1.4% versus 2022. This is composed of 6% growth in personal income tax, less than 1% growth in sales tax and significant weakness in corporate tax collections, down 11% with expected lower profits. States will continue to use federal pandemic aid (see Exhibit 2).

Thirty states have proposed or enacted some kind of temporary or permanent tax cut in light of record revenue collections and demand for tax relief. The most popular cuts are to income taxes, followed by sales taxes and then corporate taxes. Only four states have proposed or enacted tax increases.

The budgets show a 4% spending increase. Key drivers are raises for teachers due to pandemic related staffing shortages and higher Medicaid costs as pandemic-related federal funding rolls off. Further, many states historically plagued by chronic pension underfunding, including New Jersey and Illinois, expect to make higher pension payments. Other states with more consistent annual funding, like Tennessee, are choosing to make supplemental payments to tackle long-term underfunding.

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EXHIBIT 2: FEDERAL PANDEMIC AID HAS SUPPORTED STATES

States have used or plan to use about 20% of the $350 billion in federal American Rescue Plan Act funds for general operations and administration through 2024. As extraordinary aid ceases, some states may have to find other sources of revenue or cut spending to keep their budgets balanced.

States' Use of American Rescue Plan Act Funds 2021-2022 (%)

Purpose	% of funds
State operations and administration	22
Unemployment trust fund	12
Water infrastructure	11
Health	9
Other	7
General infrastructure	7
Broadband	6
Education	6
Housing	6
Economic relief and development	5
Workforce development	5
Human services	2
Arts, culture and tourism	2
Access to justice	1

Source: National Conference of State Legislatures

A POTENTIALLY DIFFICULT TRANSITION ON THE HORIZON

Record reserves and unspent federal aid have made states more resilient than in the past. However, federal pandemic aid will dry up eventually. To adjust, we believe some states will need to cut spending or find alternative funding sources. These states — including California, Pennsylvania and Illinois — already tend to have above-average tax rates, making tax increases a more challenging option to generate additional revenue.

Some states will need to adjust to moderating revenue growth from lower capital gains taxes and moderating corporate profits. This is particularly true in states such as California or New York, which depend more on that kind of economically sensitive tax revenue. Further, some states with higher tax rates are seeing net out-migration from residents, which may, over the long-term, challenge their ability to maintain current levels of taxation. Migration from higher tax states to lower tax states accelerated during the pandemic, although taxes haven't been identified as a key reason for moving.

Over the past two years, only New York, New Mexico and Washington D.C. have implemented material tax increases. Many states, including Arkansas, Colorado, Idaho, Louisiana, Montana, North Carolina and Tennessee, have decreased income taxes. Five states (Arizona, Oklahoma, Iowa, Mississippi and Georgia) are transitioning from a graduated tax rate to a lower flat tax rate.

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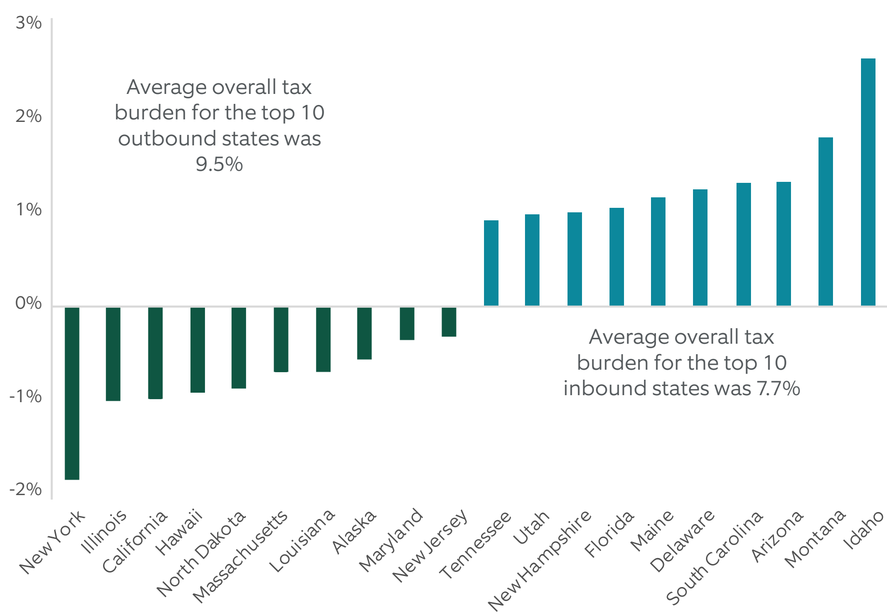
EXHIBIT 3: DOMESTIC MIGRATION LEANS TOWARDS LOWER TAX STATES

States with higher tax rates are losing population to states with lower tax rates.

State Net Domestic Migration July 2020 to July 2021 (% of state population)



Sources: U.S. Census Bureau, WalletHub. The net domestic migration for a given geographic area is the difference between in-migration (the number of people moving in) and outmigration (the number of people moving out) during a migration period.

WHAT THIS MEANS FOR MUNICIPAL BOND INVESTORS

The vast majority of states enter fiscal year 2023 stronger than before the pandemic. They are well-positioned to meet their debt obligations, building a positive foundation for state-issued municipal bonds. However, the normalization of fiscal operations may eventually create problems for some states.

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To learn more about Northern Trust Asset Management's municipal bond strategies, please visit northerntrust.com, contact your Northern Trust relationship manager or call us at 877.651.9156.

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