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MuniNotes
from our Credit Research Team

November 2024

State ballot initiatives will impact muni bonds in 2025 and beyond

State ballot initiatives can significantly alter government revenue streams, project funding and fiscal stability. These changes directly affect a municipality's financial outlook and its ability to service debt, potentially affecting bond ratings and borrowing costs. Here we share some local results from the November 2024 election.

HIGHLIGHTS

- **State ballot initiatives may have significant influence on municipal bonds.**
- **Municipal obligations of areas impacted by Hurricane Helene are expected to remain strong.**
- **Pandemic-era federal funding is expiring, creating budget challenges for K-12 schools.**
- **Chicago Board of Education navigates its tight budget amid a disruptive political environment.**

VOTERS DECIDE ON TAX POLICY, EDUCATION FUNDING AND BOND ISSUANCE

Numerous initiatives on state ballots this November were important for the municipal bond market. Voters weighed in on measures relating to tax policy changes, the right to fund private school education with public money, and the authorization to issue bonds. Here we share some results.

Bond authorizations

Passed: California Several states sought authorization to issue general obligation (GO) bonds, although only California's bond measures are noteworthy for their size. California received voter approval to borrow $10 billion for climate-related programs and $10 billion for public-school construction. The California constitution requires that most new bonds be approved by voters. These bonds are usually repaid from the state general fund. The state currently has about $80 billion in GO bonds outstanding and retains authorization to issue another $35 billion.

California is currently paying about $6 billion (3% of annual general fund revenue) each year to repay bonds. The two bond authorizations are estimated to cost the state an additional $900 million each year to repay, which is about one-half of 1% of the state's annual general fund revenue.

Failed: California Voters failed to approve Proposition 5, which would have lowered the supermajority vote requirement from 66.67% to 55% for local bond measures that fund housing and public infrastructure.

Tax policy

Passed: California Proposition 35 makes the existing tax on managed care health insurance plans to fund Medi-Cal programs permanent. The proposition also requires the state to use more tax revenue to increase funding for Medi-Cal or other health programs. The tax is estimated to bring the state between $7 billion and $8 billion annually. Medi-Cal is a federal-state program that provides health coverage for low-income people. More than 14 million residents, or roughly one-third of the state's population, use Medi-Cal.

Failed: Washington Voters overwhelmingly rejected Initiative Measure 2109, which would have repealed the 7% excise tax on capital gains for individuals with annual gains of over $250,000. The capital gains tax has generated over $1 billion since inception in 2022. The funds are earmarked for public education and common school construction.

Failed: North Dakota's Initiated Measure 4 would have prohibited state and local governments from levying property taxes based on assessed value (except for the repayment of bonds), which would have made North Dakota the first state without property taxes. The measure would have also prohibited municipalities from issuing GO bonds secured by property taxes beginning in 2025. The state would have had to reimburse local governments every year for the revenues lost by eliminating the tax. Cost estimates for the fiscal impact of Measure 4 were between $2.3 billion and $3.2 billion for the 2025-27 biennium.

> *Washington voters rejected repealing the 7% excise tax on capital gains for individuals with annual gains of over $250,000.*

Passed: Illinois Voters approved an advisory referendum calling for a higher tax rate on income over $1 million. This was a non-binding measure to gauge public opinion on whether the state constitution should be amended to create an additional 3% tax on income greater than $1 million for the purpose of reducing property taxes across the state, though it's not clear how property tax relief would be distributed. According to an Illinois Department of Revenue estimate, the measure would generate about $4.5 billion a year. Illinois's state constitution currently requires a flat income tax rate and does not allow for a progressive income tax structure. Implementing a 3% additional tax on higher incomes would require a future constitutional amendment.

School choice

Failed: Colorado Amendment 80 sought to amend Colorado's constitution to guarantee the right to school choice for each K-12 student. The amendment needed more than 55% of the vote to pass. Had the measure passed, it would have opened the door to future changes to laws and funding for education, potentially diverting tax dollars from public schools to private institutions.

Failed: Kentucky Voters resoundingly rejected a constitutional amendment that would have allowed public tax dollars to fund K-12 education for students attending private or charter schools. The Kentucky General Assembly had enacted a private school voucher program in 2021, but the state Supreme Court struck it down for violating Kentucky's constitution.

Repealed: Nebraska Nebraskans voted overwhelmingly to repeal Legislative Bill 1402, which appropriated $10 million each year of taxpayer money for private school tuition.

NORTH CAROLINA IN THE WAKE OF HELENE

Hurricane Helene made landfall on the Florida Gulf Coast as a category 4 storm in late September before moving north and wreaking havoc on the southern Appalachian region. Western North Carolina was stunned by the catastrophic rainfall, and the mountains funneled water into low lying valleys. Fast-rising floodwaters and mudslides caught communities off guard and resulted in devastating loss of life and property.

It is too early to assess the full economic loss, but the municipal obligations of states and communities impacted by the storm are expected to remain strong. Past natural disasters, even unprecedented large-scale events such as Hurricane Katrina in 2005, have not resulted in municipal bond payment defaults or long-term credit quality deterioration.

Debt service payments that may be due soon have likely been funded already. Property taxes for GO debt service are typically set aside well in advance, as is debt service for obligations backed by dedicated taxes or utility revenues. Revenue pledges can often draw upon reserve funds should there be a temporary deficiency of collections or a timing issue.

North Carolina entered the hurricane season from a place of financial strength. Most North Carolina counties have relatively low debt and practice good financial management under guidance from the state's Local Government Commission.

After Hurricane Helene, S&P placed several high-quality North Carolina credits on a negative watch list, which indicates that the credit ratings could be downgraded in the near term. However, all the municipalities on the watch list have investment-grade ratings (most are in the AA or AAA rating categories) and have substantial financial reserves. For example, the City of Asheville (a regional economic hub) has posted more than a decade of positive general fund results, and reserves are currently equal to about 90% of general fund revenues. The city has the financial capability to front costs related to the hurricane.

While there could be some pressures or downgrades on the margins, North Carolina is home to multiple industries outside of tourism.

Longer term, rebuilding efforts following natural disasters often provide a boost to the local economy and tax base. Homeowners who had uninsured damages will seek federal disaster assistance through FEMA (Federal Emergency Management Agency). President Biden approved federal disaster assistance in six states affected by Helene. This opens federal help for survivors in designated areas in Florida, Georgia, North Carolina, Tennessee and Virginia. In total, over 8,200 federal personnel – including 4,300 FEMA staff – were deployed to communities in these states to assess the damage. FEMA has already approved about $550 million for approximately 400,000 households to jumpstart recovery.

Deployment of recovery funding normally provides both short- and long-term economic benefits. Reconstruction efforts bring new jobs and can improve infrastructure, strengthening the tax base in the long run. One risk worth monitoring will be potential population losses. Should residents who've been forced to relocate temporarily end up making a permanent move because services and utilities are too slow to come back online, that could erode the economic base over time.

While there could be some pressures or downgrades on the margins, especially as tourism lags, North Carolina is home to multiple industries outside of tourism. Municipalities should have the ability to draw on reserves as needed, and federal disaster assistance will help with recovery. We expect the widespread damage to prompt many communities to reconsider their resiliency and readiness for extreme weather events. Assessing climate risk and disaster readiness must remain a key part of credit analysis for investors.

EXPIRING FEDERAL AID CREATES POTENTIAL FISCAL CLIFF FOR K-12 SCHOOL DISTRICTS

In response to the pandemic, nearly $200 billion of supplementary federal support was allocated to public schools (districts and charters), with most of the funding coming from the American Rescue Plan Act (ARPA). Elementary and Secondary School Emergency Relief (ESSER) funding came in three tranches between 2020 and 2021. Schools were given wide latitude in how to use this funding as they managed the transition back to in-person learning and addressed learning loss stemming from students' time away from the classroom. The federal funding was need-based, heavily favoring lower-income districts. An estimated 50% of the funding was directed to labor costs, including hiring additional teachers, administrative staff, reading/math specialists and counselors. Some schools used funding for one-time capital projects or facility improvements.

The U.S. Department of Education reported that $63 billion had been spent by mid-2024, but with all federal funding to be obligated or committed to a specific purpose by September 2024. Any unobligated funding must be returned. No new source of funding should be expected to replace this temporary revenue. While pandemic aid is rolling off, state revenue growth is slowing, making additional state aid less likely. After several years of increasing per-pupil funding, more states opted to keep school funding formulas flat for their fiscal year (FY) 2025 budgets.

> *Many districts, especially those that used the one-time funding to add teachers, must contend with closing budget gaps.*

Many districts, especially those that used the one-time funding to add teachers, may now face a fiscal cliff and must contend with closing budget gaps over the next few years. Potential gaps will largely depend on the extent to which funding was used for ongoing operating costs versus one-time expenditures like capital improvements. While total enrollment fell during the pandemic due to declining birth rates and a shrinking school-age population, the number of teachers grew by 11%. Many schools also added non-teaching supports like after-school enrichment programs, counselors, academic coaches, librarians and nurses.

Maintaining higher staffing levels will be a challenge. A survey of 300 Texas school districts found that over half expected to end FY24 with an operating deficit and expect to implement cuts or spend down fund balances in FY25. Districts with a higher reliance on federal aid and those with lower per-pupil spending are expected to struggle the most to maintain balanced budgets once the funds are depleted.

Most districts have built up a financial cushion with higher reserves, which will soften the impact of maintaining some of the new spending, although cuts may be necessary in many cases. Median reserves for public school districts are higher than pre-pandemic levels (27.2% of operating revenues for FY23 compared to 23.4% pre-pandemic), but we expect these fund balances to be somewhat pressured over the next two years.

Despite higher reserves, many of the school programs and teachers added in the last few years will be difficult to cut, as they are politically popular and provide much-needed investment in vulnerable populations. A district's ability and willingness to maintain balanced financial operations and sufficient liquidity are key credit considerations.

In October, Moody's placed 31 K-12 school districts on review for possible downgrade. Districts were placed under review based on several factors, including an available fund balance ratio falling below pre-pandemic levels, a fund balance below their rating category, having a structurally imbalanced budget or significant enrollment declines. All carried a rating of at least A2, and more than half were rated Aa3 or higher when placed on review.

The move is a sign the operating environment for many districts is becoming more challenging, and additional downgrades in the sector over the next few years should not come as a surprise.

Bondholders are insulated from operating risk

Traditional public K-12 school districts issue long-term bonds typically secured by a GO pledge and a dedicated property tax levy to repay the debt. Most school districts are subject to state-imposed debt limits and are required to petition voters for approval to issue debt, providing investors assurance that the bonds and the debt-funded projects have community support.

Property tax revenues collected from levies established for debt service are legally unavailable for operating costs. This insulates investors from operating risk and budgetary pressures and ensures debt service is paid, even if the district has a structural budget gap.

CHICAGO BOARD OF EDUCATION FACES A STEEP FISCAL CHALLENGE

Chicago Board of Education (CBOE), IL has been in the headlines over the past few months as the district attempts to reach a contract agreement with the Chicago Teachers Union (CTU) amid a contentious and disruptive political environment.

Like many other districts, CBOE spent about half of the $2.8 billion it received in federal pandemic aid on staffing. This funding has been spent, but the district now has about 9% more teachers than were employed in 2020, even as enrollment has continued its long-term trend of decline. CTU's contract expired in June 2024 and meeting the union's demands would create a significant budget gap in the current and future fiscal years.

Staffing cuts and school closures are opposed by CTU, the school board (which is transitioning to an elected board) and Mayor Brandon Johnson, limiting the district's ability to curtail expenditure growth. Like many other school districts, CBOE has limited options to increase revenues. State tax levy limits constrain revenue growth, and the district has already increased the property tax levy to the maximum allowed by state law. The path to resolution is not yet clear.

CBOE bondholders benefit from a strong security pledge. Most of the district's general obligation alternate revenue (GO alt) bonds are backed by both a pledge of state aid and the district's unlimited tax pledge. Some GO alt revenue bonds are secured by a pledge of other local revenues as their first pledge. If pledged revenues are not available, the district must levy unlimited ad valorem property taxes to pay debt service. The levy is automatically on the tax roll, levied each year until and unless the board takes action to abate it. The district is currently rated Ba1/BB+/BB+/BBB (Moody's/S&P/Fitch/KBRA).

For more information, please visit us at nuveen.com.

Endnotes

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