

Bond Case Briefs

Municipal Finance Law Since 1971

Oil Price Decline Mostly Positive for Municipals... At Least for Now.

Summary

- Most states and local governments should benefit from higher tax receipts as more consumer discretionary income leads to a pick-up in spending.
- Negative effects will be localized around energy producing areas, especially if oil prices stay low for an extended period.
- Longer-term implications could be negative for credit quality if weaker economic conditions in other parts of the world create a drag on U.S. growth.

The dramatic move lower in crude oil prices over the last six months is good news for consumers at the pump. Since most gas tax revenues are collected on a per gallon basis, money formerly spent on gas should net most governments higher tax receipts if consumers spend the newfound money.

Of course, those states with economies heavily concentrated in energy production, namely Alaska, Wyoming and North Dakota, are likely to experience job losses and lower overall tax revenues. There will also be localized pain in cities and towns in other parts of the country involved directly in production or upstream vendors heavily tied to the energy industry. Cutbacks in production are already occurring and are likely to pick up, especially if crude oil prices stay lower for an extended period.

Fortunately, many governments understand their strong connection to the energy industry and conservatively set aside above average levels of reserves knowing that prices may one day fall, especially since they have done so in the past – crude oil has fallen by more than 50% five times since the mid-1980s. Of course, there will be outliers that experience financial distress and all governments directly connected to the industry are likely to run near-term deficits as they right size budgets to match lower tax receipts. Fortunately, many of those affected are starting from a very strong position, so we don't expect to see many, if any, municipal defaults as a result of the large decline in crude oil prices.

Toll roads are one transportation sector likely to benefit as lower gasoline prices lead to more travel and congestion, making toll roads an attractive alternative. Airports should also strengthen as their major tenants, the airlines, take advantage of lower costs and possible increases in travel. The decline in gasoline prices may also make increasing the Federal gas tax a more palatable solution to funding the Highway Trust Fund. More members of the new Congress, previously committed to not increasing taxes, have indicated that additional taxes on gasoline could be part of the solution for funding infrastructure.

Of course, oil price declines at least partly reflect economic weakening in other parts of the world. The U.S. economy has thus far stayed the course of slow, but positive growth. However, the economic malaise in other parts of the world could eventually slow growth in the U.S. and reverse some of the short-term benefits most municipal credits are currently experiencing.

Income from tax-exempt municipal bonds or municipal bond funds may be subject to state and local taxes, and a portion of income may be subject to the federal and/or state alternative minimum tax for certain investors. Federal income tax rules will apply to any capital gains.

There are risks associated with an investment in bond investments, including the impact of interest rates, credit and inflation. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

Seeking Alpha

By Chad Farrington, CFA

Jan. 12, 2015 3:15 PM ET

Copyright © 2024 Bond Case Briefs | bondcasebriefs.com