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The Outlook for Public Finance in 2022 in 6 Themes.

Barring unknowable virus mutation scenarios, state and local fiscal managers have the opportunity to navigate trends and crosscurrents already underway to make better decisions. One factor figures into almost everything: inflation.

Last year brought an unusual crop of surprises to the state and local government financial community. But even without 20/20 foresight, several macro trends now underway should make it easier in this new year for well-informed policymakers, professional staff and financial services providers to make better decisions that benefit the public sector at large. Here are six of the top themes to keep in mind, with the caveat that a global coronavirus mutation beyond pharma solutions — one requiring a new round of economic lockdowns — would be all-bets-off:

1. Inflation will remain a monetary fact of life. Most of the kinks in industrial and logistics supply chains should get worked out in the coming year, and red-hot commodity prices are cooling off, but that won't put an end to inflation.

Three factors almost guarantee an inflation rate that ends 2022 well above the Federal Reserve's long-term target of 2 percent: First, real estate prices and rental rates have not yet worked their way into the statistics, and that alone will drive employee wage demands and expectations higher; until interest rates move high enough to cool off the housing market, the costs of shelter will drive up cost-push inflation. Second, salaries, including those of public employees, will have to adjust upward to cover the recent surge in the CPI, and those costs of doing business will not be transitory. Finally, the elephant in the room is the massive increase in the money supply that the Fed's monetary policies of the last two years has left in our midst.

What macroeconomists call aggregate demand ultimately follows money supply when unemployment rates are low. Here's a chart showing the unprecedented surge of "M2″ — cash and demand deposits such as checking accounts, plus time deposits such as savings accounts, money market funds and CDs — in billions of dollars during the pandemic, notably in 2020.

But persistent inflation does not mean we have to return to the 1970s' stagflation debacle. If the U.S. can enter 2023 with annualized price increases receding to about 4 percent, our economy is capable of eventually reverting to a tolerable and somewhat lower long-term trend. The M2 "pig" depicted above will ultimately work itself through the Fed's COVID-19 quantitative-easing "python." Prices and eventually wages will likely reset yet another 10 percent higher by then, but thereafter we should then see offsetting disinflationary forces, including cost-saving technological innovations, the new frugality of a retiring fixed-income baby-boom generation, and an abundant supply of lower-cost labor overseas.

However, even an inflation rate as low as 4 percent next December would probably be enough to trigger an embryonic multiyear wage-price spiral, setting up a new trifecta of trends in the labor markets, the money market and the bond market, all of which will likely impact the finances of states and localities.

2. Payroll budgets will escalate. Every public employer has its own unique workforce characteristics, local labor markets and history, so it's unwise to generalize. But policymakers who think they can penny pinch on labor costs are putting their heads in the sand. Unless a new COVID-19 variant sweeps through the country and compels another lockdown, it's hard to predict an abundant and excess supply of labor in 2022; continued labor scarcity is far more likely.

Employee unions won't be gullible about inflation on the salary side, and in contract negotiations, their leaders would be derelict if they don't push for "COLA plus X" provisions. Where it could get particularly interesting in 2022 is in public employees' cost of housing. My newly hatched term for this is "COHAs" – cost of housing allowances. It seems almost inevitable that high-cost or housing-short municipalities will need to offer rent relief to help their newer employees afford to live locally or risk losing them.

3. Higher interest rates will present cash-management opportunities. Financial media have been focusing on the "taper" of central-bank bond purchases — the end of COVID-19 era quantitative easing. Less mention is made outside of business channels about the revised outlook for short-term interest rates, which shifted up notably as I heralded last October. Again barring a global COVID-19 mutant monster, the Fed now needs to "normalize" its short-term rates by cautiously and prudently lifting the overnight money market rates closer to 1 percent by year-end, and arguably even higher. Eventually, money market rates need to approximate the inflation rate.

For public treasurers and cash managers, the good news is that they will finally be able to report some positive earnings on their short-term investments. The bad news is that public portfolio managers who stick out their necks into longer maturities beyond 2023 will probably come to regret it — and somebody will, as happens in almost every rate cycle.

4. Higher muni bond yields are coming. Current bond yields now make no sense; I cannot reconcile the inflation elephant in the room with the lowest municipal bond interest rates in decades.

Public officials should be racing to the market to get their infrastructure and other funding done as soon as possible. The risk of higher bond yields now clearly outweighs the opportunity for lower costs any time before the next recession. Historically, most long-cycle expansions require an interest rate spike before settling into a lower but sustainable growth rate. For now at least — unless we hit an "exogenous" factor like war or a far-worse mutant virus — a recession seems most likely to be several expansion-cycle years away. That augers for higher muni bond yields in the next year or two.

5. Public pensions will face a COLA pinch. Pension fund trustees will inevitably devote agenda time to educational sessions with their actuaries over their long-term inflation assumptions, and it's a safe bet that most pension actuaries and employee reps will do their best to brush off the inflation hawks on their boards. Pension boardroom jokes will abound over speakers' ill-chosen references to "transitory" inflation; I anticipate growing use of the camouflaged substitute term "nonpersistent" to describe 2022 inflation rates in pension circles.

But the reality is that many plans that include cost-of-living increases in retirees' pensions will experience an increase in their unfunded retiree liabilities as 2022's COLAs exceed their actuarial assumptions. Of course, the payroll base will eventually grow to catch up, so pension contribution rates as a percentage of pay may remain stable.

6. Fiscal uncertainty will continue to prevail in Washington. The Senate impasse over the Democrats' Build Back Better plan portends a year of political hurdles for any major fiscal measures that would materially benefit states and localities beyond those already enacted in the 2020 and 2021 COVID-19 relief packages.

If Sen. Joe Manchin's objections to inflation-inducing federal spending were purely fiscal, that problem could be solved by the party's progressives by introducing more-impactful "pay-for" revenue-raising planks in their platform, to pluck the richest geese. Those could include reforms of the estate tax step-up, a stiffer minimum tax rate on millionaire incomes, a cap on the pass-through private-business personal income deduction known as QBID , a sensible surtax on company stock buy-backs, reform of the carried-interest preference given to investment fund managers, and elimination of petroleum extraction depletion allowances.

The problem for state and local advocates is that they don't want to make lifelong enemies of lobbyists for the one percenters who buy muni bonds, and the professional associations are keen to preserve their bipartisan reputation. Maybe the progressive camp in Congress will pivot and play a balanced-budget game with populist tax proposals that have broad voter support. Even so, public finance proponents operating behind the scenes will still be just the tail wagging the dog on any revised federal tax-and-spend package.

The bottom line for public finance: For most state and local officials, 2022 will hopefully be the most "normal" year they've experienced since 2019, so awareness and preparation will help navigate these macro crosscurrents.

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