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Muni Issuers Face Pressures from Remote Work.

Credit and income sensitive municipal bond investors are well served to note recent comments by industry experts citing remote work as an emerging credit risk.

In affirming its negative outlook on Kansas City, Missouri, Fitch Ratings cautioned that based on increased remote work, it anticipates a slow recovery in payroll taxes – the city's largest source of general fund revenue.

The narrative continued with Bloomberg Intelligence strategist Eric Kazatsky's observation that "a handful of cities in Ohio, such as Cincinnati and Toledo, that rely heavily on income taxes could also see weakness in their revenue streams from remote working and potentially be subject to a downgrade."

The cautionary sentiment ironically came shortly on the heels of JP Morgan Chase CEO Jamie Dimon's begrudging acknowledgment that "working from home will become more permanent in American business."

Indeed, Dimon's concession to "the new normal" echoes what seems to be the growing consensus despite efforts by President Biden, governors, and mayors to encourage workers to return to their offices to help revive urban economies.

While the path back to pre-pandemic office life remains uncertain, a protracted work from home reality may be a harbinger for future credit rating downgrades of cities heavily dependent on commuter-driven revenues, especially after federal stimulus funds run dry.

The potential drag on tax revenues extends well beyond wages – sales taxes, transit systems, toll roads and small businesses will, to varying degrees, also feel the pinch.

A shrinking commuter base could also be a double whammy for big cities such as Los Angeles and New York, which are already grappling with population losses.

For example, the migration of millionaires leaving New York has diminished a primary demand component for the state's municipal debt.

The demographic shift has presented an unusual opportunity for highly taxed NYC residents who remain to invest in-state "triple tax-free" at higher absolute yields than offered by states with no income tax, such as Florida.

As remote work becomes an increasingly relevant credit driver, income-focused investors and investment managers will likely have similar opportunities to capture higher yields as impacted issuers come to market at cheaper levels.

Conversely, cities that rely more heavily on property taxes relative to earnings and sales taxes are likely to be more resilient to long-term shifts to remote work.

Also, smaller towns and suburban areas outside larger business districts would be the logical economic beneficiaries should hybrid work become the new paradigm.

A study by Pew Research Center, using 2019 Census Bureau data, reveals that among the workforces of 10 large metropolitan hubs, Richmond, Virginia had the highest share of workers commuting from outside the city at 77%.

Surprisingly, New York City had the lowest commuter share at 28%, but this result was somewhat misleading as the survey counted anyone residing within the city's five boroughs as a non-commuter.

Further complicating the credit calculus is the daunting task of determining which state collects taxes on wages for employees that live in a different state from the company for which they work.

While the rules governing taxation are literally all over the map, the guiding principle is that states that do not impose "double taxation" on employees working from a different state than their employer have the greatest exposure to lost earnings tax revenues.

Currently, there are only five states – Connecticut, Delaware, Nebraska, New York, and Pennsylvania – that assert the right to impose income tax on wages earned while working for an employer based in that state, even if performed remotely from another state.

However, neighboring states might strike a reciprocal agreement, such as the one between New Jersey and Pennsylvania, stipulating conditions under which remote employees only owe taxes to their resident state.

Given these complexities, portfolio managers will want to perform an issuer-by-issuer analysis in order to determine exposure to remote work risks as part of a broader credit assessment after which they can evaluate if yields adequately compensate for such risks.

An instructive case in point is last week's Moody's upgrade of New York State to Aa1 even as the ratings agency noted "risks associated with the Metropolitan Transit Authority, a component unit of the state, and uncertainties regarding recovery of the office-intensive New York City metropolitan area, which is the key driver of the state's economy."

The takeaway is that municipal investors need to consider remote work in their credit analysis to inform their buy/sell decisions.

Evidently, the ratings agencies are already paying increasingly close attention.

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