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From Climate to Cyber to Politicization, Mega Trends Impacting Municipal Market.

We are at the initial stages of a major paradigm shift that has significant implications for the municipal market over the next five to 10 years. A number of societal mega-trends will present material challenges for the municipal market. These include climate change, growing federal debt, shrinkage of the workforce, the impact of remote work, cybersecurity attacks, and political polarization.

This commentary will discuss each of these trends and their interrelationship. In combination, these trends will likely increase expenses and decrease revenue resulting in growing challenges for municipalities.

Whether it be unprecedented droughts, forest fires, floods, tornadoes, wind, or heat waves, it is evident that climate change has begun in a dramatic fashion. How quickly it will escalate is unknown but that it will escalate is a near certainty, absent a quick dramatic change in human activity. As climate change escalates there will be even more damage to infrastructure, farmland, coastal properties, utilities, homes, and businesses. The cost of addressing these damages will likely rise significantly.

According to the National Oceanic and Atmospheric Administration, in 2023 there were 28 separate billion-dollar climate disaster events, the highest count of record. The cost of these events was $92.9 billion, and this number may rise by several billion as more costs are identified.

As these costs escalate, the Federal Emergency Management Agency (FEMA) will not be able to pay the costs of all of these climate-driven events and will limit their spending by putting more responsibility on localities to contribute to paying these costs. The Disaster Recovery Reform Act of 2018 requires FEMA to increase the thresholds for paying relief and encourages FEMA to place adequate responsibility on state and local governments. Insurance companies are already refusing to provide property insurance in at risk areas such as coastal properties.

In addition, as interest costs on the federal debt continues to grow in unprecedented ways there will be even less of a possibility or desire for the federal government to fund own climate change costs. The Congressional Budget Office projects that interest on the ever-expanding federal budget will grow from $870 billion in 2024 to $1.6 trillion in 2034. That is an 87% increase and is a whopping 22% of all tax revenues. The payments for social security, Medicaid and other non-discretionary budget items will leave a shrinking percentage of the federal budget for all discretionary items. Overall, the federal deficit will grow to 116% of GDP by 2034. The money just will not be there to pay the significant increase in climate change costs that will arise around the country.

There will be growing pressure for state and local governments to provide the funds to address climate catastrophes. As more events occur and the federal government pays less of the remedial costs, localities will have to pay the costs so that their communities and economies can be sustained. This will be a matter of political and economic survival. In addition, as the federal government pays less for mitigation projects, localities will increasingly see it in their interests to pay for these projects to avoid even greater costs in the future.

Where will localities get the monies for climate change mitigation and remediation? It will have to be either from raising taxes or from issuing more bonds. Increasing taxes is always difficult politically but it will also cause other problems. If taxes in a locality are too high more people will move to another location. This in turn would undermine the tax base overall to raise the needed funds.

The more likely and more often used tool will be municipal bonds. States and municipalities are very likely to increase their debt load substantially over the next decade due to climate change. This increased debt load will result in varying degrees of fiscal stress as debt service payments as a percentage of the overall local budgets will increase. This could result in rating downgrades in some places which would in turn result in higher interest rates on debt. The U.S. territories (which are all islands) and coastal states are particularly at risk.

As expenses increase as projected above, revenue is likely to decline. This will be due to a number of mega-trends. One such trend is an unprecedented shrinking workforce resulting in lower economic growth. The baby boomer generation has come of age and people have and are retiring. At the same time subsequent generations have had significantly fewer children. And the present generation has an even lower birth rate. The result is a shrinking workforce.

And historically a major driver of growth has been new flows of immigrants into the workforce. Recently the only reason for a modest increase in population growth has been immigration. But immigration has become a controversial issue with some wanting to severely limit immigration, not just illegal entry into our country.

If and as the workforce declines resulting in lower economic growth, the tax base of municipalities will decline as well. The revenue base will shrink.

In addition, due to changes in work habits in reaction to COVID-19, major cities have experienced a serious loss of their tax base. This has occurred due to loss of population, lower values of real estate (especially office buildings) resulting in less property tax, and decreased foot traffic producing less sales tax revenue. Absent a change in remote work, major cities will continue to face these revenue challenges.

Certain mega-trends like cyberattacks and political polarization have the potential to negatively impact either or both of expenses and revenue. As cyberattacks grow with a greater sophistication, revenue collection may be disrupted, and expenses will rise to both defend against such risk and/or address an actual attack. Political polarization could result in political paralysis, which may result in the loss of revenue opportunities and/or in greater expenses. For example, if a city council or state legislature is divided and unable to reach compromises on important budget decisions, such as how to mitigate and remediate climate change, difficult decisions may not be made. This could ultimately be quite costly.

Of course, there are potential mitigants to each of these trends. Countries may successfully cut back carbon emission enough to reverse climate change. Congress may reverse the direction of the federal deficit. Shrinkage of the workforce may be offset by productivity increases without creating excessive unemployment. Workers may go back to work five full days a week. Costly but sophisticated safety systems may protect government entities from cyberattacks. Political polarization may subside. We think it is highly unlikely that most, if any, of these mitigants will occur.

The next five to 10 years will present unprecedented challenges for states and municipalities. In combination, these trends will present serious obstacles to maintaining fiscal health and they exist independent of economic cycles. They will likely be exacerbated by and exacerbate economic downturns. Localities that understand these trends and develop policies to counter them will be in the best position to address them effectively.

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