



June 2018

Supreme Court Decisions to Have Limited Impact on Municipal Credits

by The Municipal Bond Team

The U.S. Supreme Court rendered verdicts in two cases that could have broad implications on the municipal market: *South Dakota v. Wayfair, Inc.* and *Janus v. American Federation of State, County, and Municipal Employees*. The *Wayfair* decision, a ruling in favor of South Dakota, will allow states to assess sales taxes on online retail transactions. The *Janus* decision, a ruling in favor of plaintiff Mark Janus, prohibits public unions from requiring workers to pay union dues. While both decisions were close, decided by a 5-to-4 vote, the implications are significant for municipal credits, but the ultimate impact may be less than investors expect.

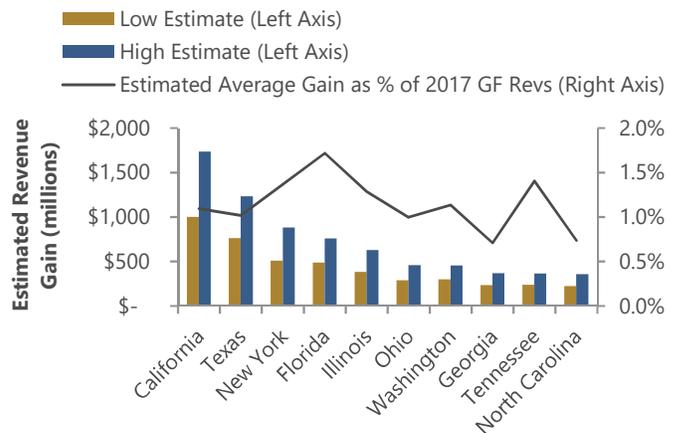
South Dakota v. Wayfair

On June 21 in the case of *South Dakota v. Wayfair, Inc.*, the U.S. Supreme Court ruled in favor of South Dakota. The 5-to-4 decision effectively allows states to pass laws subjecting online retail transactions to sales taxes. This ruling overturns the Court's 1992 decision in *Quill Corporation v. North Dakota*, which prohibited states from requiring a business to collect sales tax unless the business had a physical presence in the state. The *Wayfair* decision should cause an increase in sales tax receipts, which may benefit some state and local general obligation credits, as well as some special tax credits that are secured by sales taxes. However, we do not believe the impact will be of a magnitude that would result in a significant quantity of credit upgrades or material spread compression.

Wayfair Ruling Impact on State and Local Credits

Several factors will drive the impact of the *Wayfair* decision on specific state and local credits, including if online sales are already taxed and the magnitude of the dependence on sales taxes as a percentage of the general fund. The chart below shows the top ten states that are poised to receive the largest absolute revenue gain from additional sales taxes and the corresponding increase as a percentage of fiscal year 2017 general fund revenues.

Top Ten States Highest and Lowest Revenue Gain Estimates



Source: Government Accountability Office as of November 2017 and Bloomberg.

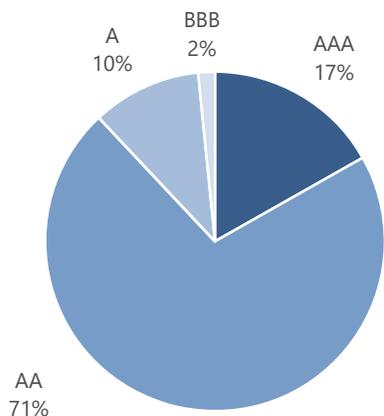
The Government Accountability Office (GAO) estimates that state and local governments already collect sales taxes on about 75% to 80% of online retail sales, which according to data compiled by the Federal Reserve Bank of St. Louis, accounted for about 9% of total national retail sales in 2017. Further, the GAO estimates that state and local governments could gain between \$8 billion and \$13 billion if states were given the authority to require sales tax collection from remote sellers, with an average gain of about \$200 million per state. Based on annual state and local government sales tax receipts, we expect additional revenue gains will amount to less than 3% in aggregate. At present, 45 states levy sales taxes and 31 of those states currently have laws taxing online sellers without a physical presence through various "nexus" provisions.

Under the Supreme Court ruling, any new laws to tax online sales will have to avoid imposing an undue burden on interstate commerce. South Dakota's law, for example, applies only to out-of-state sellers that deliver more than \$100,000 of goods or services into the state or engage in 200 or more separate transactions into the state. South Dakota is also a member of the Streamlined Sales and Use Tax Agreement (currently there are 23 member states), which reduces administrative and compliance costs and even provides state-funded sales tax administration software. Most major online retailers already collect sales taxes on online sales, and some states have signaled that they will not be amending their existing laws, leading us to conclude that the actual impact may be closer to the low end of the GAO estimate. While some states without internet sales tax collection laws in place now have the opportunity to benefit from this additional revenue capture, we do not expect the ruling to have material impact on state or local credit quality.

Wayfair Ruling Impact on Sales Tax Bonds

While the Wayfair decision is expected to increase sales tax receipts overall, the impact on the ratings of sales tax bonds should be minimal as we expect that the incremental revenues will be relatively small and the bond ratings for a sizeable percentage of sales tax credits already reflect strong debt service coverage. As shown below, Fitch's ratings on bonds backed by sales taxes already reflect their very high quality, with 88% of sales tax bonds rated in the AA and AAA categories. However, rating agencies may also take into account the credit quality of the municipality that levies the sales tax, in some cases capping the rating on the sales tax bond based on the rating of the state, city, town or county.

Distribution of Fitch Sales Tax Ratings



Source: Fitch Ratings, as of June 26, 2018.

Janus v. American Federation of State, County, and Municipal Employees

On June 27, the Supreme Court ruled 5-4 in favor of Mark Janus in the case of *Janus v. American Federation of State, County, and Municipal Employees* (AFSCME). The Court opinion states that public unions are prohibited from requiring workers to pay union dues, overturning a 1977 precedent (*Abood v. Detroit Board of Education*) with its decision. Janus' argument was based on a violation of the First Amendment: the plaintiff felt that the political rhetoric of the union was against his personal beliefs and being forced to pay dues to the organization was unconstitutional. AFSCME's position was that non-members who do not pay dues would become free riders that share in the benefits of union bargaining without sharing the costs.

Janus Ruling Impact on State and Local Credits

Union membership has declined in recent years, and the ruling is expected to contribute to this trend. There are about 15 million union members in the United States, equal to 11% of the workforce. Roughly one in three government employees are union members, compared to 6.5% of private sector employees. We believe the Supreme Court's ruling will be a long-term positive for municipal credits that directly interact with public sector unions. Budgetary pressures associated with collective bargaining, such as wages, healthcare costs and pension benefits, have been consistent challenges for municipalities. Due to the ruling, union political influence may diminish, opening the door for reduced benefits and potentially easing long-term financial burdens on state and local governments.

More Sizzle than Steak

While these Supreme Court decisions are highly significant from a social perspective, we expect they will have a muted impact on state and local finances in the near term. Additional sales tax collections are positive for municipalities, but the extra revenue will be relatively small and likely not impact credit ratings or interest rate spreads. A reduction in union dues may diminish the labor unions' bargaining power in the long run, but changes to collective bargaining agreements often play out over a long period of time.



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