THE STATE OF NEW JERSEY: LIFE IS NOT A BEACH

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INTRODUCTION

Everything may be legal in New Jersey, sang Lin-Manuel Miranda in *Hamilton*, but the state nevertheless has to balance its budget and stabilize its credit ratings. That won't be easy after 11 downgrades from the big ratings agencies in six years. At A3/A/A, New Jersey is now one of the lowest-rated states in the country, despite being the second wealthiest. Costly public schools, neglected infrastructure, rising healthcare costs, and woefully underfunded pension systems mean that the soon-to-be-elected governor and the state legislature will need to make some tough and potentially unpopular decisions to maintain the confidence of state and local debt holders, as well as residents and businesses.

ECONOMY

New Jersey finally recovered just last year from the financial crisis of 2008-2009, almost four years behind the country as a whole.[1] In addition to its fiscal challenges, the state's relative productivity advantage is narrowing, caused by its high cost of living and doing business, and its low proportion of working-age residents.[2] New Jersey does have strong transportation links to New York City (although most are in dire need of repair), and areas in Jersey City and Hoboken are still able to attract productive residents and related businesses. However, young professionals who can choose between the state's many suburban office parks and more urban, diverse and dynamic settings, notably in nearby New York City, are increasingly drawn to the bright lights.

New Jersey's own economy remains diverse. Some of the major industries that drive the workforce are:

- Health Services and Life Sciences: 14 of the world's 20 largest biopharmaceutical companies operate in the state, including Johnson & Johnson, Bristol-Myers Squibb, Merck, Novartis, Novo Nordisk, and Bayer. Teaching hospitals, research institutions and clinical trial assets are all attractive for these biopharmaceutical developers. Despite recent consolidation in the pharmaceutical industry and continued competition from West Coast areas attracted by their own dynamic universities and research institutions, this is still an important sector for the state.
- Financial Services: New Jersey is an attractive base for financial services firms due to its population density and proximity to New York City. Prudential and Chubb both keep headquarters in New Jersey, and a number of major banks have operations close to New York or Philadelphia. Several large data centers that service New York financial clients are also located in the state.
- Construction: Residential construction is being driven by demand for multifamily units, which is offsetting some weakness in demand for single-family homes. Spending on infrastructure improvements is expected to drive employment, especially among civil engineers. This includes projects from the Port Authority, New Jersey Turnpike Authority[3], and New Jersey Transit.
- Information Technology: New Jersey has the second highest concentration of information and communications technology, or ICT, in the United States. The number of corporate headquarters in New Jersey and nearby major cities, which includes significant Verizon and AT&T operations, is attractive to ICT vendors.
- Aerospace and Defense: New Jersey is ranked sixth in the nation in defense systems manufacturing

employment. The presence of large military facilities, including Lakehurst Naval Air Base and McGuire Air Force Base, help drive demand for large number of local engineers, as does Boeing's three separate facilities throughout the state.

- Transportation, Logistics and Distribution Industry Cluster: This sector employs 11.2% of the state's private sector workers, compared to the national average of 8.8%. The state offers good access to the nation's freight rail network and is also home to several key transportation facilities, including three major seaports and Newark Airport.

It's important to note another positive for the state; The immigrant population in New Jersey is strong and growing, comprising 21.2% of the population, a substantially larger proportion than the 12.9% for the United States as a whole. Many are educated business owners or families drawn by the still high quality of the state's public education system.[4]

Schools

As in many states, the school funding formula in New Jersey is contentious and consistently proves to be one of the major stumbling blocks in budget negotiations.[5] The cost of public education accounts for the largest portion of property tax bills and roughly one third of the state budget. While recognizing the significant financial resources dedicated to public K-12 education in the state, the results are still impressive. In measures such as student-teacher ratio, average SAT and ACT scores, and dropout rates, New Jersey consistently ranks among the best-performing states in the country.[6]

In New Jersey, state aid is awarded based on each community's ability to generate tax revenue, leaving wealthier districts responsible to fund a larger percentage of their public school costs, leading to higher property taxes. The current governor, Chris Christie, has spoken out against this current formula that awards more than half of the state's school aid to 31 mostly low-income districts.[7] State lawmakers have also added a stipulation that guarantees school districts at least the same level of state aid they received in prior years. As the governor and the legislature grapple with other important aspects of the budget, they have managed, for now, to avoid major state cuts to K-12 education owing to its popularity and impact on property taxes.

Property Taxes:

New Jersey has the highest effective real estate tax rate in the country, averaging more than 2% of a single-family home's value each year.[8] And those homes aren't cheap — it's the fifth most expensive real estate market in the country, for the following reasons:

- Density: The more people, the greater the cost of public services and, generally, the higher the costs of maintaining the infrastructure.
- Higher-than-average labor costs: New Jersey is a high cost-of-living state, which means that local governments have to pay well. They are also saddled with the legacy costs associated with unionized public employees.[9]
- Property taxes pay for most of everything in New Jersey, in contrast to many other states, which allow county and municipal governments to impose local income and sales taxes.
- Popularity of home rule: The state has 565 municipalities and almost 600 school districts, which collectively account for a lot of administrative payroll. Shared services and consolidation could help the state to economize.
- Education: New Jersey has one of the highest per-pupil price tags in the nation.

The rate of growth in New Jersey property taxes has slowed since 2010, when a state law limited increases to 2% a year. Local governments are allowed to exceed the cap in certain cases, including response to disasters such as storm conditions, debt service, and increases in pension and health insurance costs above 2%. Municipalities, burdened by high pension costs, will still feel the pressure to maintain or even increase funding.

Transportation Infrastructure

New Jersey's transportation infrastructure has been neglected for many years. The American Society of Civil Engineers Infrastructure Report Card gave the state an overall grade of D+, with Bridges, Roads and Transit getting grades of D+, D+ and D-, respectively.[10] Continued neglect of the transportation system could cause significant damage to the economic competitiveness for the entire state. For an example of this deterioration, one needs to look no further than NJ Transit, which had more train breakdowns last year than any other commuter railroad in the nation.[11]

The agency has lost more than 90% of its state subsidy under the current administration, falling to $33 million last year from $348 million in 2009. Budget holes have been filled by fare increases and diversion of money from toll roads and utilities, along with service reductions and other cuts. NJ Transit needs dedicated sources of revenue similar to those such as the Metropolitan Transportation Authority in New York, instead of relying on an inconsistent state budget process.

Recent problems at Penn Station in New York further highlight the transit system's vulnerabilities. The $24 billion Gateway Tunnel project expects to double New Jersey rail capacity to Manhattan. Amtrak, which is coordinating the project, was counting on funding from the federal New Starts grant program, but that program will lose 43% of its own funding in the most recent federal budget proposal. Interestingly, seven years ago the same project – then called Access to the Region's Core – was canceled by Governor Christie, who also turned down $3 billion in related federal subsidies.

Some transportation relief may be derived from the state's increased gas tax, the first increase since 1988. The 23-cent increase to 37.5 cents a gallon raised the state's gas tax from the second lowest to seventh highest, though still below those of neighboring Pennsylvania and New York. Moneys from this increase, as well as increases in diesel fuel and non-motor fuels, should contribute an estimated $1.23 billion a year to the state's Transportation Trust Fund. The trust fund ran out of money for new projects over the previous summer, with all money coming in from prior gas taxes dedicated to paying off debt.

In exchange for these transportation dedicated tax increases, the 7% state sales tax will be reduced by 3/8 of a cent, costing the state as much as $600 million in annual revenue. The estate tax, which had a threshold of $675,000, had its limit increased to $2 million in January 2017. By January 2018, the estate tax will be eliminated entirely, costing the state another $600 million. Whether or not these tax cuts stay in place under a new governor remains to be seen.

Healthcare

Since the Affordable Care Act, or ACA, took effect in 2014, the federally funded expansion of Medicaid has brought healthcare to more than 700,000 previously uninsured New Jersey residents, reducing the uninsured rate to 8.7% in 2015 from 13.2% in 2013.[12] New Jersey currently pays just 10% of the cost of the expansion of Medicaid, or $218 million this year, with the federal government paying the rest. The concern, from a budget perspective, is that the formula reverts to the 50/50 split that predated the act and the state will no longer receive extra funding for new enrollees at some future date currently being negotiated. This could amount to a loss of over $2 billion in federal funding, out of a state budget of approximately $35.5 billion.

Pensions

New Jersey's pension liability is among the highest in the country, the legacy of a long history of underfunding its actual annual required pension contributions. Moody's Investors Service projects a $116 billion adjusted net pension liability for the state, or 292% of its own-source or state generated revenue in fiscal year 2017, up from 225% in fiscal 2015.[13]

Large pension liabilities can also be attributed to poor investment performance, with an actual return of -1.15% last year, compared to a 7.65% assumed return.[14] Prior pension bond issues meant to alleviate the pension liability only exacerbated the state's financial problems when weak investment returns undermined assumptions and the state neglected to fund adequately the remaining pension liabilities. This created a new debt service liability that cannot be deferred for fear of default.

The state's current plan is to annually increase contributions by 1/10th of the annual required contribution, or ARC, with the gap gradually declining over the next seven years.[15] However, these funding shortfalls have increased the unfunded liability and contributed to a significant cash-flow deficit in the state's pension fund. New Jersey's ability to increase its pension contributions on schedule will be critical to reversing this cash flow deficit and maintaining a stable credit profile. Also worth noting is that the State Supreme Court in June 2016 upheld the suspension of pension cost of living adjustments, a key element of the state's 2011 pension reform, eliminating the risk that pension contributions and liabilities would increase an additional 30%. Generally, many state pension problems are exacerbated by its own courts when determining flexibility for changing existing schemes.[16]

Local governments participate in the state administered Public Employees' Retirement System and Police and Firemen's Retirement System. While the state has not fully funded its ARC, local governments are required to fully fund their portion. As a consequence, while state funding levels have only reached 33%, the contributions of local governments are nearly double that at 64%. Funding levels for teacher retirement systems are much closer to the state average, since only the state and not the local school districts are responsible for this pension funding. (For potential fixes to the state's teacher pension problems, see the box at the end of the piece on the State Pension Commission.)

Local Credits and New Jersey Finance Board

The state has a strong, paternalistic relationship with its local government units. New Jersey has sought to manage local financial affairs so that cities, towns, counties, authorities, and special districts, such as those responsible for fire and utilities, can avoid defaults and bankruptcy. No municipality in the state has filed for Chapter 9 bankruptcy protection since Fort Lee in 1938. Camden came close in 1999, but the state intervened and put up additional money so that the city could pay its bills. A handful of other states engage in varying degrees of monitoring, oversight, and control of local government finances. Unlike most of these states, however, New Jersey offers money to distressed local governments to help them balance their budgets in the short term until their revenue and expenses can be restructured. This includes additional aid and emergency loans. New Jersey's tradition of intervention has endured for decades through Republican and Democratic governors and legislatures. The most recent example is Atlantic City, which suffered a severe deterioration in its tax base as casinos faced continuing competition and revenue loss.[17]

The state also reviews all local revenue estimates; if forecasts seem too optimistic, the local government must cut the projection. New Jersey additionally imposes a borrowing limit that localities cannot exceed without the state's approval. This proactive oversight usually prevents a certain level of financial stress that occurs in many other states.

Reconciling the Budget

The state's current plan to resolve its structural budget gap and reverse the growth of unfunded pension liabilities hinges on escalating pension contributions over the next six years. The concern is that the plan relies on optimistic assumptions about pension investment returns, as well as about economic and revenue growth which add budget risk, particularly in light of recent tax cuts. We believe that closing the gap will be more feasible with structural spending cuts and realistic economic growth assumptions.

New Jersey's post-recession economic recovery lagged the nation and personal income growth has not kept pace with the national average. As a result, New Jersey's average annual revenue growth has been

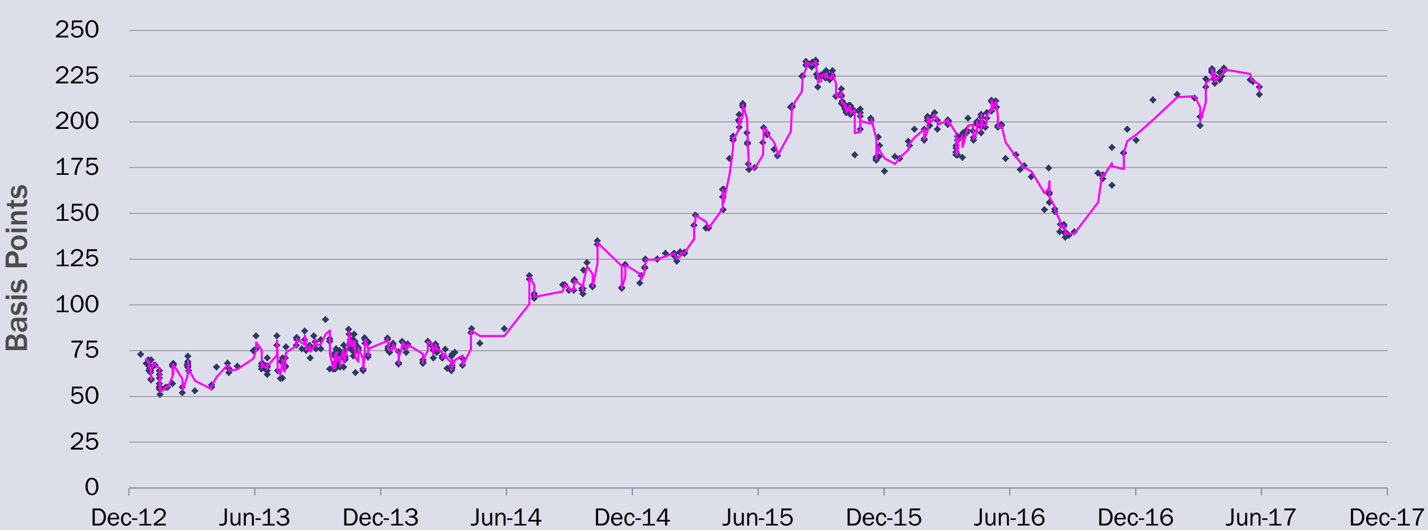
2.8%, underperforming the Northeast region and the United States as a whole.

Tax increases have been politically unpopular during the current gubernatorial administration but future governors may be able to use tax increases as a tool to balance the budget. Many discussions have centered on a millionaires' tax, reinstating the estate tax, and revoking the sales tax reduction. However, there may be limits to additional tax increases, given the state's slow economic growth and risk of more affluent residents, particularly without school-age children, questioning the costs and benefits of living in the state.

On the expenditure side, New Jersey's Other Post-Employment Retirement Benefits, or OPEBs, are not statutorily or constitutionally protected. The state has more flexibility to revise health benefits than more legally preserved pension benefits. However, reducing healthcare benefits for employees requires direct legislation or approval of two plan design committees comprised of state and employee representatives. Therefore, health benefit reforms require a high degree of political support before implementation.

New Jersey budget dramas have significant consequences. The recent short-lived shutdown affected 30,000 state workers furloughed, closing state parks, motor vehicle offices, state courts, and other services that are deemed nonessential (as well as a lame-duck governor who thought he was working on his tan in peace). The state's shutdown mechanism provides added incentive to continue negotiations, no matter how contentious.

NJ School Construction Bonds—Spread to AAA MMD (Basis Points)
Uninsured, Baa1/BBB+/A- 5.00% Coupon, 7 to 10-Yr Maturity, Non-callable



Source: Loop Capital Markets

Debt

New Jersey bonds continue to attract strong investor demand from residents due to the state's high wealth levels and income tax rates. The potential for higher tax rates as part of the solution to structurally balancing the state's budget could further increase demand.[18] The next governor will certainly have to grapple with budget issues, and solutions are likely to have financial and credit impact on cities, counties and school districts. As the graph illustrates, yields have increased and prices have declined for New Jersey appropriation debt as a result of budgetary imbalance, tepid economic recovery, and increasing pension liabilities. In selecting New Jersey bonds for our clients, we currently aim to avoid entities that are dependent upon the state for a significant portion of their revenues, as they may be vulnerable to cuts. While we feel that the state will continue to pay debt service on its own general obligation and appropriation debt, spreads for the state may continue to widen until the market is convinced that budget and pension issues are addressed, and the economy regains some of its momentum.[19]

New Jersey credits that are currently not as dependent on state funding include the following (Ratings Moody's/Standard and Poor's):

- Bergen County: Aaa/AAA
- Burlington County: Aa2/AA
- Middlesex County: Aa2/AAA
- Monmouth County: Aaa/AAA
- New Jersey Environmental Infrastructure Trust (state revolving fund for water and wastewater systems): Aaa/AAA
- New Jersey Housing & Mortgage Finance Agency, Single Family: Aa2/AA
- New Jersey Student Loan Revenue Bonds, 1st Indenture: Aaa/AA
- Princeton University: Aaa/AAA
- Union County: Aaa/AA+
- Robert Wood Johnson Barnabas Health: A1/A+
- Port Authority of New York-New Jersey: Aa3/AA-
- New Jersey Turnpike Authority: A2/A+

Conclusion

The state is in a precarious but not irreparable position when it comes to creating and maintaining a sustainable budget. New Jersey's strengths, including a still high quality of life, a diverse economic base and impressive public schools, are all important in attracting and retaining residents. They are also expensive to maintain, along with improving sorely neglected infrastructure, providing healthcare for the neediest, and honoring pension obligations. In order to offer sufficient services in an efficient manner, the state will need more funding in an era where it may not be able to rely on the federal government for additional help. Increasing taxes without restricting the economy, and working with various unions in further renegotiating salaries and benefits, are keys to sustaining the strengths of the state and balancing the budget. We will continue to evaluate these considerations and make investment recommendations accordingly. There is a certain irony in the fact that, while the state has lacked a fiscal discipline, New Jersey imposes one of the strictest budgetary oversight mechanisms on local governments. This has preserved many a local budget and bond rating – providing good security and variety despite the state's own fiscal woes. We will also monitor any changes to this added layer of protection, including new costs to this local level of government.

State Pension Commission

The governor's commission on teacher pension reforms has recommended a shift of pension and other post employee benefit costs from the state to school districts. It is intended to be a comprehensive solution to pension burdens at both the state and local levels. It is also intended to be cost neutral to taxpayers with the increased costs at the school district level to be offset by savings in healthcare plans across New Jersey school districts and municipal governments. The commission proposes to alter current generous healthcare plans at school districts and municipal governments to levels commensurate with the private sector. The resulting savings would be used to cover newly assumed pension and retiree healthcare obligations the districts take on from the state. Along with modifying the coverage levels, the commission calls for freezing the Teacher Pension Fund and creating a new and lower-cost cash balance, defined-benefit pension plan to be paid for by schools. Already accrued benefits would remain the responsibility of the state. It is intended that the transfer of pension and retiree healthcare costs to districts would be more than offset by the healthcare savings at the district and local government levels.

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Endnotes:

[1] Rutgers Economic Advisory Service R/ECON Forecast: January 2016 New Jersey, An Economy on the Mend for the Long Term
[2] New Jersey Business & Industry Association – Outmigration by the Numbers: How do we Stop the Exodus? February, 2016
[3] New Jersey Turnpike Authority is coming to the end of its current 10-year, $7 billion capital program with almost $6 billion already spent.
[4] Source: US Census Bureau "Historical Census Statistics on the Foreign-Born Population of the U.S."
[5] In the most recent budget, some school districts, particularly those with drops in enrollment, will lose aid as funding shifts toward districts with a rising number of students.
[6] 2016's States with the Best & Worst School Systems: Wallethub.com. New Jersey is also third in the country, behind Alaska and New York in money spent per pupil at $17,907 vs the national average of $11,621: Public School System Finances, U.S. Census Bureau.
[7] In 2016, of the $9.1 billion in state education aid, about $5.1 billion went to the 31 districts, while the other $4 billion goes to the remaining 546 districts. Looked at another way, 23% of the state's students get 59% of state aid.
[8] 2017's Property Taxes by State: WalletHub & U.S. Census Bureau data
[9] There are multiple studies comparing salaries and benefits of public vs. private sector employees in the US as well as New Jersey specifically. Generally speaking, NJ public-sector workers are more highly educated than private sector workers with college-educated labor on average making less than private sector employees with the earning differential greatest for professional employees, lawyers and doctors. On the other hand, the public sector appears to set a floor on compensation. The earnings for less educated workers, when compared to similarly educated workers in the private sector, are higher for state or local government. (See Economic Policy Institute – Rutgers University, Bloustein School of Planning & Public Policy, Briefing Papers on Public Employee Pay).
[10] American Society of Civil Engineers Infrastructure Report Card 2016: an infrastructure grade of "D" means facilities are "At Risk" and in poor to fair condition and mostly below standard, with many elements approaching the end of their service life. A large portion of the system exhibits significant deterioration. Condition and capacity are of significant concern with strong risk of failure.
[11] Federal Transit Administration, National Transit Database, 2015 Breakdowns
[12] U.S. Census Bureau Health Insurance Coverage in the U.S.
[13] Moody's Investors Service Report: State of New Jersey – State's Severe Pension Underfunding Continues to Grow, April 12, 2017
[14] IBID
[15] Chapter 78 Pension and Health Benefits Reform Program of 2011 established a new contribution arrangement that required public workers and certain retirees to contribute more towards the cost of the employee benefit coverage. Teachers' Pension and Annuity Fund and Public Employees' Retirement System pension contribution rates were increased from 5.5% to 6.5% of salary with an additional 1% increase phased in over 7 years. Other increases were negotiated for Police & Firefighters and Judicial as well as health benefit reform provisions.
[16] Municipal Market Analytics - Weekly Outlook, June 12, 2017: As part of the state's budget negotiations, New Jersey is transferring the state lottery to the pension system for a period of 30 years and dedicating the associated revenues. Based on state accounting, the unfunded liability should improve by $13.5 billion. The projected earnings of the lottery over the transfer period are $37 billion. This plan shifts money that would be utilized for other general fund spending, leaving a funding gap for the affected programs (including higher education and social services) estimated at $970 million for the current fiscal year.

[17] The state took over Atlantic City in November 2016 under the Municipal Stabilization and Recovery Act and gives state designees broad authority to unilaterally modify or terminate union contracts, sell city assets, hire or fire workers, enter shared services agreements, restructure debt, abolish departments and assume control of city litigation. Atlantic City has also benefited from the new way casinos are taxed, providing greater stability without threats of appeal, as well as beneficial changes to state aid.

[18] Owing to the requirement of statewide voter approval for general obligation state debt, New Jersey has mostly relied on debt subject to legislative appropriation; $31 billion of the state's $40.3 billion of outstanding bonds. We believe that the importance of maintaining access to the capital markets provides strong incentive for the state to continue making these appropriations.

[19] The state also had a very strong school support program for debt issued by individual districts. Under the New Jersey School Bond Reserve Program, Chapter 72 rated A3/A-, the state maintains accounts funded to at least 1% of aggregate school district debt issued after July 1, 2003. In the event the account falls below that amount, the state treasurer is required to appropriate and deposit in the fund amounts necessary to meet the requirements. The fund secures an individual school district's debt service should it be unable to meet its principal or interest payments. The rating for this enhanced program matches the state general obligation rating. Unfortunately, since the state's rating has suffered with its budgetary and economic issues, so too has this program's rating. Consequently, it no longer provides the same added security as it did previously.

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