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Fitch: N.J. Exec Budget; New Revenue & Spending; Legacy Costs Remain Driver.

Fitch Ratings-New York-22 March 2018: The New Jersey governor's executive budget delivers on policy goals outlined during his campaign; however, numerous new program and tax credit initiatives, combined with proposed extensive tax policy actions, cannot in the near term materially change the persistent underfunding of retiree liabilities and the elevated long-term liability burden that are the key drivers of the state's below-average 'A' Issuer Default Rating (IDR), according to Fitch Ratings.

The $2 billion, or 5.7%, proposed revenue growth from fiscal 2018 includes $1.5 billion from tax increases, supporting 4.2% growth in state appropriations. These increased revenues would go to new spending and leave the state with still slim reserves and reduced flexibility to respond to future economic downturns through revenue raising. Fitch notes that the state has significant spending pressures not only due to the demands of underfunded retiree benefit liabilities but also because natural revenue increases resulting from modest economic growth in recent years have gone primarily towards the phased-in growth in annual pension contributions. This dynamic has led to underfunding of other state needs.

GRADUAL PENSION RAMP UP CONTINUES

If implemented, the budget would continue the state on the path of a gradual 1/10th annual phase-in to the full actuarially determined contribution (ADC) for pensions in fiscal 2023. Despite the $691 million increase to the pension contribution, Fitch would expect further deterioration in the funded condition of the plans over the near term as the contribution remains well below the ADC. The $3.2 billion total pension contribution (9% of the budget) is a 28% increase from fiscal 2018 that accounts for 39% of proposed budget growth and funds 60% of the ADC. The contribution meets Fitch's rating expectations given the state's policies in recent years and hews the governor to the same path as his predecessor.

Employee and retiree medical expenses also continue to loom large, representing $3.4 billion (9%) of the governor's budget. As in most states, OPEB contributions remain well below actuarial recommendations, growing the accrued liability. Escalating pension and OPEB liabilities are expected to remain negative rating factors absent further policy action that reduces the liabilities, forestalling improvement in the state's IDR.

FISCALLY PRUDENT PROPOSALS

The governor's proposals for increased funding to New Jersey Transit (NJT), greater adherence to full education formula funding, reduced one-time budget balancing actions and an addition to state cash balances to provide greater financial cushion would either address critical state needs or support more sustainable financial operations, in Fitch's view. Further, the suggested return of the state sales tax rate to 7%, lowered as part of the transportation funding agreement in 2016, would provide $581 million in additional revenue. This is a positive step. At the time of that agreement,

which lowered the sales tax rate in exchange for an increase in the gas tax, Fitch noted that the state had replaced a growing revenue source with one with more limited growth prospects and added to the pressure on operating funds.

NEW PROGRAM INITIATIVES

Excluding the operating budget's increased pension contribution, recommended program expense grows by a net $918 million. Significant increases include $933 million in additional K-12 education funding, including $283 million in added formula aid, $242 million in additional state subsidies for NJT, $120 million for state and teacher employee and retiree health benefits, $100 million for opioid addiction programs and $50 million for assistance to community college students. Medicaid grows by $244 million, boosting this program's draw on the operating budget to 12% of proposed expenditures although remaining far below the 46% of the budget dedicated to education (including higher education). Offsetting these increases are reductions to various line items, $46 million in expected state-wide salary and operational savings, and reductions in certain state aid categories and capital construction. In addition to programmatic adjustments, the governor has proposed tax policy changes that reduce revenue to the state, including increases in the earned-income tax credit ($27 million) and the state property tax deduction cap ($80 million).

EXTENSIVE NEW REVENUE MEASURES

To fund these initiatives, the governor has proposed a milestone 10.75% personal income tax (PIT) rate for taxpayers earning more than $1 million, which would provide an estimated $765 million in fiscal 2019, as well as numerous business tax changes for an additional $110 million; both in addition to the proposed sales tax changes. The governor's budget also includes the legalization and taxation of marijuana which is estimated to deliver $80 million in tax revenue. Fitch believes there is uncertain legislative interest in the PIT proposal, particularly given recent passage of federal tax changes in December 2017 that capped the deduction for state and local taxes (SALT) and is expected to increase residents' effective state tax burden. Should the measures fail to be approved, other revenue solutions or expenditure reductions will need to be identified to balance the fiscal 2019 budget.

The state's revenue forecast is premised on 2.4% growth in the sales tax base; 4% and 4.2% growth in personal income in 2018 and 2019, respectively; 4% growth in gross state product in both 2018 and 2019; and 1% and 0.8% growth in nonfarm employment in 2018 and 2019, respectively. Fitch believes these forecasts to be reasonable based on recent quarterly experience but somewhat robust when considering the state's recent annualized growth, while noting that future economic growth is expected to remain below that of the nation.

BALANCED FISCAL 2018 OPERATIONS

Updates to the state's fiscal 2018 financial operations are included in the executive budget and point to anticipated budgetary balance this fiscal year. Current forecast revenue is a 2.2% improvement over the forecast used to enact the budget; however, the improvement largely incorporates a shift of sales tax revenue from non-operating funds to operating funds in addition to expected PIT revenue that is above forecast, offset by shortfalls in other revenue sources. Over 40% of the increase in the PIT is attributable to $253 million in one-time revenue related to the repatriation of overseas hedge fund profits, a direct effect of Section 457A of the federal Internal Revenue Code passed in 2008. Unexpected growth in the PIT excludes $200 million collected in December from taxpayers seeking to take advantage of the higher SALT deduction as the state believes this revenue would have been collected in April 2018.

Final, estimated appropriations increase by $1.2 billion (3.6%) from the enacted budget, partly incorporating appropriations linked to the moved sales tax revenue. The state's estimated year-end budgetary fund balance, which the state views as its budgetary cushion, is projected to be $738 million (2% of operating fund appropriations) largely incorporating a larger beginning fund balance than anticipated when the budget was enacted.

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