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S&P Bulletin: New Jersey's Fiscal 2022 Budget Could Signal Improved Finances If Windfall Revenues Do Not Lead To Increased Deficits

NEW YORK (S&P Global Ratings) July 1, 2021–S&P Global Ratings said today that any improvement in New Jersey's (BBB+/Stable) overall creditworthiness will depend on the state's success in establishing structural budgetary balance following this year's $46.4 billion budget.

As the 2022 fiscal year begins, S&P Global Ratings will be monitoring the following credit factors:

- Given the sizable year-over-year increase in appropriations, largely funded by reserves, the state's ability to identify future funding sources or curtail out-year spending will be a credit focus.
- With a 57% year-over-year increase in pension funding, this could mark the start of improved funding discipline; however, it will take a demonstrated commitment to paying the actuarially determined contribution (ADC) from reoccurring revenues and sustained improvement to funded ratios in the state's pension plans to materially alter our view on the budget pressure caused by past actions.
- We believe New Jersey's debt burden is high, and to the extent overall liabilities materially improve, from the inclusion of $3.7 billion dedicated to debt reduction or other funding, this could have positive implications.

The enacted budget includes $1.5 billion of additional spending on top of increases in the governor's proposed budget, raising total year-over-year spending by 2.3% from the fiscal 2021 adjusted budget. Although the state forecasts both income and sales taxes will improve, much of this spending is funded by a one-time reserve spend down of $4.3 billion in reserves or 9.2% of appropriations, which we view as an operating deficit. These reserve balances are largely the result of $4.3 billion in deficit bond proceeds, which were expected to fund revenue losses that did not materialize. Now, officials plan to spend the resulting surplus on a combination of one-time items and increased support for pensions and debt reduction, which could support an improved financial position for the state if future budgets find the means to continue funding. We believe certain items added, including more money for education, health, human services, and tax rebates, might prove difficult to reduce in future years. The increased spending appropriated in the fiscal 2022 budget is largely in addition to the $6 billion of American Rescue Plan (ARP) funding the state received and will spend over the next three years. Important in a state saddled with high costs from long-term liabilities, these funds cannot be used to shore up pension plans or to pay down debt. Given this, we will be watching what the state spends them on, as use of federal funding to offset state costs in the short term could lead to increased budget gaps when the money runs out. If the state can find the money to maintain increased recurring obligations in future budgets, without continued reliance on reserve or federal funds, its financial position could improve, bringing it more in line with that of higher-rated peers. However, should additional spending be maintained without sufficient recurring revenues to support it, the state's structural deficit would persist, limiting upward rating potential. We will continue to monitor any potential effects funding decisions could have on our rating on the state as details emerge on ARP spending plans, pension funding, and debt defeasance.

One credit-favorable item to note in the enacted budget is additional pension funding, with the state not only fully funding its ADC for the first time in 25 years, but also adding about $500 million on top of the payment. This extra funding could lead to a modest reduction in long-term pension liabilities. To the extent future actuarial studies lead us to believe New Jersey will sustain a net pension ratio of more than 40%, this could have positive implications. However, the additional funding is intended to offset the increase in liabilities following a planned reduction in the plans' discount rate. Critical to maintaining the rating is the ability to fund long-term obligations. At 38.4% as of July 1, 2020, New Jersey's combined defined-benefit pension funded level is among the lowest in the country. Sustained improvement in funding discipline, as demonstrated by continued full payment of the ADC in future years from reoccurring resources, is necessary to reduce the risk that these obligations will pressure future budgets even more, forcing the state to cut services or dramatically increase revenues.

The other major funding included in the budget that we believe could improve New Jersey's financial position is the commitment to reducing the state's debt burden. New Jersey had the fourth-highest tax-supported debt burden in the U.S. at the end of fiscal 2020, which did not include the general obligation deficit bonds. The state is dedicating $3.7 billion to help reduce the financial impact of this debt burden through a debt-defeasance fund and pay-as-you go capital spending that would otherwise be funded by debt issuance. At this point, it is not clear what effect this will have on our view of the state's debt profile because details are not yet available. However, given where debt per capita stood at the end of fiscal 2020, it is unlikely these programs alone will be enough to materially improve New Jersey's debt profile, in our view.

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