New Jersey Local Governments
New Jersey Cities and Counties Remain Resilient Despite State's Credit Challenges

Summary
New Jersey local government credit strength will be stable in 2015 despite the lagging economic recovery and the State of New Jersey's (A1 negative) ongoing fiscal challenges. Local governments in the state benefit from relatively well-funded pensions, stable revenues that are not highly economically sensitive and a strong institutional framework. These factors will help local governments to remain resilient in the face of the state's growing budget imbalance, persistent revenue shortfalls, rapidly growing unfunded pension liabilities and weak liquidity.

New Jersey local governments have a median rating of Aa3, the same as the national median. In contrast, the state's A1 is well below the national Aa1 median for states and falls just shy of last place, before Illinois (A3 negative). Although cities and counties share the same economy as the state, local governments benefit from a number of factors, including:

» Local governments don’t have the same pension problem as the state. The local government portion of New Jersey’s pension plans are funded at a much higher level.

» Local governments rely primarily on property taxes, which have remained relatively stable. Conversely, New Jersey’s state budget relies almost entirely on volatile sales and income tax revenue.

» State aid is not a major revenue source for local governments. Local governments are not overly reliant on state aid.

» Local governments benefit from a strong institutional framework. Strong state oversight helps local governments to control expenditures and provides additional support to troubled cities.
Local governments do not have the same pension problems as the state

The local portion of the state-administered pension plans are funded at a much higher level than the overall state plan. While the state has underfunded its Annual Required Contribution (ARC) every year since 1996 and even took pension holidays by skipping its contributions between 2001 and 2004, local governments continued to fund near the ARC, at a level set by state statute, leaving the local pension systems on much better footing.

Cities and counties participate in two plans together with the state — Public Employees’ Retirement System (PERS) and the Police and Firemen’s Retirement System (PFRS). While the local and state pension programs are combined into one system, local asset liabilities and contributions are accounted for separately from those of the state. Local governments are responsible for funding the portion of the plan dedicated to local employees and the state is responsible for state employees.

As a result, local government pensions currently are not affected by the state’s severe pension underfunding problem. On a reported basis, the divergence between state funding levels and the local portion is acute. As seen in Exhibit 1 local funding for PERS and PFRS is much higher at 74% and 77%, respectively. Similarly, the PERS Unfunded Actuarially Accrued Liability as a percentage of covered payroll is much better at the local level at 212%, compared to a higher, and worse 422% for the state (see Exhibit 2).

Exhibit 1
Local Portion of PERS and PFRS Better Funded

The Police And Firemen’s Retirement System Of New Jersey Annual Report Of The Actuary, prepared as of July 1, 2013
New Jersey’s 2013 Moody’s adjusted total net pension liability of 180% of state governmental revenues ranked as the fourth highest among the fifty states, behind Kentucky (193%; Aa2 stable), Connecticut (236%; Aa3 stable) and Illinois (268%; A3 negative). In contrast, the total Moody’s adjusted net pension liability for New Jersey was a lower 123% of all county revenues in 2013. We currently calculate Moody’s adjusted net pension liabilities by using a market-based discount rate, uniform duration assumption and a fair market value of assets instead of a smoothed value of assets.

The new GASB 67 disclosure further reveals a significant divergence between the financial health of state and local shares of two New Jersey plans, PERS and PFRS. Assets in the state’s share of PERS are projected to be depleted by 2024, while the local share is not projected to ever deplete its assets. The historical difference between local and state employer contributions relative to actuarial requirements is the root cause behind this divergence.

Cities and counties have historically contributed to PERS and PFRS at much higher rates than the state. These local governments’ annual rates determined contributions, determined by state statute, have ranged from 84% to 92% of ARC in recent years, versus the state’s very low 4% to 28%. (see Exhibit 3). Given these higher rates of contributions, locals will not face the same budgetary pressure from ramping up contributions as the state. Still, it is important to note that the failure of cities and counties to fund their full ARC is contributing to growing unfunded pension liabilities.
Exhibit 3
Locals Fund Near the ARC for PERS and PFRS

Rapidly increasing pension contributions will continue to limit the state’s budget flexibility. In 2011, the state adopted legislation laying out a plan to escalate its pension contribution annually over seven years to reach the full ARC by 2018. During fiscal 2015, the state decided to fund less than was statutorily promised in the 2011 funding plan. It paid just 30.3% of the $2.25 billion combined required contribution under pension reform legislation, including on-behalf Teachers Pension Annuity Fund payments.

Some states have decided to push their pension problems down to their local governments in some form. Through legislative action, the state of New Jersey could choose to do the same by combining the funds’ assets or requiring school districts to contribute toward teacher pensions. Either of these cost shifts from the state to its localities would be very challenging politically and thus far there has been no indication that these options are under consideration.

Local government revenues are less economically sensitive

New Jersey local governments rely primarily on property tax revenue, which is a relatively stable revenue source (see Exhibit 4). Conversely, the state budget relies heavily on very economically sensitive sales and income tax revenue. Cities received approximately 60% of revenues in 2013 from property taxes and counties received 65%. As a percentage of total municipal revenues, property tax collections have remained consistent (see Exhibit 4). In 2013, the state received 64% of its revenues from sales and use taxes and gross income tax. Local governments do not collect sales or income taxes, with the exception of a few cities designated as urban economic zones, which receive a portion of sales taxes collected by the state.
MOODY'S INVESTORS SERVICE

U.S. PUBLIC FINANCE

NEW JERSEY LOCAL GOVERNMENTS
NEW JERSEY CITIES AND COUNTIES REMAIN RESILIENT DESPITE STATE'S CREDIT CHALLENGES

5 02 DECEMBER 2014

Exhibit 4
Property Tax as % of Revenues Largest Revenue Source for Cities and Counties

Data based on Moody's rated local governments

Source: Moody's Investors Service

The predictability of property taxes lends to a greater degree of financial stability for local governments. Property tax revenue has remained very stable for New Jersey local governments while income and sales tax contracted significantly following the financial crisis (see Exhibit 5). Property taxes for cities and counties even increased steadily during the economic downturn as local governments raised property tax rates during the housing market downturn while economically sensitive revenues suffered. Although the property tax levy is capped at 2% over the prior year's levy, New Jersey cities and counties have managed by implementing incremental increases that are more easily absorbed by constituents. Property tax revenue also benefits from a very high collection rate for cities and a 100% collection rate for counties, which have the cities serving as their property tax collection agencies.

Exhibit 5
Local Government Property Tax Revenue More Predictable than State Income and Sales Taxes

Property tax revenue is historically a more consistent tax revenue stream

Data based on Moody's rated local governments

Source: US Census and New Jersey Division of Local Government Services

Higher home values in New Jersey than the rest of the country will continue to foster stable property tax revenues. Property tax values are still very high in New Jersey compared to the nation, despite the sluggish economic recovery. The New Jersey median for full value per capita for cities is 149% of the national median. Housing completions are projected to continue to outpace the US (see Exhibit 6). Notably northern New Jersey is performing better than southern New Jersey as it benefits from the spillover effect.
effect of rapidly rising values in New York City (Aa2 stable). New Jersey does continue to face a higher foreclosure rate than the national average. If foreclosures are cleared faster than expected, New Jersey home values are expected to benefit.

Exhibit 6
New Jersey Housing Completions Outpace the United States
Using 2005 as a Benchmark Year, New Jersey has Recovered Faster than the United States

Source: US Census Bureau & Moody’s Analytics Forecast
State aid is not a major revenue source for local governments

New Jersey cities and counties rely only modestly on aid from the state, which can be subject to cuts or delays. State aid for cities contributes to about 12% of total municipal revenues, and counties do not collect aid from the state outside of grant funding. School districts rely more heavily on state aid at about 20% of revenues, and as a result they are more exposed to the state’s financial problems. New Jersey has not cut aid for cities since 2010 and reports claim that state officials chose to reduce pension funding in fiscal 2015 instead of cutting aid. This approach has kept municipalities protected to date from the state’s financial troubles trickling down to the local level. Going forward, cities do have some exposure to the possibility of cuts in state aid, but as a relatively small portion of total revenues most cities would be able to manage over time as they did following cuts in 2010 (see Exhibit 7).

Local government have strong institutional frameworks

New Jersey state oversight of local governments is exceptionally strong. In 2013, we designated New Jersey as one of six states with strong oversight of their local governments (see Exhibit 8). The Division of Local Government Services (DLGS) at the State Department of Community Affairs serves as a regulatory oversight body for all 565 municipalities and 21 counties, overseeing their financial condition. The DLGS requires timely fiscal reporting, reviews and approves municipal budgets, and licenses CFOs, clerks, tax collectors, and procurement officials. The DLGS can place a troubled city under formal state supervision and appoint a comptroller to oversee the city’s financial decisions. It can also force a municipality to increase its property tax levy in order to adopt a balanced budget. Importantly, no local government can file bankruptcy without approval from the DLGS, and none have filed since the Great Depression.
There have been numerous examples over the last few years of the DLGS helping municipalities from falling into financial
distress. In 2010, the division set a tax rate for Trenton (A3 stable) just before the end of the fiscal year. In 2011, the DLGS lent $4.8 million to Paterson (Baa2 negative) when it struggled with weak cash balances. Following Superstorm Sandy, the DLGS director reached out to the investment community assuring potential note purchasers that the state would provide liquidity assistance to municipalities should they have trouble repaying the lender. This helped many Sandy-affected issuers receive the financing needed to quickly begin clean-up efforts quickly.

New Jersey’s local governments also benefit from a strong regulatory and legal framework that equips municipalities with the
tools to control expenditures. The 2% cap on police and firefighter arbitration agreements allows cities and counties to control
costs associated with employee salaries because it limits any salary creases arrived at through arbitration to no more than 2%. 
This cap provides an invaluable degree of predictability to the largest expenditure line item.

In addition, the DLGS recently changed its budget disclosure requirements for public authorities affiliated with local
governments, dramatically improving disclosure. Greater disclosure of authority financial operations will enhance accountability
and lead to better cost controls.

Lastly, cities and counties in New Jersey present their audited financial results under a mode of accounting that is unique to
New Jersey. The state’s statutory accounting presentation fosters generally more conservative picture of cities’ and counties’
available reserves than the Generally Accepted Accounting Principles used by most local governments in other states. New Jersey
statutory accounting is a cash basis of accounting that excludes accounts receivable in fund balance, which GAAP includes. As a
result, New Jersey fund balance amount are primarily cash funded.
School districts are more exposed to state troubles

Several factors expose school districts much more to the state’s financial troubles than cities and counties. School districts have a pension plan, the Teachers’ Pension Annuity Fund, that is as poorly funded as the state’s pensions at 57.1% and is funded by the state through on-behalf payments. Furthermore the state currently funds only 52.3% of the ARC, whereas cities and counties fund at approximately 90%. We have seen a number of states choose to reduce their on-behalf payments for teachers, forcing the unexpected cost onto school budgets, although this has not been actively discussed in New Jersey.

Additionally, schools are more exposed to state aid cuts or payment delays than cities or counties, because they are more reliant upon aid as a revenue source, at an average of 20% of revenues. State aid for schools makes up 36% of the state’s budget, including on behalf pension payments, which could make this line-item expenditure a source of state budget cuts.

Another smaller factor setting school districts apart is the lack of a similarly strong legal framework that benefits cities and counties. While schools have a similar level of state oversight, they are not protected by the 2% arbitration cap and financial reporting is done on a GAAP basis, rather than the more conservative, New Jersey statutory accounting.

Moody’s Related Research

Drivers of New Jersey’s Downgrade to A1 from Aa3 (170747)

US Local Government GO Focus: Debt Security Pledge Summaries Across 50 States (171780)

State of New Jersey November 21, 2014 General Obligation Update Report

Adjusted Net Pension Liabilities Show Improvement (1000056)
NEW JERSEY LOCAL GOVERNMENTS NEW JERSEY CITIES AND COUNTIES REMAIN RESILIENT DESPITE STATE’S CREDIT CHALLENGES