All Eyes on Washington, but Many Critical Issues Move Forward at the State Level

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The question lingering since the November election has been: 'what might come out of Washington and what will be the impact?' For many local governments, a much more important question may be: 'what actions has my state already taken and how do we need to respond?' While we wait for additional clarity out of Washington, states have been taking action and pursing proposals that may have significant downstream credit impacts on local governments. Often, the critical fiscal issues facing local governments are influenced more by state-level laws than policy set at the federal level. In addition, while a national infrastructure plan has garnered a great deal of interest, much of US infrastructure is funded at the state and local level. Several states have moved forward with notable infrastructure pushes of their own.

Tax Policy – Local Tax Policy Often Set By State

The Trump Administration's recently released tax plan included eliminating the deductibility of state and local taxes, which would make tax payments to local governments more expensive to residents.[1] This is particularly important in high tax states. However, the timing of federal tax reform being enacted into law and the magnitude of the change remain uncertain. While this is an important development for municipal governments to monitor, state policy can have a more significant impact on their ability to raise revenues locally. Local governments are inherently creatures of their state, from which they derive their governing and taxing powers. Action by the States of Kansas and New York provide recent examples of the importance of influence from the statehouse.

Effective January 1st, local governments in the State of Kansas are subject to increased restrictions on their ability to raise property taxes. The state will set an inflation-linked rate at which local governments are allowed to increase their revenues. With certain exceptions, if a local government wishes to exceed this amount, they must receive voter approval. Often, this can represent a high hurdle and can limit financial flexibility. The law was originally set to go into effect in 2018, but was accelerated by a bill signed by Governor Brownback.[2] This continues the trend of sweeping changes to the Kansas tax system enacted by Brownback.

New York State implemented a property tax cap for its local governments several years ago. As part of the New York State 2018 budget, Governor Andrew Cuomo included language that made it a more costly decision for certain local governments to override the cap.[3] In addition, the budget contained a provision that would allow the State to make mid-year funding cuts in the event federal funding to the state is cut. Positively, the budget also included a meaningful increase in state aid to local school districts which helps mitigate the impacts of the property tax limits to some degree. These are important developments for local governments within New York, both on the revenue and expenditure side.[4]

Pensions – Lower Discount Rates and Cost Shifts

Largely unrelated to the federal government, one important challenge facing local governments in the United States is the task of addressing unfunded pension liabilities. While both state and local governments have significant liabilities, many local governments participate in plans that are run at the state level. This is particularly common for school districts. Decisions regarding how much a local government will have to contribute towards their pensions each year can have a significant impact on the budget process. That determination is often made at the state level and is based on many factors including the assumed investment rate of return and the amount of time the plan is projected to take to pay down its pension debt. Importantly, states also determine the percentage of the annual bill for these plans that will be passed down to the local government. California, Connecticut and Texas have each made significant changes in the past several months that demonstrate the importance of state-level action on downstream governments.

California's largest pension plans, CalPERS and CalSTRS, are often seen as trendsetters for pension plans across the nation. Since December, the board for each plan announced that they would be lowering their assumed rate of return. CalPERS from 7.5% to 7.0% by 2020 and CalSTRS from 7.5% to 7.0% by 2018.[5] From a credit standpoint, the decision to lower the discount rate is a long-term positive, albeit with some short-term side effects. A lower discount rate helps paint a more realistic picture of the size of the liability and may reduce the amount of investment risk required to achieve the required return. At the same time, a larger reported liability will require increased annual contributions in order to be properly funded. For local governments participating in these plans, pension contributions will escalate in the coming years.

Connecticut's pensions have been a topic at the forefront of this year's budget negotiations. In addition to lowering the discount rate on one of its largest plans in 2016, the Governor proposed a significant change in who shoulders the burden for teacher pension payments.[6] Historically, the State has made contributions on behalf of local governments for teachers' pension plans. Given state budget pressures, Governor Malloy proposed shifting one third of teacher pension payments down to local governments. Significant resistance to the proposals has surfaced and the ultimate outcome remains uncertain.[7] If Connecticut successfully shifts these payments, it would follow the State of Texas, which recently shifted an increased portion of teachers' annual pension payments down to the local level.

Infrastructure – State Funding Critical to Nations Infrastructure

Much of the market reaction to the November election appeared to be a response to anticipated stimulus, both from tax reform and through an infrastructure program. The Trump campaign promoted a $1 trillion infrastructure spending plan, driven by private capital and federal tax credits. Infrastructure appears to remain a key priority for the new administration, though the ultimate scope of a federal plan is far from certain. While we await further clarity, there are notable infrastructure pushes moving forward in many states that include new projects and increases to revenues funding maintenance and repairs. This pickup in activity is an important development for our nation's infrastructure. As noted in a 2015 report from Pew Research, of all monies spent on roads, bridges and transit, just 25% comes from the federal government and a combined 75% comes from state and local governments.[8]

In New York, Governor Cuomo continues to push his '$100 billion' infrastructure program.[9] Among the many major projects either currently under construction or anticipated to move forward: major construction at both La Guardia and JFK Airports, a replacement for the Tappan Zee Bridge, and a new hub for Amtrak and the Long Island Railroad adjacent to Penn Station. Discussions are ongoing at the Port Authority of New York and New Jersey over how to replace its outdated bus terminal on Manhattan's west side. A new train tunnel connecting New Jersey and New York City likely hinges on support from the Trump administration to move forward. Overall, the projects are funded from a variety of sources including direct state dollars, federal funds, private capital and even monies from bank settlements relating to the financial crisis.

In addition to large-scale projects like those mentioned in New York, maintenance of the existing roads and bridges is an area receiving much needed public attention. According to the American Road and Transportation Builders Association, the number of structurally deficient bridges in the United States fell by 0.5% from 2015 to 2017.[10] While that is a positive development, there remains a staggering 55,710 structurally deficient bridges across the country. Action at the state and local level will be critical to addressing this backlog and additional revenues will likely be required.

While the federal gasoline tax has not changed since the early 1990's, several states have recently increased their gas taxes to fund transportation infrastructure. In October, New Jersey struck a deal that increased the gas tax from 14.5 cents per gallon to 37.5 cents. New Jersey had previously had one of the lowest gas taxes in the country. Similar action was seen in Indiana, Michigan, Tennessee, and Montana. [11] On the west coast, California passed a law on April 1, 2017 that increased the state's gas tax by 12 cents per gallon and raised other revenues.[12] In total, these revenues are projected to increase annual infrastructure spending by over $5 billion. Proposals are moving forward in other state legislative chambers as well. A well-structured federal infrastructure program will be a welcome development to many, but the action from these states reminds us of the critical role states play in funding our core infrastructure.

Conclusion

Proposals from the new administration, if implemented, are likely to have impacts across many asset classes. This makes the events unfolding in Washington of critical interest to investors. For those assessing local credit quality, new federal policies and the downstream impacts will be important considerations. We noted the potential cost shift from health care reform in our Quarterly Commentary as particularly important. However, it is critical to remain focused on the policy and proposals being put forth in statehouses across the country. Broadly speaking, we believe local government credit quality remains strong and state policy will continue to influence the ability of these governments to navigate the fiscal challenges they face.

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