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Impact of Political Willingness on Municipal Credit Quality

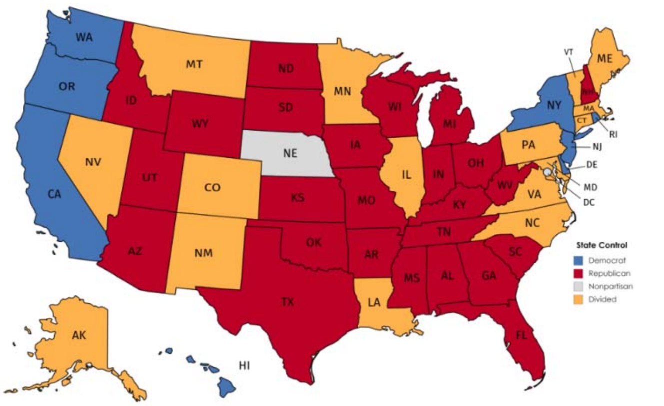
by Andy Shin, CFA, Senior Research Analyst and
Daniel Barton, CFA, Director & Head of Research for Tax-exempt Bonds

Over the past several years, a number of rating actions have affected state and local credits. The most frequently cited reasons for negative rating actions include depressed economies, poorly funded pension systems and fiscal stress caused by declining energy prices. Traditional credit analysis, which focuses on economic factors, demographics, debt burden (including pensions), finance, liquidity and governmental framework, among other factors, is useful in predicting these rating actions. However, we have also seen negative rating actions caused by political discord, which most frequently occurs when there is a split in the political makeup of the executive and legislative branches of government. With the gap between the views of Democrats and Republicans widening, we believe it is increasingly important to include political factors when analyzing municipal credits.

Analysis of Political Willingness

Political willingness is defined as elected officials' willingness to make fiscally prudent yet politically challenging decisions that may be controversial, even to the extent of going against their party platform or alienating their political base. To properly analyze and measure political willingness, one must understand the underlying political dynamics of key state decision makers: governors and legislators. Politicians are often driven by political ideology and beliefs—including those of their political parties and campaign supporters—apportioned in two- or four-year electoral cycles. As we have seen throughout the country, divided governments (when one party controls the governorship and the other controls at least one house of the legislature) tend to interfere with fiscally prudent decision making (see Figure 1). The states that best fit this profile include Illinois, New Jersey, Pennsylvania and Connecticut. However, New Jersey recently elected a Democrat, Phil Murphy, and the Democrats now have control of both the governorship and legislature.

Figure 1: 2018 State Partisan Composition



Source: National Conference of State Legislatures, BNY Mellon

Credit Impacts

The forces of political willingness can be useful in predicting a state's credit trajectory. Republican and former New Jersey Governor Chris Christie regularly clashed with the Democratic legislature on issues ranging from pension funding to tax increases, resulting in numerous rounds of credit downgrades and spread widening during his tenure as governor (see Figure 2). However, market perception began to change during the 2017 gubernatorial election campaign as Democratic candidate Phil Murphy, who began leading in the polls by a wide margin and ultimately won the governorship, proposed fiscally prudent policies to address the

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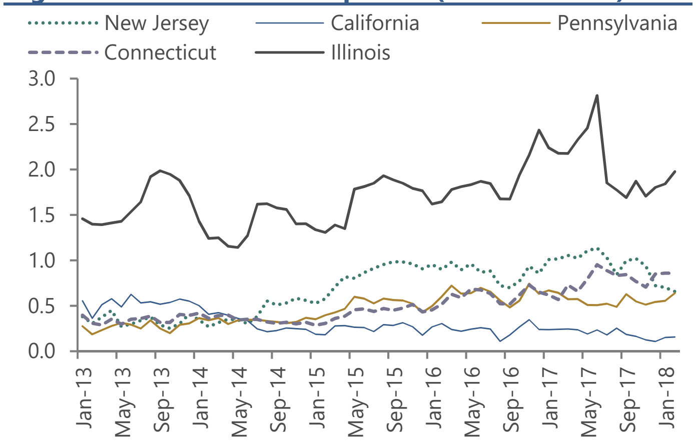
state's fiscal issues, including several revenue-raising solutions to deal with pension funding and other funding priorities. Leaders of the Democratic-controlled legislature responded positively to some of the key revenue-raising proposals, which likely contributed to the tightening of credit spreads in the state.

Figure 2: State GO Credit Spreads (10-Year BVAL)



Source: Bloomberg as of February 28, 2018

Illinois is another example of a state that is operating in a difficult political environment. Republican Governor Bruce Rauner has been at odds with the Democrat-controlled legislature since his election in November 2014, most notably culminating in a FY 2016 budget stalemate that lasted more than a year. Governor Rauner continues to hold fast to his principals of fiscal discipline via expenditure reductions and pension/healthcare reforms, while the legislature favors revenue-raising measures (e.g. tax increases) to meet its obligations. Conflict remains in the state, which will likely result in another delayed budget for the fiscal year beginning July 1, 2018.

Conversely, California is an example of a positive credit impact in a state with common control. Despite the presence of public unions that are among the most powerful in the United States, Governor Brown has made significant improvement in the state's governance and fiscal condition over the last few years. In fact, Governor Brown's fiscal stewardship arguably has been the single biggest factor in the state's credit trajectory turnaround. California progressed from having one of the worst credit ratings in the country to a solid credit stance with one of the tightest spreads, trading in line with AAA-rated states.

Political Willingness and Political Reality

Importantly, political willingness can help determine the credit trajectory of state and local governments, and we believe its significance has largely been undervalued or neglected by many investors and analysts. The political reality that elected leaders face in their jobs—the importance of party ideology/discipline, two- and four-year legislative and campaign cycles, and the influence of key stakeholders like public employees and their unions—often lead governors and legislators to make decisions that go against sound fiscal policy. Furthermore, divided control of a state tends to create political gridlock and, in turn, makes sound fiscal policy and decision making more difficult for its political leaders. The 2018 elections, with 36 states electing governors and virtually every state holding legislative contests, could have far-reaching impacts on many states' political willingness and their credit trajectory.

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BNY Mellon Asset Management North America Corporation
Boston • Pittsburgh • San Francisco

Standish Mellon Asset Management (UK) Limited
London

www.bnymellonamna.com
info@standish.com

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