

Taxing Times in New York: The Muni Outlook for the State and New York City by Howard Cure

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Solid Democratic control of the New York Senate, along with continued Democratic control of the executive branch and assembly, could have a significant impact on major legislative and budgetary initiatives for bondholders.

The new commanding majority in the New York State Senate, with 40 Democrats versus 23 Republicans, and the continued dominance of Democrats in the state assembly (106 to 43, with one Independent) paves the way for Governor Andrew Cuomo to move ahead on a number of socially progressive bills, including the Dream Act, (the Development, Relief and Education for Alien Minors), expanding voting rights, and legalizing marijuana, while maintaining his centrist approach to fiscal and economic policy.

However, some issues may prove divisive even among the one party, particularly between suburban and upstate legislators and those representing New York City.

Key legislation to be considered in the first half of the year includes:

Millionaire's Tax: Back during the 2009 recession, New York imposed a euphemistically named "high-income surcharge" as a temporary measure to close a budget deficit, requiring joint filers making over \$500,000 to pay a rate of 8.97%, and those making between \$300,000 and \$500,000 to pay 7.85%. This was quite the leap at the time; the highest previous tax rate was 6.85% for those earning above \$40,000. All of this was meant to be temporary, set to be phased out by 2012. Instead, this tax has persisted, albeit with some adjustments. (See Table in appendix.)¹ Additionally, New York State has tried to relieve some of the tax burden on its citizens by now permitting certain deductions even if they don't itemize their federal tax deductions.

Concerns that higher tax rates for the state's top earners will cause New York's most affluent residents to flee is so far unsupported. Indeed, there is little empirical evidence that upper income professionals left during prior tax increase periods. (However, the new federal tax cap of \$10,000 on state and local tax deductions won't help keep New Yorkers at home.)

At the same time, there is evidence that additional taxes on the relative wealthy do provide some support for state finances. The 1.97% additional marginal rate (8.82%; 6.85% for joint filers making over \$2 million) brings in about \$4 billion to the state, compared with total state personal income tax receipts of around \$49 billion. (The top tax rate for joint filers in New Jersey is 10.75% at income over \$5 million and 6.99% in Connecticut for income over \$1 million). It should also be noted that state revenues are very reliant on this small group of higher earners: 0.6% of filers generate 40% of state personal income tax revenues.² This tax maintenance proposal could make revenues more susceptible to economic downturns and could finally lead to a high-income earner exodus.

With these current taxes set to expire at the end of 2019, and with a new Democrat-dominated Senate, will there be another temporary extension or a permanent one? Or will more tax brackets distinguish between various classes of wealthy? The governor is proposing renewing the state's top income tax rates for five years.

Infrastructure

Infrastructure projects remain a focus for Governor Cuomo. Considering state debt, local government contributions and user fees, federal grants and loans, and private funding, the governor is seeking \$66 billion for transportation projects and \$32 billion for environmental facilities. The investments are meant to build on a \$100 billion program already underway to modernize airports, train and bus stations, and build and repair bridges. Questions remain in every case: What is the source of financing? How will it be repaid and by whom? One of Cuomo's key goals is to figure out funding for the Gateway project, a program for repairing existing and building new train tunnels essential to connect New York and New Jersey. He recently pleaded with President Trump to return an Obama-era pledge of federal money to fund half the project, with New York and New Jersey set to split the other half. The president expressed concern for the needs of his home state but has not committed to funding these gaps.

Metropolitan Transportation Authority (MTA)³: Given the age and size of the MTA's infrastructure and the backlog of deferred maintenance from before 1982, there are substantial capital requirements to improve asset conditions. The 2020-2024 Capital Program will be proposed by the MTA to the state in the second half of 2019 and is expected to be substantial. Preliminary estimates for the Fast Forward Plan, which would accelerate the state of good repair projects for the transit system, are approximately \$40 billion and do not include the capital needs of the commuter railroads or bridges and tunnels.

Congestion pricing could be an additional potential source of revenues for the beleaguered system – and it could provide an estimated \$1 billion in additional annual funding for the MTA⁴. However, New York City residents outside of Manhattan and commuters to NYC living in suburban areas may feel an undue financial burden, as they are more likely to use their cars when entering Manhattan. Now may be the time to push for this controversial proposal, not only to address critical infrastructure needs but also because demographics in many of the boroughs are changing. Younger professionals priced out of Manhattan are not interested in commuting by car and would prefer improvements to mass transit.

Also, a deal to increase funding for city subways typically would also need to include money to improve service on the Long Island Railroad and the Metro-North Railroad – which each serve millions of suburban customers a year – to garner support from suburban lawmakers to fund improvements to the New York City Transit system.

Even with congestion pricing money, there would still need to be some type of increase in gasoline, sales or income taxes, value capture⁵ property improvements, or fees on auto registrations. The MTA's finances are already stressed, thanks to subpar service and competition from ride-hailing vehicles, and bike-sharing concerns are taking a toll, even as the population rises. A miscalculation now, such as cutting services or raising fares too high, could have dire consequences, as could any missteps in May when the MTA renegotiates its biggest labor contract with the more than 40,000 members of Transit Workers Union 100. Payroll, health care and pensions already account for more than half of the MTA's \$16.7 billion 2019 budget⁶.

Education Funding

The 2019 state legislature includes several newly elected Democrats who have expressed support for increased education funding based on the Campaign for Fiscal Equity⁷ decision, which could add billions of dollars to the state budget. The state Board of Regents recently proposed a \$2.1 billion increase in education funding for next year, which would be a significant jump from the current estimated state aid of \$26 billion. According to the Citizens Budget Commission⁸ (CBC), New York already spends nearly twice the national average on per-pupil funding but doesn't necessarily allocate funding to the districts that need it most. The CBC has argued for changing the key formula, known as Foundation Aid, noting that many wealthy districts are recipients, even though they already spend more than the national average on education and more than the already-high state

average by leveraging local tax dollars. Education spending per student in New York is \$21,206, the highest in the country at almost double the national average of \$11,372.⁹

Charter schools and privately-run public schools represent an additional aspect of that debate. Senate Republicans are more supportive of charter schools and have clashed with Democrats in the assembly over providing them with increased per-pupil funding, as well as increasing the cap on the number of charters that can be awarded to start new schools. With a new Democrat-dominated Senate, the charter cap and funding will be a subject of negotiation in 2019, and it may be tied to mayoral control of New York City schools, which is again set to expire.

New York City

Mayor Bill De Blasio has frequently suggested an additional New York City millionaire's tax as a way to finance myriad programs such as pre-kindergarten, transportation improvements and affordable housing. Like the state, New York City has to weigh massive capital needs with various tax and fee burdens with an eye toward the impact on the economy and potential relocation of wealthy individuals.

Rent Regulation: One of the most contentious issues expected to arise in the state legislative session in 2019 will be the expiring rent regulations that apply to approximately one million apartments in New York City and determining several ways in which rents are capped and when, and by how much landlords are allowed to increase rents or remove a unit from the regulated roles. While the regulations are set to expire in June, it is widely expected that they will be extended. The main questions are what, exactly, they will look like and whether the fact that Democrats will control both the governor's office and both chambers of the state legislature will mean sweeping changes that benefit tenants. Affordable housing is a growing problem in New York City, as salaries of low-income residents have not kept pace with the rising cost of housing.

Working rent reforms¹⁰ into the state budget would provide faster resolution and may offer an opportunity for broader budget negotiations such as education funding, MTA supplemental revenues or income tax changes. The city does have significant control over its own property tax rates and many consider this system as a culprit in the increasing unaffordability in New York City housing. However, the assessment rate for each property class is set by the state and the City has to go through Albany for virtually any change to these rent regulations.

The broad consensus appears to be that New York City's property taxes lack transparency and equity. A patchwork of rates, assessments, caps and phase-ins is based on the classification of each property. Yet an equitable assessment system that would maintain the overall total revenues derived by the city would also create winners and losers.

Market Considerations

New York bonds continue to attract strong investor demand from residents due to the state's high wealth levels and income tax rates. We have included the major government entities, New York City & New York State (through the personal income tax bonds) and the two major regional transportation entities, the MTA and the Port Authority of New York and New Jersey, in our pricing comparison. With the exception of the MTA bonds and a few brief intervals after the election of Donald Trump and the passage of the federal Tax Cuts and Jobs Act¹¹, spreads for New York City, The Port Authority of New York and New Jersey and New York State Personal Income Tax bonds have all remained within a relatively tight range compared to the triple-A municipal bond scale. In addition, New York State has consistently demonstrated a conservative pension funding approach, with net pension liabilities well below state medians. However, the state has allowed local governments to defer payment on a portion of annual pension contributions, creating larger future liabilities. Here is a brief description of these four major issuers, which are also among the top-10 issuers of debt in the United States.

Metropolitan Transportation Authority of New York: \$31.6 billion in debt outstanding, rated A1 (negative outlook)/A (negative outlook) by Moody's and Standard and Poor's respectively.

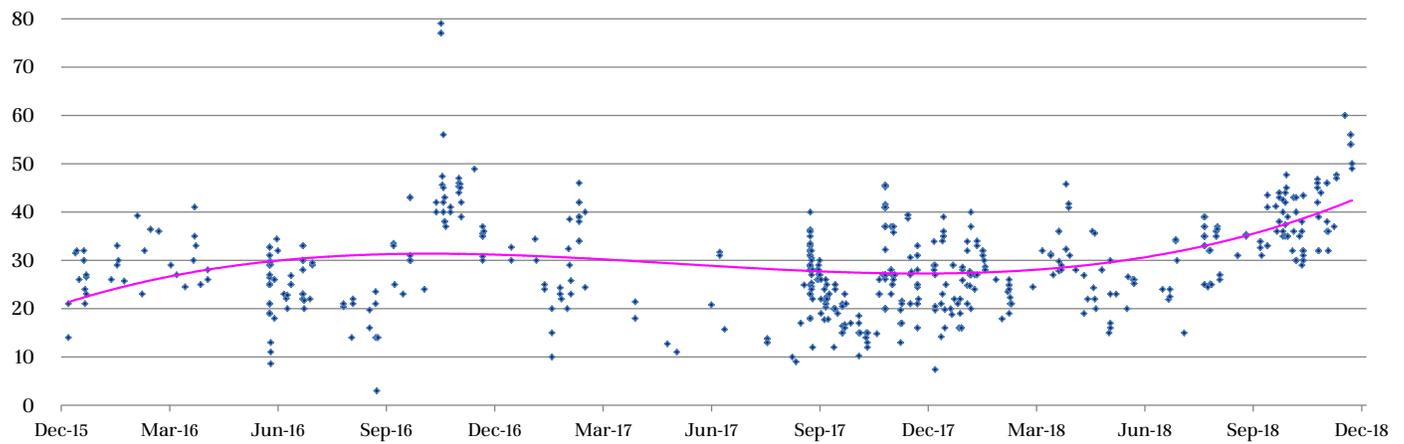
New York City: \$38.6 billion in general obligation debt outstanding, rated Aa2/AA.

Port Authority of New York and New Jersey: \$21.3 billion in debt outstanding, rated Aa3/AA-. The Port Authority of New York and New Jersey is a bi-state entity. Besides providing tax-exempt bond investment opportunities for both New York and New Jersey residents, the authority provides the majority of regional transportation infrastructure including bridges, tunnels, airports and ports, as well as the Port Authority Bus Terminal, Port Authority Trans-Hudson (PATH) trains and the Trans-Hudson Ferry Service, six marine terminals and the World Trade Center.

New York State Personal Income Tax Revenue Bonds: \$36.6 billion in debt outstanding, rated Aa1/AAA.

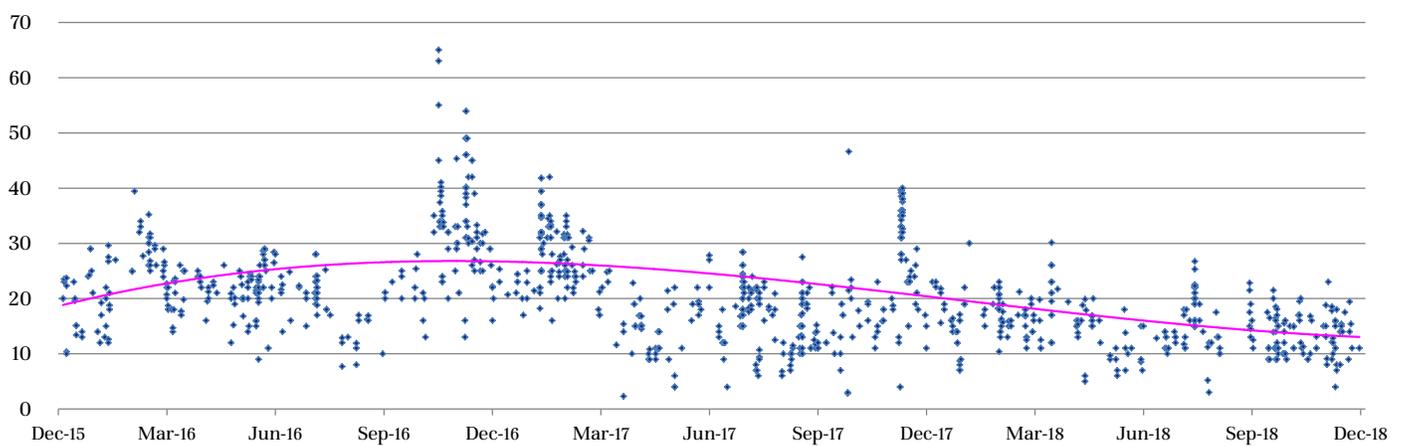
MTA Transportation Revenue Bonds—Spread to AAA MMD (bps)¹²

Uninsured, A1/A/AA-, 5.00% Coupon, 5 to 10-Yr Maturity, Non-callable



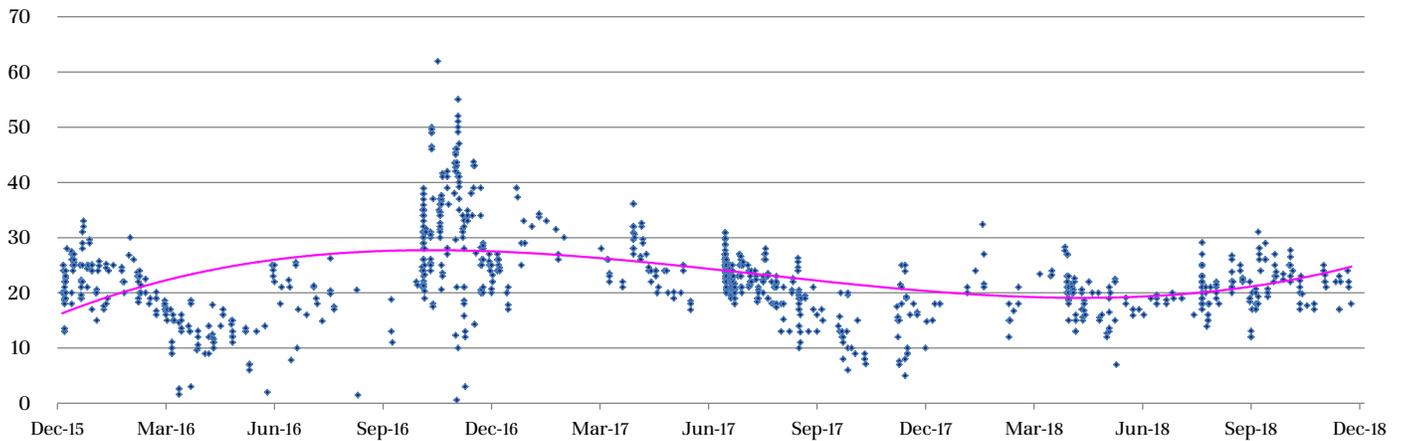
New York, NY G.O. Bonds—Spread to AAA MMD (bps)¹²

Uninsured, Aa2/AA/AA 5.00% Coupon, 5 to 10-Yr Maturity, Non-callable



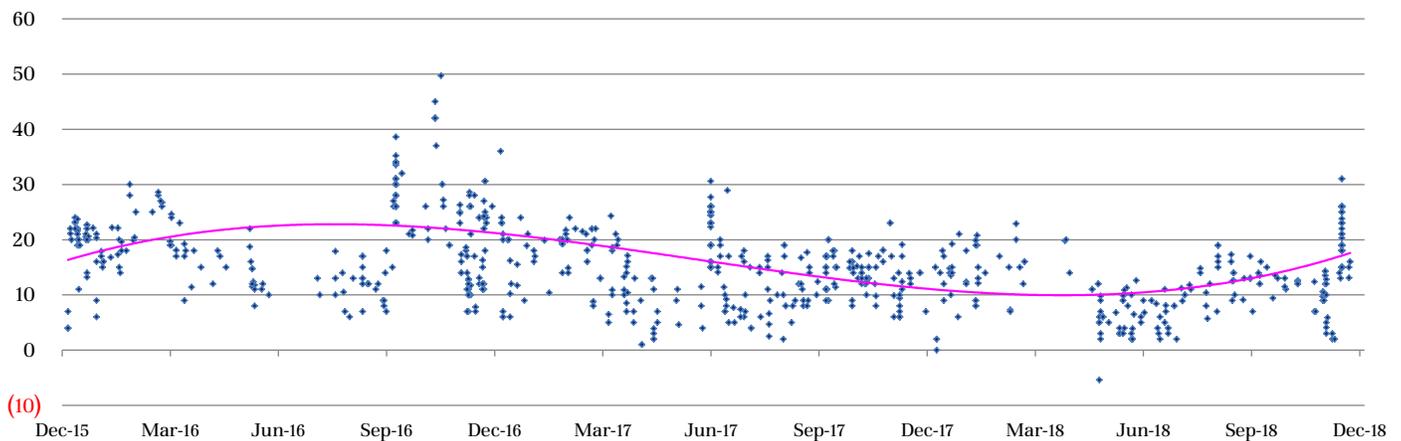
Port Authority NY/NJ Revenue Bonds—Spread to AAA MMD (bps)¹²

Uninsured, Aa3/AA-/AA- 5.00% Coupon, 9 to 10-Yr Call, 12 to 30-yr Maturity



DASNY PIT Bonds—Spread to AAA MMD (bps)¹²

Uninsured, Aa1/NR/AA+ 5.00% Coupon, 5 to 10-Yr Maturity, Non-callable



(10)

New York State has shown stability in its creditworthiness based on the expanding and increasingly diverse economy of the New York City metropolitan region. The new Democratic-dominated senate will be confronted with a series of major budgetary issues concerning taxes and aid for education as well as how much autonomy to give to New York City regarding its education system and rent control issues. The longer-term challenges center on infrastructure projects and how to finance programs to accommodate growth, deferred maintenance and sustainability against a changing climate. From an investor’s perspective, while this report focused on some of the largest New York issuers, there are many investment opportunities on the regional or local level with the state of New York willing to impose strict oversight to maintain fiscal discipline. There remain sufficient quantities of quality New York tax-exempt issuers to build and maintain a well-diversified portfolio of state credits.

¹ New York State Income Tax Rates (Joint Filers)

Up to:	Pre-2009	2009-11	Current Rates	Inflation Adjusted Brackets	2019 Up to:	2020 Up to:	2021 – 2024 Up to:
\$16,000	4.00%	4.00%	4.00%		\$17,150 (4.00%)	\$17,150 (4.00%)	\$17,150 (4.00%)
\$22,000	4.50	4.50	4.50		\$23,600 (4.50%)	\$23,600 (4.50%)	\$23,600 (4.50%)
\$26,000	5.25	5.25	5.25		\$27,900 (5.25%)	\$27,900 (5.25%)	\$27,900 (5.25%)
\$40,000	5.90	5.90	5.90		\$43,000 (5.90%)	\$43,000 (5.90%)	\$161,550 (5.50%)
\$150,000	6.85	6.85	6.45		\$161,550 (6.21%)	\$161,550 (6.09%)	\$323,200 (6.00%)
\$300,000	6.85	6.85	6.65		\$323,200 (6.49%)	\$323,200 (6.41%)	Over \$323,200 (6.85%)
\$500,000	6.85	7.85	6.85		\$2,155,350 (6.85%)	Over \$323,200 (6.85%)	
\$2 million	6.85	8.97	6.85		Over \$2,155,350 (8.82%)		
Over \$2 million	6.85	8.97	8.82				

² Citizens Budget Commission Statement on the NYS Executive Budget for FY 2020 – January 16, 2019

³ The MTA is a component unit of New York State. Operations are performed through nine different agencies, including the Triborough Bridge and Tunnel Authority. The MTA serves the District including New York City and the surrounding NY counties of Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk and Westchester. In addition to these counties, MTA’s service area also includes Fairfield and New Haven counties in Connecticut. MTA Transportation Revenue Bonds (\$21.5 billion outstanding) are payable solely from transit and commuter systems revenues (bus, subway, Long Island Railroad and Metro North) and certain state and local operating subsidies. MTA Dedicated Tax Fund Bonds (\$5.4 billion) are payable solely from monies held in the MTA Dedicated Tax Fund, which receives appropriated dedicated tax revenues related to fuel and motor vehicles, as well as a fraction of certain other sales taxes.

⁴ “Congestion Pricing, Take Two” 12/10/18, City & State Magazine. Congestion pricing is a traffic congestion fee charged to vehicles traveling into or within a predetermined area in the Manhattan Central Business District.

⁵ Value Capture: public investment in transportation improvements can generate huge increases in surrounding land values. Value capture can claw back some of the increased business revenue or land value. These funds are then allocated towards the costs of infrastructure improvements.

⁶ “Wrapping up 2018 and Quick Thoughts on the MTA,” Citigroup Research Municipal Weekly 12/17/18

⁷ The Campaign for Fiscal Equity filed a suit, claiming that the underfunding of New York City schools by the current system denies students their constitutionally protected right to quality education. After a number of challenges, the legislature was required to determine the cost of providing all students with a “sound basic education,” as well as creating a system of accountability to make sure students were in fact provided with this opportunity.

⁸ Citizens Budget Commission Analysis of Education Funding Proposals, February 2018

⁹ Education Week, “Under Construction: Building on Every Student Succeeds Act K-12 Foundation.”

¹⁰ Reforms could include vacancy decontrol (set rent at market or near market levels when a unit is vacant and regulates the raising of rent), vacancy bonuses (allow landlords of rent-regulated units to increase rents up to 20% to incoming tenants once an apartment is made vacant), preferential rent (rent an owner agrees to charge that is lower than the legal regulated rent that the owner could lawfully collect. Owners can decide to terminate the preferential rent and charge the higher legal regulated rent upon renewal of the lease or when that tenant permanently vacates the apartment) the Urstadt Law (preventing New York City from controlling its own rent laws) and Major Capital Improvements or MCI (potential for landlords to fraudulently claim improvements that are not made or less expensive than claimed).

¹¹ After the 2016 election, concerns over inflation and large deficits weighed on treasuries while municipal bonds had additional concerns over tax cuts. There was also an assumption of hefty infrastructure investment, increasing supply, and cuts in tax rates reducing the desirability of municipal bonds. Last, during the immediate period after the election, there was concern over a focus on national priorities over global issues that might lead to trade wars and ensuing inflationary impact. There were smaller spread spikes around December 2017 with the passage of the Tax Cuts and Jobs Act, as fears around the elimination of private activity bonds (unfounded) and advance refunding bonds (enacted) drove an unprecedented torrent of issuance at the end of the year.

¹² Source: Loop Capital Markets.

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