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## Summary:

# Washington; General Obligation

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### Credit Profile

US\$177.9 mil motor vehicle fuel tax GO rfdg bnds ser R-2015F due 07/01/2033		
<i>Long Term Rating</i>	AA+/Stable	New
US\$172.3 mil var purp GO rfdg bnds ser R-2015G due 07/01/2032		
<i>Long Term Rating</i>	AA+/Stable	New
US\$133.5 mil motor vehicle fuel tax GO rfdg bnds ser R-2015H due 07/01/2031		
<i>Long Term Rating</i>	AA+/Stable	New

## Rationale

Standard & Poor's Ratings Services assigned its 'AA+' long-term rating to Washington's:

- \$177.9 million motor vehicle fuel tax (MVFT) GO refunding bonds, series R-2015F;
- \$172.3 million various purpose GO refunding bonds, series R-2015G; and
- \$133.5 million MVFT GO refunding bonds, series R-2015H.

At the same time, we affirmed our 'AA+' long-term rating and underlying rating (SPUR) on the state's existing GO and MVFT GO debt. The outlook on all long-term ratings is stable.

The ratings reflect our view of the state's:

- Relatively well-educated workforce and good income indicators;
- Sales tax-based revenue structure that, although somewhat less sensitive to economic cycles than income tax-reliant states, is following a decades-long stagnating trajectory as a share of total personal income;
- Good internal access to sources of liquidity;
- Strong financial policies and practices, including statutory provisions requiring that the state's biennial budget and projected subsequent two fiscal years' spending plans be balanced; and
- Moderately high per capita debt burden but well-funded pension plans.

The state's full faith, credit, and taxing powers secure the state's GO bonds. The state's MVFT GO bonds are first payable from state excise taxes on motor vehicle and special fuels. The refunding GO bonds are being issued to refinance some of the state's existing debt.

The state will have a total of \$18.8 billion of GO bonds outstanding after the current offering. Of this, \$7.45 billion of the state's GO debt is payable first from excise taxes on motor vehicle and special fuels or from toll revenue. The state also has \$1.02 billion of certificates of participation and other appropriation-backed debt outstanding. Of this, \$77.88 million is GO debt of various local agencies within the state and is a contingent obligation of the state government in the event of nonpayment by a local government agency.

Governor Jay Inslee's budget proposal for the 2015-2017 budget biennium addresses a large projected gap between

state resources and its spending needs. A significant portion the funding shortfall stems from extraordinary -- mostly noneconomic -- expenditure pressure. In particular, a 2012 State Supreme Court ruling adds an estimated \$1.2 billion in education spending during the 2015-2017 biennium with another \$2 billion from a 2014 voter initiative to reduce classes. Were it not for the court ruling and voter initiative, we estimate that the state's projected baseline revenue growth of \$2.8 billion (8.6% for the biennium) would be nearly sufficient to keep pace with the increase in its underlying expenditures (\$3.0 billion). But once the court and voter mandates are funded and certain pressing policy needs (health treatment for the mentally ill and collective bargaining allotments for employee pay) are accounted for, the state's projected budget gap grows to \$4.45 billion.

In December, the governor responded to the situation by proposing to collapse elements of the education-related spending mandates into a large—but not additive—\$2.3 billion increase in funding. He would pay for the additional education spending—and the other non-education expenditure increases—through a mix of cuts (\$423 million), fund transfers (\$217 million), use of reserves (\$450 million), and tax increases (\$1.4 billion). The state is no stranger to a rancorous budget negotiation process. It required two special legislative sessions to close a projected \$2.5 billion budget gap prior to enacting its 2013-2015 biennial budget. We anticipate that several of the governor's spending and revenue proposals could face political opposition in the legislature and result in protracted budget negotiations.

On the spending side, the governor's plan would fully fund basic education reforms in fiscal 2017, putting the state somewhat ahead of the legislatively adopted schedule, which requires that it do so by 2018. On the other hand, although the governor funds reduced class sizes for kindergarten through third grade, it does not do so for other grades as required by Initiative 1351. And, for the next two years amendment of the initiative will require agreement by two-thirds of the state legislature. As for the governor's revenue proposals, while they won't require more than a majority of legislative agreement, we anticipate a vigorous debate. In particular, the governor's proposal to impose an excise tax on capital gains could run into political opposition; therefore, it represents a source of risk to the budget since it accounts for over half of the revenue proposals. Although they would only weigh in on the matter indirectly through their elected legislators, voters in Washington have previously rejected initiatives to levy an income tax. This included a proposal to target the state's highest income earners, as the capital gains tax proposal would do.

That being said, we recognize that revenues under Washington's existing tax structure have stagnated relative to personal income growth in the state. General fund revenues have slid to about 5% of state personal income today from 7% in 1990. Washington does not levy a personal income tax, making its retail sales and use tax the largest single source of general fund revenue (estimated at 48% of general fund revenue in fiscal 2015). But the goods and services subject to the state's retail sales and use tax has not evolved along with its economy, which has gradually become more service oriented. However, while the governor's proposal to tax certain capital gains income would likely offset some of the revenue slide (relative to personal income), it could cause the state's revenues to be more volatile. We have observed that capital gains-related tax revenues are among the most cyclical and difficult to forecast revenues in numerous other states.

Overall, the governor's package tilts toward relying on recurring solutions. The governor's proposed spending cuts and maximization of federal funding, a majority of the fund transfers, and most of the revenue measures all primarily comprise recurring budget adjustments. The most significant nonrecurring gap-closing solution is the governor's

proposal to utilize \$450 million from the budget stabilization account (BSA). However, this is largely a matter of timing and reflects that the full amount of revenue from the tax increases would not be realized until the 2017-2019 biennium. Furthermore, under the governor's budget proposal, despite making a withdrawal, the state would continue its regularly scheduled BSA deposit of \$372 million during the biennium. That would leave the state with a \$910.8 million balance at the end of fiscal 2017 versus the \$1.1 billion anticipated for the end of fiscal 2015.

Although we would consider the state's budget reserves, at 4.6% of annualized spending at the end of fiscal 2017 as good, it presumes continued steady economic growth.

In 2013, real state GDP expanded at an estimated 2.7% rate, well ahead of the national growth rate of 2.2%. However, the differential relative to the nation evaporated in 2014, and we now anticipate that national GDP growth in 2014, which we estimate will have been 2.3%, could be faster than Washington's (2.0%, per IHS Global Insight). State GDP growth could hover around 2.5% through 2017 whereas we now forecast national output to grow by approximately 2.9% to 3.1% per year. Among the factors contributing to the leveling off of the state's economic growth is its exposure to Boeing, which downsized its workforce by 2,300 in 2013 and recently announced plans to move 4,300 jobs out of the state. As the largest employer in the state (81,939 employees), Boeing's activities have an outsized effect due in part to its numerous suppliers. There are approximately 1,350 aerospace-related firms with more than 132,000 employees in the state. Boeing's workforce reductions have contributed to somewhat soft employment trends in the manufacturing sector, which has increased 1.7% (year-over-year through December). Overall employment gains have been considerably stronger, up 2.7%, considerably faster than the national 1.99% increase in payroll jobs. Sectors leading the job growth have been construction (9.5%), trade, transportation, and utilities (3.2%), and leisure and hospitality (3.2%).

At this point, the state has recovered all of the jobs it lost during the Great Recession. From March 2008 through February 2010, the state lost 184,200 payroll jobs (6.1% of the total) but since then has added back 270,200 jobs, a 9.6% increase. Despite payroll jobs growing faster than the nation, the state's unemployment rate has edged up since July to 6.3% in December and it's now above the national jobless rate. The development reflects that workers have been reentering the state's labor force faster than jobs have been added.

Through the third quarter of 2014, housing starts came in below the state's forecast with multifamily starts making up for a portion of single-family starts' underperformance relative to the forecast. With a seasonally adjusted annual rate of 33,100 new housing permits issued during the third quarter, the state was slightly behind the 33,900 that had been forecast for the period. Starts fell slightly short of forecast during the first quarter as well, which the Economic Revenue and Forecast Council (ERFC) attributed at the time to a weaker-than-expected January. The bounce-back, which the ERFC suggested was possible, hasn't yet materialized, and fourth quarter starts are off-pace as well. In addition, according to the S&P/Case-Shiller Home Price Index (seasonally adjusted), home prices in the Seattle metro area increased 6.3% in the 12 months through October 2014, which was slightly higher than the 4.5% increase for the 20-city composite index. Prices are also 28% above the trough they reached in November 2011.

To the benefit of the state's credit quality, the legislature has taken a more structural approach to crafting fiscal policy in recent years, in our view. One reason is a 2012 statute requiring the state to enact a budget that it projects will remain balanced through four fiscal years although, for technical reasons, additional education-related expenses

resulting from the McCleary decision and higher costs under I-1351 are excluded from general fund expenditure estimates for upcoming current biennium. In our view, excluding some of the state's more challenging funding obligations from its statutory requirement to project balanced budgets somewhat mutes the otherwise favorable credit implications of the law.

In general, Washington's approach to financial management is strong, in our view, as reflected in our Financial Management Assessment and budget management scores. Well-established economic and revenue forecasting and increasingly refined debt management practices and oversight served the state's credit quality well during the recession and its aftermath. Forward-looking state policies facilitate budget practices we view as prudent, including minimal reliance on payment deferrals or other one-time responses to anticipated budget gaps.

For December 2014, the state treasury and treasurer's trust fund's month-end cash balance was \$4.59 billion, similar to the \$4.7 billion at the same point in 2013. As with fiscal 2014, cash balances in fiscal 2015 are well above where they stood in the fiscal 2010 through 2012 timeframe. Investments are conservative, in our view, with an average of 68.1% of funds invested in U.S. Treasuries and agencies in November 2014. In addition to the state's investment guidelines, state policies require that collateral in repurchase agreements for U.S. Treasury, agency, and money market instruments be priced at 102% of market value. Mortgage-backed repurchase agreements of more than seven days are subject to a higher, 105% requirement.

As of the end of fiscal 2013, the state's direct tax-supported debt burden (\$19.2 billion in GO and appropriation-backed bonds outstanding) was moderately high, in our opinion, at \$2,784 per capita (based on the U.S. Census 2013 state population of 6.9 million), 5.9% of total personal income (2013), and 4.7% of state gross domestic product (2013).

Gross GO and lease appropriation-backed debt service is moderate, at 5.46% of expenditures from funds from which the state pays its debt service in fiscal year 2014 (audited). Portions of the state's debt are funded from self-supporting or reimbursable sources, however. Considering just the general fund, adjusted for these offsetting revenues, we estimate that debt service was 6.4% of expenditures, moderate in our view. We anticipate that continuing transportation needs, including two major urban highway projects, will likely translate into continuing GO issuance in the next two to three years. The state currently projects that it may issue approximately \$891 million in GO and MVFT refunding bonds in February 2015. It tentatively anticipates issuing approximately \$700 million in new GO and MVFT GO bonds in June or July 2015. Finally, the state estimates that it may issue around \$30 million in certificates of participation (COPs) in March 2015.

Long-term state liabilities include those related to the state's pension system and retiree health care. As measured by the actuary, the state's pension liability profile has deteriorated somewhat as of its fiscal 2014 audited financial statements because of a change in the state actuary's mortality assumptions related to pension beneficiaries. In addition, the state has adjusted the discount rate applied to its liabilities to 7.8% from 7.9%. As of June 30, 2014, the actuarial accrued liability (AAL) of the defined-benefit portion of the state's 12 pension plans totaled \$69.8 billion. Actuarial assets of \$65.6 billion in aggregate accounted for 88.3% of the AAL.

Based on the most recent comprehensive annual financial report, in 2014 (reflecting actuarial data through fiscal 2013), the state's aggregated total unfunded actuarial accrued liability (UAAL) on a combined basis for its pension plans was

\$4.4 billion, equal to \$626 per capita (using 2013 U.S. Census population figures), which we view as lower than average. Relative to total personal income, it is 1.3%, which is low in our view (which we score as "strong"). The state's contributions to the pension funds totaled \$507 million in fiscal 2014 equaled a low 2.0% of general fund expenditures (in practice, only about half of the annual pension contribution is paid from the state general fund). Although the state makes its required contributions to each plan as set forth in the plans' respective funding policies, contributions tend not to equal the annual required contributions (ARC). For fiscal year 2014, the total contributions from the state equaled 67% of the state's ARC.

Other postemployment benefits (OPEB) are funded on a pay-as-you-go basis. The state's OPEBs produce an implicit liability by allowing retired employees to purchase health, life, and vision insurance in the same pool as current employees at a subsidized rate.

Based on the analytic factors we evaluate for states, on a scale of 1 (strongest) to 4, we have assigned Washington a composite score of '1.8'.

## Outlook

The outlook is stable, reflecting that the state begins 2015 in a strong position. But coming to agreement on a new two-year state budget during the upcoming legislative session may be challenging, in our view. According to the governor's budget proposal, the state faces a large operating shortfall for the next biennium. There is significant upward pressure on spending that originates in legal- and voter-approved mandates. While the governor proposes to sidestep some of what is required in a voter-approved class-size reduction measure, doing so would require consensus among at least two-thirds of the legislature. And to help pay for aggressively implementing court-ordered funding increases for education, the governor proposes a new capital gains tax. A vigorous debate in the legislature, which we expect will ensue, won't in itself result in negative rating pressure. But an inability of the legislature and governor to come to an agreement prior to the new fiscal year could. Likewise, if lawmakers resort to a heavy reliance on nonrecurring budget solutions, it could put negative pressure on the rating.

The projected budget shortfall, emerging at a time of economic growth, also means the state would have less margin for error in the event that economic -- and revenue -- trends unexpectedly slowed.

Nevertheless, the stable outlook reflects our view that the state's liquidity, financial trends, and strengthening economy have resulted in a strengthened financial position. Coupled with the state's strong financial management policies and institutions, we see the credit rating as stable through the outlook period. Although we see potential for the state's pace of economic expansion to level off a bit through 2014 and into 2015, we see the gains to date as having helped bolster the state's fiscal position. This offers some cushion heading into the latter part of the current biennium, which will encompass the budget development process for the 2015-2017 biennium.

In our view, the state has begun to approach what could be a difficult stretch but from a relatively strong position. Despite a contentious 2013-2015 budget development process, the state adhered to its automatic budget-stabilization fund deposits, which are likely to serve its credit quality well. The state could end the current biennium with an ending balance and budgetary reserve equal to more than 7% of expenditures. Having remained committed to its

reserve-rebuilding efforts, it will enjoy some fiscal cushion as it transitions to a higher funding base for its K-12 education system.

## **Related Criteria And Research**

### **Related Criteria**

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006

### **Related Research**

U.S. State And Local Government Credit Conditions Forecast, Dec. 10, 2014

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