



## RATING ACTION COMMENTARY

# Fitch Rates \$745MM State of Washington GOs 'AA+'; Affirms Outstanding; Outlook Stable

Feedback

Thu 15 Jul, 2021 - 5:11 PM ET

Fitch Ratings - San Francisco - 15 Jul 2021: Fitch Ratings has assigned a 'AA+' rating to the following State of Washington general obligation (GO) bonds:

--\$598,430,000 various purpose GOs, series 2022A;

--\$42,310,000 motor vehicle fuel tax GOs, series 2022B; and

--\$93,405,000 GO bonds series 2022T (taxable).

In addition, Fitch has affirmed the state's 'AA+' Issuer Default Rating (IDR), the 'AA+' rating on the state's approximately \$19.5 billion in outstanding GO bonds and Washington School District Credit Enhancement Program at 'AA+'.

The Rating Outlook is Stable.

The series 2022A, 2022B and 2022T bonds are expected to sell competitively on July 29. The proceeds of the series 2022A and series 2022T bonds will be used for various capital

projects. Proceeds of the series 2022B bonds will be used for construction of various state and local highway improvements.

## SECURITY

All GO bonds are general obligations of the state to which the state has irrevocably pledged its full faith, credit and taxing power.

## ANALYTICAL CONCLUSION

Washington's 'AA+' IDR and GO bond rating reflect the state's large and diverse economy, with solid long-term revenue growth prospects, a demonstrated commitment to fiscal balance and combined long-term liabilities that place a low burden on resources. The ratings also reflect the state's very strong financial resilience supported by reserves, a statutory requirement for a balanced multiyear budget and formulaic funding of the constitutional budget stabilization account (BSA), which has reduced reliance on above-average revenue growth.

Washington's School District Credit Enhancement Program's 'AA+' ratings is on par with the state's 'AA+' IDR, reflecting the pledge of the state's full faith, credit, and taxing power, as well as administrative procedures and structural protections in place.

## ECONOMIC RESOURCE BASE

Prior to the pandemic-induced downturn, Washington's economy had been characterized by exceptional growth and increased employment diversification. The state removed all pandemic-related restrictions July 1, and the state is well positioned for continued expansion over time given robust population and labor force growth, as well as continued expansion in sectors outside the traditionally dominant manufacturing sector, primarily information technology-related interests.

## KEY RATING DRIVERS

**Revenue Framework: 'aaa'**

Revenue performance over time has generally been above inflation, and Fitch expects this to continue to support solid growth prospects. The state has complete independent control over taxation, with an essentially unlimited legal ability to raise operating revenues as needed.

### **Expenditure Framework: 'aa'**

Washington benefits from solid expenditure flexibility, although its flexibility is somewhat more restricted than is true for most states due to court mandates on education funding. The state has a low burden of carrying costs for debt service and retiree benefits and benefits from the broad expense-cutting authority common to most U.S. states. Medicaid is also a key cost driver; however, Fitch expects these costs to remain manageable.

### **Long-Term Liability Burden: 'aaa'**

The combined burden of debt plus pensions is low as a percentage of personal income but above the median for U.S. states. Elevated debt ratios incorporate the funding of substantial capital needs, particularly for transportation, but are offset by a moderate net pension liability and growth in population and personal income.

### **Operating Performance: 'aa'**

Washington maintains very strong gap-closing capacity in the form of its superior budget flexibility and solid reserves. The state is well positioned to deal with economic volatility, with very strong gap-closing capacity derived from its control over revenues and spending, as well as strong budgetary reserves and the BSA.

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--Strong economic and revenue growth that outpaces GDP over time;

- Financial flexibility as demonstrated through maintaining reserves around current levels;
- Ability to maintain higher spending for education while maintaining superior financial flexibility.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

- A material increase in the long-term liability burden;
- Failure to implement policy measures to counteract changing economic conditions and address budgetary challenges, which would be contrary to Washington's past practices and Fitch's expectations.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## **CURRENT DEVELOPMENTS**

### **Federal Relief Provides Critical Support**

Under the Coronavirus Aid, Relief and Economic Security (CARES) Act of 2020, Washington received about \$2.2 billion, with an additional \$1.1 billion allocated to local governments.

Under the American Rescue Plan Act (ARPA) of 2021, Washington expects to receive \$4.4 billion directly: \$2.2 billion was received in May and the other half is expected in 2022.

Washington's spending plan for the funds received under ARPA is related primarily to school reopening, rental assistance, vaccine deployment, and services for low-income individuals, as well as to address a federal injunction related to fish culverts under state highways. Overall,

Washington estimates state, local and individuals received \$27 billion in federal stimulus funding in 2020 and 2021.

The amount of federal aid allocated to the state is considerable when viewed in the context of a roughly \$59 billion biennial budget for fiscal 2021-2023. Fitch does not expect the stimulus aid to alter Washington's long-term credit fundamentals given the state's focus on using one-time monies for one-time spending.

## Washington Fiscal Update

Washington entered the downturn in a strong reserve and budgetary position, benefitting from constitutionally-required multiyear budget balancing BSA funding. In addition, the state had budgeted conservatively in recent years, assuming revenue growth would slow, which helped to limit ongoing additional budgeted spending. Revenues had been performing very well through February 2020, but quickly reversed with the onset of the pandemic.

In response, the governor worked with the legislature to veto about \$500 million of the new spending and directed agencies to limit spending to current legal requirements. The governor also enacted a hiring freeze, eliminated a 3% wage increase for many employees, which had been due on July 1, 2020, and implemented furloughs for most employees. Further, the governor requested 15% budget reductions from agencies, which ultimately were not needed as revenue performance began to recover with the aid of federal stimulus payments. These actions and additional Medicaid funding from the enhanced federal match saved \$1.1 billion, or about 4% of fiscal 2021 spending.

Washington forecasts that it finished the 2019-2021 biennium (fiscal years 2020 and 2021, ended June 30) with \$3.8 billion in combined general fund balance and the BSA, equal to about 14% of total general fund - state revenues (taxes and other non-tax state revenues) [GF-S revenues]. This represents an increase over the 2017-2019 biennium ending fund balance and BSA of \$2.6 billion, equal to about 11.7% of audited fiscal 2019 GF-S revenues.

The state transferred the BSA balance of \$1.8 billion to the general fund in fiscal 2021, as permitted under the state constitution, to provide budget flexibility. The enacted biennial budget ends with about \$3.6 billion in combined general fund reserves and BSA and the BSA will be replenished from constitutionally required transfers of 1% of GF-S revenue (roughly \$500 million per biennium).

The enacted 2021-2023 biennial budget includes a new excise tax on gains from the sale of certain assets, generally targeted at capital gains from securities rather than real estate or

businesses. The June 2021 revenue forecast estimates it will generate \$415 million in the biennium. The tax is being challenged as unconstitutional. Offsetting concerns about the ultimate validity of the new tax stream, the enacted budget does not include use of the projected revenues, and the tax is not effective until January 2022 with the first payments not due until April 2023.

The tax collections will be deposited into the Education Legacy Trust Account (ELTA) a special revenue fund, which may be used only for support of K-12 public schools, certain higher education purposes, and in support of early learning programs. Funds in the ELTA are not yet appropriated. The budget also includes an \$800 million deposit into the state teacher pension system (TRS 1) to reduce the unfunded liability.

The state's most recent economic and revenue forecast from June 23, 2021 indicates growth in employment, personal income and the state's primary GF-S revenues: retail sales and use and business and occupation taxes. The 2021-2023 biennial revenues are forecast to be \$1.4 billion higher in the June 2021 forecast than in the March 2021 forecast absent policy action. Despite the positive recent trends, uncertainties remain, including the possibility of a new wave of coronavirus infections resulting in business failures, weak demand and additional job losses.

## CREDIT PROFILE

The pandemic and related public health measures significantly affected the state's economy and related tax revenue. After a steep loss of jobs in April 2020, Washington's job recovery (60% of job losses regained through May 2021) is modestly weaker than the national average of 66%. The Fitch-adjusted unemployment rate (which adds back labor force exits) shows Washington at 7.4% in April 2021, compared to the Fitch-adjusted state median unemployment rate of 6.8%. Some of the weaker employment in Washington is likely due to changes at Boeing, which eliminated 19,000 jobs in the state prior to February 2021 and expects to eliminate 10,700 more by the end of 2021 as it moves some production out of the state.

Boeing remains a large employer in Washington and an important contributor to its economy; however, the state's overall manufacturing sector is about the same proportion of GDP as the nation's manufacturing sector, while Washington's information technology sector generates over 2.5x the proportion of GDP as the nation.

Microsoft and Amazon combined employ almost two times more individuals than Boeing, and several software and information companies continue to expand in the state. The workforce is highly educated, income levels are comparatively high and the state poverty rate is below the national average. Nonetheless, the state's economic recovery will face headwinds as Boeing plans to eliminate additional jobs in the state through 2021, as further noted below.

## REVENUE FRAMEWORK

Washington relies on broad consumption-based revenues to fund operations and does not levy an income tax. This revenue mix results in collections that quickly reflect consumer spending and construction trends; overall, general fund revenues exhibit a moderate level of volatility.

Washington's revenue structure is based on a retail sales tax (about half of total general fund - state revenues) and, to a much lesser extent, a business and occupation gross receipts tax (about 19%) and state property tax (16%). The importance of the real estate excise tax (4% of tax revenues in fiscal 2021) varies considerably depending on the point in the economic cycle. The state does not have an income tax. As noted, the state enacted a capital gains tax in 2021 which is forecast to generate about \$415 million in the 2021-2023 biennium, equal to less than 1% of biennial GF-State revenues.

This revenue structure makes the state budget especially sensitive to trends in consumer spending. In addition, construction (labor and materials) is assessed under the broad sales tax and receipts are significant to sales tax revenue performance. Fitch expects revenues to continue to reflect cyclical trends offset somewhat by the state's ongoing population growth.

Washington has complete independent legal ability to control taxes, a significant credit strength.

## EXPENDITURE FRAMEWORK

As in most states, education and health and human services are Washington's largest operating expenses. Education is the larger line item, with state funding for local school districts and the public university and college system accounting for more than half of state general fund expenditures. Human services programs represent another third.

Washington's spending growth, absent policy actions, will likely be marginally above its solid revenue growth, requiring regular budget management to ensure ongoing balance. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. As with all federal initiatives, Medicaid remains subject to regulatory changes that could affect various aspects. However, federal action to revise Medicaid's fundamental programmatic and financial structure does not appear to be a near-term priority of the current federal administration or congressional leadership.

Washington retains solid expenditure flexibility. While Medicaid costs are somewhat beyond the state's ability to materially change given federal requirements for the program, the state's carrying costs for long-term liabilities are low. Like most states, Washington's operating budget (outside of Medicaid) goes largely toward funding of services rather than direct service delivery, allowing the state to shift costs to lower levels of government in times of fiscal stress. This is true even for education spending, as the state appropriates money to local school districts rather than operating any schools itself.

## **LONG-TERM LIABILITY BURDEN**

On a combined basis, Washington's burden of direct debt and adjusted net pension liabilities, at 6.1% of personal income, is above the 5.0% median for U.S. states (both per Fitch's 2020 state pension report) but still low overall. Debt levels are twice the U.S. state median, reflecting in part the demands of many years of strong population growth. However, pension liabilities are below the median. Fitch expects the combined burden to remain at similar levels going forward, despite large capital needs, given strong population and personal income growth.

Washington's outstanding debt equals about two-thirds of Fitch-adjusted long-term liabilities and is primarily GO bonds. Capital needs are substantial, particularly for



transportation, and future borrowing is anticipated. The state has repeatedly demonstrated its ability and willingness to raise revenues in support of transportation capital investment, most recently through an electrification fee for electric vehicles and an increase to the service fee for vehicle title transaction and registration. Tolling is also utilized as part of the funding solution.

In fiscal 2019, Washington's aggregate fiduciary pension assets covered over 97% of total pension liabilities on a reported basis, assuming a 7.5% investment return for most of the plans. This ratio falls to an estimated 81% using Fitch's standard 6% investment return assumption. The state has made changes to manage pension costs, including elimination of cost of living adjustments. The state has deferred full contributions to the closed pension systems in times of economic strain.

Other post-employment benefits (OPEB) are limited and funded on a pay-as-you-go basis.

Contingent liabilities include a school district credit enhancement program (School Bond Guarantee Program) that provides a GO guarantee to \$16.3 billion in outstanding school district debt as of July 1, 2021. The state utilized the enhancement for the first time ever on June 1, 2021 to advance approximately \$3.2 million due to an internet connectivity issue with the county's bank delaying debt service transfers for school districts in Mason County. The county made the transfer within the same day, fully covering the state's advance.

Fitch continues to exclude the covered school district debt from our long-term liability calculation as we consider the recent advance a very short-term issue affecting only a minimal portion of the contingent liability and not indicative of any ongoing need for state advances.

## **OPERATING PERFORMANCE**

Frequent reviews of economic and financial forecasts allow the state to respond effectively to changing conditions. During the Great Recession and the recent pandemic-driven downturn, the state demonstrated its willingness and ability to utilize broad budget flexibility in response. In fiscal 2009 through fiscal 2011, the state implemented a combination of ongoing and one-time actions, and fully depleted accumulated reserves.

In 2020, the state implemented spending cuts and planned reserve draws, though the ultimate draws on reserves were much less than planned at the outset of the pandemic. Fitch

expects the state to similarly make use of its very strong gap-closing capacity, supported by its solid, reinstated reserve position, during the future cyclical downturns.

Budgeting can be challenging, in part due to the education lawsuit-related K-12 funding demands and a statutory mandate that the budget show projected balance over a four-year period rather than just the current biennium. However, the state took advantage of growth over the last decade to rebuild financial flexibility.

The state has solid funding provisions for its BSA supporting rapid rebuilding of financial flexibility. This constitutional account receives the first 1% of revenues collected every year, until it reaches its cap of 10% of annual general revenues. Furthermore, 75% of extraordinary growth in state revenue (defined as growth in general state revenues that exceed by one-third the average biennial growth of the prior five biennia) must be transferred to the BSA on top of the 1%. This measure also serves to limit the effect of revenue volatility on the operating budget.

Washington's initiative and referendum environment creates a level of operating and financial uncertainty. However, it is significant that any law approved by voters in this manner can be amended or repealed by the legislature by a two-thirds vote in the first two years after approval and by a simple majority thereafter. The legislature repeatedly has shown the ability and willingness to suspend initiatives. The state constitution may not be amended by initiative or referendum.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

## **REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING**

The principal sources of information used in the analysis are described in the Applicable Criteria.

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Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit [www.fitchratings.com/esg](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Washington, State of (WA) [General Government]	LT IDR	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
● Washington School District Credit Enhancement Program (WA) /State School Bond Program Rating/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
● Washington,	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating

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**APPLICABLE CRITERIA**

[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 04 May 2021\) \(including rating assumption sensitivity\)](#)

**APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

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Washington School District Credit Enhancement Program (WA)

EU Endorsed, UK Endorsed

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