FitchRatings

RATING ACTION COMMENTARY

Fitch Rates State of Washington's $105.1 Million GO Bonds 'AA+'; Outlook Stable

Thu 08 Oct, 2020 - 5:20 PM ET

Fitch Ratings - San Francisco - 08 Oct 2020: Fitch Ratings has assigned a 'AA+' rating on the following state of Washington (state) bonds:

--$105,095,000 various purpose general obligation (GO) refunding bonds, series R-2021B.

In addition, Fitch has affirmed the 'AA+' on the state's Issuer Default Rating (IDR) and its $19.7 billion in outstanding GO bonds.

The Rating Outlook is Stable.

The bonds are expected to price competitively on Oct. 20. Proceeds of the series R-2021B bonds will be used to refund the state's R-2011A and 2011B GO bonds for debt service savings.

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+' GO bond ratings and IDR 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 rating also reflects the state's very strong financial resilience supported by reserves, 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.

The Stable Outlook reflects Fitch's expectation that the state will use its strong revenue forecasting and budget control to address fiscal challenges, including those related to the coronavirus pandemic and related recessionary revenue declines, while maintaining solid fundamental financial flexibility.

ECONOMIC RESOURCE BASE

For the last several years, Washington's economy had been characterized by exceptional growth and increased employment diversification, and the state is well positioned for continued expansion over time once the current pandemic induced downturn subsides. The state benefits from robust population and labor force trends, as well as continued expansion in sectors outside traditionally dominant manufacturing, primarily information technology.

Washington's economy is influenced by Boeing, but the manufacturing sector overall is about the same proportion of GDP as the nation's manufacturing sector, while Washington's information sector generates over 2.5 times the proportion of GDP as the national rate. Microsoft and Amazon combined employ almost 50% more people than Boeing, and several software and information companies continued to expand in the state throughout the economic expansion. 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 does remain vulnerable to shifts in employment at Boeing, due both to the current pandemic-related job losses as well as the possibility that Boeing will consolidate 787 Dreamliner production in South Carolina.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

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. Revenue performance over time has generally tracked economic performance, 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 generally broad expense-cutting authority common to most U.S. states. Medicaid is also a key cost driver, but 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, although 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 growing population and personal income.

Operating Performance: 'aa'

Washington has a history of quickly responding to changes in revenue and 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 downturns, with very strong gap-closing capacity derived from its control over revenues and spending as well as strong budgetary reserves and budget stabilization account. Fitch expects the state to draw on reserves as well as manage revenues and spending and to restore financial flexibility during the economic recovery.

RATING SENSITIVITIES

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

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

-- Ability to sustain required spending for education while maintaining superior financial flexibility.

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

-- A return to economic contraction in the U.S., consistent with Fitch's coronavirus downside scenario, which triggers greater than anticipated, sustained and deep revenue declines and results in material erosion of the state's gap-closing capacity;

-- A material increase in long-term liability burden.

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

Sectorwide Coronavirus Implications

The outbreak of coronavirus and related government containment measures worldwide has created an uncertain global environment for U.S. state and local governments and related entities. Fitch's ratings are forward-looking in nature, and Fitch will monitor the severity and duration of the budgetary impact on state and local governments and incorporate revised expectations for future performance and assessment of key risks.

While the initial phase of economic recovery has been faster than expected, GDP in the U.S. is projected to remain below its 4Q19 level until at least 4Q21. In its baseline scenario, Fitch assumes continued strong GDP growth in 3Q20 followed by a slower recovery trajectory from 4Q20 onward amid persisting social distancing behavior and restrictions, high unemployment and a further pullback in private-sector investment. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the report titled, "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases - Update" (https://www.fitchratings.com/research/sovereigns/fitch-ratings-coronavirus-scenarios-baseline-downside-cases-update-08-09-2020), published Sept. 8, 2020 and "Fitch Ratings Updates Coronavirus Scenarios for U.S. State and Local Tax-Supported Issuers" (https://www.fitchratings.com/research/us-public-finance/fitch-ratings-updates-coronavirus-scenarios-for-us-state-local-tax-supported-issuers-01-10-2020), published on Oct. 1, 2020 on www.fitchratings.com.

Federal Aid Provides Some Support for State Budgets

Federal aid measures enacted in recent months will benefit state budgets, although details remain fluid. The Families First Coronavirus Response included a 6.2 percentage point (pp) increase in the Federal Medical Assistance Percentage (FMAP) for Medicaid for every quarter of the national emergency. FMAP is the rate at which the federal government reimburses states for Medicaid spending. Using 2017 data, the Center on Budget and Policy Priorities estimates the 6.2-pp increase could provide Washington with $600 million in federal aid over a full year, or roughly $150 million each quarter. For the first quarter of 2020, the state reports receiving about $131 million in additional FMAP funding.

Under the Coronavirus Aid, Relief and Economic Security (CARES) Act enacted on March 27, the U.S. Treasury department distributed $150 billion to state and local governments using a population-based formula. The statute limits the use of funds to coronavirus expense reimbursement rather than to offset anticipated state tax revenue losses. The U.S. Treasury allocated $2.9 billion to Washington. To date, the state has allocated about $1.8 billion in coronavirus-related costs that might be reimbursable from CARES Act moneys. Fitch notes the uncertainty surrounding which budget items will ultimately be reimbursable by CARES Act money.

CARES also provides for supplemental federal aid for local school districts, passed through state departments of education with the Elementary and Secondary School Emergency Relief Fund. The act allocates almost $217 million to the state, with a minimum of approximately $195 million designated for local school districts, all to be spent within one year of receipt for a fairly broad set of allowable uses.

Washington Liquidity Update

Fitch considers Washington well positioned to address liquidity pressures emanating from the coronavirus pandemic and related economic downturn, with no anticipated interruption in timely payments for key operating expenses, including debt service. Several county treasurers extended property tax payment deadlines to June 30; however, the magnitude of these deferrals did not cause any cash flow issues for the state. Washington entered the current crisis with a high level of liquidity, resulting from positive operating performance over the course of the economic expansion that followed the Great Recession and does not intend to borrow from the federal Municipal Liquidity Facility.

Coronavirus - Washington Economic Update

Economic implications for Washington will be significant as in all states. The pandemic and related public health measures have significantly affected the state's economy though it has recovered somewhat more than the nation. Washington's non-farm payrolls declined 16% from February through April compared with 13% nationally but Washington had recovered about 55% of its lost jobs by August compared to the national average of 51%. The Fitch-adjusted unemployment rate (which adds back labor force exits) shows Washington at 8.7% in August and the nation at 10.4%. For the week ended Sept. 19, Washington's insured unemployment rate IU; not seasonally adjusted, the ratio of continuing claims for unemployment insurance [UI] to total employment covered by the UI program) was 7.0% compared with 7.9% nationally. The weekly IU rate is different from the more commonly used monthly unemployment rate, but it provides a useful forward look given its timeliness.

Fitch notes that economic and employment data remain volatile and state economic performance is likely to be closely tied to public health conditions, which remain difficult to forecast while the pandemic persists.

Coronavirus - Washington Budgetary Update

As with its liquidity position, Washington's budget remains in a very strong position to absorb the budgetary implications of the pandemic-driven downturn without materially affecting its long-term credit profile. The state came into the downturn in a strong reserve and budgetary position, benefitting from a constitutionally required multi-year balanced budget requirement, constitutionally-required budget stabilization account funding, and expectations for slower growth, which helped limit ongoing additional budgeted spending in recent years. Revenues had been performing very well through February 2020, but the onset of the pandemic in March quickly reversed the strong revenue trend.

The state's June 2020 economic and revenue forecast indicated sharp declines in the state's primary revenues (sales and business and occupancy taxes), which would have resulted in $1.5 billion in lower collections (roughly 9% decline in sales taxes and a 10% decline in B&O taxes) in fiscal 2021 compared with fiscal 2019. However, due largely to higher than expected stimulus payments to individuals and businesses supporting economic recovery, the September 2020 forecast indicates significant revenue improvement over the June forecast, with total fiscal 2021 near general fund -- state revenues (revenues collected by the state) about $1.9 billion higher in the September forecast than in June.

As a result, even if the state relies solely on reserves and takes no action to adjust its budget for the 2019-2021 biennium, the state's office of financial management estimates ending fiscal 2021 (the end of the biennium) with about $770 million in BSA, which represents almost 3% of fiscal 2021 budgeted spending. Fitch expects the state to make sufficient budget adjustments for the remainder of the biennium in order to maintain its very strong resilience, likely in the form of additional budget management measures for the current biennium when it reconvenes for its January 2021 session to also consider the state's next biennial budget. The governor has already required some agencies to furlough employees and not provide a planned wage increase as of July 1, 2020, and vetoed about $234 million in the legislature's 2020 supplemental omnibus budget bill which the governor signed on April 3.

Downside risks remain. In particular, the September forecast assumes additional stimulus payments in October and $300 per week unemployment benefits through the rest of the year, which Fitch considers unlikely absent a supplemental federal stimulus bill.

CREDIT PROFILE

Washington's economy, historically reliant on manufacturing supplemented by regional and international trade and tourism, has broadened over the last several years. Areas of concentration, including Boeing, Microsoft and Amazon, offer relatively high-wage employment, and the population is well educated. In addition, population growth has far exceeded that of the U.S. as a whole for many years, a trend that seems likely to continue. The state's unemployment rate is slightly above the U.S., while the labor force and employment growth rates have been well above the national pace.

Prior to the pandemic, exports had experienced declines in 2019 due to safety concerns related to the Boeing 737 Max. Given the collapse in air travel, demand for airplanes is expected to be suppressed for some time. Boeing announced plans to lay off about 10,000 employees in the state of Washington and additional jobs may be lost in the state if Boeing decides to consolidate production of the 737 MAX in South Carolina.

REVENUE FRAMEWORK

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 (10%-12%). The importance of the real estate excise tax (5% of tax revenues in fiscal 2019) varies considerably depending on the point in the economic cycle. The state does not have an income tax.

This revenue structure makes the state budget 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.

Like most states, 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. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress.

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; however, given the litigation related to school funding requiring the state to contribute more to K-12 education, Fitch considers the state's ability to reduce spending in this area to be more limited than is true in some other states.

LONG-TERM LIABILITY BURDEN

On a combined basis, Washington's burden of direct debt and adjusted net pension liabilities, at 6.9% of personal income, is above the 5.7% median for U.S. states (both per Fitch's 2019 state pension report). 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. The combined liabilities place a low burden on the state's resource base, and Fitch expects this to remain so 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 has also been utilized as part of the funding solution.

The state administers 12 defined benefit retirement plans and three hybrid defined benefit/defined contribution plans. Most are multi-employer plans, with the state participating as either an employer or a non-employer contributing entity in all but one of the plans. 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 would fall to an estimated 81% based on the use of a standard 6% investment return assumption. Two plans for general government employees (PERS1, closed in 1977, and PERS2/3), account for the bulk of the state's direct net pension liability. The state has made changes to manage pension costs, and a state Supreme Court decision in 2014 upheld the elimination of cost of living adjustments that had been subject to longstanding legal challenge. The state has deferred full contributions to the closed pension systems in times of economic strain.

Non-contractual 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 that provides a GO guarantee to $15.9 billion in outstanding school district debt as of Sept. 1, 2020. The enhancement has never been called upon and is not included in Fitch's long-term liability calculation.

OPERATING PERFORMANCE

Frequent reviews of economic and financial forecasts allow the state to respond effectively to changing conditions. As the economy and revenues repeatedly and significantly underperformed estimates in the Great Recession, the state demonstrated its willingness and ability to utilize broad budget flexibility in response. The state implemented a combination of ongoing and one-time actions, and fully depleted accumulated reserves. Fitch expects the state to similarly make use of its very strong gap-closing capacity, supported by its solid, reinstated reserve position, during the current and future cyclical downturns.

Once the economy and revenues had recovered solidly from the Great Recession, Washington replenished reserves and strengthened reserve funding mechanisms. The state ended the fiscal 2017-2019 biennium on June 30, 2019 with reserves of $3.6 billion (including the general fund ending balance and the budget stabilization account), equal to 16% of general fund - state revenues in fiscal 2019.

Updated FAST Analysis for Washington

The Fitch Analytical Stress Test (FAST) scenario analysis tool, which relates historical tax revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria, has now been adjusted to reflect GDP parameters consistent with Fitch's global coronavirus forecast assumptions. FAST is not a forecast, but it represents Fitch's estimate of possible revenue behavior in a downturn based on historical revenue performance. Hence, actual revenue declines will vary from FAST results. FAST provides a relative sense of the risk exposure of a particular state compared to other states.

Strong revenue growth prospects are expected to enable the state to rebuild resilience through the eventual recovery period. The current coronavirus baseline scenario results in a first-year decline in Washington's revenues of 13%, followed by an 8% increase and cumulative result over the three-year scenario of a 0.3% decline. This compares to the state median decline of 14% in the first year and negative 3% over the three-year scenario. In the downside scenario, Washington's first-year decline would be 14%, followed by a slower rebound of 2% in the second year. The cumulative three-year decline of 10% under Fitch's downside scenario is somewhat better than the median 12% decline for all states reflecting Washington's historical economic strength and potential for a strong recovery.

Budgeting has remained challenging and sometimes contentious, in part due to the McCleary 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. The constitutional account was approved by voters in 2007. The BSA receives the first 1% of revenues collected every year, until it reaches its cap of 10% of annual general revenues. In 2011, voters approved another constitutional amendment that requires 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) be transferred to the BSA on top of the 1%. This measure also serves to limit the impact 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 November 2019, voters approved the ballot initiative 976, which, if enacted, would lower motor vehicle fees, light duty truck weight fees, and certain electric vehicle license fees to $30, and eliminate the 0.3% sales tax on vehicle purchases, resulting in a loss of an estimated $409 million (about 6%) of state transportation revenues for the 2019-2021 biennium and an estimated $2.3 billion in local revenues over the next six years. The initiative was scheduled to go into effect on Dec. 5, 2019, but was stayed pending legal challenges.

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.

ESG CONSIDERATIONS

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

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

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

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Dodd-Frank Rating Information Disclosure Form

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Washington, State of (WA)	EU Endorsed

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