

2016 Outlook: U.S. States

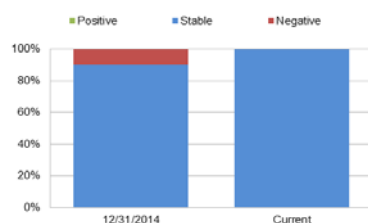
Credit Stability but Budgeting Remains a Challenge Outlook Report

Rating Outlook

STABLE

(2015: STABLE)

Rating Outlooks



Source: Fitch

Sector Outlook

STABLE

(2015: STABLE)

- Budget challenges continue to be manageable in an environment of economic and revenue growth.
- Low energy prices are a challenge for some states but benefit most.
- Federal action remains an ongoing exposure but risk currently muted.

Related Research

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[2015 State Pension Update \(October 2015\)](#)

[Sustained Low Natural Resource Prices Slash State Revenue Forecasts \(October 2015\)](#)

[U.S. States: The Rising Cost of Care \(July 2015\)](#)

[U.S. States Snapshot \(March 2015\)](#)

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All State Ratings Now Stable: For the first time since the 2008–2009 downturn, all of Fitch Ratings' ratings on U.S. states carry a Stable Rating Outlook, indicating stable credit trends for the coming year.

State Revenues Track Economy: State revenues closely track economic cycles and continued slow economic growth has meant continued slow growth in state revenues. As the economic experience has varied by state, so have revenue trends. Forecasts remain cautious.

Budgeting Conflicts Increase: Budget negotiations in numerous states were marked by increased contention in 2015, with lingering stalemates in two. That dynamic seems likely to continue for reasons both ideological and practical. Budget managers face ongoing demands for additional spending on one side and tax relief on the other and the pace of revenue growth is insufficient to satisfy all.

Natural Resource States Pressured: Fitch expects soft prices for crude oil and natural gas to continue to moderate production, dampening energy states' economic growth and extending weak revenue prospects for severance taxes and economically sensitive revenues well into 2016. The severity of the impact is expected to vary considerably by state.

Medicaid Remains Key Focus: Fitch anticipates efforts to slow growth rates in Medicaid, one of the largest areas of state spending, to remain a priority in 2016. Discussions around the Affordable Care Act (ACA) will shift from planning for increased enrollment towards absorbing the new expenses that expansion states are scheduled to take on from the federal government in the next fiscal year.

Transportation Getting Attention: Transportation needs will continue to be a pressure point for states in 2016. Fitch expects to see more proposals to augment funding sources. Public-private partnerships (PPPs) are likely to remain a modest component of state capital spending, but states will increasingly turn towards that model for larger, more complex projects where the benefits are clearest.

Pension Contributions Rising: Although remaining a small share of state budgets, pension contributions will continue to rise in 2016 for reasons including past investment losses and contribution practices, use of more conservative assumptions, and demographic trends. Most states will report new data under GASB 68, requiring allocation of plan liabilities across participating governments for the first time.

New Criteria to Improve Communication: Fitch will be implementing revised rating criteria for states in 2016. The revisions are focused on communicating opinions more clearly and providing the market with tools that facilitate a more forward-looking, predictable approach to ratings. Given that this is not a reconsideration of prior credit decisions, Fitch expects rating changes to be limited.

Outlook Sensitivities

Sector Influenced by Economy, Feds: Unexpected economic weakening in 2016 would make the operating environment for states more difficult. In addition, unexpected federal funding changes would present a challenge, particularly in the absence of related mandate relief.

Rating Outlook Durable: Fitch's overarching philosophy is that ratings should not change due to normal cyclical variations, so it is only an economic cycle of unusual depth or duration that would be expected to result in a higher level of rating transition. Scenario analysis, which will be introduced to state ratings in 2016, will highlight this point. Broad shifts different from a normal economic cycle, such as a fundamental change in intergovernmental relationships, could also affect ratings. None are currently expected.

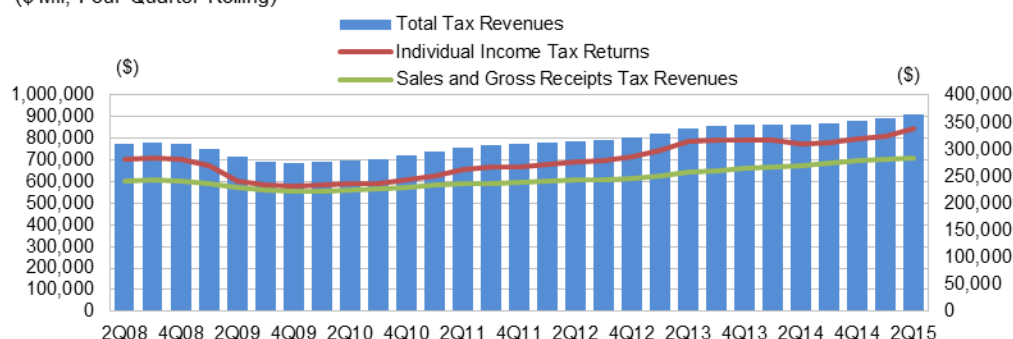
Key Issues

Revenues Grow with Economy: By far the biggest driver of state financial positions is the performance of the economy. The income and sales taxes that provide the bulk of state funding quickly reflect changing economic conditions, and budgets have benefited from the comparative stability of recent years even though growth has been slow by historical standards.

Revenue results for fiscal 2015, which ended on June 30 for most, reflect baseline trends to a much larger degree than was the case in the prior two years. (The 2013 federal tax increase that resulted in taxpayer acceleration of income into 2012 skewed results, with revenue overperformance in fiscal 2013 and underperformance in 2014 common.) Although reported figures include the impact of tax cuts enacted in recent years, aggregate state taxes grew a reported 5% overall. Income tax growth has been stronger than that of consumption-based revenue streams.

State Tax Revenues

(\$ Mil; Four-Quarter Rolling)



States with biennial budgets generally start the biennia in even-numbered fiscal years, so the majority enacted budgets this past spring. Most are assuming continued slow but steady revenue growth for 2016. This is consistent with Fitch's expectations for the economy; the most recent Fitch "Global Economic Outlook," dated September 2015, projects U.S. GDP growth for 2016 at 2.5%, matching 2015. Revenue expectations could change quickly with unexpected softness in the economy.

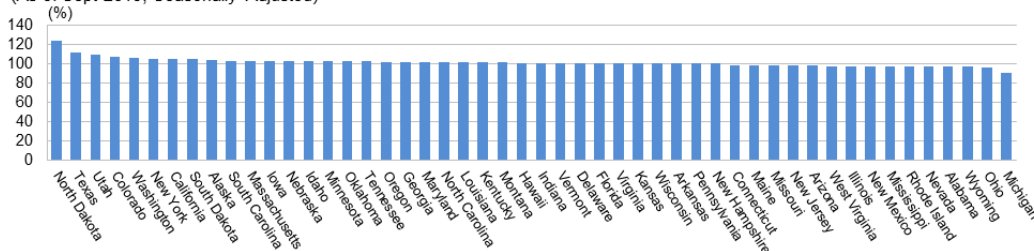
One clear risk is the performance of financial markets. Income tax revenues have shown increased volatility in recent years and in some states this revenue stream is heavily exposed to the stock market and its effect on capital gains performance. Although state budget forecasts tend to be conservative, such revenues are difficult to predict.

Fitch believes that another ongoing exposure for state budgets, the threat of federal action that derails economic recovery or materially lowers funding to the states, has abated for the time being. Longer term, states remain significantly exposed to the possibility of federal funding cuts, although Fitch believes states would have time to adjust to any significant federal actions.

Economic Performance Uneven: Fitch has observed significant variation in economic performance. Fifteen states have yet to fully recover jobs lost in the Great Recession while others are showing performance well ahead of the U.S. pace. Six states (Missouri, Montana, Oklahoma, North Dakota, West Virginia, and Wyoming) have seen backsliding since last year at this time.

Current Nonfarm Employment as % of Pre-Recession Peak

(As of Sept 2015; Seasonally Adjusted)



Source: U.S. Bureau of Labor Statistics.

Weakened Commodity Sector: Crude oil prices remained low throughout 2015, notably below most states' expectations, and were matched by weak prices for natural gas. The anemic price environment is expected to continue in the coming year. On Nov. 9, Fitch lowered the oil and gas price assumptions it uses when rating energy-sector corporates, reflecting the continued imbalance between oil supply and demand as well as our expectation that marginal costs will fall further in the medium term. The new assumption has the per barrel price for West Texas Intermediate averaging \$50 in 2016.

This extended low price environment will prolong producers' steep reductions in operating rigs, employment, and natural resource production from 2015. For states that benefit from either or both of the crude oil and natural gas industries, Fitch expects continued weakness in collections of related revenue sources such as severance taxes, personal income taxes, and sales and corporate income taxes. The related uncertainty will also present a challenge in projecting revenues in support of fiscal 2017 budgets. Coal mining states face the additional challenge of stricter carbon-reduction rules contained in the U.S. Environmental Protection Agency's Clean Power Plan, finalized in August 2015.

The severity of the economic and budget impact on energy states is expected to vary considerably, determined by the importance of related natural resource revenues to the state's operating budget, natural resource industries' contribution to state employment, and the conservatism of the state's forecasts. Fitch expects economic growth in states that grew strongly in the early years of the current national expansion such as North Dakota, Oklahoma, and Wyoming to be weaker in 2016 and be surpassed by states with more diversified economic bases.

Medicaid a Continued Focus for Cost Control: Fitch expects that Medicaid, an area of state budgets that is one of the largest and most difficult to control, will remain a key area of focus in the coming year. Historically, Medicaid spending has grown at a faster rate than states' tax revenues. Between 1994 and 2014, Medicaid spending growth by states averaged 6.2% annually while states' tax revenues averaged 4.3% growth.

To manage Medicaid's growth challenge, states have increasingly turned towards approaches used widely in the private healthcare marketplace. Managed care, particularly through managed care organizations (MCOs), is an increasingly prominent tool. The Kaiser Family Foundation (KFF) reports that 39 states used MCOs as of July 1, 2015, and that enrollment in MCOs increased 23% from the prior year, well ahead of general Medicaid enrollment growth of 14%. Fitch anticipates states will continue the shift towards managed care, as well as other efforts to revise how Medicaid services are delivered and paid for.

Budget and fiscal implications of the ACA have been prominent in the last two years as 29 states expanded Medicaid access to newly eligible populations under ACA and all states dealt with difficult to predict enrollment increases for those previously eligible but not enrolled in Medicaid. Fitch anticipates reduced uncertainty in 2016 as only two new states (Alaska and Montana) are beginning ACA expansions in 2016 versus three in 2015 and 26 in 2014, with Utah also considering expansion.

One topic that is likely to factor into budget discussions in the coming year is paying for the state share of the ACA expansion that will begin to phase in on Jan. 1, 2017 (roughly midway through most states' next fiscal year). ACA expansion states will need to bear 5% of the costs for the newly eligible population in 2017. This cost share is scheduled to increase gradually, reaching 10% on Jan. 1, 2020 and thereafter. Some states already have revenues in place to cover the costs; for example, Indiana brokered an agreement with its hospitals to use an existing hospital assessment fee to help cover the state's share of ACA expansion. Other expansion states will debate how to incorporate these additional costs during the upcoming budget sessions.

Transportation Proposals Gain Momentum: 2015 was a banner year for transportation funding changes and Fitch anticipates continued activity in 2016. In the past year, 11 states increased taxes and transportation-related fees (primarily gas taxes and vehicle registration fees) while Texas voters approved a constitutional amendment allocating a portion of future growth in sales tax revenues to transportation. Funding increases came even in states typically not supportive of tax increases including Utah and Georgia. In another conservative tax-policy state, the Nebraska legislature overrode a gubernatorial veto to enact a gas tax increase.

States are also considering alternative funding sources beyond the traditional gas tax or transportation user fees given the likelihood that increasing federal fuel efficiency standards, technological evolution, and shifting consumption patterns will limit, or even drive down, fuel consumption in the future. In July 2015, Oregon became the first state to pilot a vehicle miles travelled (VMT) fee using GPS devices installed in residents' cars and trucks. California is on track to implement its own pilot in 2018 and other states are considering similar programs. According to the National Conference of State Legislatures, 18 states considered 43 bills relating to VMT fees between 2013 and 2015.

Federal uncertainty continues to play an important role in motivating states to take action on transportation needs. After more than a year of short-term extensions, Congress is nearing approval of its first six-year transportation bill in over a decade. But the most recent versions of the legislation rely on one-time or short-term solutions to provide only three years of funding, setting up more uncertainty for states historically reliant on federal aid. Between 2009 and 2013, federal aid accounted for more than one third of total state spending for highways and transit.

Fitch anticipates use of PPPs will remain relatively modest amongst states next year, but some new high profile projects could utilize the model. Although not a panacea for funding issues, Fitch believes transportation PPPs can be a useful procurement mechanism where the economics make sense.

Pension Contributions Rising: For most states pension contributions are a small share of budgets compared to core services such as Medicaid and education, but contributions are continuing to rise. Fitch calculates the average growth of actuarially-determined contributions to be approximately 9.5% annually since fiscal 2007; our baseline assumption is for this trend to continue.

Factors behind persistently high unfunded liabilities and a steady increase in actuarially determined contributions include past investment losses and contribution practices, shifts to more conservative actuarial assumptions, and broad demographic trends. In addition, rising public concern about pension obligations and the gradual ebbing of other budgetary pressures have led states to devote more budgetary resources to pension contributions.

Pension funded ratios have now leveled out after absorbing the investment losses from the last recession, with little progress made toward a return to pre-recession funded ratios. Alongside a string of years with strong asset portfolio returns (with the notable exception of 2015), liabilities have continued an uninterrupted rise since before the last downturn. Shifts to more conservative

actuarial assumptions have increased reported liabilities; in its 2015 state pension update Fitch noted the average investment return assumption for large statewide plans has fallen to 7.69% in 2014 from 7.97% in 2008.

Fitch expects systems to continue to lower discount rates in 2016. Fitch views this trend as positive, as it reflects the recent experience of two severe recessions in a single decade, the likelihood of slower investment growth, and the steady maturing of plans, which requires a larger share of assets to be invested in shorter-term, more liquid investments to meet rising benefit payouts, even as employee contributions level out or decline.

Making progress on funded ratios under these circumstances necessitates higher contributions from governments, which bear virtually all risk of plan underperformance under the defined benefit model. States have been making more of an effort to make full contribution payments. Fitch's 2015 state pension update noted that 53% of major statewide systems received at least 100% of their actuarially determined contributions, up from 42% in 2011.

For most states in multiemployer pension systems, fiscal 2015 financial reports will be the first to reflect the impact of GASB 68, which requires the allocation of multiemployer plan liabilities across participating governments under most circumstances. Fitch views the allocation of multiemployer system liabilities to be a positive development which will provide a better reflection of the long-term obligation of governments to their workers' retirement benefits. As with implementation of GASB 67 last year, Fitch expects few surprises from the change. Information quality will be improved, but comparability challenges will remain.

Revised Criteria Will Enhance Analysis: Given the expected stability in the credit environment, the most significant driver of rating changes in the coming year is likely to be implementation of revised tax-supported rating criteria. Fitch expects the rating impact of the new criteria to be limited; changes are likely to affect less than 10% of the total local and state government portfolio, with a roughly equal mix of upgrades and downgrades. This number is likely lower for states, as the factors most likely to result in rating changes do not apply to state-level credits.

The goal of the revised criteria is to communicate Fitch's credit opinions more clearly, presenting well-defined opinions about both rating conclusions and underlying fundamentals. Fitch will introduce forward-looking tools to the rating process; revenue sensitivity and scenario analysis tools work together to consider potential financial performance under a common set of economic assumptions, thereby highlighting how cycles affect different issuers differently. Fitch's ratings will continue to be based on the judgment of a team of experienced analysts rather than model-based outcomes. For more information and a complete discussion of proposed changes, see "Exposure Draft: U.S. Tax-Supported Rating Criteria" dated Sept. 10, 2015.

2015 Review

Most states saw budget performance in line with or better than forecast in 2015. Aggregate state tax revenues have now grown for five straight years and the vast majority of states have rebuilt financial flexibility to strong levels.

In this stable credit environment, all of Fitch's U.S. state ratings now carry a Stable Rating Outlook. This compares to the end of 2014, when four state ratings were on Negative Outlook. Over the course of 2015, three of these ratings were stabilized at the existing level (Connecticut, Mississippi, and New Jersey) while another was downgraded (Illinois). Fitch believes that each of these states is now positioned to weather future downturns in a manner consistent with the current rating.

Fitch also upgraded California's GO rating in 2015. This was the second upgrade of the state's rating in the current recovery. The upgrades have reflected institutionalized changes to fiscal operations in recent years that, when combined with the ongoing economic and revenue recovery,

have enabled the state to materially improve its financial position, enhancing its ability to address future fiscal challenges.

Appendix: Issuer Ratings

State	Rating	Outlook
Alabama	AA+	Stable
Alaska	AAA	Stable
California	A+	Stable
Connecticut	AA	Stable
Delaware	AAA	Stable
Florida	AAA	Stable
Georgia	AAA	Stable
Hawaii	AA	Stable
Idaho	AA+ (Implied GO)	Stable
Illinois	BBB+	Stable
Indiana	AAA (Implied GO)	Stable
Iowa	AAA (Implied GO)	Stable
Kentucky	AA- (Implied GO)	Stable
Louisiana	AA	Stable
Maine	AA	Stable
Maryland	AAA	Stable
Massachusetts	AA+	Stable
Michigan	AA	Stable
Minnesota	AA+	Stable
Mississippi	AA+	Stable
Missouri	AAA	Stable
Montana	AA+	Stable
Nevada	AA+	Stable
New Hampshire	AA+	Stable
New Jersey	A	Stable
New York	AA+	Stable
North Carolina	AAA	Stable
Ohio	AA+	Stable
Oklahoma	AA+	Stable
Oregon	AA+	Stable
Pennsylvania	AA-	Stable
Rhode Island	AA	Stable
South Carolina	AAA	Stable
South Dakota	AA+ (Implied GO)	Stable
Tennessee	AAA	Stable
Texas	AAA	Stable
Utah	AAA	Stable
Vermont	AAA	Stable
Virginia	AAA	Stable
Washington	AA+	Stable
West Virginia	AA+	Stable
Wisconsin	AA	Stable
District of Columbia	AA	Stable

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