State of Washington

New Issue Report

Ratings

Long-Term Issuer Default Rating	AA+

New Issues

$468,695,000 Various Purpose General Obligation Bonds, Series 2019C	AA+
$172,230,000 Motor Vehicle Fuel Tax General Obligation Bonds, Series 2019D	AA+

Outstanding Debt

General Obligation Bonds	AA+

Rating Outlook

Stable

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New Issue Summary

Sale Date: Feb. 5, 2019

Series: $468,695,000 various purpose GO bonds, series 2019C; $172,230,000 motor vehicle fuel tax GO bonds, series 2019D

Purpose: New money

Security: General obligation

Analytical Conclusion

Washington's 'AA+' GO rating and Issuer Default Rating (IDR) reflect the state's solid economy and revenue growth prospects, a demonstrated commitment to fiscal balance, and combined long-term liabilities that place a low burden on resources despite an above-average debt load for a U.S. state. Fitch Ratings believes that strong budget control will allow the state to continue to address challenges while maintaining fundamental financial flexibility even at times of economic and revenue decline.

Economic Resource Base: Washington's economy is characterized by generally sound performance and increased employment diversification. The state economy is growing at a faster rate than the U.S., and the state is well positioned for above-average results. The economy is still heavily influenced by Boeing and Microsoft, while Amazon and other technology companies continue to expand. The workforce is highly educated, income levels are comparatively high, and the state poverty rate is below the national average.

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. 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 with a low burden of carrying costs for debt service and retiree benefits and the broad expense-cutting authority common to most U.S. states. Education is a key cost driver, as is Medicaid, 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.

Operating Performance: 'aa'
Washington has responsive financial management and very strong gap-closing capacity. In a moderate economic downturn, Fitch expects the state would act in line with historical practice,

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AA+	Affirmed	Stable	8/13/18
AA+	Affirmed	Stable	7/19/13
AA+	Affirmed	Negative	1/27/12
AA+	Revised	Stable	4/05/10
AA	Affirmed	Stable	12/31/08
AA	Affirmed	Positive	9/04/07
AA	Affirmed	Stable	4/13/06
AA	Downgraded	—	1/11/02
AA+	Upgraded	—	11/25/97
AA	Assigned	—	8/18/92

Related Research

Fitch Rates State of Washington's $641MM 'AA+'; Stable Outlook (January 2019)

Related Criteria

U.S. Public Finance Tax-Supported Rating Criteria (April 2018)

drawing down reserves and managing revenues and spending to maintain balance and overall financial flexibility. As conditions improve, the state replenishes its cushion against future underperformance. The initiative and referendum environment creates some uncertainty, but this is limited by the legislature's authority to amend or repeal any law approved by voters in this manner.

Rating Sensitivities

Solid Financial and Liability Management: The rating is sensitive to shifts in Washington's fundamental credit characteristics, including a low liability burden supported by an increased focus on debt affordability. The rating assumes that the state will continue to address budgetary challenges, such as recent increases in K-12 education funding requirements, in a sustainable manner.

Credit Profile

Washington's economy, historically reliant on manufacturing supplemented by regional and international trade and tourism, has broadened. 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, a trend that seems likely to continue.

The state's recovery from the Great Recession has been significantly more robust than the U.S. as a whole and among the strongest of the states. The state's unemployment rate is slightly above the U.S., while the labor force growth rate has been well above the national pace.

Revenue Framework

Washington's revenue structure is based on a retail sales tax (about half of state general fund tax revenues) and, to a much lesser extent, a business and occupation gross receipts tax (about 20%) and state property tax (10%–15%). The importance of the real estate excise tax (5% of tax revenues in fiscal 2018) 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 and the state's ongoing population growth.

Like most states, Washington has complete independent legal ability to control taxes, a significant credit strength. A 2013 state Supreme Court decision found a prior two-thirds legislative vote requirement for tax increases to be unconstitutional, making it easier to raise revenues. A November 2015 initiative that attempted to re-establish the restriction by other means also was found to be unconstitutional.

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 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 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 recently resolved litigation related to school funding, 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 7.3%, is above the 6% median for U.S. states (both figures per Fitch's 2018 state pension report). Debt levels are more than twice the U.S. state median while 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 even given the state's large capital projects.

Washington's debt alone equals approximately two-thirds of Fitch adjusted long-term liabilities and is primarily GO. Capital needs are substantial, particularly for transportation. The state has repeatedly demonstrated its ability and willingness to raise revenues in support of transportation capital investment, most recently through a gas tax increase in the 2015 session. Tolling has also been utilized as part of the funding solution.

The state has increased its focus on debt affordability in recent years. In November 2012, voters approved a constitutional amendment that tightened the constitutional debt limit, which limits annual debt service as a percentage of revenues.

The state administers 14 defined benefit retirement plans, three of which have hybrid defined benefit/defined contribution components; most are multi-employer, with the state participating as either an employer or a non-employer contributing entity in all but one of the plans. Based on fiscal 2018 financial statements, aggregate fiduciary pension assets covered over 90% 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 76% based on Fitch's more conservative 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 effectively made changes to manage pension costs, and a 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.

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 $13.9 billion in outstanding school district debt as of Dec. 21, 2018. The enhancement has never been called upon.

Operating Performance

Frequent reviews of economic and financial forecasts allow the state to respond effectively to changing conditions. For details, see Scenario Analysis, page 5.

Budgeting has remained challenging and sometimes contentious even in the current recovery, in part due to the McCleary education lawsuit-related K-12 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 has taken advantage of this time of growth to rebuild financial flexibility.

As the economy and revenues have recovered solidly, Washington has replenished reserves and strengthened reserve funding mechanisms. The state ended the fiscal 2015-2017 biennium on June 30, 2017 with reserves of $2.8 billion (including the general fund ending balance and the budget stabilization account), equal to 14% of tax revenues in fiscal 2017 alone. The state's most recent forecast for the current 2017-2019 biennium includes an increase in reserves to $4.5 billion at fiscal 2019 year-end, equal to 16% of projected tax revenues in fiscal 2019. This forecast improves upon the $2.4 billion reserve balance assumed in the enacted biennium budget, largely due to strong revenue performance.

The state has solid funding provisions for its budget stabilization account (BSA). The constitutional account was approved by voters in 2007. The BSA receives 1% of revenues off the top every year, capped at 10% of annual general revenues. In 2011, voters approved another constitutional amendment that requires any 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.

Current Developments

Washington's supplemental budget for the current biennium provided $702 million in new funding for K-12 education for the 2018-2019 school year, adding to the $1.8 billion in new education funding included in the enacted biennium budget and funded primarily from increased property taxes and one-time reserves. These funding increases were in response to the long-running McCleary education lawsuit, which the state Supreme Court has now declared resolved. Washington also adopted a full capital budget for the 2017-2019 biennium in 2018 after the legislature adjourned in 2017 without taking action.

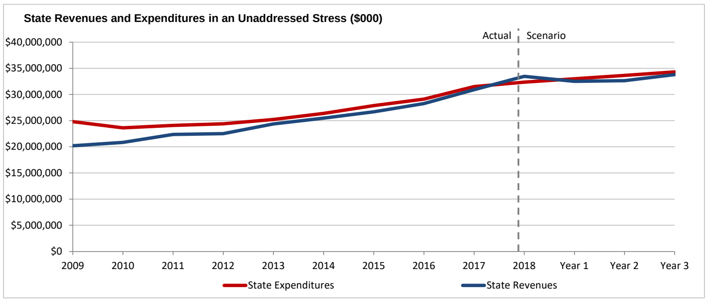
Revenue performance continues to be strong and the state's baseline revenue forecast has been raised at every review since the start of the biennium, supported by growth in all major tax revenues.

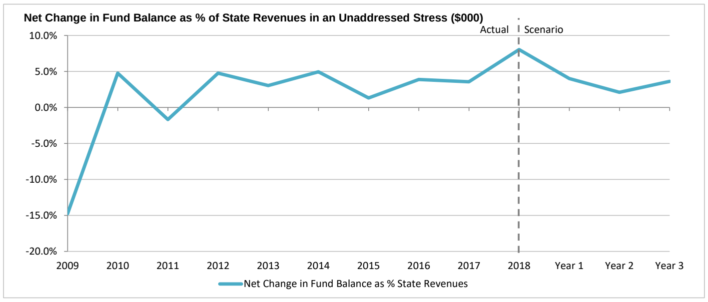
The governor released his proposed fiscal 2019-2021 biennium budget last month. The proposal includes $3.7 billion in revenue measures, including a new tax on capital gains, an increase to the existing business and occupation tax for services and a more progressive real estate excise tax. The new revenues would finance reforming the mental health system, additional K-12 education and environment preservation. The legislative session began on

Jan. 14, 2019. At this time, it is not possible to predict the form the final budget will take. The governor's budget proposal would leave reserves at $2.8 billion at the end of the biennium.

Washington, State of (WA)

Scenario Analysis





Analyst Interpretation of Scenario Results:

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 take actions 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 during future cyclical downturns.

Scenario Parameters:	Year 1	Year 2	Year 3
GDP Assumption (% Change)	(1.0%)	0.5%	2.0%
Expenditure Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	(2.9%)	0.4%	3.6%

Revenues, Expenditures, and Net Change in Fund Balance	Actuals										Scenario Output		
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Year 1	Year 2	Year 3
Expenditures													
Total Expenditures	35,347,000	36,017,000	36,693,000	36,290,000	37,111,000	39,553,000	42,571,000	44,146,954	46,876,157	47,989,794	48,949,590	49,928,582	50,927,153
% Change in Total Expenditures	7.9%	1.9%	1.9%	(1.1%)	2.3%	6.6%	7.6%	3.7%	6.2%	2.4%	2.0%	2.0%	2.0%
State Expenditures	24,799,000	23,629,000	24,094,000	24,385,000	25,222,000	26,385,000	27,859,000	29,113,421	31,506,179	32,343,483	32,990,353	33,650,160	34,323,163
% Change in State Expenditures	3.4%	(4.7%)	2.0%	1.2%	3.4%	4.6%	5.6%	4.5%	8.2%	2.7%	2.0%	2.0%	2.0%
Revenues													
Total Revenues	30,748,000	33,235,000	34,951,000	34,430,000	36,250,000	38,649,000	41,399,000	43,294,691	46,269,050	49,114,776	48,473,851	48,913,340	50,410,502
% Change in Total Revenues	(0.5%)	8.1%	5.2%	(1.5%)	5.3%	6.6%	7.1%	4.6%	6.9%	6.2%	(1.3%)	0.9%	3.1%
Federal Revenues	10,548,000	12,388,000	12,599,000	11,905,000	11,889,000	13,168,000	14,712,000	15,033,533	15,369,978	15,646,311	15,959,237	16,278,422	16,603,990
% Change in Federal Revenues	20.3%	17.4%	1.7%	(5.5%)	(0.1%)	10.8%	11.7%	2.2%	2.2%	1.8%	2.0%	2.0%	2.0%
State Revenues	20,200,000	20,847,000	22,352,000	22,525,000	24,361,000	25,481,000	26,687,000	28,261,158	30,899,072	33,468,465	32,514,614	32,634,918	33,806,511
% Change in State Revenues	(8.7%)	3.2%	7.2%	0.8%	8.2%	4.6%	4.7%	5.9%	9.3%	8.3%	(2.9%)	0.4%	3.6%
Excess of Revenues Over Expenditures	(4,599,000)	(2,782,000)	(1,742,000)	(1,860,000)	(861,000)	(904,000)	(1,172,000)	(852,263)	(607,107)	1,124,982	(475,739)	(1,015,242)	(516,652)
Total Other Financing Sources	1,615,000	3,775,000	1,367,000	2,932,000	1,601,000	2,165,000	1,524,000	1,948,380	1,707,652	1,567,704	1,782,547	1,706,057	1,742,468
Net Change in Fund Balance	-2,984,000	993,000	-375,000	1,072,000	740,000	1,261,000	352,000	1,096,117	1,100,545	2,692,686	1,306,808	690,815	1,225,816
% Total Expenditures	(8.4%)	2.8%	(1.0%)	3.0%	2.0%	3.2%	0.8%	2.5%	2.3%	5.6%	2.7%	1.4%	2.4%
% State Expenditures	(12.0%)	4.2%	(1.6%)	4.4%	2.9%	4.8%	1.3%	3.8%	3.5%	8.3%	4.0%	2.1%	3.6%
% Total Revenues	(9.7%)	3.0%	(1.1%)	3.1%	2.0%	3.3%	0.9%	2.5%	2.4%	5.5%	2.7%	1.4%	2.4%
% State Revenues	(14.8%)	4.8%	(1.7%)	4.8%	3.0%	4.9%	1.3%	3.9%	3.6%	8.0%	4.0%	2.1%	3.6%

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. For further details, please see Fitch's US Tax-Supported Rating Criteria.

The ratings above were solicited and assigned or maintained at the request of the rated entity/Issuer or a related third party. Any exceptions follow below.