FitchRatings

Fitch Rates State of Ohio's $97MM GO Bonds 'AA+'; Outlook Stable

Fitch Ratings-New York-06 December 2017: Fitch Ratings has assigned a 'AA+' rating to the following state of Ohio general obligation (GO) bonds:

--$50 million GO conservation projects bonds, series 2018A;
--$35 million GO natural resources bonds, series W;
--$12 million GO coal development bonds, series O.

The bonds are expected to be sold via competitive bid on Jan. 9, 2018.

The Rating Outlook is Stable.

SECURITY
The bonds are general obligations of the state of Ohio with its full faith and credit pledged, excluding highway user receipts and lottery proceeds.

ANALYTICAL CONCLUSION

The state's 'AA+' GO rating and Issuer Default Rating (IDR) are based on its careful financial management, ongoing record of maintaining fiscal balance, and a moderate, rapidly amortizing debt burden. Liabilities are supported by an economy that is slowly adding jobs lost in the recession.

Economic Resource Base
Ohio's economy is large and diverse, with distinct economic regions centered on several large urban centers. Manufacturing remains a disproportionally large sector with a concentration in more cyclically sensitive durable goods industries. Transportation equipment and related suppliers have had a strong presence. The state's economy is expanding but at a slower pace than immediately following the recession.

KEY RATING DRIVERS

Revenue Framework: 'aa'
Like most states, Ohio maintains unlimited legal ability to raise operating revenues. Its revenue base is diverse and relies on broad-based income and sales taxes. Tax policy changes pursued over the past several biennia have been manageable, aided by favorable economic and fiscal trends.

Expenditure Framework: 'aaa'
Ohio retains ample flexibility to cut spending throughout the economic cycle. The natural pace of spending growth is likely to be generally in line with its somewhat slowly growing revenue stream. Carrying costs for debt and pensions are below the median for states. Spending pressure in Medicaid and education appears to be well controlled.

Long-Term Liability Burden: 'aaa'
Debt is typically conservatively managed and primarily consists of GOs. On a combined basis, outstanding debt and pension obligations are low and a well below-average burden on the state.

Operating Performance: 'aaa'
The state generally has a careful approach to financial operations and has consistently managed to achieve budgetary balance. In recent years, the state has relied more on budget reductions than revenue enhancements to balance the budget and also utilized several one-time sources during the recession. The state's budget stabilization fund (BSF) has been restored after being drawn down during the recession and now totals $2 billion, or 6% of GRF revenues.

RATING SENSITIVITIES
Ohio's 'AA+' IDR and GO rating is sensitive to shifts in its fundamental credit characteristics and to continued successful maintenance of fiscal balance in light of ongoing efforts to reduce the tax burden.

CREDIT PROFILE

The great recession had a widespread impact on the Ohio economy, accelerating a longstanding slump in manufacturing and weighing on the slowly growing service sector. Important employment sectors include transportation, distribution, and warehousing of manufactured goods, which is facilitated by an extensive system of ports on Lake Erie, barge service on the Ohio River, and advanced air-cargo and rail infrastructure. Health care and education are growing as employment and economic sectors and relatively low non-manufacturing wages in the state have been a magnet for back-office, banking, personnel and trade operations. However, while there has been steady year-over-year job growth since July 2010, the state has yet to fully achieve the peak employment reached in May 2000 prior to the recession.

Revenue Framework
Ohio relies on a diverse set of broad-based taxes to support operations, including income and sales and use taxes. These major tax revenues are collected in the GRF with constitutional exceptions for highway-related revenues, which are directed to highway purposes, and lottery proceeds, which are directed to education.

In recent biennia the state has pursued wide-ranging tax policy changes, shifting the source of GRF tax receipts and lowering overall receipts relative to baseline. To date, these tax policy changes have been manageable, aided by favorable economic and fiscal trends.

Ohio's historical revenue growth, adjusted for the estimated impact of policy changes, has lagged economic growth and has even declined on a real basis, with growth slightly below the inflation rate. Recent performance has been stronger than is reflected in the historical trend, but Fitch anticipates the long-term trend for revenue growth will be generally in line with inflation absent a strengthening in economic growth expectations.

Ohio has no legal limitations on its ability to raise revenues through base broadening, rate increases, or the assessment of new taxes or fees.

Ohio's spending growth is expected to generally track or be marginally above future revenue growth, absent offsetting policy action. Primary cost drivers include Medicaid and education spending. With a shift to managed care, Medicaid spending growth is contained and with only modest population growth, education spending pressures should be manageable. Federal action to revise Medicaid's programmatic and financial structure, including a basic restructuring of federal Medicaid funding to a capped amount, remains a possibility. Whether a change in federal Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increase liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Ohio has solid expenditure flexibility. The state has had a budget-cutting bias rather than relying on revenue increases when necessary to maintain budgetary balance, even in core spending areas. During the last recession, Ohio reduced distributions and phased out certain tax reimbursements to both local governments and school districts. The state's carrying cost for debt and pension obligations is below the state median and is expected to remain low given the state's well-funded pensions and conservative debt management.

Long-Term Liability Burden
Ohio's liabilities are low, and debt ratios are expected to approximate current averages going forward as GRF principal continues to roll off and personal income grows. As of Fitch's 2016 state pension report, the combined burden of net tax-supported debt and adjusted unfunded pension obligations equaled 3.9% of personal income, below the 5.1% median for U.S. states. Using a more conservative 6% return assumption for pensions, instead of the 7.5% rate assumed under the state's accounting valuation, would raise the burden of long-term liabilities to a still low 5%.

Funding of retirement benefits, both for pensions and health care, has historically been considered a credit strength, with pension systems generally well-funded and a history of state full funding of annual contributions. Plans are cost-sharing, multi-employer with limited liabilities attributed to the state. However, as is the case for most pension plans, funding for Ohio's five pension systems declined significantly with recessionary market losses and has only just begun to recover. Reform measures enacted in September 2012 have contributed to the improved financial sustainability of PERS and the state's other major systems.

Operating Performance
Ohio's ability to respond to cyclical downturns reflects its ample budget flexibility and availability of reserves. During the great recession, Ohio's revenues suffered significant declines, exacerbated by ongoing tax reductions. The state closed the resulting budgetary gaps with both ongoing and one-time measures. Some of these measures include use of the rainy day fund, refunding debt for current year savings, unpaid employee leave, and accelerating the phase-out of tax reimbursements for schools and local governments. Fitch expects that Ohio will continue to rely primarily on expense reductions to address a future downturn and would again draw upon its now restored rainy day fund.

During times of economic recovery, Ohio rebuilds its financial flexibility including restoring draws on its rainy day fund and reducing the use of one-time budget items. In recent biennia, natural revenue growth has been met with tax reductions, which have, to some extent, absorbed the natural tax revenue growth related to overall economic expansion. While it has been a concern that ongoing tax reductions could limit future flexibility, a statutory increase in the rainy day funding requirement from 5% to 8.5% of prior year revenue provides additional capacity to address future downturns and is emblematic of the state's approach during this period of expansion.

The state benefitted from lower than anticipated Medicaid spending in the fiscal 2016-2017 biennium, with lower spending offsetting a slight softening in revenue collection. Tax revenues grew 1.9% year-over-year in fiscal 2016 but were 1% below forecast, primarily due to lower than anticipated personal income tax revenues. Tax revenue growth was relatively flat in fiscal 2017 but 3.7% below the mid-biennium revised forecast. In addition to spending controls, and in particular, lower Medicaid spending, the state utilized a portion of the general revenue fund cash balance to achieve balance.

The state made a small deposit to the budget stabilization fund from the FY 2016 ending balance, bringing its balance to just over $2 billion, or a sound 6% of GRF revenue, which was maintained through fiscal 2017. The state's cash position is sound. It does not borrow for cash flow purposes and has ample ability to provide liquidity for its own variable rate debt.

The enacted budget for the fiscal 2018-19 biennium is balanced, does not rely on one-time revenues or use of reserves, and appears to be based on a conservative forecast for revenue growth. The budget funds a modest increase in K-12 education and continues to modify the school funding formula with the goal of better distributing resources to districts with less capacity to raise revenues locally. Medicaid funding is increased, but a portion is being shifted from the general fund to a non-GRF fund with the replacement of the Medicaid Managed Care Organization sales tax by a Medicaid Health Insuring Corporation (MHIC) provider assessment.

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

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017) (https://www.fitchratings.com/site/re/898466)

Additional Disclosures

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