FITCH RATES STATE OF CONNECTICUT'S $500MM GO BONDS 'A+'; OUTLOOK STABLE

Fitch Ratings-New York-24 May 2018: Fitch Ratings has assigned an 'A+' rating to $500 million of state of Connecticut general obligation (GO) bonds consisting of the following series:

--$400 million GO bonds (2018 series C);
--$100 million GO refunding bonds (2018 series D).

The bonds are expected to be sold via negotiation June 6, 2018.

In addition, Fitch has affirmed the state's Issuer Default (IDR) and outstanding GO ratings at 'A+' and the ratings on bonds supported by state appropriations as listed at the end of this release.

The Rating Outlook on all of the ratings is Stable.

SECURITY

GO bonds are supported by the full faith and credit of the state pledged to payment of principal and interest.

ANALYTICAL CONCLUSION

Connecticut's 'A+' IDR and GO bond rating reflect expectations for relatively flat economic and revenue performance that will continue to challenge the state in matching revenues to expenditures together with the state's broad economic resource base and the continued fiscal flexibility inherent in a state's budget autonomy. The state's long-term liabilities are expected to remain well above the U.S. state average, an elevated although still moderate burden on the wealthy resource base and one that limits expenditure flexibility compared to that of most states.

The state's operating performance has suffered from the need to address chronic economic and fiscal challenges throughout the current prolonged period of national economic expansion.
The rating assumes that the state will continue to proactively manage its challenged financial operations.

Economic Resource Base
Connecticut has a wealthy, mature and diverse economy anchored by a large finance sector and important manufacturing and education and health sectors. The impact of the Great Recession on Connecticut was severe and economic and revenue recovery has been very slow compared to previous economic cycles. The state forecasts fairly weak employment growth over the next several years. The state is the wealthiest in the U.S. as measured by per capita personal income, although aggregate personal income gains have trailed the nation and key finance and manufacturing sectors are experiencing only modest growth after the retrenchment of recent years.

KEY RATING DRIVERS

Revenue Framework: 'a'
Tax revenues are diverse, although the largest tax revenue source, personal income tax (PIT), is subject to considerable cyclicality. Sales, corporate income, transportation and gaming taxes serve to diversify the tax base. Baseline growth of taxes has been marginal, requiring tax policy changes

to boost revenues, and modest future economic growth will continue to constrain resources. The state has unlimited legal ability to levy taxes.

Expenditure Framework: 'aa'
Connecticut's natural pace of spending growth is expected to be higher than that of revenues given projections for weak growth in revenues. The state has consistently demonstrated the ability to cover its comparatively high fixed costs, including making full actuarial contributions to pensions, and benefits from the large degree of budget autonomy common to states.

Long-Term Liability Burden: 'a'
The state's long-term liability burden is elevated and among the highest for a U.S. state but still considered moderate. Net tax-supported debt consists primarily of GO and transportation borrowings, with much of GO borrowing undertaken on behalf of local schools. Unfunded pensions are more significant, with recent reforms providing budgetary savings but raising the unfunded liability.

Operating Performance: 'a'
Gap-closing capacity remains strong but its robustness has been reduced by the state's modest economic growth during the current national economic expansion and the resulting repeated need for gap-closing actions. Resiliency improves at the close of fiscal 2018 with the expected deposit of windfall revenue to the budget reserve fund (BRF), despite an appropriation to cure a sizable forecast operating deficit. However, the state is expected to remain challenged by future cyclical budgetary pressures, while out-year budget gaps remain an issue to be addressed. Frequent revenue re-forecasting allows the state to identify revenue underperformance and quickly implement corrective actions.

RATING SENSITIVITIES

MAINTAINING FISCAL RESILIENCE: Connecticut's IDR is sensitive to the state's ability to rebalance financial operations to current economic and revenue growth expectations in a manner consistent with the current rating level.

CREDIT PROFILE

Connecticut has a diverse, mature and wealthy economic base, with flat to modestly declining population trends and an aging demographic profile. In contrast to past economic expansions, the state's performance in the current expansion has been unusually slow and uncertain. The state projects positive medium-term economic growth but at rates below the nation's.

Employment gains through much of the recovery have been well below national averages and slower than past recoveries; through April 2018, the state regained about 80% of jobs lost in the Great Recession compared to a national average of 215%. Rates of recovery have also varied across the state's larger metropolitan regions, ranging from robust gains in the New Haven region to only modest gains in areas like Waterbury. The finance sector, with important banking and investment activity in the southwestern part of the state and insurance activity in Hartford, saw sizable employment losses through the recession and well into the recovery. These areas have now almost fully recovered employment lost in the recession.

The state's large and sophisticated manufacturing sector has seen relatively flat employment since steep recessionary losses ended, although important defense-related manufacturing anchors the sector and may bring future gains. Tourism has grown in importance over time, but prospects for the state's gaming resorts are more uncertain given rising competition in neighboring states. The opening of a state-approved third tribal casino, which could stem revenue losses to venues outside the state, has been subject to delays. The state's unemployment rate has historically run below the

U.S. rate, but has exceeded the nation since 2012. Personal income per capita ranks highest among the states, at 139% of the national level, and aggregate personal income growth continues, albeit at rates below the nation.

Revenue Framework

Tax revenues for general fund needs are diverse, with PIT, corporate income and sales taxes serving as the primary tax sources. PIT receipts, particularly those derived from non-withholding, are particularly important but their volatility has had a negative impact on the state's financial position. The separate transportation fund receives a range of transportation-related receipts as well as resources from the general fund.

Historical growth in the state's revenues, after adjusting for the estimated impact of tax policy changes, has been well below the pace of national GDP growth, and below inflation, due to contractions in the important financial services sector as well as the maturity of the state's economy. As of the state's April 2018 consensus revenue estimate (CRE), expected $18 billion in revenue for fiscal 2018 was 3.8% shy of the forecast used to enact the budget. The CRE forecast incorporates significant revenue from a one-time repatriation of overseas hedge fund profits, a direct effect of Section 457A of the Internal Revenue Code passed in 2008, which pushed the estimates and finals component of the PIT over the state's volatility cap and triggered a transfer to the BRF.

The revenue forecast used to support the fiscal 2019 budget was slightly boosted in the April CRE, net of a required deposit to the BRF, due to the expectation of a now-adjusted volatility cap again being triggered. Estimated $19 billion in revenue in fiscal 2019 is forecast to drop by a sharp 8% in fiscal 2020 based on current law, as nonrecurring revenue actions fall off and the hospital tax is automatically reduced; these current law measures could be reversed by future legislatures in order to maintain general fund revenues at the higher level.

The state has unlimited legal ability to raise tax revenues. Tax rate competitiveness is more of a factor in Connecticut than in some other states due to the nature of its taxpayer base, its relatively small size, and its proximity to neighboring states' urban employment centers. Passage of the federal Tax Cut and Jobs Act (TCJA) heightens this concern, as the deduction for state and local taxes was limited in the Act, increasing residents' effective tax burden. As part of the fiscal 2019 budget discussions, the state enacted legislation intended to mitigate the expected negative effects of TCJA on state taxpayers. Approved legislation creates a revenue-neutral tax on pass-through entities, offset by a personal income tax credit, and authorizes municipalities to create charitable organizations in support of town services accompanied by a local property tax credit.

Transportation revenues, while statutorily dedicated for transportation needs, have been subject in the past to frequent diversion for general operations. To more quickly address identified transportation capital needs, the fiscal 2019 revised budget accelerates the deposit of motor vehicle sales taxes to the special transportation fund from the general fund. A measure on the November 2018 ballot would amend the state constitution to restrict the state transportation fund solely to transportation purposes.

Expenditure Framework

As with many smaller states, Connecticut's scope of spending is very broad, with the state responsible for delivering or funding numerous services normally handled at the local level. Formula funding for local schools and subsidies for higher education highlight the state's role in education, which extends as well to making teacher pension contributions and funding school capital. Municipal aid is also significant, although previous sharing of sales tax revenue was suspended in the enacted budget for the current biennium. Municipal aid in the current budget is instead funded through a number of targeted grants coming directly from the general fund, including to the financially troubled city of Hartford.

Fitch expects that spending growth, absent policy actions, will be ahead of comparatively weak natural revenue growth, and require regular budget adjustments to ensure ongoing balance.

The state retains solid ability to cut spending despite successive budgetary adjustments during the current and last biennia. Statute requires swift response in the event of forecast underperformance, either through rescissions, allotment cuts, or with legislative concurrence, depending on the size of the projected deficit.

The state partly addressed a forecast $5 billion (15% of 2018-2019 baseline revenue) forecast budget gap for the current biennium with savings from a renegotiated contract with the state's employee bargaining agent coalition (SEBAC), providing one of the largest recurring actions. The renegotiated contract included three years of wage freezes followed by two years of increases, healthcare plan revisions, increased state employee retirement system (SERS) pension contributions from employees, a revised cost of living formula for retirees, and a new hybrid defined benefit/defined contribution retirement tier for all new SERS employees. Savings of about $700 million began in fiscal 2018 and are expected to escalate over time.

While achieving significant savings, the agreement somewhat reduced the state's operating flexibility, as it extended the length of the existing SEBAC agreement for pension and healthcare benefits from fiscal 2022 to fiscal 2027 and provided layoff protection through June 30, 2021 for existing employees. The wage agreement remains in effect through fiscal 2021. As a result, Fitch believes that absent new revenue initiatives through fiscal 2021, actions to address an unforeseen economic or financial downturn could be limited to programmatic reductions or shifts in municipal aid.

The state's relatively high carrying costs of over 20% in fiscal 2017 continue to constrain policy options. The metric includes debt service for GO bonds issued for school construction, past deficit borrowing, and conversion to GAAP budgeting, as well as full actuarial contributions toward paying down the state's unfunded pensions. While not included in the enacted budget, the governor's proposal for municipal contributions toward the employer share of teachers' pension costs points to one potential area for future offset to carrying costs. Expected positive impact on the carrying cost metric in future years from pension and employee and retiree health care savings provided in the SEBAC agreement was partly offset by the state's new commitment to match the 3% employee contribution to the state's OPEB trust fund; this contribution totals $120 million in fiscal 2018.

Spending for Medicaid remains a key fiscal challenge for Connecticut, one that 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. In other major areas of spending such as education, the state is able to more easily adjust the trajectory of growth. 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 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 increased liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Long-Term Liability Burden

Connecticut's long-term liability burden for debt and pensions, adjusted to a 6% return assumption on pensions, is amongst the highest for a U.S. state at 27% of 2016 personal income as of Fitch's December 2017 State Pension Update. Incorporating the state's fiscal 2017 annual financial report (CAFR), 2017 personal income and the recent agreement with the city of Hartford in which the state has assumed the obligation for annual city debt service payments, the adjusted liability increases to 29%. The state's fiscal 2017 CAFR incorporated multiple pension liability assumption changes and the revised SEBAC agreement and resulted in a large, although expected, boost in the net pension liability. The liability burden remains an elevated but still moderate burden on resources and the state continues to contribute full actuarial contributions to its pensions.

Net tax-supported debt alone totals $25 billion, or almost 10% of 2017 personal income. Over 70% of net tax-supported debt is GO, a large share of which has been issued for local school capital needs. GO borrowing includes $2.3 billion in pension bonds issued in 2008 to improve the funded ratio of the teachers retirement system (TRS). Debt attributable to the state now includes almost $550 million of general obligation bonds issued by Hartford, supported by the state's full faith and credit pledge, as part of the contract assistance agreement between the state and the city.

Both of the state's two major pension systems, covering SERS and the TRS, have relatively low funded ratios driven by weak contribution practices in the past. Both plans have now received full annual actuarial determined contributions for many years, the TRS under a covenant linked to the GO pension bonds. A December 2016 memorandum of understanding for SERS shifted to the more conservative entry-age cost method for calculating contributions, extended the state's closed amortization period, and lowered the return assumption to 6.9%. These actions, which produced budgetary savings, resulted in raising the liability to reflect a far more realistic return assumption while lowering the risk that future investment loss could lead to a spike in contributions. The governor has recommended similar modifications for TRS which the legislature has declined to take up. The GO pension bonds issued in 2008 may preclude extensive changes to TRS funding practices while outstanding.

The 2017 SEBAC agreement increased employee pension contributions for all existing SERS members, revised the COLA formula and timing for post-2022 SERS retirees, and created a new hybrid defined benefit/defined contribution retirement tier for all new SERS employees. In conjunction with agreed-to wage freezes, the modifications provided for modest improvement in SERS's funded ratio. The agreement also provided significant savings through revisions to the healthcare plan design and premium cost-sharing arrangement for current employees. The state's healthcare actuary estimates a reduction in the OPEB liability from $20.9 billion projected as of June 30, 2017 to $17.4 billion as a result of the agreement.

Operating Performance

Fitch views Connecticut as having still strong gap-closing capacity, but this capacity has been reduced in recent biennia due to the state's comparatively weak economic and revenue performance. Expenditure and revenue actions, particularly expenditure cuts, have been the state's primary sources of financial resilience given limited reserve funding since the Great Recession, although the balance in the BRF is expected to be boosted by a net $556 million deposit in fiscal 2018. The deposit, related to the one-time repatriation of hedge fund managers' overseas profits in 2017, is after use of $718 million for the expected operating deficit (4% of revenues) in fiscal 2018. With the deposit, the BRF will be boosted to a more substantial 4.3% of fiscal 2018 net revenues from 1.2% in fiscal 2017, and is projected to rise further in fiscal 2019.

The fiscal 2018 deposit is required under a volatility cap included in the 2018-2019 enacted budget that directs all revenue from estimated and final PIT payments in excess of $3.15 billion to the BRF. If the BRF reaches a balance of 15% of net general fund appropriations, no additional deposits are required. The legislature subsequently modified the volatility cap requirements, subjecting the $3.15 billion threshold to annual adjustment by a formula of compound annual growth in personal income over the prior five-year period. This change has the effect of annually increasing the threshold that mandates deposits to the BRF. The threshold amount may also be modified by a three-fifths majority of the General Assembly in response to changes in state or federal tax law or significant adjustments to economic growth or tax collections.

The BRF may be drawn upon to cure a prior fiscal year deficit or if estimated general fund revenues decline by 1% or more from the forecast used to enact the budget. Future legislation can also assign surplus balances to other uses. These powers permit the state's expected use of the BRF as part of its actions to close the identified budget gap in fiscal 2018 and follows draws on the BRF balance to close ending deficits of $113 million in fiscal 2015, $170 million in fiscal 2016, and $23 million in fiscal 2017. The $213 million fiscal 2017 BRF balance was well below the nearly $1.4 billion peak in fiscal 2009.

Recent budgetary challenges have been driven by revenue underperformance, particularly in the non-withholding component of PIT collections. The state took extensive administrative and legislative actions first to narrow forecast gaps before relying on reserves. Fitch believes tax rate increases adopted in recent biennial budgets, together with the passage of the TCJA, could make future revenue initiatives more challenging. Financial resilience is supported by multiple revenue monitoring mechanisms, including consensus forecasting, and disciplined mechanisms to respond to identified budgetary weakness.

Despite the challenges posed by its slow recovery from the Great Recession, the state's fiscal management has generally improved in recent biennia, with a greater reliance on structural solutions and continued full actuarial pension contributions. Fitch also recognizes the intent of the state to bolster balances in the BRF and remove some of the cyclicality of PIT collections from the general fund. Nonetheless, expirations on taxes, the restoration of sales tax municipal revenue sharing and the continued deferral of contractually agreed-upon appropriations to correct a longstanding GAAP deficit will weigh on the state in future years. Appropriations to amortize the GAAP deficit were pledged in a 2014 bond issue whereby the state covenanted to amortize this deficit, now at $680 million, by fiscal 2028.

Current Financial Operations

While the significantly delayed budget for the current biennium was largely enacted with recurring actions on the part of the state, budget gaps for both fiscal years 2018 and 2019 remained. The state has drawn on windfall, one-time tax revenue related to the repatriation of foreign income in addition to other policy actions to close the fiscal 2018 gap. Expenditure restraint and the anticipated receipt of delayed federal grants related to hospital reimbursements and Medicaid is expected to provide balance in fiscal 2019.

The enacted 2018-2019 general fund biennial budget provided for $18.7 billion in appropriations for fiscal 2018 and $18.8 billion for fiscal 2019. The fiscal 2018 budget funded growth of 5.4% from fiscal 2017. The state's April 2018 CRE and May revised budget plan continue to anticipate lower revenues from most state tax sources, excluding the PIT, and the delayed receipt of $622 million in federal grants related to hospital supplemental payments and Medicaid. The revised budget plan eliminated the shortfall by appropriating part of the $1.29 billion that would otherwise be deposited to the BRF. The revised budget plan also provided for the carry forward of fiscal 2018 appropriations into fiscal 2019, largely related to the delayed federal grants for hospital payments and Medicaid that are expected to be received in fiscal 2019. Revenues in fiscal 2019 are modestly boosted to $19 billion and provide support for almost $19 billion in expenditures.

Nonrecurring actions in the enacted budget combined with current law provisions that automatically reduce certain tax revenues after this biennium contribute to the state's projection for out-year general fund budget gaps in fiscal years 2020 through 2023 of $2 billion, $2.6 billion, $3.2 billion and $3.7 billion, respectively, even assuming continued revenue growth. While noting that some of the automatic actions embedded in current law may prove less controversial to adjust, Fitch believes the state will find it challenging to provide solutions to these gaps.

Related Ratings

Fitch has affirmed the following ratings that are supported by state appropriations as follows:

--University of Connecticut state debt service commitment bonds, subject to annual appropriation, at 'A';
--Connecticut Higher Education Supplemental Loan Authority state supported revenue bonds payable from special capital reserve funds, subject to annual appropriation, at 'A';
--Capital City Economic Development Authority appropriation-backed parking and energy fee revenue bonds, series 2004B and 2008D at 'A';
--Connecticut Development Authority and Connecticut Innovations appropriation-backed general fund obligation bonds, series 2004A, 2006A and 2014A at 'A';
--Connecticut Development Authority appropriation-backed general obligation bonds, series 2004B, at 'A-'.

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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. 03 Apr 2018)
https://www.fitchratings.com/site/re/10024656