FITCH AFFIRMS VERMONT'S GOS AND IDR AT 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-16 December 2016: Fitch Ratings has affirmed the following State of Vermont ratings:

--State of Vermont (VT) general obligation (GO) bonds at 'AAA';
--Issuer Default Rating (IDR) at 'AAA'.

The Rating Outlook is Stable.

SECURITY

GO bonds have a pledge of the state of Vermont's full faith and credit.

KEY RATING DRIVERS

Vermont's 'AAA' Issuer Default Rating (IDR) primarily reflects conservative financial management, including prompt action to address projected budget gaps as they emerge, and maintenance of sound reserves. Vermont's economic growth has been steady but below national rates. Long-term liabilities, measured as a percentage of personal income, are above the states' median, but remain low.

Economic Resource Base
Vermont's small and modestly growing economy has a larger-than-average reliance on health and educational services, manufacturing, and tourism and remains exposed to several key large employers. During the recession, Vermont's peak-to-trough monthly employment loss of 4.8% (seasonally adjusted levels) was less severe than the national 6.3% decline. The state's jobs recovery has been on par with the national trend. Vermont's population is older than most states' and domestic out-migration continues to pose a challenge. The state's labor force has been flat to declining over the past decade, in contrast to slow growth at the national level. As with several other New England states, high educational attainment levels provide some potential for more accelerated economic development, but the state has not fully benefited from that potential to date.

Revenue Framework: 'aaa' factor assessment
Fitch anticipates Vermont's revenues used for direct state operations will grow at a moderate pace, reflecting our expectations for the state's economy. Property taxes represent the largest component of state revenues and have grown at a robust rate, but these revenues do not drive the state's overall revenue framework. Property tax revenues are essentially passed through to school districts, rather than used for state operations, and are adjusted annually based on multiple factors include decisions of voters in local school districts. The state has complete legal control over its revenues.

Expenditure Framework: 'aaa' factor assessment
The state maintains ample expenditure flexibility with a low burden of carrying costs for liabilities and the broad expense-cutting ability common to most U.S. states. Vermont has been particularly focused on addressing healthcare spending, including Medicaid which is a key expense driver.

Long-Term Liability Burden: 'aaa' factor assessment
Vermont's long-term liabilities burden is low, but above the median for U.S. states. Close debt management and a commitment to full pension funding should keep the burden stable.

Operating Performance: 'aaa' factor assessment
Fitch anticipates Vermont would utilize its broad gap-closing capacity to manage through economic downturns while maintaining a high level of fundamental financial flexibility. The state has taken steps during the expansion to expand its flexibility and position itself well for the next downturn.

RATING SENSITIVITIES

FUNDAMENTAL CHARACTERISTICS: The rating is sensitive to changes in the state's fundamental credit characteristics. Weakened fiscal discipline or material deterioration in economic growth prospects could negatively affect the rating.

CREDIT PROFILE

Revenue Framework
The state's revenues used for direct state operations consist primarily of personal and corporate income taxes, sales and use taxes, and a meals and rooms tax meant to export a share of the tax burden to visiting tourists. The state also levies a state property tax for education, an unusual feature for state governments, which is the largest source of total state revenues. Since Vermont essentially passes through property tax collections to local school districts, Fitch discounts the importance of this stream in the revenue framework assessment. There are no legal limitations on the state's ability to raise revenues.

Fitch anticipates growth in Vermont's revenues used for direct state operations will be moderate, ahead of inflation but below national economic growth. Vermont's total tax revenue growth, adjusted for policy changes, has been robust over the past decade when property taxes are included. General fund revenue growth (primarily sales and income) has been moderate and consistent with the state's moderate-growth economy. State property tax revenue growth has been stronger and is linked to the spending authorized by each local school district and not directly related to the state's direct spending needs.

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

Expenditure Framework
Education is the state's largest expenditure from own source revenues, driven by the unique funding system in Vermont with the state covering the full cost for locally administered K-12 schools primarily through the property tax, a general fund appropriation, and a share of the sales and use tax. Health and human services, primarily Medicaid, is the second largest expenditure area.

Spending growth, absent policy actions, will likely be slightly ahead of revenue growth, driven primarily by Medicaid, requiring regular budget measures 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 likely, although the magnitude and timing of changes for state budgets remains unknown. Both the incoming Presidential administration and Congressional leadership support significant Medicaid policy shifts. As one of the largest parts of state budgets and by far the biggest source of federal funding to the states, federal decisions could have significant implications for states' ability to manage this key budget item.

For education, state spending growth pressure is somewhat offset by the funding structure as school districts' property tax rates (collected by the state) increase when voter-approved school district budgets increase. Revenue growth does not fully mitigate spending increases through, exposing the state to a level of ongoing expenditure growth as reflected in the steadily growing annual state general fund appropriation to the education fund.

Vermont's fixed carrying cost burden is low and Fitch anticipates it remaining stable given the state's long history of full actuarial contributions to its pension systems and careful management of debt issuance. Overall, the state retains ample flexibility to adjust main expenditure items.

Long-Term Liability Burden
Vermont's combined burden of debt and unfunded pension liabilities of 8.5% of personal income is above the 50-states' median of 5.1% (both per Fitch's November 2016 State Pension Update report), but still a low long-term pressure. Debt levels of 2.2% are just below the states' median of 2.4% and closely monitored through the state's Capital Debt Affordability Advisory Committee (CDAAC). The governor and legislature consistently stay within CDAAC's recommendations for annual bond issuance.

Unfunded pension liabilities are more significant. The pension liability calculations include essentially 100% of the liability in the Vermont State Retirement System and the State Teachers' Retirement System, for which the state makes the full contribution. Market losses during the last two recessions contributed to recent growth in unfunded liabilities for both systems. Since the Great Recession the state has negotiated with employee groups and implemented multiple changes including to benefits, contributions, and actuarial methods. Given a demonstrated commitment to full actuarial funding and carefully monitored debt levels, Fitch anticipates Vermont's long-term liability burden will remain consistent with a 'aaa' assessment.

Operating Performance
Vermont's exceptionally strong gap-closing capacity derives from institutional and statutory mechanisms, and a demonstrated ability to prudently manage through economic downturns. The state maintains multiple budget reserves including fully-funded budget stabilization reserves (5% of revenues) in each of its three primary operating funds (general, education and transportation), and separate fund specific reserves or unreserved balances of lesser amounts. Official revenue forecasts are updated at minimum biannually through the Emergency Board, a consensus process involving the administration and legislature.

The governor can implement a spending reduction plan unilaterally (if a revenue forecast downgrades revenues less than one percent from the prior forecast) or with legislative cooperation. During the Great Recession, and again in a more recent shortfall, the governor, legislature, and other key stakeholders including employee unions, worked quickly and cooperatively to develop spending rescission plans to address emerging deficits. The state's recent trend has been to focus on expenditure cuts, such as negotiated wage reductions or programmatic cuts, rather than revenue increases.

Vermont's revenue sensitivity calculated using the Fitch Analytical Sensitivity Tool (FAST) is among the lowest for states, but somewhat understated in Fitch's view because of the school funding and property tax system in the state. The state collects property tax revenues and essentially passes them through to local school districts with only indirect effect on the state's fundamental fiscal flexibility. Primary operating revenues for state functions are historically more volatile and typical of other state governments, as indicated by the fiscal stress experienced during the last recession. The 50-states median year one revenue decline in a moderate economic downturn is 3.1%.

Through the economic expansion Vermont has maintained its primary budget reserves, even through a temporary revenue shortfall in fiscal 2015. Recently the state has taken steps to build in additional fiscal capacity through additional reserves including the general fund balance reserve and a 27/53 reserve that will set aside funds for the infrequent years with a 27th biweekly payroll or 53rd weekly Medicaid payment cycle.

The state's budgeting practices tend to be conservative in forecasting and proactive through the year, with most years ending with a general fund budget surplus despite the lack of a statutory or constitutional balanced budget requirement. Vermont's new governor takes office in January and Fitch anticipates a continued focus on fiscal prudence as demonstrated through prior gubernatorial transitions.

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

Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
https://www.fitchratings.com/site/re/879478