# State of Vermont

## New Issue Report

### Ratings

| | |
|---|---|
| Long Term Issuer Default Rating[a] | AA+ |

### New Issues

| | |
|---|---|
| $84,000,000 General Obligation Bonds (Competitive), Series 2019A | AA+ |
| $41,000,000 General Obligation Refunding Vermont Citizen Bonds (Negotiated), Series 2019B | AA+ |

### Outstanding Debt

| | |
|---|---|
| General Obligation Bonds[b] | AA+ |

[a]Downgraded from 'AAA' on July 10, 2019.
[b]Downgraded from 'AAA' on July 10, 2019.

### Rating Outlook

Stable

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## New Issue Summary

**Sale Date:** Week of July 22, 2019.

**Series:** $84 million State of Vermont General Obligation (GO) Bonds (Competitive), Series 2019A, and $41 million GO Refunding Bonds, Series 2019B (Vermont Citizen Bonds) (Negotiated).

**Purpose:** To fund various capital projects and refund certain outstanding GO bonds.

**Security:** General obligations of the state of Vermont backed by its full faith and credit.

## Analytical Conclusion

The downgrade of Vermont's Issuer Default Rating (IDR) and GO rating to 'AA+' from 'AAA' reflects Fitch Ratings' lowered assessment of the state's revenue framework; in particular, it reflects an expectation of slower growth prospects. Fitch considers Vermont's growth prospects to be more consistent with most of its New England peers, which generally face similar economic and demographic headwinds.

The 'AA+' IDR and GO rating also reflect conservative financial management, including prompt action to address projected budget gaps as they emerge and maintenance of sound reserves. The moderate long-term liability burden, measured as a percentage of personal income, is above the states' median but should remain relatively stable given Vermont's close oversight and management of debt issuance and policy changes to improve pension sustainability over time.

**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 Great Recession, Vermont's peak-to-trough monthly employment loss of 4.8% (seasonally adjusted) was less severe than the national 6.3% decline. But the state's jobs recovery has trailed the national trend.

Vermont's population is older than most states and growth has been relatively limited. 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 economic gains, but Vermont has not fully benefited from that potential to date.

## Key Rating Drivers

**Revenue Framework: 'aa'**
Fitch anticipates Vermont's revenues used for state operations will grow at a modest pace, consistent with 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 and are adjusted annually based on multiple factors including decisions of voters in those school districts. The state has complete legal control over its revenues.

## Rating History (IDR/GO)

| Rating | Action | Outlook/ Watch | Date |
|---|---|---|---|
| AA+ | Downgraded | Stable | 7/10/19 |
| AAA | Revised | Stable | 4/05/10 |
| AA+ | Affirmed | Stable | 4/13/06 |
| AA+ | Upgraded | — | 10/25/99 |
| AA | Assigned | — | 8/18/92 |

**Expenditure Framework: 'aaa'**

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: 'aa'**

Vermont's long-term liability burden is moderate and above the median for U.S. states.

**Operating Performance: 'aaa'**

Fitch anticipates Vermont will 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

**Fiscal Management:** Vermont's IDR is sensitive to the state's demonstrated commitment to improving its fiscal resilience and carefully managing its long-term liability burden, particularly in the context of modest revenue growth expectations.

**Economic Growth:** The IDR is also sensitive to changes in the state's fundamental economic growth trajectory. Material and sustained improvement in the state's demographic profile, such as through consistent population and labor force gains, could support stronger revenue growth prospects and a more robust revenue framework assessment.

## Credit Profile

Vermont's population has been largely unchanged since the turn of the century, falling off the national trend of slow and steady growth. From 2012 until 2017, the state had actually been in a slight decline. But over the past two years, population and labor force declines leveled off. While the state's unemployment rate is the lowest in New England and amongst the lowest nationally, labor force weakness has been the primary factor contributing to this. Vermont's government remains focused on addressing its demographic challenges with multiple policy efforts to enhance the state's attractiveness for new residents and businesses, including a grant program for remote workers relocating to Vermont. These efforts, along with economic improvement in the state, may have played a role in fostering the recent stabilization.

However, given Vermont's small population of 626,299 as of July 2018 (second lowest amongst the states), even minor shifts in migration trends could again lead to population and workforce declines. Fitch considers the state's economic growth trajectory modest and in the middle relative to its New England peers.

### 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. Vermont also levies a state property tax for education — an unusual feature for state governments — that 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 limited growth in Vermont's revenues, relatively in line with inflation, given the state's modest economic growth prospects. Vermont's historical total tax revenue growth,

### Related Research

Fitch Downgrades Vermont's IDR to 'AA+'; Rates $125MM GOS 'AA+'; Outlook Stable (July 2019)

U.S. States and the Growth Implications of an Aging Population (October 2018)

A Visualization of Demographic Strength & Stability Trends (July 2018)

### Related Criteria

U.S. Public Finance Tax-Supported Rating Criteria (April 2018) adjusted for policy changes, has been slightly negative on a real basis over the past decade, which includes an extended multi-year decline during the Great Recession. Recent Fitch analyses of states' economic trends and likely trajectories ("A Visualization of Demographic Strength and Stability Trends," dated July 2018, and "U.S. States and the Growth Implications of an Aging Population," dated October 2018) illustrate some of the state's ongoing and anticipated constraints on economic and revenue growth.

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 Vermont's largest expenditure from own-source revenues, driven by its unique funding system, with the state covering the full cost for locally administered K-12 schools primarily through the property tax, as well as the sales and use tax. Health and human services, primarily due to 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 less likely in the near term given divided control in Congress.

Vermont has been particularly aggressive in addressing the long-term national trend of steadily rising healthcare costs (including Medicaid), with the most recent effort being a shift toward outcome-based care under an "all-payer" system, rather than the traditional fee-for-service model. Under terms of agreements with the federal government for the all-payer system, Vermont is transitioning Medicare and Medicaid to an outcome-based accountable care organization model, with the goal of getting participation from private insurers and providers as well over the program's initial five-year period. The state began an initial all-payer pilot program with Medicaid patients in January 2017.

#### *Medicaid Spending Leveling Out*

Healthcare spending in recent years has leveled off, with the state reporting that actual expenditures for the Agency for Human Services (AHS, responsible for Medicaid in the state), and acute care spending specifically, have been seeing either declines or essentially no growth since fiscal 2016. The state also reports that Medicaid enrollment declined sharply in this period (by 21% between fiscal years 2016 and 2019), a trend seen by many other states as well given the ongoing economic expansion and a key factor in slower Medicaid spending growth. Between fiscal years 2003 and 2016, AHS spending increased at nearly 6% annually. Vermont's change in spending trajectory has been particularly sharp, even relative to other states seeing enrollment declines, which may reflect benefits of the policy efforts such as the all-payer model.

#### *Education Funding Changes*

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

In 2018, the legislature revised funding mechanisms and replaced the general fund appropriations with full dedication of the state's sales and use tax and a portion of the meals and rooms tax to the education fund, and away from the general fund, beginning in fiscal 2019.

#### *Lake Champlain Cleanup Costs*

Following a June 2016 agreement between the EPA and the state to address pollution issues in Lake Champlain, Vermont's legislature enacted legislation (S.96) this year in an effort to address a federal requirement to establish an ongoing source of funding for cleanup efforts. S. 96 dedicates 6% of the meals and room tax (MRT) collections to a clean water fund, which, in combination with other allocated revenues, the state estimates will have $50 million available in fiscal 2020. The EPA is reviewing the legislation and will make a final determination on whether it addresses the requirement.

The MRT allocation to the clean water fund modestly reduces the share for the general fund; in fiscal 2020 the shift will cost $7.5 million and will grow to an estimated $10 million to $11 million in fiscal 2021. These amounts are very small relative to estimated general fund tax revenues that exceed $1.2 billion in both years, but they will require offsetting growth from existing general fund revenues, enactment of new revenue sources, or matching expenditure cuts. For fiscal 2020, the state anticipates recent upticks in general fund revenue performance discussed further below will cover the $7.5 million allocation.

Vermont's fixed carrying cost burden is low and Fitch anticipates it will remain stable given the state's commitment to at least full actuarial contributions to its pension systems and careful management of debt issuance. The state has regularly contributed in excess of actuarially determined amounts for pensions in an effort to manage and reduce the net pension liabilities. Overall, the state retains ample flexibility to adjust main expenditure items.

### Long-Term Liability Burden

On a combined basis, Vermont's debt and net pension liabilities as of Fitch's “2018 State Pension Update," dated November 2018, totaled 11.9% of 2017 personal income, compared with a statewide median of 6.0%. Based on the most recently available data, Fitch calculates a long-term liability burden of 11.5%. This ratio includes special obligation transportation infrastructure bonds (TIBs) supported by a dedicated share of Vermont's gasoline and diesel taxes. Vermont considers the TIBs as self-supporting from the dedicated tax revenues as part of its legal and policy calculations for tax-supported debt.

Debt levels remain modest at just 2% and are 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.

Net pension liabilities are more significant, with Fitch-adjusted net pension liabilities representing approximately 10% of personal income. 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 actuarial contribution. Market losses during the last two recessions contributed to recent growth in net liabilities for both systems.

Since the Great Recession, the state has negotiated with employee groups and implemented multiple changes to benefits, contributions, and actuarial methods to improve pension sustainability over time. Given recent shifts to somewhat more conservative actuarial assumptions, including a decrease in the investment return assumption from 7.95% to 7.5%, Fitch anticipates Vermont's long-term liability burden will remain consistent with a 'aa' assessment over the long term.

OPEB liabilities are also significant, with the reported 2018 net OPEB liability equal to approximately 7% of the state's personal income. The state has taken some modest steps toward pre-funding OPEB liabilities and has also made some progress in reducing liabilities through collective bargaining with unions, both of which are positives. The state has also benefitted from recent favorable health care claims experience.

### 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. For details, see Scenario Analysis, page 7.

The state's budgeting practices tend to be conservative in forecasting and proactive through the fiscal year, with most fiscal years ending with at least a modest general fund budget surplus despite the lack of a statutory or constitutional balanced budget requirement. Through the economic expansion, Vermont has maintained its primary budget reserves. Recently, the state has taken steps to build in additional fiscal capacity through additional reserves, including the general fund balance reserve (established in 2012 to replace the revenue shortfall reserve), a human services caseload reserve (established in 2017 and primarily for Medicaid), and a 27/53 reserve (established in 2016 to address years with a 27th biweekly payroll or a 53rd week of Medicaid disbursements).

#### *Current Developments*

Based on the January 2019 emergency board forecast and mid-year budget adjustments under the 2019 Budget Adjustment Act (BAA), Vermont projects a sizable increase to general fund reserves for the year that just ended on June 30. Under this current law scenario, the state estimates total general fund reserves will increase to approximately $209 million, or 13% of total general fund uses as of June 30, 2019. Education fund reserves are on track to remain stable while combined general and education fund reserves are projected to total roughly $278 million, or 9% of total general and education fund uses.

These projected general fund reserve gains largely reflect transfers of funds from the Global Commitment Waiver fund, totaling nearly $80 million at the end of fiscal 2018, to the general fund in fiscal 2019. The funds will be reserved in the general fund's human services caseload reserve and 27/53 reserve, both related to Medicaid, which the global commitment waiver fund was also intended to support. Excluding those specific reserves, the current law forecast indicates the broader general fund budget stabilization and general fund balance reserves will remain relatively stable at $94 million, or 6% of total general fund uses as of June 30, 2019.

Robust revenue performance in the second half of fiscal 2019 has improved the revenue outlook and the administration now estimates a roughly $50 million general fund surplus will result in a $15 million contribution to the general fund balance reserve, leading to a combined budget stabilization and balance reserve total of $109 million, or 7% of total general fund uses.

General fund revenue for fiscal 2019 is tracking ahead of the January 2019 estimate by approximately $50 million, or 4%, through May, and 6% up over the prior year. These estimates adjust both years for the full allocation of the sales and use tax (SUT) to the education fund as of fiscal 2019. Personal income tax (PIT) and corporate income tax (CIT) have been particularly strong, up $43 million and $11 million, respectively, from forecast, and 5% and 43%, respectively, from the prior year. PIT also increased sharply in fiscal 2018 by 10% over 2017.

In developing its revenue forecasts, the emergency board noted that, as in many other states, effects of the December 2017 federal tax changes (commonly referred to as the Tax Cuts and Jobs Act, or TCJA) heavily influenced PIT and CIT collections in 2018 and 2019. The next emergency board forecast due by the end of July will assess what portion of the 2019 PIT and CIT increases are sustainable and recurring. While economic performance in the state remains positive, Fitch anticipates the bulk of the above-forecast PIT and CIT revenue performance in fiscal 2019 was one-time or otherwise short-lived. SUT collections, now captured solely in the education fund, are up just under 4% for the year through May, essentially in line with the January 2019 forecast, implying economic growth has been largely within expectations.

In addition to the anticipated $15 million contribution to the general fund balance reserve, the state anticipates allocating approximately $9.4 million of the estimated fiscal 2019 surplus as carry-forward resources for fiscal 2020 and $25 million to the state employees OPEB trust fund. In fiscal 2019, the state used a portion of the surplus revenue to help fully retire an interfund loan to the teachers OPEB trust fund ahead of schedule and set the state up for pre-funding in future years.

### *Fiscal 2020 Budget Overview*

Vermont enacted its fiscal 2020 budget in mid-June when the Governor signed H. 542 into law. The tone of budget negotiations differed considerably from last year. Last June, a dispute over the governor's push to use surplus revenues to keep state property tax rates flat versus legislators' push for competing priorities including paydown of teachers' pension system liabilities led to two gubernatorial vetoes, and just a day before the start of the new fiscal year, the governor allowed the legislature's budget to become effective without signing or vetoing it.

For fiscal 2020, the budget uses a portion of undesignated education fund reserves to limit state property tax rate increases while maintaining a modest $5 million cushion beyond the $38 million education fund budget stabilization reserve. The education fund-enacted budget also reflects a bill passed by the legislature to expand SUT provisions to online marketplace facilitators, building off last year's U.S. Supreme Court Wayfair decision, to generate an estimated $13.4 million in new revenue. The current estimate calls for robust nearly 7% growth in the SUT in fiscal 2020 based on the new law.

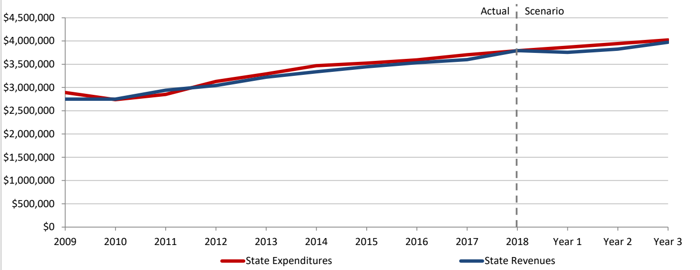
In the general fund, the enacted budget includes only modest tax code changes, including a medical expense deduction for the PIT ($2 million loss to the general fund) and a new limit on the capital gains exclusion ($2 million gain). As noted, to address Lake Champlain cleanup efforts, the budget also dedicates a modest portion of the meals and rooms tax (MRT, roughly $8 million) to the clean water fund, away from the general fund. The MRT diversion requires retaining a portion of the anticipated revenue surplus in fiscal 2019 into fiscal 2020 to backfill the re-allocated tax revenue. The dedicated portion of the MRT will grow to $10 million–$11 million annually in future years, according to the administration.

The enacted budget also permanently shifts recognition of nearly $300 million in state health care resources fund (SHCRF) revenues to the general fund. The change, first implemented in the fiscal 2019 BAA, is essentially an accounting change.

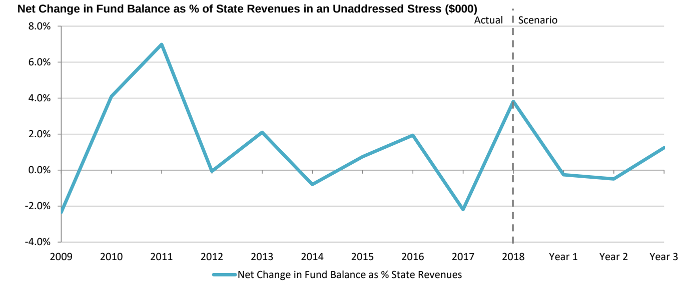
## Vermont, State of (VT)

**Scenario Analysis**

**State Revenues and Expenditures in an Unaddressed Stress ($000)**




**Net Change in Fund Balance as % of State Revenues in an Unaddressed Stress ($000)**




**Analyst Interpretation of Scenario Results:**

Vermont's revenue sensitivity calculated using the Fitch Analytical Stress Tool (FAST) of negative 0.2% is among the lowest for states. The 50-states median year one revenue decline in a moderate economic downturn is 3.3%. Fitch considers Vermont's metric to be somewhat understated because of the school funding and property tax system. The state records property tax collections as its own revenues and essentially passes them through to local school districts with only indirect effect on Vermont's fundamental fiscal flexibility. Primary operating revenues for state functions are historically more volatile than property taxes, and typical of other state governments, as indicated by the fiscal stress experienced during the last recession. Between fiscal 2008 and 2010, Vermont's general fund tax revenues declined 14%.

| 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) | (1.0%) | 1.8% | 3.9% |

| 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 | 4,318,873 | 4,666,695 | 4,860,504 | 5,017,124 | 5,157,410 | 5,408,365 | 5,611,911 | 5,614,127 | 5,695,460 | 5,787,926 | 5,903,685 | 6,021,759 | 6,142,194 |
| % Change in Total Expenditures | 4.1% | 8.1% | 4.2% | 3.2% | 2.8% | 4.9% | 3.8% | 0.0% | 1.4% | 1.6% | 2.0% | 2.0% | 2.0% |
| State Expenditures | 2,892,526 | 2,739,842 | 2,852,399 | 3,129,968 | 3,291,870 | 3,470,157 | 3,524,751 | 3,592,491 | 3,703,795 | 3,791,118 | 3,866,941 | 3,944,279 | 4,023,165 |
| % Change in State Expenditures | 2.2% | (5.3%) | 4.1% | 9.7% | 5.2% | 5.4% | 1.6% | 1.9% | 3.1% | 2.4% | 2.0% | 2.0% | 2.0% |
| **Revenues** | | | | | | | | | | | | | |
| Total Revenues | 4,175,754 | 4,677,762 | 4,949,512 | 4,929,587 | 5,088,868 | 5,276,849 | 5,532,771 | 5,554,187 | 5,589,659 | 5,790,446 | 5,792,446 | 5,902,285 | 6,091,473 |
| % Change in Total Revenues | 2.8% | 12.0% | 5.8% | (0.4%) | 3.2% | 3.7% | 4.8% | 0.4% | 0.6% | 3.6% | 0.0% | 1.9% | 3.2% |
| Federal Revenues | 1,426,347 | 1,926,853 | 2,008,105 | 1,887,156 | 1,865,540 | 1,938,208 | 2,087,160 | 2,021,636 | 1,991,665 | 1,996,808 | 2,036,744 | 2,077,479 | 2,119,029 |
| % Change in Federal Revenues | 8.2% | 35.1% | 4.2% | (6.0%) | (1.1%) | 3.9% | 7.7% | (3.1%) | (1.5%) | 0.3% | 2.0% | 2.0% | 2.0% |
| State Revenues | 2,749,407 | 2,750,909 | 2,941,407 | 3,042,431 | 3,223,328 | 3,338,641 | 3,445,611 | 3,532,550 | 3,597,994 | 3,793,638 | 3,755,701 | 3,824,806 | 3,972,444 |
| % Change in State Revenues | 0.2% | 0.1% | 6.9% | 3.4% | 5.9% | 3.6% | 3.2% | 2.5% | 1.9% | 5.4% | (1.0%) | 1.8% | 3.9% |
| **Excess of Revenues Over Expenditures** | (143,119) | 11,067 | 89,008 | (87,537) | (68,542) | (131,516) | (79,140) | (59,941) | (105,801) | 2,519 | (111,239) | (119,473) | (50,721) |
| **Total Other Financing Sources** | 78,438 | 101,450 | 116,561 | 85,505 | 136,216 | 104,926 | 104,723 | 128,397 | 26,941 | 142,304 | 101,458 | 100,765 | 99,973 |
| **Net Change in Fund Balance** | (64,681) | 112,517 | 205,569 | (2,032) | 67,674 | (26,590) | 25,583 | 68,456 | (78,859) | 144,823 | (9,781) | (18,709) | 49,252 |
| % Total Expenditures | (1.5%) | 2.4% | 4.2% | (0.0%) | 1.3% | (0.5%) | 0.5% | 1.2% | (1.4%) | 2.5% | (0.2%) | (0.3%) | 0.8% |
| % State Expenditures | (2.2%) | 4.1% | 7.2% | (0.1%) | 2.1% | (0.8%) | 0.7% | 1.9% | (2.1%) | 3.8% | (0.3%) | (0.5%) | 1.2% |
| % Total Revenues | (1.5%) | 2.4% | 4.2% | (0.0%) | 1.3% | (0.5%) | 0.5% | 1.2% | (1.4%) | 2.5% | (0.2%) | (0.3%) | 0.8% |
| % State Revenues | (2.4%) | 4.1% | 7.0% | (0.1%) | 2.1% | (0.8%) | 0.7% | 1.9% | (2.2%) | 3.8% | (0.3%) | (0.5%) | 1.2% |

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.