U.S. State Government Tax-Supported Rating Criteria

Sector-Specific Criteria

This report replaces the report of the same title published on Aug. 15, 2011 and fully incorporates and expands upon Fitch Ratings' tax-supported rating criteria, with a focus on U.S. state government debt.

Four Interactive Key Rating Factors: Fitch Ratings evaluates four major factors (debt, economy, finances, and management) to establish the credit quality of a U.S. state government bond. The rating process analyzes trends in these areas and seeks to identify actual and potential future obligations and exposures. The major rating factors are interactive. For example, while a state may have a vibrant and wealthy economy, weak fiscal management may offset positive credit factors. In turn, a weak economy may be offset by other strengths, such as proactive management or a very low debt burden. The emphasis on specific factors is influenced by the nature of the rated security, with the analysis of bonds backed by a specific revenue stream focusing more on economic drivers of that revenue and less on management and administrative factors.

Debt and Other Long-Term Liabilities: In evaluating debt and other long-term liabilities, Fitch seeks to determine the extent and nature of the issuer’s outstanding liabilities and evaluates the outlook for the future, with a focus on affordability and flexibility.

Economy: Fitch’s economic analysis considers the capacity of the issuer’s economic base to support balanced ongoing operations and repayment of debt and provides insight into potential future financial and debt resources or challenges.

Finances: Fitch’s analysis of finances is focused on the issuer’s financial resources and flexibility to support its obligations over the near and long terms.

Management and Administration: Management practices and actions can positively or negatively influence the other major credit factor. Fitch’s analysis of management encompasses both elected officials and appointed staff members.

Strong Legal and Institutional Framework: Fitch’s analysis of U.S. state governments incorporates the extraordinary autonomy that states possess in the U.S. government framework. U.S. states have substantial control over revenue-raising and spending. In addition, the states’ primary role is funding rather than providing services (primarily education and social services), allowing additional flexibility to control expenditures by downloading fiscal challenges to service providers. The majority of U.S. states are required to craft balanced budgets, and states cannot file under Chapter 9 of the U.S. Bankruptcy Code.

Very High Credit Quality: Fitch’s ratings for states’ GO debt generally fall within the two highest rating categories of ‘AAA’ or ‘AA’, with a few outliers. The GO full faith and credit pledge is the broadest security a U.S. state government can provide and, therefore, is the best indicator of its overall credit quality. The top-tier ratings reflect states’ inherent strengths. U.S. states generally have broad economic and tax base resources and strong powers to manage their budgets. Given these inherent strengths, in only a few instances have the inability or unwillingness to address large financial challenges led to ratings below the ‘AA’ category. Due to their high degree of autonomy, Fitch does not cap U.S. states’ ratings at the federal government’s rating.

Related Criteria
Rating Guidelines for State Credit Enhancement Programs, June 19, 2012
Rating Guidelines for Moral Obligations, April 20, 2012
Rating U.S. Municipal Short-Term Debt, Dec. 8, 2011

Related Research
Improving Comparability of State Liabilities, March 28, 2012
Enhancing the Analysis of U.S. State and Local Government Pension Obligations, Feb. 17, 2011

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Scope and Limitations

This report represents a sector-specific extension to Fitch’s global criteria “Tax-Supported Rating Criteria,” dated Aug. 14, 2012 and available on Fitch’s Web site at www.fitchratings.com. It identifies factors considered by Fitch in assigning ratings to a particular entity or debt instrument within the scope of the criteria. This criteria report covers Fitch’s analysis of bonds supported by the issuer’s GO pledge as well as special tax bonds (which Fitch defines as bonds secured by tax revenues but not a GO pledge) and state appropriation-backed debt.

Ratings are assigned to individual borrowings where criteria requirements are met. Not all rating factors outlined in this report may apply to each individual rating or rating action. Each specific rating action commentary or rating report will discuss those factors most relevant to the individual rating action.

Rated Security

Prior to an analysis of a state government’s general credit quality, Fitch details the nature of the security being rated and evaluates the relationship between the credit quality of the security and the general credit quality of the state.

Legal Pledge

A security’s rating takes into account the strength of the legal pledge. If a debt obligation carries both primary and back-up pledges, such as a special tax pledge backed by a GO, Fitch takes note of the “double-barreled” feature but does not consider the two pledges to be additive. Instead, Fitch will rate the issue based on the stronger of the two pledges.

As noted above, the GO full faith and credit pledge is the broadest security a U.S. state government can provide to the repayment of its long-term debt, and the rating on this type of obligation reflects the general credit quality of the issuer.

In cases where bond payment requires annual or biennial legislative appropriation, this lesser long-term commitment to repayment generally is reflected in a lower rating than the GO rating. Such debt is typically rated one notch below the GO rating. If concerns about non-appropriation are heightened as, for example, in cases where there is no clear essentiality for the project being funded (e.g. sports stadium financing), such debt can be rated two or more notches below the GO rating. Conversely, if the risk of non-appropriation is judged to be effectively eliminated, for example, through a mechanism that traps substantial operating funds if appropriation is not made, the appropriation debt can be rated on par with the GO credit. Fitch considers the issuer’s recognition and treatment of the obligation in its legislative, administrative, and budget processes a significant indicator of its commitment to the debt.

Similarly, if there are concerns about the adequacy of funds from which appropriation may be made, the mechanism for or timing of the appropriation and debt service payments, or the issuer’s commitment to the obligation, the debt may be rated more than one notch below the GO rating. Conversely, if the risk of non-appropriation is judged to be effectively eliminated, for example, through a mechanism that traps substantial operating funds if appropriation is not made, the appropriation debt can be rated on par with the GO credit. Fitch considers the issuer’s recognition and treatment of the obligation in its legislative, administrative, and budget processes a significant indicator of its commitment to the debt.

The rating for a special tax security, where payment is derived from a specific tax revenue source, while still informed by the analysis of the state’s general credit, also reflects structural factors, such as lien status, indenture requirements, and debt service coverage, and places more emphasis on analysis of the breadth and stability of the revenue stream used to secure the bonds.
The rating of special tax bonds issued by states may be higher than that of the GO credit, although this is rare because state GO bond ratings tend to be at or above the level that any special tax bond would support due to the broad nature of the GO pledge and states’ inherent credit strengths. To achieve a rating higher than the GO rating, the special tax security must be structured to provide bondholders a statutory lien and an irrevocable priority security interest in the special tax, and the flow of the pledged revenue must be structurally protected from the state’s general financial operations. The amount of credit Fitch will give to such a structure is tempered by the risk that a state, faced with extreme financial stress, could exercise its sovereign powers to the detriment of bondholders.

**Lien Status**

In state tax-supported ratings, the lien status is generally only a rating consideration for special tax bonds, which normally provide a first lien on pledged revenue. Rating distinctions between senior and subordinate lien debt generally are based on notably weaker legal protections for subordinate bonds provided by the indenture. Fitch only makes such distinctions in cases where there are no cross-default provisions between the liens and, when made, the distinctions are generally small (one to two notches).

**Indenture Requirements and Relevant Statutes**

Similar to lien status, indenture requirements are most relevant to special tax bonds. Important indenture provisions include the issuer's covenants, the flow of funds, any requirements that enhance or hinder bondholders' ability to be repaid, recourse available to bondholders that could prevent a default, and, in particular, the additional bonds test (ABT). Bondholder protections incorporated into statute are particularly strong.

Since special taxes are almost always levied at a fixed rate, bondholder protections for debt obligations supported by such revenues generally do not include rate covenants. Consequently, restricting future debt service coverage dilution through limits on additional bond issuance is a critical rating factor. In analyzing projected debt service coverage, Fitch considers the ABT and practical limits to additional issuance. Regardless of current issuance plans, Fitch considers the impact of leveraging the pledged revenue to the full extent permitted by the test.

ABTs for special tax bonds cover a broad range but are generally based on historical collections and require coverage by pledged revenue in a recent 12-month period of MADS. Narrower taxes require higher coverage thresholds for additional issuance to achieve high ratings, although greater coverage can only partially offset an inherently weak tax base. Fitch views ABTs based solely on projected revenue unfavorably. If variable-rate debt is permitted, Fitch views most favorably a calculation of MADS utilizing a significantly higher long-term interest rate than the prevailing rate at the time of issuance.

For special tax bonds, a debt service reserve fund (DSRF) can provide a buffer against low tax-collection periods. Fitch believes this protection is more important for structures with relatively weak coverage or revenue streams with significant volatility and has little impact on the credit quality of bonds whose coverage and ABTs are already strong. However, if coverage begins to erode, an issuer’s rating may decline more quickly in the absence of a DSRF. The credit given to a DSRF funded with a surety bond will be determined in accordance with the criteria for enhancement providers, found in Fitch’s “Counterparty Criteria for Structured Finance Transactions,” dated May 30, 2012.
Bank Bond Ratings

In conjunction with or subsequent to a borrower’s issuance of variable-rate demand bonds, Fitch may be asked to assign a long-term rating to the borrower’s corresponding bank bonds, i.e. variable-rate demand bonds that have been tendered and not remarkedeted and then purchased by the liquidity provider in accordance with the liquidity support agreement. Fitch bases this rating on its analysis of the underlying credit strength of the issue, taking into consideration the potential negative effects of a purchase of the bonds by the bank, which may include a ramp-up in interest rates and an accelerated repayment of principal. Since these factors are considered in Fitch’s analysis of the underlying rating of all parity debt, including any variable-rate demand obligations (VRDOs), bank bonds whose security is on parity with their corresponding VRDOs carry the same underlying long-term rating as those VRDOs.

Similarly, an obligation arising from commercial paper being purchased by a liquidity provider would be assigned the same rating as the issuer’s parity obligations.

Debt and Other Long-Term Liabilities

In evaluating debt and other long-term liabilities, Fitch seeks to determine the extent and nature of the issuer’s outstanding liabilities and evaluates the outlook for the future, with a focus on affordability and flexibility.

Debt Ratios and Trends

Debt analysis includes a review of trends in the amount of debt issued and outstanding, and in debt in relation to resources. Sustained increases in debt at a rate in excess of economic growth may ultimately overburden a tax base and strain budget resources. State debt measures are reviewed in the context of factors that affect the magnitude of borrowing, such as the allocation of functions between the state and other levels of government.

State debt analysis focuses on net tax-supported debt, which includes all long-term, fixed obligations of the issuer, excluding debt fully supported by user charges, tobacco settlement bonds, and unfunded pension and other post-employment benefit (OPEB) liabilities, which are considered separately in the context of an issuer’s overall long-term liabilities. Fitch includes grant anticipation revenue vehicles (GARVEEs), which are special obligations supported by the state’s share of federal transportation funds, in the calculation of net tax-supported debt because, by dedicating this portion of a state’s transportation resources, a GARVEE bond is effectively committing state resources. Bond anticipation notes and commercial paper are included in debt calculations if it is expected that such instruments will be replaced with long-term debt. Fitch also includes bonds issued to fund a pension obligation (POB) in net tax-supported debt calculations.

In general, a low debt burden is a positive credit factor. Fitch considers net tax-supported debt measured against a state’s personal income the best indicator of debt burden, because a state typically derives its financial resources directly or indirectly from this wealth base. Generally, Fitch considers a ratio of net tax-supported debt to personal income of less than 2% to be a low burden on resources. Debt to personal income ranging from 2%–7% is considered moderate. A debt to personal income ratio greater than 10% is generally considered very high, a point at which servicing debt may pose a significant ongoing constraint on resources. Fitch also reviews debt per capita. Although not a wealth measure, debt per capita links outstanding obligations to the population benefiting from the debt and allows for ready comparability among states.
Another measure of affordability is debt service as a percentage of general government spending. The ratio reveals the relative burden of debt against other budgetary needs and, under stress scenarios, may indicate the extent to which debt service could crowd out other needs.

For special tax bonds, debt ratio analysis includes the calculation of historical, current, and projected future coverage of debt service by the pledged revenue source.

**Debt Structure**

Fitch reviews the types and proportions of debt utilized (e.g. GO, appropriation-backed, or special tax). A change over time in the composition of debt, such as a shift to appropriation debt from GO, may indicate a change in public support for debt issuance. The amount of short-term debt is also reviewed in relation to prior-period short-term borrowing. The presence of short-term borrowing may indicate uneven timing of revenue receipts or expenditures that is part of the state’s normal operations; however, it also could indicate financial stress and could present a financial pressure in and of itself.

Fitch views the disclosure of all debt obligations of the entity, including direct bank placements and other obligations that may not carry ratings, to be a management best practice. Fitch will include all such obligations, including the impact of any covenants they may contain, into its analysis.

Fitch also analyzes the rate at which debt is repaid. The pace of debt amortization is a general indicator of the level of conservatism of a state’s debt management. Fitch considers a 65% or more rate of amortization over 10 years to be rapid. A state that maintains rapid debt amortization, even considering a higher-than-average debt burden, benefits from greater financial flexibility and the fiscal capacity to continuously finance its capital requirements, as debt rolling off makes room for new issuance. Fitch’s analysis also notes changes to the pace of amortization over time.

The review of outstanding debt includes an assessment of the uses of borrowed funds. The use of bonding for noncapital purposes is considered a credit weakness, and deficit borrowing is a clear negative credit factor, although this can be mitigated to some extent if issuance is limited and in the context of a larger plan to address an overall state financial shortfall.

Another consideration is the percentage of variable-rate obligations in the state’s debt portfolio. Fitch views high levels of short-term debt, variable-rate debt, debt with put features, and the use of derivative products, such as swaps and swaptions, with concern to the extent that they expose the entity to the possibility of unexpected and, in extreme cases, unaffordable financial demands in the future. Fitch looks for the issuer to have a clear understanding of the benefits and risks associated with these types of transactions and products, and the financial and legal flexibility to adjust its debt structure as appropriate. Generally, Fitch considers a level of 15%–20% of variable-rate debt a prudent maximum for states.

**Future Capital and Debt Needs**

Debt factors are considered within the context of the issuer’s infrastructure needs and capital plans. Current debt levels may be low; however, future capital projects may significantly increase debt ratios, weakening the issuer’s debt profile. Fitch evaluates the impact of expected future debt on the issuer’s debt ratios and views favorably a comprehensive and
realistic approach to capital planning. The issuer’s ability to meet its capital needs where there are restrictions on debt issuance is also a consideration.

In rating special tax bonds, Fitch reviews the issuer’s stated plans for issuance in light of existing capital needs, expected economic growth levels or deferred maintenance, and alternative funding sources, recognizing the possibility that there may be future issuance not currently foreseen that would dilute coverage.

**Pension and Other Post-Employment Benefit Funding**

Fitch reviews defined benefit pension plan and OPEB funding as part of the analysis of debt and long-term liabilities. Defined contribution plans are not subject to Fitch’s pension analysis, as they are a predictable annual commitment and considered as part of the issuer’s operating budget.

The analysis of pension obligations focuses on whether there has been stabilization or progress in the funded ratio over time and a commitment to funding actuarially calculated annual required contributions (ARCs). Key considerations are the magnitude of the liability, the funded ratio, the size of the resource base from which funding is derived and the liability as a percentage of this base, the amount of the state’s budget needed to make pension contributions, and the state’s historical commitment (or lack thereof) to system funding, as well as actuarial and other assumptions influencing the burden.

For each rated entity, Fitch closely evaluates all significant pension plans in which the government participates. This generally excludes the smallest systems, such as the pension plans for judges and legislators that exist in many states but do not place a meaningful burden on resources. Fitch does not attribute to the state all the obligations of the state-run, cost-sharing, multi-employer (CSME) pension systems through which many state and local governments provide pensions to their employees. In many cases, the state is not the majority employer or contributor in a state-run system.

When available, Fitch relies on states’ explicit allocations of CSME plan liabilities. If no such data are available, Fitch makes an estimate using other disclosed pension data. Recognizing states’ responsibility for multi-employer plans; however, Fitch considers all of a state-sponsored multiemployer plan’s unfunded actuarial accrued liability (UAAL) as a contingent liability of the state.

To improve comparability among plans, Fitch creates standardized investment return scenarios. Fitch considers the funded ratio with a 7% investment return assumption adjustment, rather than the funded ratio as reported by the system. Fitch generally considers pensions with funded ratios 80% and above to be well-funded. Achieving sufficient funding from a relatively low funded ratio will inevitably pose more of a burden over time than doing so from a relatively high funded ratio.

Fitch views favorably states that have well-funded pension plans and consistently fund the ARC. In cases where a pension or OPEB unfunded liability is sizable, Fitch views positively actions or plans to reduce it over time. Concerns arise if the liability level is high or increasing, or if the actual contribution is consistently below the ARC.

Although pension and OPEB liabilities are not included in the calculation of an issuer’s net tax-supported debt ratio, Fitch does calculate an additional long-term liability metric for use in the credit analysis of states. This metric measures each state’s net tax-supported debt combined with the portion of the UAALs of its major pension systems that are the responsibility of the
state as a percentage of personal income. Fitch calculates the debt plus pension metric using the adjusted UAALs to reflect a 7% investment return assumption.

The pension component of the combined metric aggregates the UAALs for which the state takes direct responsibility for all major state-sponsored systems. The share of state multiemployer systems’ UAALs that is attributable to other (generally local) government employers is excluded from the calculation.

Fitch believes that OPEB is a legally softer obligation than debt or pensions, perhaps more aptly considered a service obligation, that, in most cases, is subject to modification by the government. As such, Fitch does not calculate a metric that includes a state’s OPEB liability.

Indirect Risks and Contingent Liabilities

In looking at a state’s debt obligations, Fitch examines not only liabilities directly incurred and payable by the issuer, but also outstanding debt for which the issuer may in the future have an obligation. Examples include moral obligations, where the issuer may support — but is not legally obligated to support — the debt upon failure of the primary security. Such obligations are monitored but typically excluded from direct debt calculations, unless the issuer’s resources have been relied on to cover the obligation during the past three years.

Attributes: Debt and Other Long-Term Liabilities

<table>
<thead>
<tr>
<th>Above Average</th>
<th>Low overall debt burden as measured by debt to personal income (less than 2%).</th>
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<tbody>
<tr>
<td></td>
<td>Low debt service burden.</td>
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<td></td>
<td>Modest future capital and debt needs.</td>
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<td></td>
<td>Debt amortization greater than 65% within 10 years.</td>
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<td></td>
<td>Consistent full funding of pension ARC.</td>
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<td></td>
<td>Low combined debt and unfunded pension liability (using a 7% discount rate) as percent of personal income (less than 6%).</td>
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<tr>
<td></td>
<td>Limited OPEB liability.</td>
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<tr>
<td>Average</td>
<td>Moderate overall debt levels as measured by debt to personal income (2%–7%).</td>
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<tr>
<td></td>
<td>Manageable debt service burden.</td>
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<td></td>
<td>Manageable future capital and debt needs.</td>
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<td></td>
<td>Average debt amortization.</td>
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<td>Commitment to funding of pension ARC.</td>
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<td></td>
<td>Moderate combined debt and unfunded pension liability (using a 7% discount rate) as percent of personal income (less than 10%).</td>
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<tr>
<td></td>
<td>Moderate OPEB liability and/or some efforts to prefund OPEB obligations or reduce the liability.</td>
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<tr>
<td>Below Average</td>
<td>High overall debt levels as measured by debt to personal income (more than 7%).</td>
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<tr>
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<td>High debt service burden.</td>
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<td></td>
<td>Large future capital and debt needs without identified funding sources.</td>
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<td></td>
<td>Slow debt amortization (less than 40% within 10 years).</td>
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<td>Failure to fully fund pension ARC on a consistent basis.</td>
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<tr>
<td></td>
<td>Elevated combined debt and unfunded pension liability (using a 7% discount rate) as percent of personal income (more than 10%).</td>
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<tr>
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<td>Large OPEB liability with limited options to reduce.</td>
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ARC – Annual required contribution. OPEB – Other post-employment benefits.

Economy

Fitch’s economic analysis considers the capacity of the issuer’s economic base to support balanced ongoing operations and repayment of debt and provides insight into potential future financial and debt resources or challenges.

Major Economic Drivers

The evaluation of the economy begins with a determination of the types of economic activity that dominate in the state. Although most states benefit from broad economic and tax bases, some economies may be overweighted in an industry like automobile manufacturing or natural
resource mining. Fitch identifies the major economic drivers for a state and their direction and considers factors that will either enhance or inhibit growth. Fitch also reviews a state’s own forecast of economic trends against both recent experience and other published forecasts. A broad, diverse, and stable economy is a credit strength, and undue concentration in one or a small group of industry sectors or a high level of cyclical may be cause for concern. For special tax bonds, the analysis includes a determination of the particular economic drivers of the pledged tax revenue.

**Employment**

Fitch reviews trends in employment and seeks an understanding of why a given sector has expanded or contracted. Historical and recent gains or losses in overall state nonfarm employment are evaluated not only to gauge general expansion, but also to track cyclical and sensitivity to broader national and regional trends. Trends in unemployment are reviewed in the context of labor force changes and other factors that may have an impact, such as cyclical. Gross state product trends complement the employment data in cases where the state economy has a large natural resources or agricultural component.

**Income and Wealth**

Income levels are evaluated on both an absolute basis and relative to regional and national averages. Reviewing trends in the issuer’s income and wealth, compared with those of the region and nation, provides an indication of the rate of economic value being created, which has implications for future revenue performance.

Fitch analyzes a state’s personal income per capita and its relation to national averages. Total personal income growth is tracked against national and regional averages, which is indicative of the robustness of overall economic growth. The components of personal income are also a valuable analytical tool for understanding which sectors are most influential in the economy, both in their importance to the state and performance over time. Similar to employment, broad growth and balanced sources of income serve as credit positives.

**Other Demographic Factors**

Fitch reviews key demographic metrics, particularly population trends. Fitch considers the reasons why a particular area attracts or loses population. Demographic structure and projections are important for assessing future expenditure pressures, particularly in healthcare and education.

Among the other demographic factors that Fitch considers are age profile, educational attainment, and poverty level. Each measure serves as an important indicator of current or future demand for state infrastructure and governmental services and as a gauge of economic potential. Internal and international migration data, as well as birth and death rates, further inform the analysis of population growth figures and testify to dynamics of the populace. The age of a state’s population is considered not only as a median for comparative purposes, but is also evaluated by age cohort to generally capture school, workforce, and retirement ages. Educational attainment — percentages holding a high school or equivalent degree or at least a bachelor’s degree — is reviewed to assess the competitiveness of a state’s workforce.
Tax Burden

Comparing the level of taxation, regionally and nationally, can provide an indication of competitiveness, financial flexibility, and/or tax relief pressures. Fitch reviews tax rates in comparison to those of other states nationally and in the region. The analysis of tax rate levels considers the state’s role in funding public services versus the role of local governments and the relative breadth or narrowness of tax bases.

Attributes: Economy

| Above Average | • Broad, diverse, and stable economic base.  
|              | • Consistent population and employment growth levels.  
|              | • Stability and diversity among major employers.  
|              | • Robust wealth indicators, including personal income per capita.  
|              | • Solid demographic factors, including average age and education levels. |
| Average      | • Fairly diverse economic base.  
|              | • Population and employment performance in line with national averages.  
|              | • Sound wealth indicators, including personal income per capita.  
|              | • Demographic factors in line with national averages, including average age and education levels. |
| Below Average | • Limited or concentrated economic base.  
|              | • Declining population and employment levels.  
|              | • Dominance of one or a handful of industries or employers.  
|              | • Below-average wealth indicators.  
|              | • Weak demographic factors, such as elevated average age or low educational attainment. |

Finances

The analysis of a state’s finances is focused on evaluating its financial resources and flexibility to support its obligations over the near and long terms. Fitch focuses on the general fund and any other large funds that are responsible for major functions or receive substantial tax revenues, such as education funds or property tax relief funds. State financial recordkeeping and reporting vary considerably. As such, Fitch reviews both budgetary and GAAP-based financial reports; budgetary reports are more timely, while GAAP reports allow for more comparability among the states.

Revenue Analysis

Fitch reviews revenue sources for volatility and diversity. In general, a diverse revenue system with a foundation of broad-based taxes is more stable and better able to capture the issuer’s economic wealth, resulting in a stronger financial profile. Reliance on economically sensitive revenues, such as real estate transaction taxes, may expose the issuer to financial volatility and lead to a credit concern.

Fitch also considers the amount of the state’s operating revenues that are not under its control, specifically the percentage of revenues coming from the federal government. Fitch evaluates the consistency of federal funding and how potential adjustments would affect the finances of the state.

To determine the stability of a state’s revenue structure, Fitch analyzes the historical performance of revenues throughout economic cycles, focusing on base growth (e.g., growth removing the impact of tax rate increases or cuts, or base broadening or narrowing) to fully capture baseline trends. The underlying causes of volatility, such as above-average exposure to capital gains or commodity prices, are evaluated. Fitch’s analysis also considers changes to tax rates or bases over time.

The dilution of the general fund through the dedication of major revenue sources to specified purposes, whether by policy decision or voter mandate, generally is viewed negatively as an
inhibitor to financial flexibility. However, the motivation for the revenue diversion can mitigate this concern if, for instance, the diversion addresses a long-standing funding pressure for the state.

To evaluate the state’s current financial position monthly, or as frequently as possible, budgetary-basis revenue results are compared with budget forecasts for the current year, as well as prior-year results. This provides an early indication of possible financial pressure.

For special tax bonds, the revenue analysis considers the nature of the tax and the historical performance of the pledged revenue stream, including its average rate of growth and year-to-year volatility. If a tax has been recently imposed, historical estimates based on the most similar existing tax are considered. If no similar tax exists, Fitch will look at relevant economic variables to gauge past economic activity.

Expenditure Analysis

Fitch reviews trends in expenditures, the expected stability in each major spending item, and the issuer’s flexibility to make adjustments in spending, both as part of the annual budget process and during the course of the fiscal year. The centralized ability, or mandate, to implement timely spending cuts to maintain balance is a credit strength. As states’ primary role is funding rather than providing services (primarily education and social services), Fitch considers the state’s practical and legal flexibility to reduce funding to service providers, particularly lower levels of government.

The analysis also considers potential funding pressures, including outstanding litigation and unfunded mandates from the federal government. The level of state spending does not necessarily correlate to credit strength; comparatively high-spending states can achieve higher ratings, whereas states with much more limited spending can be financially strained. However, Fitch’s analysis considers the state’s expenditure profile as an indicator of burdens being placed on the state.

Operating Margin Trends

Fitch evaluates recurring revenues, compared with recurring expenditures. Concerns arise when operating expenditures consistently exceed operating revenues, as the use of nonrecurring revenue is unsustainable and usually leads to depletion of reserves and deeper financial imbalances. Similarly, an increase in accounts payable or deferred payments to service providers can provide an indication of financial strain.

Fund Balance and Reserve Levels

Fitch views a satisfactory fund balance and reserve position as an important cushion against potential revenue and expenditure volatility. The amount Fitch considers satisfactory varies based on such factors as economic concentration, revenue and/or expenditure volatility, and flexibility to adjust revenues and spending. More volatile financial profiles dictate larger financial cushions that will give the state time to react in a downturn. Established reserves that benefit from automatic funding mechanisms and clear restrictions on use are the strongest credit features, but fund balances that have been maintained consistently over time also are beneficial.

Similarly, segregated funds that are available, or could be made available, for general expenditures can contribute to financial flexibility. Annual surpluses in and of themselves are
not considered significant financial cushions, as they can be, and often are, appropriated for operations or special purposes.

Fitch reviews trends in reserves and fund balance, with the key metric being reserves and balance levels as a percentage of general government spending. Fitch believes that a general target for prudent reserve levels is 5%-10% of general government spending, although the appropriate level ranges widely by state. GAAP financial statement analyses focus on the unrestricted fund balance as a percentage of revenues, since fund balance designations are discretionary and vary among states.

**Liquidity**

Fitch analyzes a state’s cash position with a focus on the timing of tax collections and disbursements and the availability of internal borrowable funds, if necessary. Those in the strongest position do not depend on external cash flow borrowing. The liquidity analysis is particularly important in periods of financial stress. Balance sheet analyses look at trends in the state’s cash position.

**Attributes: Financial Profile**

<table>
<thead>
<tr>
<th><strong>Above Average</strong></th>
<th>Diverse and broad-based sources of operating revenue.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Ample ability and demonstrated willingness to make structural budget adjustments as needed, either as part of the budget process or during the fiscal year.</td>
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<tr>
<td></td>
<td>• Consistently positive operating margins.</td>
</tr>
<tr>
<td></td>
<td>• Consistently sound reserve levels, with clear restrictions on their use and automatic funding mechanisms.</td>
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<tr>
<td></td>
<td>• Substantial available liquidity, without requiring external short-term borrowing.</td>
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<thead>
<tr>
<th><strong>Average</strong></th>
<th>Broad-based sources of operating revenue, with possibility of some concentration in a relatively broad-based tax source.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Ability and willingness to make budget adjustments to maintain balance as needed, with some use of nonrecurring measures in downturns.</td>
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<tr>
<td></td>
<td>• General trend of positive operating margins.</td>
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<td>• Satisfactory reserve levels maintained over time, with some year-to-year fluctuation.</td>
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<tr>
<td></td>
<td>• Sound available liquidity without requiring external short-term borrowing.</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Below Average</strong></th>
<th>Concentrated sources of operating revenue.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Historical inability or unwillingness to make structural budget adjustments as need to maintain balance; reliance on one-time measures to resolve budget shortfalls.</td>
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<tr>
<td></td>
<td>• Trend of negative operating margins.</td>
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<tr>
<td></td>
<td>• Low or nonexistent reserve levels, without a clear path to replenishment.</td>
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<tr>
<td></td>
<td>• Low liquidity levels; external short-term borrowing required to meet routine obligations.</td>
</tr>
</tbody>
</table>

**Management and Administration**

Management practices and actions can positively or negatively influence the other major credit factors, affording strong ratings to entities with comparatively limited economic or financial resources or weaker ratings to more diverse or affluent entities.

**Institutionalized Policies and Budgeting Practices**

Fitch views positively implementation of and consistent adherence to sound processes and policies for financial operations and debt. Strong, notable practices include established rainy-day reserve funds (particularly those with automatic funding sources and limits on use), multiyear revenue and expenditure forecasts, restricting use of nonrecurring revenue to nonrecurring expenses, and sound capital planning. Concerning debt policy, affordability guidelines, careful consideration of future needs and the requisite effects on debt levels, and centralized debt management are signs of credit strength.
Fitch reviews an issuer’s budgeting practices, particularly revenue and expenditure estimations, and compares the key assumptions included in an issuer’s budgets with actual revenues and expenditures over time. Fitch views conservative estimates favorably and is concerned if an issuer does not appear to be fully incorporating current economic, political, or financial conditions. Forecasts developed on a consensus basis among multiple entities, generally the executive branch and the legislature together, are also viewed favorably by Fitch due to the diversity of constituents employed in their development.

Regular intrayear budget reviews, which can allow an issuer to identify underperforming revenues or overspending in time to make necessary adjustments to eliminate or lessen budget gaps, are also a positive credit factor. Most states are required to pass balanced budgets, and budgetary policies that conservatively limit appropriations to a level below that of estimated revenues (e.g. 98%) are viewed favorably. An ongoing constitutional or statutory authorization or mandate to order expenditure cuts to maintain budgetary balance is a credit positive.

Financial Reporting and Accounting

Fitch assumes compliance with GAAP and relevant Government Accounting Standards Board policies; failure to comply creates significant concerns. Fitch views negatively late releases of audited financial statements. Additional financial reporting, such as interim financial results through the year, is viewed positively.

Political, Taxpayer, and Labor Environment

A key credit factor for states is the efficiency with which an elected government can make service and spending decisions, as well as its ability to adjust and react to changing economic and financial conditions. Fitch evaluates management’s willingness and ability to make necessary budget modifications in a timely fashion in lean years and prudently allocate surplus moneys in strong revenue environments.

Evidence of taxpayer dissatisfaction, with either the level of taxation or service provision, is a credit concern, as it may reduce an issuer’s flexibility to address budget shortfalls. A negative taxpayer environment could include voter or legislative attempts to contain the government’s legal ability to raise revenues or build reserves. This concern increases in environments with easy access to the voter initiative process. As state government spending is more programmatic in nature and not as labor-intensive as that of local governments in most cases, labor relations is a less significant state credit factor.

Fitch’s ratings for state credits do not assume a federal government backstop, nor do they assume that the federal government would step in to remedy a state’s financial problems.

Revenue and Spending Limitations

Establishing and adhering to policy guidelines are considered a credit positive. However, onerous statutory or constitutional operating limitations are potential credit risks. Additionally, Fitch recognizes that, in some instances, practical limitations are just as restrictive. An inability to generate sufficient revenue to fund needed services due to political or other practical concerns can have long-term implications for an issuer’s financial and economic health.
## Attributes: Management and Administration

### Above Average
- Highly efficient decision-making process, focused on financial prudence.
- Strong evidence of consistent cooperation among elected officials.
- Institutionalized, prudent financial and debt management policies that are consistently followed.
- Conservative and thorough budgeting process with regular interim reviews, contingency planning, and the ability to make adjustments as needed during the fiscal year.
- Long-term financial planning process.
- Monthly detailed budget reports and timely financial reporting on a GAAP basis (comprehensive annual financial reports produced less than six months after the fiscal year end).

### Average
- Efficient decision-making process.
- Evidence of generally cooperative relationship among elected officials.
- Financial and debt management policies that may be somewhat less conservative but still reasonable and, if not followed, a process is in place to regain compliance.
- Realistic budgeting process and ability to make adjustments during the fiscal year.
- Regular intrayear budget reports and timely financial reporting on a GAAP basis.

### Below Average
- Often cumbersome decision-making process; resolution of key issues often problematic.
- Difficulty in gaining consensus among elected officials.
- Taxpayer initiatives limiting management flexibility.
- Financial and debt management policies not present or not consistently followed.
- Optimistic budget assumptions and impediments to midyear adjustments.
- No intrayear budget reports; financial reporting delayed, not in compliance with GAAP, and/or not audited.