FITCH RATES $617MM CONNECTICUT GO BONDS 'A+'; OUTLOOK STABLE

Fitch Ratings-New York-15 March 2018: Fitch Ratings has assigned an 'A+' rating to the following bond issues of the state of Connecticut:

--$250 million general obligation (GO) bonds (2018 Series A);
--$367 million GO refunding bonds (2018 Series B).

The bonds are expected to be sold via negotiation on or about March 28, 2018.

The Rating Outlook 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+' Issuer Default Rating (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, along with the significant delay in enacting a budget for the current biennium highlighting the narrowed options for closing a substantial $5 billion (15% of general fund biennial revenues) forecast budget gap. While the budget was largely enacted with recurring actions on the part of the state, including achieving sizable budgetary savings from a renegotiated labor contract, budget gaps for both fiscal years 2018 and 2019 have been identified. 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 the economic and revenue recovery has been very slow compared to previous economic cycles. Over 2012-2016, employment in the state rose at roughly half of the pace enjoyed by the nation, and current employment remains below the pre-recession peak. The state forecast is for 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 burden of debt and unfunded pension liabilities in relation to resources 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. Reserve balances are low and the state has continued to increase taxes and cut spending throughout the expansion, reducing its means to tackle future cyclical budgetary challenges, while out-year budget gaps remain an issue to be addressed. Under current law, windfall revenue received in fiscal 2018 related to federal tax law is deposited to the state's budget reserve fund (BRF) and will improve balances, unless offsetting action is taken by the state. Frequent revenue re-forecasting allows the state to identify revenue underperformance and quickly implement corrective actions.

RATING SENSITIVITIES
MAINTAINING FISCAL RESILIENCE: The rating is sensitive to the state's ability to rebalance financial operations to its current economic profile 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 January 2018, the state regained 80% of jobs lost in the Great Recession compared to a national average of 209%. 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 141% 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. According to the state's January 2018 consensus revenue estimate (CRE), tax policy changes in the enacted budget contribute to a 4.5% boost in revenues in fiscal 2018 from fiscal 2017 although the expected $18.5 billion in revenue is $260 million shy of the forecast used to enact the budget. The fiscal 2018 CRE forecast is net $665 million from a one-time repatriation of oversees 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 require a transfer to the BRF.

The revenue forecast used to support the fiscal 2019 budget is also running below expectations, by $283 million (1.5%), requiring state action to balance. Estimated $18.6 billion in revenue in fiscal 2019 is forecast to drop by a sharp 6.4% in fiscal 2020 based on current law, as nonrecurring revenue actions fall off, the hospital tax is automatically reduced, and sales tax revenue sharing through the municipal revenue sharing account is restored; 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 revised fiscal 2019 executive budget proposal, the governor has proposed legislation intended to mitigate the expected negative effects of TCJA on state taxpayers. Recommendations include the creation of a revenue-neutral tax on pass-through entities, offset by a personal income tax credit, and authorization for municipalities to create charitable organizations in support of town services accompanied by a local property tax credit. These measures are expected to be considered by the legislature as it seeks to balance the fiscal 2018 and 2019 budgets.

Transportation revenues, while statutorily dedicated for transportation needs, have been subject in the past to frequent diversion for general operations. Positive support for a measure that will appear 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 biennial budget. 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 $5 billion (15% of 2018-2019 baseline revenue) forecast budget gap 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. The state estimates savings of $700 million beginning in fiscal 2018, escalating over time.

While achieving significant savings, the agreement somewhat reduces the state's operating flexibility, as it extends the length of the existing SEBAC agreement for pension and healthcare benefits from fiscal 2022 to fiscal 2027 and provides 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 new SEBAC agreement is 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
As of Nov. 1, 2017, Connecticut's long-term liability burden for debt and pensions adjusted to a 6% return assumption on pensions, at 27% of 2016 personal income, is amongst the highest for a U.S. state. It 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 $24.2 billion, or 10% of 2016 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).

The state may enter into a contract assistance agreement with the city of Hartford, authorized by the 2017 budget act, which would refund outstanding city debt obligations and be secured by deemed-appropriated state payments and its full faith and credit pledge. The size of a potential refunding is currently unknown; the city's outstanding debt is approximately $540 million.

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.

As part of the fiscal 2019 mid-biennial executive budget proposal, the governor has recommended similar modifications for TRS including reducing the investment return assumption below 7%, from the current 8%, and extending the amortization period for the unfunded liability. The state estimates that the changes would reduce the currently expected actuarially determined contribution while mitigating the budgetary risk that a future market downturn could pose if the state maintains the current closed amortization period; under these requirements, the state would eliminate the bulk of the teachers' retirement fund's unfunded liability by fiscal 2032. GO bonds issued in 2008 for TRS require the state to make full actuarial contributions and 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, remain the state's primary sources of financial resilience given limited reserve funding since the Great Recession, although the statutorily required $665 million deposit to the BRF related to the one-time repatriation of hedge fund managers' overseas profits in 2017 could boost the BRF to a more substantial 4.8% of fiscal 2018 net revenues from 1.2% in fiscal 2017. The deposit is required under a new 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.

Notwithstanding this provision, funds continue to be available from the BRF 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. Consequently, the state could tap the BRF as part of its actions to close the identified budget gap in fiscal 2018, resulting in an uncertain, final balance for the BRF this fiscal year.

Draws on the BRF balance have been used to close ending deficits of $113 million in fiscal 2015, $170 million in fiscal 2016, and $23 million in fiscal 2017. The draw in fiscal 2017 was much less than forecast, as the state implemented across-the-board personnel savings, reduced municipal and education funding, and reduced sales and use tax transfers to locals to address a May 2017 forecast budget gap of $390 million. 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, although the state took extensive administrative and legislative actions first to narrow the 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

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 funds growth of 5.4% from fiscal 2017. The enacted budget was based on a revenue growth forecast of 5.9% in fiscal 2018 and 0.9% in fiscal 2019 that incorporates the policy actions discussed above. The state's January 2018 CRE forecast lowered anticipated revenues by $277 million to incorporate PIT and sales tax reallocations and shortfalls and a large decline in federal grants. Incorporating prior state balances and updated revenues and expenditures, the state's office of policy and management in February 2018 forecast a $195 million (just over 1%) operating deficit for fiscal 2018.

The governor has proposed a deficit mitigation plan to eliminate the shortfall that includes tax policy actions, reductions to municipal revenue sharing and spending cuts. The governor has also submitted a mid-biennium status report to the legislature on the enacted budget, reporting on an estimated $165 million budget gap for fiscal 2019 and proposing revenue enhancements and appropriation adjustments to close the gap. The legislature is considering these proposals, together with the governor's deficit mitigation plan for fiscal 2018 and several proposed revenue changes for the special transportation fund, in the current session.

Nonrecurring actions in the enacted budget combined with current law provisions that automatically restore municipal sales tax revenue sharing and reduce the hospital provider tax after this biennium contribute to the legislative Office of Fiscal Analysis projection for out-year general fund budget gaps in fiscal years 2020 through 2022 of $2.2 billion, $2.9 billion, and $3.4 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.

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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 Short-Term Debt Rating Criteria (pub. 01 Nov 2017)
https://www.fitchratings.com/site/re/905637
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
https://www.fitchratings.com/site/re/898466