

24 Feb 2020 | New Issue

Fitch Rates Maryland's \$780M GOs 'AAA'; Outlook Stable

Fitch Ratings-New York-24 February 2020:

Fitch Ratings has assigned a 'AAA' rating to the following \$779.815 million State of Maryland general obligation (GO) bonds, state and local facilities loan of 2020, first series:

--\$495,000,000 first series A, tax-exempt bonds (competitive);

--\$50,000,000 first series B, taxable bonds (competitive);

--\$234,815,000 first series C, tax-exempt refunding bonds (competitive).

The bonds are expected to be offered by competitive sale on or about March 4, 2020.

Additionally, Fitch has affirmed the Long-term Issuer Default Rating (IDR) of the State of Maryland at 'AAA' and the following ratings on securities that are linked to the IDR:

--\$9.6 billion in outstanding state GO bonds at 'AAA';

--\$46.899 million in outstanding certificates of participation (COPs) issued by the Maryland Department of Transportation supported by annual state general and transportation appropriations at 'AA+';

--\$138.403 million in Maryland Stadium Authority lease revenue bonds at 'AA+';

--The public private partnership (PPP) counterparty obligation rating for the Maryland Department of Transportation's Purple Line PPP Project at 'AA-'.

The Rating Outlook is Stable.

SECURITY

The bonds being issued are general obligations for which the state's full faith and credit are pledged.

Appropriation-backed debt issued by the Maryland Department of Transportation and the Maryland Stadium Authority is rated one notch below the state's IDR, reflecting repayment from

annual state appropriations.

ANALYTICAL CONCLUSION

Maryland's 'AAA' IDR reflects its broad, diverse and wealthy economy, very strong fiscal management with consensus-oriented long-term planning and multiple sources of flexibility. Although liabilities are elevated for a state, they are moderate relative to resources and carefully managed. The state's economy has long benefited from proximity to the nation's capital, although exposure to federal budget cuts poses a greater uncertainty for Maryland than for most states given its large federal agency presence and associated private contracting.

Economic Resource Base

Maryland's economy is wealthy, diverse and service-oriented. The federal government's presence has long served as an important anchor to Maryland's economy, with numerous federal agencies, military facilities and contractors supporting the state's solid economic performance. Trade and port activity are also significant given Baltimore's prominence. Economic expansion continues, despite several years of drag caused by federal sequestration. The state anticipates modest deceleration over the next several years, partially driven by weakness in federal employment, but also headwinds facing the national economy.

KEY RATING DRIVERS

Revenue Framework::'aaa'

Maryland's revenue growth is expected to be in line with or above the level of U.S. economic growth, given the state's solid economic base. Maryland retains unlimited legal authority to raise operating revenues. Cyclical revenue performance is a risk given both the prominence of the personal income tax in overall state revenues and the state's exposure to changes in federal spending. However, overall growth prospects for revenues remain strong.

Expenditure Framework::'aaa'

Maryland has a strong ability to change its spending commitments in response to shifting economic and revenue circumstances. Education and Medicaid remain the largest components of

spending. Carrying costs for liabilities remain moderately low but are above the median for states, partly due to the state's extensive role in funding education needs, including for capital and accrued pension liabilities.

Long-Term Liability Burden::'aa'

The burden of debt and net pension liabilities is elevated for a state but only a moderate burden in relation to Maryland's resource base. Pensions are the more significant burden; however, the state has implemented multiple changes to benefits and contribution policies to improve pension sustainability and accelerate improvement in the ratio of pension assets to liabilities over time.

Operating Performance::'aaa'

Financial resilience is extremely strong, with a well-funded budgetary reserve and a willingness to trim spending commitments and increase revenues in response to changing circumstances. Multi-year forecasting and planning are disciplined, including measuring actual performance against structural targets. Consensus-oriented practices ensure steady management of budgetary conditions and liabilities.

RATING SENSITIVITIES

FISCAL MANAGEMENT ESSENTIAL: Maryland's 'AAA' IDR is highly resilient given robust budgetary flexibility common to most U.S. states and the state's solid economic fundamentals, but failure to appropriately manage new substantial spending goals such as the Kirwan Commission's recommendations for public education with new revenues and/or expenditure changes could lower Fitch's assessments of Maryland's expenditure framework and operating performance, and also its IDR.

LINKED TO STATE IDR: The ratings on the various appropriation-linked bonds and the public private partnership counterparty obligation are sensitive to changes in Maryland's 'AAA' IDR.

CURRENT DEVELOPMENTS

Recent State Operating Performance

Through January, the state comptroller's office reports general fund revenues are up a robust 7.2% from the prior fiscal year with the pace of growth anticipated to slow over the remaining five months of the year. The December 2019 forecast from the state's Board of Revenue Estimates (BRE, its official revenue forecasting body) anticipates 2% growth in current revenues, with a forecast update scheduled for March.

Growth has been strongest in the state's primary revenue sources, the personal income tax (PIT, up 8.1%) and sales and use tax (SUT, up 6.1%). PIT growth is driven by solid wage gains supporting withholding and investment market gains supporting capital gains taxes - a January 2019 federal worker pay raise of approximately 3% has also supported PIT gains. For SUT, the state reports a primary driver has been adding remote sellers, and more recently marketplace facilitators, to the SUT base as a result of the 2018 U.S. Supreme Court's Wayfair decision and related state policy actions. Since the start of fiscal 2020, the state estimates these measures alone have accounted for \$138.4 million, or more than 90% of the approximately \$150 million yoy increase.

General fund growth will likely slow, partially given the statutory requirement that limits the general fund's share of SUT attributable to remote sellers and marketplace facilitators to \$100 million. Any additional revenue flows to the Blueprint for Maryland's Future Fund to address public school funding recommendations from the Kirwan Commission. For the PIT, the state anticipates slower yoy growth during the remainder of fiscal 2020 as last year's very robust non-withholding PIT in the second half of the year followed weakness in the first part the year. This year though, non-withholding PIT has been strong through January, leading the state to expect somewhat slower growth over the next few months, especially when compared to the very strong growth last year. This year's growth will almost inevitably slow in comparison.

On expenditures, the administration's largest mid-year funding request is for \$134 million for Medicaid. Reportedly, enrollment in one specific program significantly outpaced expectations following process changes. Expectations for fiscal 2021 are generally for stable to modestly-growing enrollment in Medicaid programs, consistent with patterns Fitch has observed in other states and in line with expectations given the well-established economic expansion.

The governor's fiscal 2021 executive budget recommends general fund spending of \$19.7 billion, a roughly 1% increase from his current projection for fiscal 2020. The largest increases are, unsurprisingly, in public health (which includes Medicaid) up nearly 4% or \$205 million, and public education up 3% or \$269 million.

Kirwan Commission Recommendation Are A Key Focus of Legislative Session

Fitch anticipates the 2020 legislative session will be dominated by discussion around public education, primarily the final recommendations of the Kirwan Commission. In December, the

Commission released its final recommendations for changes to the state's public education system, with an estimated implementation cost of \$4 billion annually within 10 years, with \$2.2 billion from the state and \$1.8 billion from local governments. The Republican governor has expressed reservations about the fiscal scope of the commission's recommendations. Democratic legislative leaders have indicated their support for the recommendations and they intend to consider various statutory measures to raise supporting revenues and/or revise spending in other areas. Initial revenue proposals have ranged from enactment of a first-in-the-nation tax on digital advertising, to legalization of sports betting to broadening of the sales tax to cover various professional services.

Revenue Framework

Maryland's revenue framework includes a broad range of tax revenues, with PIT making up the majority of the state's annual general fund revenues. Sales and use taxes are also significant, at approximately one-fourth of general fund revenue. Gaming revenues (approximately \$500 million) provide an important source of support for K-12 education spending, and flow through the state's Education Trust Fund. Transportation receipts, most significantly motor fuel taxes, have been reallocated by the legislature at times for general spending, but recent changes tightened the dedication of these revenues for transportation needs. The state also levies a small statewide property tax to support general obligation debt that flows through the annuity bond fund.

Maryland's wealthy, service-oriented economy is the basis for a revenue growth profile that, while subject to economic cyclicity and federal policy actions, is likely to grow ahead of, or in line with, national economic growth over time.

The state has an unlimited legal ability to raise revenues through rate increases or base broadenings.

Expenditure Framework

Education and social services represent Maryland's largest spending commitments. K-12 education spending, provided via transfers to counties, remains the most significant expenditure item for the state. Education spending also includes amortization contributions for local teacher retirement liabilities, capital support and a large network of higher education institutions. Social services,

primarily for Medicaid, are also a substantial and growing component of the state's budget.

Education funding demands will likely escalate over the next several years based on findings from the Commission on Innovation and Excellence (also known as the Kirwan Commission), which was statutorily-empaneled to make recommendations on education policy and funding. As noted earlier, the commission released its final policy proposals in December with recommendations for substantial increases in both state and local education funding. Fitch anticipates the legislature will consider legislation implementing the policy goals this spring, along with revenue and expenditure changes to accommodate the new spending.

Consistent with most states, Maryland's spending will likely be in line with to marginally above expected revenue growth, absent offsetting policy action, driven by both education and Medicaid. 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 fundamental programmatic and financial structure appears less likely in the near term given divided control in Congress. As with all federal initiatives, Medicaid remains subject to regulatory changes that could affect various aspects of the program.

Maryland's carrying costs for liabilities are higher than the median for states but remain well within the state's ability to control given its resources. Debt service is elevated due partially to a constitutional requirement to amortize most tax-supported borrowing within 15 years. Carrying costs also include those for accrued pension liabilities of local teachers, although newly earned benefits are the responsibility of local governments.

The state regularly contributes additional resources to pensions to accelerate funding progress, including both an annual supplemental contribution and a "sweeper" provision to divert a portion of unappropriated surpluses. The sweeper provision was originally scheduled to sunset in 2021. The state waived the sweeper provision for the fiscal 2018 and 2019 budgets but also lifted the 2021 sunset and extended the sweeper indefinitely; when the pension system reaches 85% funding, the statute triggers an analysis of the necessity of maintaining the sweeper provision. These changes also split the sweeper between supplemental pension and OPEB payments beginning in 2021. Since these contributions are beyond the actuarially determined contributions, Fitch does not incorporate them into the carrying cost metric. In his fiscal 2021 executive budget, the governor proposes waiving the pension and OPEB sweeper provisions (\$25 million each), but maintaining \$75 million in supplemental pension system contributions.

Long-Term Liability Burden

On a combined basis, debt and net pension liabilities attributable to the state as of Fitch's 2019 state pension update are above average, measuring 13.2% of 2018 personal income, compared with a statewide median of 5.7%. Based on a state debt statement as of Dec. 31, 2019 and pension data from the state's fiscal 2019 comprehensive annual financial report (CAFR), Fitch estimates the long-term liability burden at approximately 13% of 2018 personal income.

Fitch's calculations incorporate project debt associated with the Purple Line availability payment-based PPP entered into by the state's department of transportation (total \$1.2 billion, of which \$875 million is an untapped construction loan from the federal government), and Maryland Stadium Authority bonds issued for Baltimore City Public Schools (approximately \$720 million) that partially benefit from state revenue support. The state's debt affordability guidelines include holding tax-supported debt as defined by the state (which excludes the PPP and Baltimore school obligations noted above) at or below 4% of personal income.

In the current legislative session the governor and several legislators have proposed issuing up to \$2.2 billion in gaming revenue-backed bonds for school construction projects. The proposal follows up on a constitutional amendment approved by voters in November 2018 that requires the state to use gaming revenues to provide supplemental K-12 funding, rather than as replacement of other dollars. If a measure on the scale of the proposed bills is eventually enacted, Fitch does not anticipate the additional issuance would affect the 'aa' assessment of Maryland's long-term liability burden.

Pensions are a comparative credit weakness in Maryland, although the state has taken repeated action since 2011 to revise benefits and contribution practices to improve sustainability. Specific measures include lower benefit accruals, longer service requirements, a phased-in decline in the discount rate, ending a contribution methodology that had consistently left actual contributions below actuarial calculations and replacing it with full actuarial contributions, and appropriating supplemental contributions.

Most of the state's net pension liability (NPL) consists of obligations for state employees and local teachers in the State Retirement and Pension System, which calculates its liabilities based on a 7.4% investment return assumption (down from 7.75% in fiscal 2012). Fitch calculates the consolidated ratio of the state's pension assets to liabilities as reported in its comprehensive annual financial report is approximately 70%. The Fitch-adjusted ratio, based on a standard 6% investment return assumption, is approximately 60%.

OPEB Litigation and Related Legislation Shifts Liability Estimate

Other post-employment benefits (OPEB) liabilities are sizable, but not exceptionally large, roughly equivalent to Fitch's estimate of the state's debt liabilities. Maryland's reported total net OPEB liability as of June 30, 2019 is \$15 billion, or 4% of personal income. This is up from \$12 billion the prior year as the state recognized the effects of litigation originally challenging a 2011 law reducing OPEB prescription drug benefits, and recent legislation (SB 946 of 2019) enacted following filing of the litigation. The 2011 changes reduced the state's OPEB liability by approximately 40% as measured at the time, with the prescription drug changes representing the majority of those savings.

The OPEB liability could shift further as the litigation progresses. An unexpectedly large increase in the OPEB liability, to make it much closer to the level of net pension liabilities, and indications that the state's capacity to make benefit changes is significantly limited, could lead Fitch to consider the OPEB liability as a negative asymmetric rating factor consideration.

Operating Performance

Maryland's financial resilience is extremely strong. Historically the state has relied on spending cuts, revenue increases and the use of non-recurring resources, including drawdowns of general fund balance and from the revenue stabilization account (RSA; the state's primary rainy day account) when confronted with budgetary weakness.

Legislation enacted in the 2017 legislative session is intended to address revenue volatility and build up reserve balances to provide additional financial resilience. Beginning in fiscal 2020, personal income tax revenues from non-withholding components that exceed a 10-year average will be diverted from routine spending and instead be directed to build the total rainy day fund up to 10% of general fund revenues and cover pay-go project needs for K-12 and higher education. The September 2019 BRE report projects approximately \$42 million from this revenue volatility cap in the first year. The governor's fiscal 2021 executive budget proposes modifying this measure, lessening the amount allocated to reserves and providing \$134 million in additional revenues for fiscal 2021.

Maryland has disciplined and regular consensus revenue forecasting and monitoring that identify material changes in the direction of state economic and revenue performance in a timely manner. The Board of Public Works (BPW), which includes the governor, comptroller and treasurer, has the power to trim governmental spending during the year in response to budgetary weakness, and

demonstrated this ability repeatedly during the last downturn.

The state routinely budgets to maintain flexibility both in the form of a general fund unencumbered balance and the separate RSA balance; the latter has been consistently funded at 5% of general fund revenues, including through most of the last downturn. The RSA balance has risen in step with the budget in recent years, reaching \$857 million at the end of 2018 and estimated by the administration to be \$882 million at the end of fiscal 2019 (both approximately 5% of general fund revenues and spending).

Recent improvements to the state's budgetary management practices include the transition to full actuarial funding of pensions (fiscal 2017), implementation of the revenue volatility cap, and an increase in the state's primary reserve fund, the RSA, to 6.5% of estimated general fund revenues with the fiscal 2020 budget. Together, these measures reflect the state's commitment to rebuilding and enhancing its financial flexibility and a shift away from nonrecurring support of operations.

Fitch notes that the governor's fiscal 2021 executive budget proposes scaling back or slowing the pace of several of these measures including the revenue volatility cap and reducing the rainy day fund slightly to approximately 6.25% of revenues. While these proposals, if implemented, would not reduce Fitch's assessment of the state's budgetary management, they do reflect some of the pressures the state is facing and will need to continue closely managing.

Maryland Stadium Authority Transaction Details

Lease revenue bonds of the MSA are secured by leases between the MSA and the State of Maryland, with lease payments subject to annual legislative appropriation. The 'AA+' long-term rating of the bonds is thus linked to the credit quality of the State of Maryland. The MSA has funded several sports, cultural and convention venues statewide using a master lease structure, and MSA borrowing is part of state debt oversight.

Please see "Fitch Rates Maryland Stadium Auth's \$21M Lease Rev Bds 'AA+'; Outlook Stable," published on Oct. 16, 2019 for additional information on the MSA revenue bonds.

Maryland Department of Transportation (MDOT) Certificates of Participation (COPs) Details

MDOT's COPs are payable solely from purchase installments from MDOT pursuant to purchase agreements, subject to appropriation in each year by the Maryland General Assembly. MDOT intends to make payments from the department's Transportation Trust Fund, but the state's full resources are available for appropriation.

Please see "Fitch Rates Maryland DOT's \$30MM COPs 'AA+'; Outlook Stable," published on Feb. 20, 2019 for additional information on the MDOT COPs.

MDOT Purple Line PPP Counterparty Obligation Rating Details

The Purple Line is a planned 16.2-mile light rail transit line between Bethesda and New Carrollton, MD. It will include 21 stations and intersections with three existing Washington Metro Area Transit Authority (WMATA) lines, Amtrak and Maryland Area Regional Commuter (MARC) train lines. It would be owned by MDOT and the Maryland Transit Administration (MTA), the arm of MDOT that oversees various transit operations for the state. The grantor obligations under the PPP agreement meet Fitch's expectation for a rateable PPP counterparty obligation. The commitment of the grantors, MDOT and MTA, to make construction progress payments, milestone payments, and long-term availability payments to the concessionaire, is structured to resemble the state's existing transportation COPs. All MDOT and MTA obligations under the PPP agreement benefit from MDOT's contractual commitment to seek annual legislative appropriations for all scheduled payments.

Please see "Fitch Affirms Purple Line Transit Partners Sr PABs & TIFIA Loan at 'BBB-'; Outlook Stable," published on May 17, 2019 for additional information on the project revenue bonds.

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

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

Maryland, State of (MD) [General Government]; Long Term Issuer Default Rating; Affirmed; AAA;
RO:Sta

---Maryland, State of (MD) /General Obligation - Unlimited Tax/1 LT; Long Term Rating; Affirmed;
AAA; RO:Sta

---Maryland, State of (MD) /Stadium Revenues/1 LT; Long Term Rating; Affirmed; AA+; RO:Sta

---Maryland, State of (MD) /State Appropriation - Transportation/1 LT; Long Term Rating; Affirmed; AA+; RO:Sta

Contacts:

Primary Rating Analyst

Eric Kim,

Senior Director

+1 212 908 0241

Fitch Ratings, Inc.

Hearst Tower 300 W. 57th Street

New York 10019

Secondary Rating Analyst

Douglas Offerman,

Senior Director

+1 212 908 0889

Committee Chairperson

Arlene Bohner,

Senior Director

+1 212 908 0554

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email:
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

Applicable Criteria

[Public-Sector Counterparty Obligations in PPP Transactions Rating Criteria \(pub. 28 May 2019\)](#)

[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 10 Jan 2020\)](#)

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