

FITCH RATES OHIO'S \$241MM GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-29 October 2019: Fitch Ratings has assigned 'AA+' ratings to the following State of Ohio general obligation (GO) bonds:

--\$141 million Infrastructure Improvement GO bonds, series 2019A (Tax-Exempt);
--\$100 million Third Frontier Research and Development GO Bonds, series 2019B (Federally Taxable).

The bonds are expected to be sold via competitive sale on Nov. 6, 2019. They are being issued to finance various capital improvements and the cost of research and development projects in support of Ohio industry, commerce, and business.

The Rating Outlook is Stable.

SECURITY

General obligation bonds are full faith and credit obligations of the State of Ohio.

ANALYTICAL CONCLUSION

The state's 'AA+' Issuer Default Rating (IDR) and GO rating are based on its careful financial management including recent rebuilding of reserves, ongoing record of maintaining fiscal balance and low liabilities. Ohio's economy is demonstrating slow but steady growth after steep declines during the Great Recession, which compounded losses related to retraction nationally and locally in manufacturing. Sustained growth may be limited by Ohio's very slowly growing population.

Economic Resource Base

Ohio's economy is large and diverse, with distinct economic regions centered on several large urban centers. Manufacturing remains a disproportionately large sector with a concentration in more cyclically sensitive durable goods industries. Transportation equipment and related suppliers also have a strong presence. Economic growth has begun to pick up, with GDP growth and median household income trending higher.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Like most states, Ohio maintains unlimited legal ability to raise operating revenues. Its revenue base is diverse and relies on broad-based income and sales taxes. Tax policy changes pursued over the past several biennia have been manageable, aided by favorable economic and fiscal trends.

Expenditure Framework: 'aaa'

Ohio retains ample flexibility to cut spending throughout the economic cycle. As in most states, the natural pace of spending growth is likely to be somewhat above revenue growth, requiring ongoing budget management. Carrying costs for debt and retiree benefits are below the median for states. Spending pressure in Medicaid and education appears to be well controlled.

Long-Term Liability Burden: 'aaa'

Debt is typically conservatively managed and primarily consists of GOs. On a combined basis, outstanding debt and pension obligations are low and an average burden relative to other states.

Operating Performance: 'aaa'

The state generally has a careful approach to financial operations and has consistently managed to achieve budgetary balance. In recent years, the state has relied more on budget reductions than revenue enhancements to balance the budget and also utilized several one-time sources during the recession. The state's budget stabilization fund (BSF) has been restored after being drawn down during the recession and now totals \$2.7 billion, or over 11% of state source general revenue fund (GRF) revenues.

RATING SENSITIVITIES

Ohio's IDR is sensitive to shifts in fundamental credit characteristics, including sustained economic growth that improves expectations for revenue growth, and to maintaining fiscal balance in light of ongoing efforts to reduce the tax burden.

CURRENT DEVELOPMENTS

Tax revenues exceeded expectations in both fiscal years of the recently completed fiscal 2018-2019 biennium. Fiscal 2018 revenues increased 2.5% on a yoy basis and were 2.6% above the budget. The GRF operated at a surplus in fiscal 2018, allowing a \$657.5 million transfer to the budget stabilization fund, bringing it to \$2.7 billion, or 8.3% of GRF revenues. If measured against state source revenues and excluding federal revenues that flow through the GRF, the budget stabilization fund rises to just over 11% of revenues.

Strong performance continued in fiscal 2019, with tax revenues increasing \$1 billion (4.8%) yoy and 2.9% above the revised estimate, driven by stronger than anticipated tax performance and improvement in the economy. Personal income tax collections were very strong despite a change in withholding that lowered collections attributable to fiscal 2019. The state carried a significant fund balance into the fiscal 2020-2021 biennium and maintained the budget stabilization fund at \$2.7 billion.

The state was late in enacting the fiscal 2020-2021 biennial budget as the legislature could not come to agreement on a variety of tax and policy actions. The budget, enacted 17 days after the start of the fiscal year, incorporated a reduction in income tax rates, again continuing a policy of returning revenue growth to taxpayers. The budget included many of the governor's priorities, including expanding spending for education, early childhood development and battling the opioid epidemic. While the school foundation formula was not changed as proposed by the governor, the budget provided \$675 million over the biennium for targeted programs in student wellness, including mental health counseling, mentoring and other school support. Schools will receive these funds on a per capita basis. The legislature did not fully fund the Governor's proposed investment in water and natural resource infrastructure, although it did set aside \$172 million from the fiscal 2019 balance to begin the process of funding the "H2Ohio" fund.

CREDIT PROFILE

The Great Recession had a widespread impact on the Ohio economy, accelerating a longstanding slump in manufacturing and weighing on the slowly growing service sector. Recent economic performance has strengthened with GDP growth and median family income performing more in line with the U.S. after lagging for many years. Ohio's three larger cities, and in particular its capital Columbus, are doing well with stronger population growth and ongoing successful economic development efforts.

Important employment sectors include transportation, distribution and warehousing of manufactured goods, which is facilitated by an extensive system of ports on Lake Erie, barge service on the Ohio River, and advanced air-cargo and rail infrastructure. Health care and education are growing as employment and economic sectors and relatively low non-manufacturing wages in the state have been a magnet for back-office, banking, personnel and trade operations.

Service sector growth, a key source of economic expansion in other states, has been somewhat muted by Ohio's slowly growing population.

Revenue Framework

Ohio relies on a diverse set of broad-based taxes to support operations, including income and sales and use taxes. These major tax revenues are collected in the GRF with constitutional exceptions for highway-related revenues, which are directed to highway purposes, and lottery proceeds, which are directed to education.

In recent biennia, the state has pursued wide-ranging tax policy changes, shifting the source of GRF tax receipts and lowering overall receipts relative to baseline. To date, these tax policy changes have been manageable, aided by favorable economic and fiscal trends. The enacted budget for fiscal 2020-2021 continues this approach, and includes a 4% reduction in personal income tax rates. In earlier action on the transportation budget, the state increased the gas tax 10.5 cents, bringing it to 38.5 cents per gallon, and a slightly larger increase for diesel fuel, which will be directed toward transportation infrastructure spending.

Ohio's 10-year historical revenue growth through 2018, adjusted for the estimated impact of policy changes, has lagged U.S. GDP growth but has grown slightly above the inflation rate. Recent performance has been stronger than is reflected in the historical trend, given the severe impact of the recession in Ohio that followed the shift in the manufacturing-based economy. Fitch anticipates the state's revenues will continue to experience some real growth going forward given recent strengthening in economic performance and the state's economic fundamentals.

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

Expenditure Framework

Ohio has ample flexibility within its expenditure framework. The natural pace of spending growth is likely to be in line with or marginally above its somewhat slowly growing revenue stream. Carrying costs for debt and pensions are well below the median for states.

Primary cost drivers include Medicaid and education spending. With a shift to managed care, contained Medicaid spending growth and only modest population growth, education spending pressures should be manageable. Medicaid spending was significantly below forecast levels for fiscal 2019, contributing to the state's operating surplus. Enrollment growth is expected to continue to modestly decline through most of the next biennium. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress.

Ohio has ample expenditure flexibility. The state has had a budget-cutting bias rather than relying on revenue increases when necessary to maintain budgetary balance, even in core spending areas. During the last recession, Ohio reduced distributions and phased out certain tax reimbursements to both local governments and school districts. The state's carrying cost for debt and retiree obligations is below the state median and is expected to remain low given the state's well-funded pensions and conservative debt management.

Long-Term Liability Burden

Ohio's liabilities are low and debt ratios are expected to approximate current averages as GRF principal continues to roll off and personal income grows. The combined burden of long-term debt and unfunded pension obligations, as adjusted by Fitch to a 6.0% return assumption for pensions

instead of the higher rates assumed under the state's accounting valuation, equals 4.5% of personal income, below the median for U.S. states as of Fitch's 2018 State Pension Update Report.

Funding of defined benefit retirement systems, which provide both for pensions and health care, has historically been considered a credit strength, with a history of annual contributions sufficient to support full actuarial prefunding of pensions and provide some support for retiree health care. Plans are cost-sharing, multi-employer with limited liabilities attributed to the state. Funding for pension benefits declined significantly with recessionary market losses, although they have since stabilized at higher levels. Reforms since the recession have contributed to the improved financial sustainability of the public employees' system and the state's other major systems, as has shifting to lower discount rates and directing more of the system contributions to pensions from retiree health care.

Operating Performance

Ohio's ability to respond to cyclical downturns reflects its ample budget flexibility and availability of reserves. During the Great Recession, Ohio's revenues suffered significant declines, exacerbated by ongoing tax reductions. The state closed the resulting budgetary gaps with both ongoing and one-time measures. Some of these measures included use of the rainy day fund, refunding debt for current year savings, unpaid employee leave, and accelerating the phase-out of tax reimbursements for schools and local governments. It is Fitch's expectation that Ohio would continue to rely primarily on expense reductions to address a future downturn and would again draw upon its now restored rainy day fund.

During times of economic recovery, Ohio rebuilds its financial flexibility including restoring its rainy day fund and reducing the use of one-time budget items. In recent biennia, tax reductions have, to some extent, absorbed the natural tax revenue growth related to overall economic expansion. A statutory increase in the rainy day funding requirement to 8.5% from 5.0% of prior year revenue provides additional capacity to address future downturns and is emblematic of the state's approach to bolstering its financial position during this period of expansion.

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Date of Relevant Rating Committee: July 19, 2019

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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.

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Applicable Criteria

Short-Term Ratings Criteria (pub. 02 May 2019)

<https://www.fitchratings.com/site/re/10073011>

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. 03 Apr 2018)

<https://www.fitchratings.com/site/re/10024656>

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