S&P Global Ratings

RatingsDirect®

Hawaii; Appropriations; General Obligation

Primary Credit Analyst:
Oladunni M Ososami, Dallas 972-367-3338; oladunni.ososami@spglobal.com

Secondary Contact:
Gabriel J Petek, CFA, San Francisco (1) 415-371-5042; gabriel.petek@spglobal.com

Table Of Contents

Hawaii; Appropriations; General Obligation

Credit Profile		
US$575.0 mil GO bnds ser 2017, FK due 05/01/2037		
Long Term Rating	AA+/Stable	New
US$232.115 mil GO rfdg bnds ser 2017 FN due 10/01/2031		
Long Term Rating	AA+/Stable	New
US$45.0 mil GO rfdg bnds ser 2017 FO due 05/01/2021		
Long Term Rating	AA+/Stable	New
US$4.31 mil GO rfdg bnds ser 2017 FL due 06/01/2017		
Long Term Rating	AA+/Stable	New
US$1.21 mil GO rfdg bnds ser 2017 FM due 06/01/2018		
Long Term Rating	AA+/Stable	New

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to the following planned general obligation (GO) bond issues belonging to Hawaii:

- $575 million series 2017 FK GO bonds,
- $4.3 million series 2017 FL refunding GO bonds,
- $1.2 million series 2017 FM refunding GO bonds,
- $232 million series 2017 FN refunding GO bonds, and
- $45 million series 2017 FO taxable GO bonds.

At the same time, we affirmed our 'AA+' long-term rating and underlying rating (SPUR) on Hawaii's outstanding GO bonds, and our 'AA' long-term rating on the state's certificates of participation (COPs). The outlook on all the state's debt ratings is stable.

The 'AA+' GO rating reflects our view of:

- The state's strong financial position, which has weathered several major economic stressors during the past 15 years;
- Strong liquidity, particularly when including pooled cash balances available to the general fund for temporary interfund borrowing;
- The prioritizing of contributions to the retiree health care benefits system, resulting in lower actuarial estimates for the state's long-term liability;
- Management's well-established, proactive budget monitoring practices, including frequent revenue forecast updates from the independent Council on Revenues (COR), which facilitates prompt identification of potential budget adjustments for budget alignment;
- The governor's executive authority to restrict all executive branch expenditures through such actions as cutting spending midyear without legislative approval or cutting or delaying disbursements during the course of a fiscal year; and

- Other strong constitutional protections, including requiring budget balance, that allow for tax increases with legislative approval and give GO bonds first-lien priority before all other disbursements.

Partly offsetting the above strengths is our view of:

- Hawaii's inherent susceptibility to exogenous shocks that have potential to hurt its tourism sector, which accounts for 17% of state GDP;
- The weak funded status of the state's retirement system and generally higher-than-average debt ratios because of the state's centralized provision of public sector services; and
- Large, other postemployment benefit (OPEB) liability, although a 2013 statutory requirement increases annual contributions until fiscal 2019, by when contributions would equal the actuarially recommended level.

The proceeds from the series FK and FO bonds will be used to finance or reimburse the state for expenditures for appropriated public purposes and the costs of various public improvement projects. The series FL, FM, and FN refunding bonds will be used to refund certain outstanding GO bonds previously issued. All GO bonds are secured by Hawaii's full faith and credit, which the state considers as its highest payment priority, according to its constitution. None of the refunding bonds include later maturity dates than the existing debt to be refunded.

Hawaii began fiscal 2017 in a strong position. On a combined basis, its fiscal 2016 general fund ending balance ($1.1 billion) together with its Emergency Budget Reserve Fund (EBRF) ($100.9 million) equaled 16.4% of general fund expenditures. The state also has reserved funds in its Hawaii Hurricane Relief Fund (HHRF $186.4 million), which equaled an additional 2.7% of general fund expenditures. The state has accumulated these balances in recent years by maintaining conservative fiscal practices even as the economy has continued to expand. Chief among these are budgetary controls, including the governor's requirement that agencies restrict 5% of budget appropriations. This practice has given rise to larger-than-budgeted spending lapses, which have resulted in a larger ending balance than anticipated. In fiscal 2016, for example, there was $149.1 million in lapsed spending versus the $80 million assumed in the enacted budget.

For fiscal 2017, potentially slower revenue growth contributes to the state's projected $507 million (6% of expenditures) operating deficit. However, a significant portion--$299 million of the expected deficit--stems from the state's scheduled prefunding of its retiree health care benefits liability and further capitalizing its EBRF. Additional use of fund balance includes $100 million for statewide air-conditioning for schools and writing-off $185 million of receivables. The state projects to end the year with combined reserves of $832 million, or 10% of expenditures. The projected operating gap incorporates lower than expected revenue estimates from the COR for fiscal 2017 revising growth from 5.5% to 2.5% by March, based on year to date collections. The state however believes that revenue collections have met expectations in fiscal 2017, but the COR analysis does not take into account certain one-time adjustments made to general excise tax (GET) collection in the current year, thereby underestimating collections. The GET is the leading revenue source comprising about 52% of general fund revenue. The COR forecast shows revised revenue growth for fiscal 2018 of 5% from 4% and for fiscal 2019 to 4% from 4.4% in prior reports. Likewise, the multiple-year forecast shows that in fiscal 2018, the state's operating position would show deficits of $95.2 million and $21.9 million for fiscal 2017 and fiscal 2018, respectively. At the end of fiscal 2018, Hawaii's general fund would have almost $743 million in combined reserves, equal to 10% of expenditures, which we view as strong. However, the plan does not include wage increases, which could result from collective bargaining negotiations which are currently ongoing and would be effective from fiscal 2018. Based on S&P Global Ratings calculated estimates, we anticipate that additional costs could lead to lower balances, perhaps as much as $300 million, which would reduce combined reserve to about 6.3% of expenditures by 2020 without further budget adjustments.

Similar to recent forecasts, the COR continues to anticipate slowing economic growth in future years. Consistent with this, the COR slightly increased its revenue growth projection for fiscal 2020 through 2023 to 4.5% from 4.4%. We believe, however, that the state has positioned itself to accommodate the somewhat slower economic and revenue growth anticipated in its multiple-year general fund forecast and the governor will continue its practice of utilizing budget controls to manage its discretionary operations and maintain its finances. The state's multiple-year general fund forecast illustrates that even in the context of more gradual growth the state's fiscal capacity could enable it to make continued progress toward more fully funding its large pension and other long-term obligations while maintaining strong budgetary reserves. At the end of fiscal 2023, Hawaii's general fund is projected have over $2 billion in combined reserves, equal to 23.8% of expenditures, which we view as very strong. An outright recession, as opposed to just slower growth, however, would likely test Hawaii's capacity to sustain a weaker revenue environment while adhering to its current multiple-year fiscal plan.

As an island-economy state, Hawaii is inherently vulnerable to the negative effects of certain types of exogenous shock-events. On the other hand, as an importer of diesel and oil fuels--which Hawaii relies on to generate over 70% of its electricity--the state has been a clear beneficiary from what appears to be a secular decline in oil prices. In the 12 months ended September 2016, residential, industrial, and commercial customers realized 18% to 32% in savings from the cost of electricity. Certain broad economic metrics, moreover, suggest a more resilient economy than popularly perceived. For instance, although Hawaii was not immune to the Great Recession, relative to the nation, per capita personal income in the state actually increased to 104% in 2009 from 101% in 2007.

Notwithstanding the longer-term expectation of more subdued economic growth, Hawaii's financial position has benefitted from a strengthening visitor industry, which in 2016 enjoyed a fifth consecutive year of record-setting visitor arrivals. Visitor arrivals are on track to reach a new record again in 2017 with an anticipated 1.5% increase from 2016. Total visitor expenditures in 2016 increased 4.2% from 2015 and is expected to increase 2.9% in 2017, having grown by 33% since 2011. Revenue per available room was up by 4.7% in 2016, and the state projects the same for 2017, at which point, revenue will have grown by 50% since 2011. These trends, along with consistently high occupancy rates, suggest the state's key industry, leisure and hospitality (which makes up 17% of Hawaii's employment base versus 10.1% for the nation), is currently healthy. Contributing to the strength of the tourism industry is the diversity of international travelers, mainly from high income economies which somewhat insulates the island from national contracting trends in disposable income. While a majority of 2016 visitor arrivals were recorded from the contiguous U.S. (68.7%), a significant percentage was recorded from Japan (18.1%), Canada (5.4%) and Australia (3.8%). We expect the recent certification of Kona Airport as the state's second international airport to boost the trend of international tourism further. Hawaiian airlines started non-stop flights to Kona in December, contributing to a 7.6% increase in visitors in the first three months of 2017. In our view, strength in the tourist sector has contributed to pushing down Hawaii's unemployment rate to 3.02% for 2016, well below 4.5%, which the state's economist considers to be Hawaii's natural jobless rate.

Conversely, a strong U.S. dollar, especially vis-à-vis the Japanese Yen, can be a source of drag to Hawaii's economy given that visitors from Japan make up an increasing proportion of international arrivals. The state's tourist base is diversifying, however, with arrivals from Canada having almost doubled since 2006. Likewise, visitors from China have increased more than three-fold. However, we see potential for some softening ahead when it comes to tourists from Canada and China (which comprised of 1.9% of 2016 visitors). Both countries, which have entered weaker economic patches, still represented a combined and relatively minor 7.3% of total arrivals in 2016.

A strong U.S. dollar and flagging U.S. consumer confidence since 2015 has weighed on the pace of improvement in the various trends throughout the visitor industry. Some of the strongest gains occurred from 2011 through 2013, with more incremental improvement since then. Relative to the U.S. as a whole, personal income in Hawaii has slid slightly, to 101%, from its prior level, which was slightly above 103% in 2013. Growth of Hawaii's GDP, the broadest measure of its economy, suggests that Hawaii remains stuck in a slow growth mode, as it has expanded more slowly than national GDP for six consecutive years. Nevertheless, the state's economy has proved relatively resilient to exogenous shocks (i.e., the Sept. 11 terrorist attacks, the SARS epidemic). Still, we view Hawaii's economy as having some unique vulnerability to unanticipated shocks originating from external events.

Hawaii's economy is also subject to changes in federal spending. The federal government accounted for 12.6% of state GDP in 2013, according to the Bureau of Economic Analysis' most recently available data. More than half of federal spending in the state is military related, making Hawaii's economy susceptible to cutbacks under the federal Budget Control Act of 2011 (BCA). Most significantly, the BCA's sequestration has translated to $400 million in reduced military contracts being awarded in Hawaii ($2 billion compared to $2.4 billion). The effects of the cutbacks emerged in 2015 when the number of military personnel receded by 8.4% to 46,764 following a record level of personnel in 2014. Still, the 2015 level of military personnel based in Hawaii remained higher than all but three years since 1960, contributing over 6% to the state's GDP. The incomes of these personnel and households have a stabilizing influence on the rest of the state economy, in our view.

The state's real estate market is stable, with low foreclosure rates (just 0.04% in Honolulu, which is 70% of Hawaii's real estate market) and generally rising home prices. However, a chronic shortage of housing relative to demand keeps upward pressure on home prices throughout the state and poses a threat to the state's longer-term economic growth prospects. Whereas Hawaii saw roughly 6,000 new housing units per year constructed throughout the 1980s, the number has fallen to approximately 2,000 to 3,000 in recent years. Upward pressure on home prices is likely to persist given that Hawaii estimates there is demand for 6,500 new units per year leading to a current statewide deficit of 12,000 units. In our view, construction trends in the 1980s likely reflected unsustainably strong demand from Japanese investors at that time. We note, however, that the construction sector remains stronger than the rest of the nation and has expanded albeit slowly in recent years, rising above its prerecession peak in 2016 before declining slightly in 2017. State officials attribute the more recent slower construction trends to increased environmental, zoning, and permitting process rules.

Although Hawaii's debt burden of $6.9 billion of tax-supported state GO, COP, and highway (gas tax) debt is high, in our view, translating to $4,815 per capita (based on estimated 2016 population), it reflects the centralized nature of state and local government in Hawaii. Hawaii's debt level stands out as high relative to other states' in part because the state assumes numerous functions that are performed at the local level in other states. The above-average fixed costs for debt and retiree benefits liabilities is somewhat offset by Hawaii's below-average Medicaid-related expenditures.

We consider the state's three-year average pension funded ratio weak at 59%. The plans reported what we still consider as a weaker pension actuarial market funded ratio of 51.3% as of June 30, 2016, stemming from weaker than average investment returns and more conservative actuarial assumptions. The funding level decreased steadily through 2016 from a high of more than 95% in fiscal 2000. The ERS board elected to change its actuarial assumed rate of return to 7% from 7.65% and revised its mortality expectations to better reflect long-term market expectations in light of recent experience study concerns. Although such changes put additional negative pressure on the system's funded ratio, it reflects a more conservative orientation with regard to managing long-term pension liabilities. Notably, the governor introduced legislative bill 936 in the 2017 legislative session to restore the ERS to full funding within the statutorily required 30-year timeframe by phasing in higher system-wide contribution rates through 2021. The bill will require contribution rates to increase from the current 17% to 24% by fiscal 2021 for the general plan and a more aggressive increase from the current 25% to 41% by fiscal 2021 for police and fire. It is our understanding that as of April the bill has passed through all legislative committees without any amendments, but the final floor vote and governor's signature is pending. In our opinion, the successful adoption and implementation of the increased contribution rate is vital to the state's long-term's financial capacity and is essential to maintain its credit quality. Pension costs as a percentage of budgetary general fund expenditures is estimated at 10.3% for fiscal 2017 and is expected to increase to about 11.3% in 2018 as a result of increased contribution rates. Based on S&P Global Ratings' calculated estimates, we anticipate that pension costs could rise to about 13.5% by fiscal 2021. To the extent that the increased contribution rates are not adopted or the implementation leads to significant strain on future budgets operations or reserves, we could view this indication of weakening financial capacity. Based on the analytic factors we evaluate for states, we have assigned Hawaii a composite score of '1.8' on a four-point scale in which '1' is strongest.

Outlook

We have assigned a stable outlook to Hawaii's ratings considering its currently strong financial reserves, which remain particularly important for Hawaii given its above-average fixed costs stemming from its relatively large long-term liabilities. Despite the progress and commitment Hawaii has demonstrated with regard to its pension and other long-term liabilities, we believe these obligations currently represent a constraint on the state's ratings from upward movement. We specifically do not expect to raise the rating until the state has shown a steady trend towards a well-funded pension system, which we believe is beyond the current outlook period. The main downside risk we see to the state's ratings stems from the potential for economic underperformance that could lead to deteriorating fiscal performance. However, we believe the state's ratings can withstand most reasonable downside scenarios, however, given its reserve position. We also expect the state's ratings will be sensitive to any material deterioration in its pension funded status from its current level or significantly higher contribution rates which are not adequately absorbed in the future budgets, weakening its overall financial position.

Governmental Framework

Hawaii's constitution requires that the state operates on a balanced budget, including on an intra-year basis, as it monitors revenues and expenditures throughout the year and makes necessary adjustments to ensure that general fund expenditures do not exceed current general fund revenues and unencumbered cash balances. There are no constitutional restrictions on the state's ability to raise taxes or other revenues, but property tax authority rests with the counties. Approval of taxes is by simple majority vote of the legislature, and the legislature has broad legal latitude to adjust spending levels. The governor has authority to restrict all executive branch expenditures and to cut spending midyear without legislative approval via such methods as cutting or delaying spending on education, but this is politically difficult in practice.

Hawaii is not a voter-initiative state, and no vote is required to issue GO bonds or increase taxes. GO bonds in Hawaii have a first-lien status, prior to all other payments, and the issuance of GO bonds must be authorized by a majority vote of the legislature.

The Hawaii state government is highly centralized, and as such, the level of assistance to local governments is high. The state directly runs the public school system, as well as the university and community college systems. It also administers the public welfare system and operates prisons, harbors, and airport systems. The county functions are primarily property related (police, fire, streets, water, sewer, and parks). That being said, Hawaii is less exposed to fiscal pressures from rising health care and Medicaid costs than are most states. Hawaii's Prepaid Health Care Act of 1974 effectively mandates that employers provide health care coverage for any employees who work 20 hours or more per week. This has resulted in historically high rates of health care coverage in Hawaii. The transition to complying with the Federal Patient Protection and Affordable Care Act has, therefore, been more incremental in Hawaii than in most states.

On a four-point scale in which '1' is the strongest, we have assigned a score of '1.7' to Hawaii's governmental framework.

Financial Management

We consider the state's management practices strong under our FMA methodology. An FMA of strong indicates our view that practices are strong, well embedded, and likely sustainable. Among the highlights of the state's management techniques are statutorily required six-year operating and capital budgets that are updated by the governor and finance staff annually for legislative approval. The COR provides quarterly revenue forecasts for inclusion in the biennial budget, budget updates, and the multiyear financial forecast. The state's finance staff identifies budget variances throughout the year, and the governor is empowered to curtail expenditures without legislative approval, if required. The finance staff and treasury adhere to an official investment policy, and investment performance is disclosed monthly. There are statutory debt caps, including a calculation to ensure that the total amount of debt service payments required will not cause the state to exceed its debt limit of 18.5% of the average of three prior years' general fund revenues. The state constitution requires that all state debt begin to amortize principal within five years of issuance, mature within 25 years, and have either level debt service or level principal payments. State law disallows the use of swaps or other derivative products. The legislatively created EBRF which provides for a small controlled emergency fund. A formalized reserve policy has been established with a target of 5% for the unassigned general fund carryover balance and 10% for the EBRF. Additionally, legislatively mandated debt policies and a debt affordability study were adopted in fiscal 2017 restricting the amount and types of bonds issued by the state.

Budget management framework

COR, a seven-member, independent revenue forecasting body, prepares revenue forecasts at least quarterly, but also in special sessions when fiscal conditions warrant. The executive branch and legislature are required to consider the council's estimates in the budget process. Should they use a different forecast, this development and the rationale must be publicized.

Spending is controlled through an allotment system, and the Hawaii Department of Budget and Finance monitors expenditures throughout the year. Budget adjustments are implemented periodically throughout the fiscal year as the state deems necessary. Restrictions can be implemented at any time but are usually imposed at the beginning of the fiscal year. Adjustments requiring legislative action are handled during the legislative session, which begins shortly after the start of the third quarter; in extraordinary circumstances a special legislative session may be called. The governor has unilateral authority to restrict executive branch spending. Legislative approval is required to authorize spending, to impose new taxes, or to increase existing taxes.

Beginning with 2010, the state has demonstrated willingness to provide timely and structural--budget solutions when confronting previously projected budget deficits. As described above, the enacted deficit-closing solutions have been mostly structural. Deficits are not carried forward, but soft revenue performance and an expiration of the previous solutions contribute to a projected shortfall of revenue compared with baseline spending trends, necessitating either adjusted service levels or enhanced revenues for the upcoming biennium.

On a four-point scale in which '1' is the strongest, we have assigned a score of '1' to Hawaii's financial management.

Economy

We anticipate Hawaii's economy to produce slow but relatively steady growth in the upcoming years. From 2006 through 2016, total personal income in the state grew in line with the nation, at a 3.5% compound average growth rate versus 3.6%. On a projected basis, our forecast, based on IHS Markitt modeling, looks for growth of 3.4% and 4.1% in 2017 and 2018, respectively, with growth remaining below 5% through 2020. As of 2015, per capita personal income is 102% of the nation.

State GDP, on the other hand, has been growing more slowly than U.S. GDP, and the gap has widened more recently. Over the past 10 years, state GDP grew in real terms at an average annual rate of 0.99%, which is below the average U.S. annual rate of GDP growth of 1.25%. In the past five years, state GDP increased by 1.20%, on average, versus the U.S., which increased by 1.92%. For 2016, IHS Markitt estimates that Hawaii's GDP grew by 2.06%, above the national rate of growth, 1.6%, and forecasts somewhat slower growth of 1.1% in 2017.

Sluggish GDP growth notwithstanding, population growth rates have generally been slightly above average although 2016 growth estimates shows slower growth in contrast to the national average. During the past 10 years, Hawaii's population has increased 0.87% per year, on average, versus 0.8% for the nation. However, the population is growing older, which has pushed up the state's age-dependency ratio to 62.1% in 2015 from 58.4% in 2012. This puts the state in a slightly weaker demographic position, in our view, than the nation as a whole, which has a ratio of 60.7%. IHS Markitt estimates that Hawaii's aging 65-plus population represents 16% of its total population, one of the highest proportions of the elderly among all the states. Additionally, this proportion is expected to increase to 20% by 2024, making Hawaii the sixth-most-aged state in the country. This could result in a challenge for the state in funding government services for the elderly as the working-age population will barely increase over the next decade.

It's been common for Hawaii's unemployment rate to be lower than the nation's. The state's unemployment rate was 3% in 2016, well below that of the nation, which was 4.9% for the year. Tourism will likely always be an important part of Hawaii's economy--but to a lesser degree than in the past. Whereas various elements of the tourism industry accounted for 33% of state GDP in 1988, now it's only 17%.

Although the state's COR now anticipates the visitor industry will proceed at a slightly reduced pace, it continues to expect the construction sector to pick up much of the slack. That's why the more tempered activity in the construction sector since late 2013 poses an increased risk to the state's rate of overall economic growth.

Home prices and the cost of living are high in Hawaii relative to the nation, but the state's real estate sector proved considerably more stable than it did in most of the rest of the nation during the recession. Unlike many markets throughout the U.S., Honolulu's housing market (70% of Hawaii's real estate market) decline during the Great Recession was only moderate, roughly 11% from peak (in 2006) to trough (in 2009), according to the state. This compares to a 31.5% decline in home prices nationally during the same time period (the national measure is according to the S&P/Case-Shiller Home Price Index). We attribute the better performance of Honolulu's--and by extension, the state's--housing market throughout the recession to the fact that the five state-headquartered banks originate most of the home mortgages in Hawaii and, during the middle 2000s, refrained from heavy subprime lending. The state reports that Honolulu city and county rates of foreclosures are well below national averages and below those of comparable metropolitan areas around the country.

Construction activity has tended to correlate with job growth during the past several years. As of the third quarter of 2016, Hawaii is the 15th-fastest growing state, led primarily by a surge in the construction sector. Strong gains in the construction sector are a result of new development on the island state. New residential and commercial projects promise construction jobs, which should continue to see healthy gains. After the recent quarter, the construction sector is just shy of its prerecession peak, experiencing considerable 12.1% year-over-year growth. Housing starts, after dipping by 15.1% in 2011, followed by a 5.4% increase in 2012, rebounded with a 25.2% increase in 2013. But they then slid back in 2014, with an 18.5% decline in new housing starts, according to IHS Markitt. In 2015, housing started once again to rebound, however, increasing by 59.3%. IHS Connect forecasts that housing starts will continue to increase for the next few years until 2018 when they will again resemble pre-Great-Recession totals.

On a four-point scale in which '1' is strongest, we have revised our score of Hawaii's economy to '1.9' from '2'.

Budgetary Performance

After having used a significant portion of its EBRF and Hawaii Hurricane Relief Fund (HHRF or rainy day reserves) during and in the aftermath of the Great Recession, Hawaii has commenced rebuilding these balances. After four consecutive annual increases in ending balances, fiscal 2014 marked the first year in which the balance declined, albeit modestly. Combined ending and rainy day fund balances as of June 30, 2014, were $748 million, down from $868 million in fiscal 2013. Combined balances have since increased to $1.1 billion as of fiscal 2016, and are projected to end fiscal 2017 at $832 million. The state has maintained an additional $183 million in its HHRF at the end of 2016. The HHRF was established to provide hurricane insurance policies in the state when it is not available in the private market. Although the state has used the fund for general reserves in the past, we do not currently consider the HHRF fund in our calculation of its fund balances but recognize its availability in event of budget or liquidity pressures. Favorable revenue trends have enabled the state to accumulate impressive general fund ending balances and budget reserves that, in our view, add to its capacity to weather the potential for economic softening. Early in fiscal 2017, Governor David Ige signed an administrative directive specifying an unassigned general fund carryover balance of at least 5% and an emergency and budget reserve fund (EBRF) balance of at least 10% of prior-year revenues as state objectives. On a combined basis, the state's general fund and EBRF balances at the end of fiscal 2016 exceeded this 15% target.

According to the general fund financial plan, which is built on COR revenue forecasts, the outlook is for fiscal performance to soften somewhat, however. At this time, the state's fiscal 2018 ending balance plus rainy day funds are projected to be $743 million, or 10% of expenditures. Two consecutive administrations have made building and maintaining Hawaii's budget reserves a priority. A formalized state reserve policy has been established with the administration committed to maintaining budget reserves equal to 10% or more of general fund revenues, which we view favorably. While financial reserves remain particularly important for Hawaii given its above-average fixed costs stemming from its relatively large long-term liabilities, it has achieved an especially strong position.

The fiscal 2018-2019 budget proposal calls for $14.25 billion in total state spending in fiscal 2018, and $14.38 billion in fiscal 2019. General fund spending would be $7.4 billion in fiscal 2018 and $7.5 billion in fiscal 2019, projecting general fund revenue growth of 5% and 5.5%, respectively. The proposal prioritizes education, allocating $28 million each year to the state's school funding formula. The proposed budget also prioritizes homelessness and housing with appropriations proposed for housing projects, public housing improvements, rent subsidies, and supportive services for the homeless. Since the proposed budget release in December 2016, the state has proposed a number of budget adjustments to reflect softening revenue projections from COR and adjustments to the pension plan contributions. The updated general fund plan projects deficits in fiscal 2017 through 2019 ranging from 6.6% to 0.3% of general fund expenditures.

Liquidity

At the end of fiscal 2016, cash and equivalents across all governmental funds totaled $690.4 million, or 12.3% of general fund expenditures. Cash is monitored on a daily basis, with daily reports reflecting the state's investment positions. The state forecasts its liquidity needs on a one-year-forward basis, including recurring and known expenditures (debt service payments and payroll), and makes investments to provide liquidity on those dates. Annual cash flow is generally predictable although the state has made several downward revisions of forecast revenue growth following the recession. The state monitors and manages its disbursements with greater-than-average scrutiny to provide for positive general fund balances at fiscal year-end. The state has the statutory ability to borrow internally with the approval of the director of finance. The state has not done any external borrowing for cash flow purposes; it is permitted to issue GO bonds to fund a deficit but never has.

Audited financial statements

Audited fiscal results for 2016 published in the state's comprehensive annual financial report indicate that general fund tax revenues increased by 6.7% in fiscal 2016. Revenues for fiscal 2014 consisted primarily of the general excise and use taxes (approximately 50% of revenues) and the individual and corporate income tax (approximately 35%). Education expenditures (including kindergarten through grade 12 and higher education) accounted for 51% of expenditures, followed by human services and health-related expenditures, which totaled 20%. The audited combined ending assigned and unassigned fund balance in fiscal 2016 increased by $200 million to $1.8 billion, or 32% of expenditures. The balance from the fiscal 2015 level, when it was $1.59 billion was 30% of expenditures.

We believe the state's reserve position is strong although slightly less liquid than at the end of fiscal 2012 given the changes in the state's cash position. At the end of fiscal 2016, general fund cash was $234 million, up from $204 million at the end of fiscal 2015.

The EBRF, created by the legislature in 1999, is normally funded from 15% of tobacco settlement funds. However, this revenue was diverted to the state general fund during fiscals 2012 and 2013. Pursuant to state statutes, Hawaii's general fund plan resulted in deposits into the HHRF in each of fiscal year since 2014. Across two consecutive administrations, the state's commitment to replenish these funds remains intact and is a departure from earlier plans to allow the reserves to become-depleted. For fiscal 2017, the state will deposit $201.4 million in the EBRF bringing the total in the fund to $310.7 million. The total for the HHRF fund will be $182.5 million for fiscal 2017. We believe the replenishment and commitment to maintain these funds represent a strengthening of the state's credit quality.

On a four-point scale in which '1' is strongest, we have assigned a score of '1.4' to Hawaii's budgetary performance.

Debt And Liability Profile

Issuance of GO bonds must be authorized by a majority vote of the legislature, and each year, the GO authorization bill authorizes the aggregate amount of GO bonds that may be issued to finance capital improvement projects. The bill also contains a calculation to ensure that the total amount of debt service payments required will not cause the state to exceed its debt limit of 18.5% of the average of the preceding three years' general fund revenues. The state constitution requires that all debt begin to amortize principal within five years of issuance, mature within 25 years, and have level debt service payments. State law disallows the use of swaps or other derivative products.

Hawaii's debt ratios, as of June 30, 2016, on a per capita and percentage basis were high, in our view, with direct state debt approximately $6.9 billion, or $4,815 per capita, 9.5% of total state personal income, and 8.6% of state GDP, among the highest of all the U.S. states. Hawaii's high per capita debt is attributable to the state's assumption of many functions that, in other states, are generally financed by local governments, including education, health, and welfare.

Debt levels, however, rose rapidly during the 1990s as the state shifted from pay-as-you-go capital spending to GO bonds. However, debt amortization is rapid, with 65.5% of principal repaid within 10 years. Total annual tax-supported debt service (GO bonds, appropriation-backed debt, and the state highway fund) equaled $777 million in fiscal 2016, or about 12% of the expenditures from the general and state highway funds, which we consider high.

Pension liabilities

Pension benefits are administered by the Employees' Retirement System (ERS) of the State of Hawaii, which began operation on Jan. 1, 1926. The system is a cost-sharing, multiple-employer, defined-benefit pension plan that covers all regular employees of the state and each of its counties, including judges and elected officials. The system covers 119,006 active and retired beneficiaries as of June 30, 2015, up from 115,350 in 2013. Following implementation of Governmental Accounting Standards Board (GASB) statement 67 and 68, the state recognized a net pension liability of $7.65 billion for fiscal 2016. This translates to $5,357 on a per capita basis and 10.6% of total personal income, both of which we view as high.

We consider the state's three-year average pension funded ratio weak at 59%. The plans reported what we still consider a weaker pension actuarial market funded ratio of 51.3% as of June 30, 2016. The funding level decreased steadily through 2016 from a high of more than 95% in fiscal 2000. The ERS announced a negative 1.2% return on investment to end June 2016, which is worse than the average and will resulted in a lower state pension funded ratio at the end of the fiscal year. In addition, effective July 1, 2016, the ERS board elected to change its actuarial assumed rate of return to 7% from 7.65% and revised its mortality expectations to better reflect long-term market expectations in light of recent experience study concerns. Although such a change puts additional negative pressure on the system's funded ratio, it reflects a more conservative orientation with regard to managing long-term pension liabilities. These more conservative assumptions and weak recent market returns will depress future reported pension funded ratios, all else being equal, and increase required employer contribution rates in future years. As of June 30, 2016, the change in the discount rate and mortality assumptions added an additional $3 billion in unfunded liabilities to the plan's net position. Despite annual valuations, the state historically does not adjust its pension contributions mid-biennium, resulting in a delayed response to required contribution increases. In addition, the state's prior practice (which was ended in 2005) of reducing employer contributions when investment returns exceeded the assumed rate of return contributes to the ERS' currently relatively low funded ratio.

Annual pension contributions are set according to statutory formula. Throughout much of the 2000s, employer contribution rates resulted in actual contributions that roughly aligned with the actuarially recommended level. Since 2011, however, the contribution rate has repeatedly been applied to a smaller-than-expected state government workforce, the growth of which was constrained in response to the Great Recession. As a consequence, actual contributions have fallen short of the actuarially recommended level, though they are typically above 90% of it.

The state has put in place numerous reforms to improve pension funding including introducing a new benefit tier for employees hired after 2012, implementing anti-spiking provisions, and advanced full state contributions made at the start of the fiscal year to maximize returns. Notably, the governor introduced the Legislative Bill 936 in the 2017 legislative session to restore the ERS to full funding within the statutorily required 30 years by phasing in higher system wide contribution rates through 2021. The bill will require contribution rates to increase from the current 17% to 24% by fiscal 2021 for the general plan and a more aggressive increase from the current 25% to 41% by fiscal 2021 for police and fire. It is expected that the increased contribution rates will result in approximately $15 billion in savings and will begin to fund normal costs by 2046 after eliminating amortized liabilities. In our opinion, the successful adoption and implementation of the increased contribution rate is vital to the state's long term's financial capacity and is essential to maintain credit quality. To the extent that the increased contribution rates are not adopted or the implementation leads to significant strain on future budgets operations or reserves, we could view this indication of weakening financial capacity. It is our understanding that as of April, Senate Bill 936 has passed through all of the legislative committees without any amendments to the phase-in of the additional ERS contributions to ensure that the unfunded liability is paid down within 30 years. The state expects that a final vote floor and the governor's signature will follow within the next few weeks.

While we believe on the whole that management factors and actuarial inputs currently implemented for the ERS' 2016 valuation somewhat encumber our view of the state's overall pension funding discipline, it is our opinion that successful implementation of the pension reforms could improve our opinion in the near future. ERS assumes an open, 30-year amortization period and a "level percentage of pay" method which assumes rising future payroll and results in escalating pension contributions over time. However, recent actuarial reports report that actual aggregate funding period for the system is 66 years which violates the plans statutes. The plan reported an actual 4% five-year average rate of return as of June 30, 2016, which is significantly lower than its current actuarial assumed rate of return of 7.65%. Its one-year return for 2016 was negative 1.2%. Additionally, the plan smooths assets based on a four-year window of actuarial value of assets. Since they currently have investment losses, this means significant costs are being deferred into the future. The plan's ratio of active members to beneficiaries equals 1.48, which is in line with the median national ratio. However, the plan's weak pension funded ratio, is below the median. It is ERS' practice to produce an experience study every five years.

In fiscal 2011, the state created a new benefits tier for new members hired on or after July 1, 2012. The new benefits tier generally offers a lower level of benefits and requires higher employee contributions. As the mix of active plan members transition to the new tier, employee contributions will increase as the noncontributory plan members retire and are replaced with new members. Other reforms included restricting pension spiking and other similar practices that elevated the state's long-term liability. Furthermore, the state has also shifted from equal monthly contribution payments to providing a single payment at the beginning of the fiscal year. This is estimated to reduce the unfunded actuarial accrued liability between $180 million and $260 million over a 10-year period.

OPEB risk assessment

In 2013, Hawaii enacted legislation (Act 268), which initiated a schedule for prefunding the state's retiree health care benefit liability. Under the legislation, the state's prefunding of the OPEB liability would ramp up to 100% of the annual required contribution (ARC) by fiscal 2019 from 20% of the ARC in fiscal 2015. However, the administration has accelerated the escalating contributions so that, according to the governor's proposal, the state would contribute the full ARC in fiscal 2018, one year ahead of the law's schedule. To put the contribution differential into perspective, the state's pay-as-you-go cost in fiscal 2016 is $333 million while the full ARC is $742.8 million (down from over $1 billion prior to the reform legislation). The state accelerated its implementation of the prefunding in fiscals 2014, 2015, and 2016. The state is contributing an additional $97.6 million above the Act 268 schedule in fiscal 2017 and plans to contribute an additional $74.3 million in fiscal 2018. Although the state's effort to prefund its OPEB liability contributes to fiscal pressure in fiscal 2017, we believe it illustrates the policymakers' increased commitment in recent years to addressing its liabilities.

By adopting the higher funding trajectory, the Employer-Union Health Benefits Trust Fund's actuary incorporated a higher discount rate to measure the state's liability. This had the effect of lowering the state's estimated unfunded OPEB liability, estimated at $9.1 billion in fiscal 2016, or 33% less than the liability as of fiscal 2013 when Act 268 was signed into law. In general, we view the state's willingness to begin confronting its OPEB liability as favorable. Although at $6,386, the state's per capita OPEB liability remains high, it's down considerably from fiscal 2012 when it stood at $9,770 per capita.

It's common that pension and OPEB reform efforts produce material improvement in key metrics only as a result of sustained commitment on the part of policymakers and sometimes over many years. While the effects of Hawaii's Act 268 and its various pension reforms do not result in an immediate improvement to our rating on the state, we view them as important to its ability to maintain its current rating through economic cycles while also enhancing its potential for a higher rating.

We have assigned a score of '3.2' out of '4' to Hawaii's debt and liability profile, on a scale where '1' is the strongest score and '4' the weakest.

Ratings Detail (As Of April 28, 2017)		
Hawaii GO		
Long Term Rating	AA+/Stable	Affirmed
Hawaii GO (wrap of insured) (AMBAC & AGM) (SEC MKT)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Hawaii GO (MBIA) (National)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed
Hawaii APPROP		
Long Term Rating	AA/Stable	Affirmed
Hawaii GO		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.