



## RATING ACTION COMMENTARY

# Fitch Rates Talbot County, MD's \$24.9 Million GOs 'AAA'; Outlook Stable

Wed 14 Sep, 2022 - 3:16 PM ET

Fitch Ratings - New York - 14 Sep 2022: Fitch Ratings has assigned a rating of 'AAA' to Talbot County, Maryland's \$24.9 million series 2022 GO bonds. The bonds will be offered by competitive sale on or about Sept. 29, 2022.

Fitch has also affirmed the following ratings of the county at 'AAA':

--Issuer Default Rating (IDR);

--Outstanding GO bonds.

The Rating Outlook is Stable.

## SECURITY

The bonds are full faith and credit obligations of Talbot County, payable from ad valorem taxes on all taxable property within the county. The annual property tax levy is subject to a growth limitation set out in the county charter equal to 2%.

## ANALYTICAL CONCLUSION

The 'AAA' IDR and GO rating reflect the county's very low long-term liability burden and associated fixed carrying costs that are a minimal percent of spending, as well as modest future borrowing plans. The rating also incorporates the county's healthy reserves that provide the highest level of gap-closing capacity to address an economic downturn.

### **Economic Resource Base**

The county is located on Maryland's eastern shore, about 50 miles east of Washington, DC across the Chesapeake Bay. The estimated 2021 population of 37,626 is down slightly from the 2010 census level. The county is rural and its economy is largely driven by tourism, with a significant second home presence.

### **KEY RATING DRIVERS**

#### **Revenue Framework: 'aa'**

Fitch expects general fund revenues, primarily derived from property and local income taxes, to continue to increase slowly, along with inflation. The income tax base is concentrated in an unusual level of high-income earners. The county's independent legal ability to raise real property tax revenues is limited by county charter to 2%. However, the rate can be exceeded for the purpose of funding the school's operating budget by a simple majority vote of the county council, providing significant independent legal revenue raising ability.

#### **Expenditure Framework: 'aa'**

The county's spending flexibility is ample, despite some state-imposed restrictions on reducing education spending. Fixed carrying costs related to debt, pensions and OPEB are very limited. County employees do not collectively bargain and management had success controlling spending through headcount reductions during the downturn.

#### **Long-Term Liability Burden: 'aaa'**

The long-term liability burden is very low at about 3% of personal income. Debt levels are expected to remain low given the county's limited capital needs. The net pension liability is very small despite the below average ratio of assets to liabilities of the state-wide cost-sharing plan.

#### **Operating Performance: 'aaa'**

Fitch's assessment of the county's operating performance reflects its commitment to maintaining sound reserves over time, which cushions it against risk associated with a volatile revenue base in an economic downturn. Revenue raising capacity and expenditure flexibility contribute to the county's overall financial resilience.

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--The county's IDR and GO hold the highest-possible rating under Fitch's tax-supported criteria, at 'AAA'. Therefore, no upward rating action is possible.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Weakness in the revenue trend suggesting a shift toward lower revenue growth prospects below long-term inflation;

--A sustained reduction in financial resilience, particularly from severe economic declines that diminishes the county's reserve position to a level insufficient to address revenue volatility.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## **CURRENT DEVELOPMENTS**

The county was able to carry a general fund balance in excess of \$61 million, or 65% of general fund expenditures, into fiscal 2022 (June 30 year-end). The county projects that it will finish fiscal 2022 with a general fund surplus above \$2 million (2% of estimated spending), resulting in a final fund balance of about \$65 million (58% of estimated

spending). This result is primarily attributable to positive variances in tax revenues (income, recordation, and transfer).

The county received \$7.2 million in American Rescue Plan funds, which have been allocated and budgeted for one-time projects including broadband expansion, emergency services facilities, and cybersecurity improvements.

The adopted general fund budget for fiscal 2023 totals \$112.6 million, which reflects very little change yoy from the fiscal 2022 budget. The fiscal 2023 budget includes a 2.55 cent increase in the county's property tax rate over fiscal 2022. The county is adding 13 full time positions in fiscal 2023, most of which are in public safety.

## **CREDIT PROFILE**

The county is predominantly rural, with farmland comprising a majority of its land area. While agriculture is economically important, the county's main attraction is its 600 miles of shoreline. The leisure and hospitality industries represent an important share of the employment base. The shoreline is a popular retiree destination and second home location for the large number of wealthy individuals in the greater Washington-Baltimore Metro region.

In addition to hospitality and tourism, healthcare is another important economic sector as evidenced by Shore Regional Health, a member of the University of Maryland Medical System, accounting for about 10% of county employment. Fitch believes that the long-term prospects for the facility are positive, as University of Maryland Shore Medical Center at Easton serves an important regional need and continues to expand its operations. Demand may be affected by the county's large population over the age of 65.

Employment in the county has increased slowly since 2009, but remains below the pre-recession levels. Unemployment continues to decline along the lines of the state and national levels. Wealth metrics are above average compared with the state and nation.

## **Revenue Framework**

Property tax is the largest revenue category at just over 40% of general fund revenues, which is followed by the local income tax at about a third of revenues. Other local taxes, such as the recordation and accommodation taxes, account for an additional 20% of revenues.

Income taxes are a higher percentage of revenues than is true for most Maryland counties. This is partially due to the very low tax environment compared with the rest of the state, which provides incentive for a small number of high-income earners with second homes to declare their income in the county. Fitch believes this concentration contributed to very volatile general fund revenues during the previous recession.

General fund revenues grew moderately over the decade ending in fiscal 2021 when adjusted by Fitch to eliminate the effects of policy actions to increase tax rates. This increase is mostly attributable to a rise in income tax and recordation fee revenues. The housing market has been slow to recover from the Great Recession and property values have still not returned to pre-Great Recession values, despite increases in assessed values in the last three consecutive years.

Income tax revenues have fluctuated substantially over time. Recent volatility might be tied to taxpayer behavior regarding when gains and losses are realized as a result of federal tax law changes. These frequent fluctuations also reflect the fact that 1.5% of taxpayers pay approximately 30% of income tax revenues. Talbot County's share of income tax revenue from taxpayers with over \$500,000 in Maryland Adjusted Gross Income was nearly three times the statewide average for that group, at 32% of income tax revenues in fiscal 2017. The county's high-income taxpayers had an average taxable income that was the highest in the state at \$1.3 million in fiscal 2017, according to information from the state's comptroller.

Fiscal 2021 revenues increased by 5.6% compared with the year prior and fiscal 2022 revenues are projected to have grown by over 7% compared with fiscal 2021. Fitch expects the county's revenues to demonstrate modest growth over the longer term, with high volatility in income tax receipts.

Fitch believes the county maintains substantial independent ability to raise revenues compared with the level of historical volatility. From 1998 to 2020, the county's charter statutorily limited the increase of revenues derived from property taxes to the lesser of 2% or CPI growth. Since 2020, the charter has limited the increase in property tax revenues to 2%. The county adjusts the property tax levy to take advantage of the full increase allowed each year. The county's property tax rate remains one of the lowest of any county in the state.

The county has additionally levied an educational tax supplement several times since 2013, including in fiscal years 2017 through 2023. The levy and rate of county educational tax

supplements in Maryland are not subject to any limitation. Otherwise, the tax revenue cap can only be exceeded or changed by voter referendum.

The county gains added flexibility to raise recurring revenues from its remaining capacity under the state's income tax cap, at 3.2%. The county's current rate is 2.4%, and Fitch estimates the county could increase income tax revenues by approximately 35% or \$9 million by raising rates to the legal cap. While the county has the legal ability to increase the rate, Fitch recognizes that the incentive for high income-earners to declare their income in the county may be reduced. The county could also increase fines and fees and the recordation and transfer tax, none of which are subject to a cap.

### **Expenditure Framework**

Education is the primary spending category at just over half of general fund expenditures, followed by public safety at 23%. Like many local governments, a majority of the budget is devoted to employee payroll related to service delivery. According to the state maintenance of effort mandate, education spending is tied to enrollment and cannot decline from year to year without approval from the state, which somewhat limits spending flexibility.

The county's spending demands are expected to continue to grow steadily. Fitch believes underlying spending growth will likely outpace the slow revenue growth prospects without continuous policy action to adjust revenues and spending over time.

Fixed carrying costs for debt service, required pension contributions and actual OPEB payments are minimal at just under 4% of spending. This includes costs associated with not only the county's general pension plan, but also the normal cost of the board of education employees' pension, which counties in Maryland are required to pay; the state pays the share of teacher contributions associated with amortizing unfunded liabilities. The county pays the full pension contributions required by statute, which currently meet the actuarially determined contribution (ADC) at the system-wide level.

County employees do not participate in collective bargaining, which provides management with broad legal control over workforce rules, wages and benefits. Management successfully achieved cost savings during the last recession by reducing head count.

### **Long-Term Liability Burden**

The county's long-term liability burden is very low at 3.5% of personal income. The county does not plan to issue any new general obligation debt in the next five years, and the

current burden is very low. Amortization of principal is modest with 49% of all bonds maturing within 10 years. The county does not have any plans for additional debt issuance through at least fiscal 2025.

The county provides pension benefits to its employees and employees of the Board of Education (BOE) through the State of Maryland Employees Retirement and Pension System. The adjusted net pension liability for the county's and BOE's proportionate share of the system-wide liability is about 1% of personal income, despite the plan's aggregate assets that cover only about 60% of liabilities at Fitch's standard 6% investment return assumption.

### **Operating Performance**

Fitch's assessment of the county's financial resilience as being in the highest category is based on the combined strength of its fund balance position, its ample expenditure flexibility and its strong ability to adjust revenues through policy action to counterbalance its historically volatile revenues. The county typically increases its property tax levy by the full amount allowed annually under the county charter. Both the property and the income tax rates remain among the lowest in the state. The county responded to past recessionary revenue declines with expenditure cuts that included layoffs, pay freezes and employee furloughs.

The general fund's unrestricted fund balance at YE fiscal 2021 was \$61.3 million or 65% of spending. Operating results relative to budget were positive and the county concluded the fiscal year with a surplus of \$17.2 million. The county also held roughly \$8.1 million in committed reserves in its capital projects fund at YE 2021 (comprised of prior surpluses). These reserves can be used with council approval for general fund purposes, adding to operating flexibility.

The fiscal 2022 general fund budget of \$112.8 million was a 16.8% increase over fiscal 2021. The budget increased the tax levy according to the charter limit and kept the income tax rate unchanged. The budget appropriated \$20.8 million of fund balance and included a transfer of \$10 million to the capital projects fund. Officials expect the general fund will conclude fiscal 2022 (June 30) with an approximately \$2 million operating surplus that will increase available reserves to \$63 million, or about 60% of spending and transfers out.

The \$112.6 million adopted budget for fiscal 2023 represents a 0.1% decrease from the fiscal 2022 adopted budget. The budget includes a planned \$14.3 million appropriation of

fund balance, a \$1.5 million contingency against unforeseen expenses, and a \$3.0 million transfer to the capital fund.

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

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means 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](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
Talbot County (MD) [General Government]	LT IDR    AAA Rating Outlook Stable  Affirmed	AAA Rating Outlook Stable
Talbot County (MD) /General Obligation - Unlimited Tax/1 LT	LT    AAA Rating Outlook Stable  Affirmed	AAA Rating Outlook Stable

[VIEW ADDITIONAL RATING DETAILS](#)

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**APPLICABLE CRITERIA**

[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 04 May 2021\) \(including rating assumption sensitivity\)](#)

**APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

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Talbot County (MD)

EU Endorsed, UK Endorsed

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