FitchRatings

FITCH RATES $550MM MASSACHUSETTS GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-18 November 2015: Fitch Ratings has assigned an 'AA+' rating to $550 million in Commonwealth of Massachusetts general obligation (GO) bonds, consisting of:

--$150,000,000 GO bonds, consolidated loan of 2015, series D;
--$400,000,000 GO bonds, consolidated loan of 2015, series E.

The bonds are scheduled to sell via competitive sale on Dec. 1, 2015.

The Rating Outlook is Stable.

SECURITY

The bonds are general obligations of the Commonwealth, to which its full faith and credit are pledged.

KEY RATING DRIVERS

STRONG AND WEALTHY ECONOMY: Massachusetts has a broad and diverse economy with the second-highest per capita personal income in the nation. Employment growth is solid, education levels are high, and population growth has approximated that of the U.S. this decade, a marked improvement from historical experience and the performance of other states in the region.

PRUDENT FINANCIAL MANAGEMENT: The Commonwealth has benefited from conservative budgeting and sound financial practices over time. A limitation on the use of capital gains-related tax revenue has reduced the volatility of economically sensitive revenues in the budget, and the Commonwealth has shown a commitment to reserve funding.

COMPARATIVELY HIGH DIRECT LIABILITY BURDEN: Massachusetts' liability levels are high for a U.S. state government, and Fitch expects them to remain so. This is partially explained by the above-average role played by the Commonwealth in relation to local levels of government when compared to most other states. In addition, the Commonwealth is responsible for the pension benefits of Commonwealth employees and teachers statewide, contributing to a combined burden of debt and pensions well above the median for U.S. states.

RATING SENSITIVITIES

The rating is sensitive to shifts in fundamental credit characteristics including the Commonwealth of Massachusetts' commitment to strong financial management practices.

CREDIT PROFILE

Massachusetts' 'AA+' GO rating reflects its considerable economic resources and a record of prudent financial management. Credit strengths are tempered by a comparatively heavy direct liability burden that Fitch expects to remain high. The Stable Outlook reflects the expectation that the Commonwealth will continue to act as needed to ensure budget balance and maintain an adequate budgeted reserve position.

SIGNIFICANT BUDGETARY FLEXIBILITY

Fitch believes the Commonwealth retains significant flexibility to address operating under-performance and has repeatedly demonstrated its commitment to maintaining budgetary balance. Mechanisms for maintaining balance include the governor's requirement to reduce allotments or identify alterative balancing measures in the event of a mid-year forecast deficiency. The Commonwealth also has established clear mechanisms for setting aside resources in the stabilization fund (the Commonwealth's rainy day fund).

Massachusetts relied on allotment cuts, federal stimulus and draws on the stabilization fund during the last recession; the stabilization fund balance fell to $670 million in fiscal 2010, from a high of $2.34 billion in fiscal 2007. Although subsequent deposits returned the stabilization fund balance to $1.65 billion by fiscal 2012, draws since then and more recently the suspension of most deposits in fiscal 2015 have left the balance at a still adequate $1.25 billion at fiscal year-end, equal to 5% of fiscal 2015 tax revenues.

Additionally, the Commonwealth has proactively taken steps to reduce the budgetary impact of volatile revenue collections, particularly the unpredictability of capital gains-related collections. Since fiscal 2011 the budget has included a mechanism for limiting capital gains-related revenue that can be included in the Commonwealth's budget to $1 billion, with this cap adjusted annually starting in fiscal 2014 by a U.S. GDP growth-based formula, and with excesses dedicated to the stabilization fund (90%) and retiree benefit obligations (10%). The threshold is $1.087 billion in fiscal 2016.

Pursuant to this mechanism capital gains-related tax revenue contributed $468 million and $45 million to the fund in fiscal 2013 and 2014, respectively. Fiscal 2015 capital gains would have exceeded the mechanism's threshold by an estimated $621 million based on the department of revenue's July 2015 certification; ultimately only $124 million was deposited, with the remainder redirected in response to budgetary underperformance. As part of the fiscal 2016 budget, the transfer of a forecast $300 million in capital gains over the threshold has also been suspended.

A similar mechanism covers one-time judgments and settlement payments. Since a fiscal 2014 statutory change, deposits are based on whether total collections exceed a five-year benchmark for historical collections ($263 million in fiscal 2015). The stabilization fund benefited from deposit of $375 million of such payments in fiscal 2012, although the Commonwealth redirected the bulk of such revenues in fiscals 2013 and 2014 for other purposes. Fiscal 2015 payments of $226 million fell short of the $263 million benchmark. For fiscal 2016, the Commonwealth assumes payments of $125 million, also below the $267 million benchmark.

CAREFUL FISCAL MANAGEMENT

Massachusetts has maintained a solid financial position in recent fiscal years, including taking proactive steps to address emerging revenue and spending challenges. In fiscal 2015, underperformance in non-tax revenues early in the fiscal year and the unexpected triggering of an additional personal income tax rate reduction to 5.15%, from 5.2%, effective Jan. 1, 2015 (estimated impact of $70 million), led the Commonwealth to announce a $329 million deficiency in November 2014, of which $252 million was addressed through lower spending allotments and other measures.

After the new governor assumed office in January 2015, the Commonwealth retained $200 million in fiscal 2015 capital gains tax collections intended for transfer to the stabilization fund. However, higher spending needs for health care and social services and for addressing harsh winter weather, among other needs, outpaced earlier estimates and led the Commonwealth to announce a $768 million budget gap. In particular, the Commonwealth's spending needs for Medicaid far exceeded earlier estimates, driven by caseload growth in its Medicaid expansion program, MassHealth.

The Commonwealth took prompt action to close the gap, with additional allotment cuts and a legislative package of spending and revenue measures, including redirecting another $131 million in excess capital gains tax collections to the general fund instead of to the stabilization fund.

Actual tax collections in fiscal 2015 ultimately exceeded forecast expectations. The enacted fiscal 2015 budget had assumed tax revenue growth of 4.9% over then-preliminary fiscal 2014 tax revenues, to $24.4 billion, while actual figures show tax revenues up 6.7%, to $24.9 billion. Personal income taxes rose 9.4%, benefitting from solid April estimated payments and withholding gains driven by strong labor market conditions. Sales taxes rose 5.1%.

FISCAL 2016 BUDGET OUTLOOK STEADY

The fiscal 2016 tax revenue forecast, based on the January 2015 consensus and subsequent budgeted adjustments, assumes tax revenues rising 4.8% from fiscal 2015 tax revenues as forecast at the time, or 2.7% from actual fiscal 2015 collections. The forecast estimates almost $1.4 billion in capital gains, higher than the $1.087 capital gains threshold. Rather than transferring the resulting $300 million in excess collections to the stabilization fund, the budget retains the excess for current-year spending needs. The budget also conservatively assumes an additional triggered reduction of the income tax rate to 5.1%, from 5.15%, effective Jan. 1, 2016.

Budgeted expenditures and other uses, currently estimated at nearly $41.1 billion, is 7.8% higher than the prior year, a growth rate above the 6.2% level reported for fiscal 2015. The majority of fiscal 2016 expenditure increases are directed to Medicaid and health and human services needs even as the Commonwealth continues to focus on slowing the Medicaid spending growth that surged in early 2014 with health care expansion. Other key initiatives in the budget include an early retirement incentive program.

Year-to-date through October, fiscal 2016 tax revenue collections are 5.9% over the prior year and $126 million over the forecast benchmark. Although the Commonwealth has already identified several budgetary challenges in the new fiscal year, including $200-$250 million in deficiencies, Fitch views these challenges as being well within the scope of budgetary flexibility available to the Commonwealth at present.

FUNDAMENTALLY STRONG ECONOMY

Massachusetts has a fundamentally strong and wealthy economy. Institutions of higher education and health care are significant and lend stability, in addition to supporting development and innovation in other areas. At 128% of the U.S. average, per capita personal income is the second highest of the states. Education levels are high, and population growth has approximated that of the U.S. during this decade, a marked improvement from historical experience and the performance of other states in the region.

The Commonwealth's economic performance in the most recent recession was significantly better than the national experience, in contrast to 2002-2004 when Massachusetts suffered among the steepest employment drops in the country. Employment losses in 2009 were less severe than those of the U.S. (3.2% versus 4.3%), and Commonwealth employment rose 0.4% in 2010 while U.S. employment fell 0.7%.

For much of the expansion, employment gains in Massachusetts have approximated the national trend, although 2014 employment rose 1.6%, below the 1.9% national rate of growth. More recently job gains appear to have accelerated, with September 2015 employment rising 2%

annually in the Commonwealth, vs. 1.9% for the nation. As of September 2015, the unemployment rate remains well below the U.S., at 4.6% in the Commonwealth compared to 5.1% nationally.

DEBT HIGH BUT MANAGEABLE

The Commonwealth's net tax-supported debt equals a comparatively high 9.2% of personal income as of June 30, 2015, including obligations of the Massachusetts Bay Transportation Authority and the Massachusetts School Building Authority that are backed by allocations of the Commonwealth's sales tax as well as annual contract assistance commitments that support the Massachusetts Department of Transportation. GO debt continues to represent the majority of outstanding debt. The comparatively high direct debt level is partially explained by the Commonwealth's above-average role in funding local government capital, relative to most other states. Fitch expects direct debt to remain high for a U.S. state but still manageable.

Massachusetts continues to implement a long-term asset-liability management strategy with the goal of more proactively managing interest rate exposure for the Commonwealth overall. This is expected to result in issuance of approximately $3.2 billion in unhedged, floating-rate debt by the end of fiscal 2018. Fitch notes Massachusetts' high credit quality, strong management profile and demonstrated ability to manage a large capital borrowing program. Fitch expects the Commonwealth to carefully manage the program and make adjustments as needed.

The Commonwealth is responsible for the pension benefits of not only Commonwealth employees but also teachers statewide. On a combined basis, the burden of the Commonwealth's net tax-supported debt and the total unfunded liability of the Commonwealth employees and teachers systems equaled 18.9% of personal income, well above the 5.8% median for U.S. states, as of Fitch's 2015 state pension update report.

Massachusetts has undertaken some pension reforms and projects manageable growth in pension contribution requirements going forward. A 2014 agreement accelerates the schedule for full pension prefunding by increasing contributions by 10% per year through fiscal 2017 and 7% in subsequent years. Full prefunding is projected for fiscal 2036 based on current assumptions, although the statutory requirement remains fiscal 2040. The fiscal 2015 contribution was $1.8 billion.

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Date of relevant rating committee: Sept. 10, 2015.

Additional information is available at 'www.fitchratings.com'.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
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