FITCH RATES MASSACHUSETTS' $726MM GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-09 August 2018: Fitch Ratings has assigned a 'AA+' rating to $726 million in Commonwealth of Massachusetts general obligation (GO) bonds, consisting of:

--$500,000,000 GO bonds, consolidated loan of 2018, series E;
--$226,310,000 GO refunding bonds, 2018 series C.

The par amount of the GO refunding bonds is subject to change pending final sale.

In addition, Fitch affirms the Commonwealth's long-term Issuer Default Rating (IDR) at 'AA+' and the ratings on related bonds of the state as detailed at the end of this release.

The bonds will be offered by competitive sale on Aug. 29, 2018.

The Rating Outlook is Stable.

SECURITY
The bonds are general obligations of the Commonwealth, to which its full faith and credit are pledged. A statutory state tax revenue growth limit does not exclude principal and interest on debt obligations from the limit.

ANALYTICAL CONCLUSION

Massachusetts' 'AA+' IDR reflects its considerable economic resources, strong budget controls and a record of careful financial management. The Commonwealth carries a long-term liability burden that is well above average for a U.S. state but remains a moderate burden on resources. 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.

Economic Resource Base
The Commonwealth has a broad and diverse economy. Employment growth is solid, education levels are high, and population growth has approximated that of the U.S. this decade. The Commonwealth's economic fundamentals include significant strength in the health care, technology and education sectors, leaving it well positioned for solid gains going forward. Measured by per capita personal income, Massachusetts is the second wealthiest state in the nation.

KEY RATING DRIVERS

Revenue Framework: 'aaa'
Tax revenues, while diverse, are dominated by personal income taxes (PIT), which are sensitive to economic conditions, particularly those related to capital gains. Baseline growth prospects for taxes are strong, driven by the Commonwealth's solid economic fundamentals.

Expenditure Framework: 'aaa'
Consistent with most states, the natural pace of spending growth is expected to marginally exceed expected revenue growth over time, requiring ongoing cost control. The Commonwealth has ample ability to reduce spending throughout the economic cycle.

Long-Term Liability Burden: 'aa'
Liability levels in Massachusetts, while high for a U.S. state, are a moderate burden on resources. The Commonwealth's above average liability position is partly the result of state funding for needs that are more commonly funded at the local level.

Operating Performance: 'aaa'
The Commonwealth has exceptional fiscal resilience, with strong gap-closing capacity stemming from a practice of building solid reserve balances and making revenue and spending changes as needed in response to changing circumstances. Conservative budgeting, ongoing economic and revenue monitoring, and mechanisms to protect the general fund from economically sensitive PIT and judgment and settlement receipts, support the Commonwealth's fiscal flexibility.

RATING SENSITIVITIES
The IDR is sensitive to Massachusetts' consistent commitment to strong financial management practices, including preserving budgetary flexibility and actively managing its relatively high long-term liability position.

CREDIT PROFILE

Massachusetts has a fundamentally strong economy with strong growth prospects. Its dynamic, service-oriented economy includes numerous institutions of higher education and health care that lend stability, in addition to supporting development and innovation in other sectors. At 131% of the U.S. average in 2017, per capita personal income is the second highest of the states. Educational attainment is very high, and population growth has been stronger during this decade, a shift from historical experience of slow population gains. Despite this shift, the Commonwealth's population profile remains older than the U.S. average, consistent with other states in the region.

Economic performance has been highly sensitive to national trends. In the most recent recession, economic performance 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 the Great Recession were slightly less severe than those of the U.S. (down 6% in Massachusetts versus 6.3% for the U.S.), and employment since then has risen at nearly the same pace as the U.S. (up 14.5% in Massachusetts versus 14.6% for the U.S.).

Revenue Framework
General fund resources derive primarily from PIT, sales tax and corporate income tax. The former two are particularly important, with an estimated 59% of tax revenues from PIT and another 24% from sales tax in fiscal 2019. The PIT is levied at flat rates based on type of income, with a 5.1% rate currently applicable to most categories. Under current law the Commonwealth has been gradually lowering the PIT rate to 5%, from a previous level of 5.3%, in 0.05% increments based on a statutory mechanism incorporating Boston-area inflation and baseline revenue growth; no reduction was triggered as of Jan. 1, 2018, although the Commonwealth forecasts that a 0.05% reduction will be triggered as of Jan. 1, 2019. Revenues are economically sensitive, particularly PIT receipts from capital gains; receipts from judgments and settlements have also been a source of volatility.

Strong economic fundamentals and a revenue system that captures economic growth are the basis for a revenue profile that is likely to grow at or above the national average over time, in Fitch's view.

The Commonwealth has no significant legal limitations on its ability to raise revenues. A statutory tax revenue growth limit based on average wage and salary growth is present but has not hindered the Commonwealth's ability to manage its revenue resources. The initiative environment has periodically been active, and certain revenues have been affected by past initiative petitions, notably property taxes. Importantly, the legislature retains the ability to make changes to statutes passed by successful initiative petitions.

Expenditure Framework

Massachusetts' expenditure profile is very broad, driven by an expansive scope of services. Medicaid and other social services are the largest single spending commitment in the general fund at about half of total spending. Rising needs, including those emerging from implementation of the Affordable Care Act, have pressured spending in recent years. Education is also a significant commitment, with extensive funding of local schools and a broad higher education network. The Commonwealth's education commitment extends to covering the pension liabilities of local teachers, although not the liability associated with their other post-employment benefits (OPEB). Consistent with practices in many smaller states, the Commonwealth is responsible for delivering or funding many services routinely funded at local levels elsewhere.

As with most states, spending in the absence of policy actions is expected to be in line with to marginally above expected revenue growth, primarily driven by social services, particularly Medicaid.

The Commonwealth retains ample ability to cut spending; statute allows for swift response in the event of forecast revenue underperformance, including the governor's statutory powers to unilaterally cut allotments under Section 9C of Commonwealth General Law, Chapter 29. Carrying costs for long-term liabilities, including debt service, actuarial determined pension contributions, and OPEB pay-go appropriations, are elevated but manageable, at 15.1% of governmental expenditures in fiscal 2017.

Federal action to revise Medicaid's programmatic and financial structure, including a basic restructuring of federal Medicaid funding to a capped amount, remains a possibility. Whether a change in Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increased liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Long-Term Liability Burden

Debt and pension liabilities are high for a state. On a combined basis, the burden of tax-supported debt and net pension liability for employees and teachers equaled 20.2% of personal income, well above the 6% median for U.S. states as of Fitch's 2017 state pension update report, which recalculates reported net pension liabilities using a 6% return assumption per Fitch's "U.S. Public Finance Tax-Supported Rating Criteria."

As of June 30, 2018, and incorporating the new money portion of the current sale, the Commonwealth's tax-supported debt equals a comparatively high 9.3% of 2017 personal income, including sales tax-backed obligations of the Massachusetts Bay Transportation Authority and the Massachusetts School Building Authority and annual contract assistance commitments that support the Massachusetts Department of Transportation. The GO bonds 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 needs, relative to most other states. Fitch expects direct debt to remain high for a U.S. state but still manageable.

As of their June 30, 2017 financial reports, pension systems covering state employees and teachers (except in the City of Boston) held fiduciary assets covering 67.2% and 54.3% of their total pension liabilities, respectively, based on their 7.5% discount rate assumptions. At Fitch's more conservative 6% return assumption, ratios would fall to 56.6% and 46.3%, respectively. Some pension reforms have been undertaken, including shifting to more conservative assumptions while maintaining a statutorily closed amortization target for achieving full funding in 2040. Currently, the Commonwealth expects contributions to rise 8.9% per year until the projected date of full prefunding, in fiscal 2036. The Commonwealth carries an OPEB liability for state employees but not local teachers, measuring $19.4 billion net of a small amount of prefunding built in recent years, including from tobacco settlement and excess capital gains collections; the net OPEB liability measures 4.3% of 2017 personal income.

Operating Performance
Fitch believes the Commonwealth retains a high capacity to address cyclical downturns and operating under-performance and has repeatedly demonstrated its commitment to maintaining a solid financial position. Mechanisms for maintaining balance include the governor's requirement to reduce allotments or identify alternative balancing measures in the event of a mid-year forecast deficiency, under Section 9C of Commonwealth General Law, Chapter 29.

The Commonwealth has established mechanisms to cap the impact on the general fund of volatile capital gains-related PIT receipts and judgment and settlement payments, with excesses devoted to the stabilization fund (the Commonwealth's rainy day fund) or to retirement liabilities. Since fiscal 2011, capital gains have been budgeted in the general fund at $1 billion maximum, rising annually based on U.S. GDP growth; as of fiscal year 2019 the figure will be $1.212 billion. Judgments and settlements are capped based on a five-year rolling benchmark, at $213 million for fiscal 2018.

In the last recession, the Commonwealth relied on allotment cuts, federal stimulus and draws on the stabilization fund in response to revenue shortfalls. While the Commonwealth did not fully deplete the fund, the balance fell to $670 million in fiscal 2010, from a high of $2.34 billion in fiscal 2007. Thereafter, improved revenue performance quickly rebuilt the fund, to $1.65 billion by fiscal 2012.

The Commonwealth has consistently supported financial flexibility both in the form of the rebuilt stabilization fund as well as its ability to cut expenses in response to unforeseen weakness. Similar to many states, the Commonwealth has faced budgetary challenges at several points in the current economic expansion, including from the impact of shifting federal tax law and from unexpected demands for Medicaid triggered in part by federal health reform. Although these factors have weighed on its progress in rebuilding the stabilization fund balance to prerecession levels, the existing balance is adequate and considerable additional flexibility remains.

The stabilization fund balance reached nearly $1.8 billion as of fiscal 2018 following the deposit of $463 million from capital gains collections in excess of the fiscal 2018 threshold of $1.169 billion; this deposit brings the balance to 6.4% of fiscal 2018 preliminary tax revenues. In fiscal 2019, an additional deposit of $368 million is currently expected.

Recent Operating Performance

Fiscal 2018 tax collections, excluding judgments and settlements, were forecast at $26.5 billion at the time the fiscal 2018 budget was adopted, 3.5% over the actual level for fiscal 2017. The January 2018 consensus forecast modestly raised expectations for the year to just under $26.7 billion, excluding judgments and settlements partly to reflect a surge in income and corporate tax collections spurred by federal tax law changes and their impact on the timing of taxpayer filings. Consistent with expectations in other states, the Commonwealth assumes much of the excess collections have been timing-related and will be reversed in later periods. Preliminary actual collections for fiscal 2018 total about $27.8 billion excluding judgments and settlements, 8.6% over the comparable prior-year figure and 4.3% over the revised January 2018 benchmark. Over-performance is primarily in the non-withholding component of individual income taxes and in corporate levies, with sales taxes slightly below benchmark.

Fiscal 2019 tax revenues as of the January 2018 consensus revenue forecast are expected to rise 1.9% over the January 2017 consensus forecast, to about $27.6 billion, excluding judgments and settlements. The forecast assumes an additional 0.05% decrease in the PIT, to 5.05%, beginning on Jan. 1, 2019. To date the state continues to assess the potential impact of federal tax reform on state collections and potential state responses. The revenue forecast includes only $65 million in additional revenues in fiscal 2019 associated with the deemed repatriation of businesses' foreign earnings. Changes in the enacted budget bring forecast collections in fiscal 2019 to $28.4 billion excluding judgments and settlements, 2.1% higher than preliminary actual figures for fiscal 2018.

The spending plan for fiscal 2019 was adopted after a protracted delay in the legislature that reportedly was related to narrow policy questions, rather than the state's fiscal condition. As adopted, the final budget assumes spending growth of 3.2% over the adopted fiscal 2018 level, to $41.3 billion excluding the Medical Assistance Trust Fund, and includes the $368 million deposit to the stabilization fund noted earlier.

Related Affirmations

Fitch affirms the ratings on the Commonwealth's Long-Term IDR at 'AA+' and the ratings on GO or GO-linked bonds of the Commonwealth as follows:

--Approximately $23 billion in GO bonds at 'AA+';
--Approximately $265 million in Massachusetts Development Finance Agency special obligation bonds (Commonwealth contract assistance) at 'AA+';
--Approximately $198 million in Commonwealth guaranteed bonds, issued by the University of Massachusetts Building Authority and the Massachusetts Bay Transportation Authority, at 'AA+';
--Approximately $95 million in University of Massachusetts Building Authority (MA) (Commonwealth Guaranteed) refunding revenue bonds, series 2011-2 at 'AA+'/'F1+'.

The Rating Outlook on the long-term ratings is Stable.

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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 and InvestorTools.

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)
https://www.fitchratings.com/site/re/10024656