FITCH RATES MASSACHUSETTS' GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-18 December 2018: Fitch Ratings has assigned 'AA+' ratings to $926 million in Commonwealth of Massachusetts general obligation (GO) bonds, consisting of:

--$550,000,000 GO bonds, consolidated loan of 2019, series A;
--$50,000,000 GO bonds, consolidated loan of 2019, series B (federally taxable);
--$325,900,000 GO refunding bonds, 2019 series A.

The bonds will be offered by negotiated sale on Jan. 8, 2019.

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+' Issuer Default Rating (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 Fitch's 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 continues to leads the region despite falling below the U.S. average. 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 strong 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 the same pace as the U.S. (up 15.4%).

Revenue Framework
General fund resources derive primarily from PIT, sales tax and corporate income tax. The former two are particularly important, with an estimated 58% 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 the current decade. 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 Massachusetts 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. Fitch believes significant federal action to revise Medicaid's programmatic and financial structure, which had appeared to be possible in recent years, appears less likely in the near term given divided control in the U.S. Congress.

Long-Term Liability Burden

Debt and net pension liabilities are high for a state. On a combined basis based on fiscal 2017 data, the burden of tax-supported debt and net pension liability for employees and teachers equaled 20.1% of personal income, well above the 6% median for U.S. states as of Fitch's 2018 state pension update report. Fitch recalculates reported net pension liabilities using a 6% return assumption per its "U.S. Public Finance Tax-Supported Rating Criteria."

Fitch estimates the Commonwealth's tax-supported debt as of Oct. 31, 2018 at a comparatively high 8.8% 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. 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 the 7.5% discount rates used at the time. The Commonwealth since then has lowered the rate further, to 7.35%. 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 Massachusetts 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 is $1.212 billion. Judgments and settlements are capped based on a five-year rolling benchmark, at $193 million for fiscal 2019.

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. These factors weighed on steady progress in rebuilding the stabilization fund balance to prerecession levels through much of the current expansion. However, the presence of budgetary mechanisms to shift cyclical windfalls to the stabilization fund has raised its balance over the last year, and considerable additional flexibility remains.

The stabilization fund balance reached $2 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 and $209 million from prior-year surplus. These deposits bring the balance to 7.2% of fiscal 2018 estimated tax revenues. In fiscal 2019, an additional deposit of $404 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. Unaudited final collections for fiscal 2018 total just under $27.8 billion, excluding judgments and settlements, 8.3% over the comparable prior-year figure and 4.2% 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 were expected to rise 1.9% over the January 2017 consensus forecast, to about $27.6 billion, excluding judgments and settlements. The forecast assumed an additional 0.05% decrease in the PIT, to 5.05%, beginning on Jan. 1, 2019. Changes in the enacted budget have brought forecast collections in fiscal 2019 to $28.4 billion excluding judgments and settlements, 2.2% higher than the unaudited final figures for fiscal 2018. Through November 2018, fiscal 2019 collections are 4.1% above benchmark and 8.4% above the prior year.

The enacted budget for fiscal 2019 assumes spending growth of 3.2% over the adopted fiscal 2018 level, to $41.3 billion excluding the Medical Assistance Trust Fund, and included a $368 million deposit to the stabilization fund.

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Date of Relevant Rating Committee: Aug. 8, 2018

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

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Additional information is available on www.fitchratings.com

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