FITCH RATES MASSACHUSETTS' $205MM GO SIFMA INDEX BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-15 December 2014: Fitch Ratings has assigned an 'AA+' rating to the following general obligation (GO) bonds for the Commonwealth of Massachusetts (the Commonwealth):

--$33,435,000 GO refunding bonds (SIFMA Index Bonds) 2014 series D;
--$171,800,000 GO refunding bonds (SIFMA Index Bonds) 2014 series E.

The bonds are scheduled to sell through competitive bid on Dec. 17, 2014. The bonds will pay interest at a fixed spread to SIFMA and are expected to be remarketed or refunded prior to their maturity dates (Feb. 1, 2016 and 2017, respectively).

The Rating Outlook is Stable.

SECURITY

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 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 not only Commonwealth employees but also teachers statewide. This contributes to a combined burden of debt and pensions that is also well above the median for U.S. states.

RATING SENSITIVITIES

The rating is sensitive to shifts in fundamental credit characteristics including the state's commitment to strong financial management practices.

CREDIT PROFILE

Massachusetts' 'AA+' GO rating reflects 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.

FINANCES AND MANAGEMENT

Massachusetts has a solid financial position. The Commonwealth saw strong revenue recovery following a period of steep decline in the recession. Fiscal 2013 benefitted from the acceleration of income into calendar 2012 that took place in anticipation of federal tax increases, with baseline overall tax revenue growth of 5.6%.

Revenues for fiscal 2014 (ended June 30) were modestly above forecast even after the retroactive repeal of a computer and software services tax that was included in the enacted budget (estimated impact of $161 million) and a reduction of the income tax rate to 5.2% from 5.25% effective Jan. 1, 2014 that was triggered by recent revenue growth (estimated impact of $65 million). Declines off the highs of the prior year in receipts from final returns were more than offset by 5.4% baseline growth in withholding tax collections and a solid 6.1% increase in estimated payments. Sales tax revenues rose 5.9% for the year.

Through November, fiscal 2015 tax collections are $43 million below budget expectations, with overperformance in income tax revenue (up 4.1% baseline year-over-year) outweighed by underperformance in sales and corporate tax receipts. Although the Commonwealth has not revised its tax revenue forecast, the administration has taken steps to begin to address a current-year gap that it estimates at $325 million. This includes the expected $70 million current-year impact of another triggered reduction of the income tax rate to 5.15% effective Jan. 1, 2015.

Fitch believes that the Commonwealth retains significant flexibility to address budget underperformance and has repeatedly demonstrated its commitment to doing so. Strong revenue results in fiscal 2011 allowed for an increase in the stabilization fund balance to $1.4 billion, up from a low of $670 million at the end of fiscal 2010. Recovery continued in fiscal 2012, albeit at a more modest pace, and the stabilization fund balance grew further to $1.65 billion.

In fiscal 2013, scheduled draws were expected to lower reserve funding to $1.3 billion at year-end. However, the stabilization fund ended the year with a higher $1.56 billion balance. The balance dropped to a still significant $1.25 billion at the end of fiscal 2014, which is expected to fall only slightly, to $1.22 billion, at the end of the current fiscal year.

The Commonwealth has proactively taken steps to reduce the impact of volatile revenues on its budget and developed a long-term fiscal policy framework focused on budget sustainability. The variability and unpredictability of capital gains-related tax revenue has been a key factor in volatility over time. In response, the fiscal 2011 enacted budget included a new mechanism for budgeting capital gains-related tax revenue that limits the amount of such revenue that can be included in the Commonwealth's budget to $1 billion (adjusted annually by a U.S. GDP growth-based formula starting in fiscal 2014), with excesses dedicated to reserve funding (90%) and retiree benefit obligations (10%).

Capital gains-related tax revenue in fiscal 2013 contributed $468 million to the stabilization fund, and in fiscal 2014 $45 million went to the fund pursuant to this mechanism. The fiscal 2015 capital gains revenue figure is forecast at $1.17 billion, which would result in a $122 million set-aside.

A similar mechanism covers one-time judgments and settlement payments in excess of $10 million. The stabilization fund benefited from deposit of an unusually high $375 million of this revenue in fiscal 2012. The Commonwealth subsequently diverted the bulk of such revenues in fiscals 2013 and 2014 for other purposes. The fiscal 2015 enacted budget modified the policy to establish a historical baseline above which such monies will be deposited in the stabilization fund, modeled after the policy for capital gains; under the provision, the baseline is $263 million for fiscal 2015.

Massachusetts' demonstrated commitment to taking timely action to ensure budget balance in recent downturns while maintaining some level of reserves is important given the nature of its revenue system, which quickly reflects changing economic conditions. For example, tax revenue forecasts were reduced significantly over the course of fiscal 2009, from $21.4 billion in the enacted budget to actual results of $18.3 billion, and the year ended down 13% (baseline) compared to fiscal 2008.

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. 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 experienced 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%. Employment continued to grow in 2011 (1.2%), 2012 (1.6%) and 2013 (1.4%) at a pace generally in line with the national trend. In October 2014, Commonwealth employment grew 1.7% year-over-year, slightly below the nation, and the unemployment rate measured 6.0%, 103% of the U.S., as labor force growth exceeded the national pace.

DEBT AND OTHER LONG-TERM LIABILITIES

The Commonwealth's net tax-supported debt equals a comparatively high 9% of personal income, 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. The comparatively high debt levels are partially explained by the Commonwealth's above-average role in relation to local levels of government when compared to most other states. GO debt continues to represent the majority of outstanding debt. Fitch expects debt levels to remain high for a U.S. state but manageable.

Massachusetts is in the early stages of implementing 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 closely 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 state employees and teachers systems equals 18.5%, well above the 6.1% median for U.S. states.

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

Contact:

Primary Analyst
Laura Porter
Managing Director
+1-212-908-0575
Fitch Ratings, Inc., 33 Whitehall Street, New York, NY 10004

Secondary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889

Committee Chairperson
Marcy Block
Senior Director
+1-212-908-0239

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

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

In addition to the sources of information identified in Fitch's report 'Tax-Supported Rating Criteria', this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033