FitchRatings

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

Fitch Ratings-New York-16 April 2015: Fitch Ratings has assigned an 'AA+' rating to the following commonwealth of Massachusetts general obligation (GO) bonds:

--$350,000,000 GO bonds, consolidated loan of 2015, series A;
--$200,000,000 GO bonds, consolidated loan of 2015, series B (federally taxable).

The bonds are scheduled to price competitively on April 28, 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 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, contributing 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 commonwealth'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.

SIGNIFICANT BUDGETARY FLEXIBILITY

Fitch believes that the commonwealth retains significant flexibility to address budget underperformance and has repeatedly demonstrated its commitment to maintaining budgetary balance. The commonwealth has consistently prioritized setting aside resources in the stabilization fund (its rainy day fund); the balance at fiscal 2015 year-end is estimated at $1.13 billion, equal to 4.6% of forecast fiscal 2015 tax revenues.

After drawing on the stabilization fund during the downturn, 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.

Additionally, the commonwealth has proactively taken steps to reduce the impact of volatile revenue collections on its budget. The variability and unpredictability of capital gains-related tax revenue has been a key source of volatility over time. In response, the fiscal 2011 enacted budget included a mechanism for budgeting capital gains-related tax revenue limiting the amount of such 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%).

Pursuant to this mechanism capital gains-related tax revenue contributed $468 million and $45 million to the fund in fiscal 2013 and 2014, respectively. Although fiscal 2015 capital gains would have exceeded the mechanism's threshold by an estimated $331 million based on the current consensus forecast, the current year deposit was suspended in response to mid-year budget underperformance and is proposed for suspension in fiscal 2016.

A similar mechanism covers one-time judgments and settlement payments, with amounts in excess of $10 million deposited to the stabilization fund initially from fiscal 2014 onward, deposits are based on whether total collections exceed a five-year baseline for historical collections ($263 million in fiscal 2015). The stabilization fund benefited from deposit of $375 million of such payments in fiscal 2012, although diverted the bulk of such revenues in fiscals 2013 and 2014 for other purposes.

CAREFUL FISCAL 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 were modestly above forecast, even after the retroactive repeal of a computer and software services tax that had been 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 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.

Although budgetary performance in fiscal 2015 has been more challenging than expected, the commonwealth has quickly addressed emerging revenue and spending challenges to maintain forecast balance. Underperformance in non-tax revenues early in fiscal 2015 and the unexpected triggering of an additional 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 budgeted 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 spending allotment cuts and a legislative package of additional 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 have generally performed near forecast expectations. The original fiscal 2015 revenue forecast assumed baseline tax revenue growth of 5%. Following various tax law and administrative changes, including the triggered personal income rate reduction noted earlier, the commonwealth is currently assuming baseline revenue growth of 4.2%. Year-to-date through March, actual fiscal 2015 tax collections are $132 million above revised budget expectations, with over-performance in income tax receipts (up 6.7% baseline year-over-year) offsetting under-performance in sales and corporate tax receipts. Although sales tax collections year-to-date are higher than the prior year, they have been affected more recently by the impact of the unusually harsh winter on taxable spending.

FISCAL 2016 BUDGET UNDER CONSIDERATION

The commonwealth's fiscal 2016 budget is currently under consideration in the legislature. The fiscal 2016 consensus tax revenue forecast, announced in January, assumes tax revenues rising 4.8%, to nearly $25.5 billion. The forecast estimates almost $1.4 billion in capital gains, of which $300 million would be intended for transfer to the stabilization fund, and conservatively assumes an additional triggered reduction of the income tax rate to 5.1%, from 5.15% effective Jan. 1, 2016. The governor's proposed budget includes a handful of changes affecting revenues, including suspending the $300 million capital gains transfer as well as a $100 million tax amnesty.

Spending in the governor's proposed fiscal 2016 budget, at nearly $38.1 billion, is 3% higher than the prior year, a rate of growth well below the 7.8% year-over-year estimate in fiscal 2015. The majority of proposed fiscal 2016 spending increases are directed to Medicaid and health and human services needs even as the commonwealth continues to focus on lowering growth rates that surged in early 2014 with health care expansion. Growth in MassHealth is forecast at 5.6% in fiscal 2016, down from 13.7% growth in fiscal 2015. The proposed budget also includes $178 million in full year savings from an early retirement incentive plan that would be implemented under revisions to the fiscal 2015 budget.

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 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 (1.1%), 2012 (1.6%) and 2013 (1.7%) at a pace generally in line with the national trend. More recently, job gains have continued at a slower pace than the nation, with 2014 growth of 1.6%, compared to 1.9% nationally, and February 2015 employment is up 1.7%, below the 2.4% national pace of growth. As of February 2015, the unemployment rate remains well below the U.S., at 4.9% in the commonwealth compared to 5.5% nationally.

DEBT HIGH BUT MANAGEABLE

The commonwealth's net tax-supported debt equals a comparatively high 9% of personal income as of June 30, 2014, 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 debt level is partially explained by the commonwealth's above-average role in relation to local levels of government relative to most other states. Fitch expects debt levels 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 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 commonwealth employees and teachers systems equaled 18.5% of personal income, well above the 6.1% median for U.S. states, as of Fitch's most recent state pension update report.

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
Douglas Offerman
Senior Director
+1-212-908-0889
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Laura Porter
Managing Director
+1-212-908-0575

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);
--'Pension Pressures Continue: 2014 State Pension Update' (May 15, 2014).

Applicable Criteria and Related Research:
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
Pension Pressures Continue (2014 State Pension Update)
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=747605