

FITCH RATES MASSACHUSETTS' \$439MM GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-21 March 2011: Fitch Ratings assigns an 'AA+' rating to the following Commonwealth of Massachusetts general obligation (GO) bonds:

- \$78,525,000 GO refunding bonds 2011 series B;
- \$360,000,000 GO bonds consolidated loan of 2011 series A.

In addition, Fitch affirms the following ratings:

- Approximately \$18 billion of outstanding Commonwealth GO and Commonwealth guaranteed bonds at 'AA+'.

The Rating Outlook is Stable.

The series B refunding bonds are expected to sell through negotiation the week of March 21, 2011. The series A bonds are expected to sell through competitive bid on March 23, 2011.

RATING RATIONALE:

- Massachusetts has a fundamentally strong and wealthy economy.
- The Commonwealth has benefited from conservative budgeting and sound financial practices over time. Although significantly reduced, reserves remain to provide a hedge against the Commonwealth's somewhat volatile revenue stream.
- Debt levels are high.

KEY RATING DRIVER:

- Continued timely action as needed to ensure budget balance and maintenance of an adequate budgeted reserve position.

SECURITY:

General obligations of the Commonwealth, to which its full faith and credit are pledged.

CREDIT SUMMARY:

Massachusetts' 'AA+' rating reflects considerable economic resources and a record of prudent financial management. Credit strengths are tempered by a very heavy debt burden; net tax-supported debt equals about 9% of personal income and Fitch expects that debt levels will 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. Fiscal 2011 tax revenues have overperformed budget estimates, and on Jan. 18, 2011 the Commonwealth raised its revenue forecast for the year by \$706 million, to \$19.8 billion. Fiscal year-to-date revenues through February are 6.5% (baseline) above fiscal 2010 results, just under revised estimates, with income tax withholding collections up 6.3% year-over-year and sales and use taxes up 3.6% (both baseline). A November 2010 ballot initiative to reduce the sales tax rate to 3% from 6.25%, which would have resulted in a significant reduction in revenues, failed. A much more limited ballot initiative to reverse the recent expansion of the sales tax to alcoholic beverages was approved by voters, for a revenue loss estimated at \$110 million annually.

The Commonwealth, which has had a somewhat volatile revenue system that quickly reflects changing economic conditions, has taken timely action to ensure budget balance in recent downturns while maintaining some level of reserves. With economic deterioration, 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. The Commonwealth responded with spending cuts and controls, the application of

extraordinary federal stimulus assistance funds, and a large reserve draw.

The budget for fiscal 2010 included a 25% increase in the Commonwealth's sales tax rate (to 6.25%) and other revenue measures totaling about \$1 billion, as well as additional spending control, another reserve fund draw, and federal stimulus to address a gap of about \$5 billion. Gaps that developed over the course of the year, due to reduced revenue expectations and increased spending needs (largely for social services), were addressed promptly. Actual revenue performance was \$84 million above the downwardly revised estimate of \$18.5 billion (as compared to the original budget forecast of \$18.9 billion). Total taxes were down 3.4% (baseline) versus fiscal 2009, reflecting a 3.9% sales tax drop, a 4.4% personal income tax decline, and a 1.3% corporate and business tax increase. Underperformance in income tax revenues, largely attributable to weaker than expected capital gains-related revenue, was offset by above-forecast returns of the other tax revenues.

The consensus tax revenue forecast for fiscal 2011, which began on July 1, assumed baseline growth of 2.5% from fiscal 2010. The governor's budget proposal closed an estimated gap of \$2.75 billion, including through a \$175 million reserve fund draw, up to \$300 million from debt restructuring for budget relief, and federal stimulus funds of \$1.4 billion. Following the 25% increase in the sales tax rate that became effective on Aug. 1, 2009, the executive budget did not include any broad-based tax increases. The enacted budget was generally in line with the governor's proposal. With revenue overperformance and the receipts of funds from the extension of federal stimulus funds related to the Medicaid program (FMAP), the Commonwealth no longer anticipates a reserve fund draw this year, with the stabilization fund balance instead projected to rise about \$100 million to \$773 million at the close of fiscal 2011. Although reduced from the peak funding level of \$2.3 billion at the end of fiscal 2007, the reserve fund provides financial cushion against revenue underperformance or above-budget spending.

The governor's budget proposal for fiscal 2012, which was released on Jan. 26, 2011, is based on a consensus tax revenue estimate of \$20.5 billion, up 3.7% actual and 5.3% baseline compared to estimates for the current year. The proposal includes no significant revenue raising. Spending control in the area of health care is assumed to severely limit growth in spending, which will be challenging to achieve. The proposed budget draws about \$200 million from the stabilization fund.

The governor has proposed numerous reforms, including in the area of pensions. The Commonwealth is responsible for the pension benefits of not only commonwealth employees but also teachers statewide. To avoid a large increase in the annual contribution for pensions in the fiscal 2012 budget, the schedule for amortizing the unfunded liability has been extended from 2025 to 2040.

The variability and unpredictability of capital gains-related tax revenue has been a key factor in the volatility of the Commonwealth's overall budget. The fiscal 2011 enacted budget included a new mechanism for budgeting capital gains-related tax revenue that will limit the amount of such revenue that can be included in the Commonwealth's budget going forward, with excesses dedicated to reserve funding. Fitch viewed this change as a budgeting policy improvement as it reduces the volatility of the Commonwealth's budget.

Massachusetts has a fundamentally strong and wealthy economy, with the third highest personal income per capita in the nation (125% of the U.S.). The Commonwealth experienced among the steepest employment drops in the country during the prior recession and, despite registering year-over-year employment gains in every month from July 2004 to September 2008, did not regain its prior peak. Employment began to decline in November 2008 but losses were below those of the U.S. Commonwealth employment in 2010 was 0.2% above the prior year, compared to a 0.8% drop for the U.S. In January 2011, year-over-year growth of 0.4% in Massachusetts compared to a 0.7% increase for the nation. The Commonwealth's unemployment rate of 8.3% in January 2011 was 92% of the U.S. level for the month.

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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', dated Aug. 16, 2010;
- 'U.S. State Government Tax-Supported Rating Criteria', dated Oct. 8, 2010.

Applicable Criteria and Related Research:

Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=548605

U.S. State Government Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=564546

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