

## **FITCH RATES MASSACHUSETTS' \$350MM GO BONDS 'AA+'; OUTLOOK STABLE**

Fitch Ratings-New York-19 November 2010: Fitch Ratings assigns an 'AA+' rating to the following Commonwealth of Massachusetts' general obligation (GO) bonds:

--\$350,000,000 consolidated loan of 2010, series E (federally taxable-Build America Bonds-direct pay to issuer).

In addition, Fitch affirms the following ratings:

--Approximately \$17.5 billion of outstanding Commonwealth GO and Commonwealth guaranteed bonds at 'AA+'.

The Rating Outlook is Stable.

The bonds are expected to sell through competitive bid on Nov. 23, 2010.

### **RATING RATIONALE:**

--Massachusetts has a fundamentally strong and wealthy economy, although population growth is slow.

--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 Rating 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 revenues through October are \$414 million above estimates for the year. Year-to-date revenues are 5.7% (baseline) above fiscal 2010 results, with income tax withholding collections up 6.6% year-over-year and sales and use taxes up 2.6% (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, which ended on June 30, 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 assumes 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 (with more than \$600 million of that from an assumed six-month extension of federal stimulus funds related to the Medicaid program). 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 final budget was generally in line with the governor's proposal. As the extension of federal stimulus funds related to the Medicaid program (FMAP) was not approved at the time of budget adoption, the enacted budget replaced those funds with additional spending cuts and a reserve fund draw of \$100 million. The subsequent extension of the FMAP stimulus resulted in \$449 million in additional revenue in fiscal 2011, most of which has been appropriated. The Commonwealth no longer anticipates a reserve fund draw this year. The resulting estimated fiscal 2011 ending reserve fund balance of \$670 million, although reduced from the peak funding level of \$2.3 billion at the end of fiscal 2007, provides some financial cushion against revenue underperformance or above-budget spending. These estimates do not include the revenue overperformance through October noted above. The governor's budget proposal for fiscal 2012 will be released in late January.

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 believes that this change is a budgeting policy improvement as it will reduce 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 last 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 have been below those of the U.S. September 2010 employment in the Commonwealth was 0.8% above that of September 2009, the fourth straight month of year-over-year growth and above the 0.2% gain for the nation in September. This follows losses of 3.6% and 4.3% for the state and the nation, respectively, in 2009. The Commonwealth's unemployment rate of 8.4% in September 2010 was 88% of the U.S. level for the month.

Contact:

Primary Analyst:  
Laura Porter  
Managing Director  
+1-212-908-0575  
Fitch, Inc.  
One State Street Plaza  
New York, NY 10004

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

Committee Chairperson:  
Karen Krop  
Senior Director  
+1-212-908-0661

Media Relations: Brian Bertsch, New York, Tel: +1 212-908-0549, Email: brian.bertsch@fitchratings.com.

#### Considerations for Taxable/Build America Bonds Investors

The following sector credit profile is provided as background for investors new to the municipal market.

#### State General Obligation Bonds:

The general obligation full faith and credit pledge is the broadest security a U.S. state government can provide to the repayment of its long-term borrowing, and therefore is the best indicator of its overall credit quality. State ratings generally fall within the two highest rating categories of 'AAA' or 'AA', with a few outliers. The top tier ratings reflect states' inherent strengths: states generally have broad economic and tax base resources and all possess sovereign powers under a federal government system, with substantial, although varying, control over revenue raising and spending. Given these inherent strengths, in only a few instances have the inability or unwillingness to address large financial challenges led to ratings below the 'AA' category. For additional information on State ratings, see U.S. State Government Tax-Supported Rating Criteria, dated Oct. 8, 2010.

Additional information is available at '[www.fitchratings.com](http://www.fitchratings.com)'.

In addition to the sources of information identified in the 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.

For information on Build America Bonds, visit '[www.fitchratings.com/BABs](http://www.fitchratings.com/BABs)'.

#### Applicable Criteria and Related Research:

Tax-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=548605](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](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=564546)

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