S&P Global Ratings

RatingsDirect®

Summary:

Massachusetts; General Obligation

Primary Credit Analyst:
David G Hitchcock, New York (1) 212-438-2022; david.hitchcock@spglobal.com

Secondary Contact:
Jillian Legnos, Hartford (1) 617-530-8243; jillian.legnos@spglobal.com

Table Of Contents

Summary:

Massachusetts; General Obligation

Credit Profile		
US$150.0 mil GO cons loan of 2020 ser D due 03/01/2050		
Long Term Rating	AA/Stable	New
US$116.145 mil GO rfdg bnds ser 2020A due 03/01/2042		
Long Term Rating	AA/Stable	New

Rationale

S&P Global Ratings assigned its 'AA' long-term rating to the Commonwealth of Massachusetts' $150 million general obligation (GO) bonds, consolidated loan of 2020, series D, and $116.145 million GO refunding bonds, 2020 series A.

The state's full faith and credit are pledged to the GO bonds.

The outlook on all long-term ratings is stable.

Factors supporting the 'AA' GO rating include what we view as Massachusetts':

- Deep and diverse economy, which continues to outperform the nation on several economic indicators;
- High income levels, with per capita income at 132% of the nation in 2018, the second-highest among the states;
- Timely monitoring of revenues and expenditures and swift action when needed to make adjustments;
- Strong financial, debt, and budget management policies, including annualized formal debt affordability statements, and multiyear capital investment planning; and
- Good budget stabilization fund (BSF) balance, equal to an estimated 7.3% of expenditures and other uses at fiscal year-end 2019, and projected at 8.3% at fiscal year-end 2020.

Offsetting factors include high debt, pension, and other postemployment benefits (OPEB) liabilities. Combined debt, unfunded pension, and OPEBs per capita ranked fifth-highest among all the states in fiscal 2018, according to our pension commentary "U.S. State Pension Reforms Partly Mitigate The Effects Of The Next Recession," (published Sept. 26, 2019, on RatingsDirect).

In particular, the commonwealth has a low 59.3% combined pension funded ratio on a Governmental Accounting Standards Board (GASB) basis and has contributed less to its pension funds than the actuarial annual required contribution (ARC) in every fiscal year since 2011. However, Massachusetts has put in place a plan to increase annual pension contributions 9.63% per year to fully amortize unfunded pension liabilities by 2036. Furthermore, the $958 million shortfall against the ARC in fiscal 2020, which we view as a structural deficit, is only about 2% of estimated budgetary operating expenditures. The commonwealth is paying 75% of the ARC in fiscal 2020, the same level as the year before. The state projects state pension contributions will grow by $2.1 billion above the fiscal 2020 level by 2026, the year when the commonwealth projects annual payments will equal the ARC, assuming the commonwealth continues to increase payments 9.63% per year.

Massachusetts' economy remains strong, in our view, although low unemployment is constraining employment growth. The commonwealth's average annual unemployment rate in 2018 was low at 3.3%, compared with 3.9% for the nation. Overall, IHS Markit forecasts 1.0% employment growth in calendar 2020 and 0.4% in calendar 2021, compared with 1.2% and 0.7%, respectively, for the nation. Much of the recent growth has been in the professional, scientific, and technical services sector, which consists of higher-paying jobs, although is perhaps contributing to rising home prices. Massachusetts has an above-average high-technology employment sector, which IHS Markit estimates at about 10% of state employment, compared with 6.5% for the country as a whole. Total state personal income rose a strong 5.7% in 2018 according to the federal Bureau of Economic Analysis, and state per capita income was 132% (second only to Connecticut), the same as the year before. In our view, Massachusetts' economic fundamentals and key anchors, which center on higher education, technology, finance, and health care, should contribute to continued expansion.

The commonwealth's operating revenues have come in better than budgeted over the past three years. Estimated fiscal 2019 tax revenue grew faster than budgeted, in part due to strong growth in volatile corporate tax revenues, similar to what some other states experienced in the wake of federal tax reform. As a result, the commonwealth has budgeted for a corporate tax decline in fiscal 2020, contributing to an originally budgeted projection of only 1.4% overall tax collection growth in fiscal 2020. Massachusetts' enacted its fiscal 2020 budget about a month into the new fiscal year, using an interim budget in the meantime. The enacted fiscal 2020 budget currently projects a small 0.1% operating surplus in fiscal 2020 based on 2.0% growth in total tax revenues, including settlements and judgments. However, through February 2020, cumulative fiscal 2020 tax receipts were up 5.2% over the prior-year period.

The result of recent above-budgeted tax growth has been a buildup of BSF balances since 2017, after a period of drawdowns beginning in fiscal 2013. The BSF fell to 3.1% of budgetary expenditures and other uses by fiscal 2017, before rising again. The BSF totaled $3.4 billion at fiscal year-end 2019, or a good 7.3% of expenditures and other uses, and is budgeted to increase to $4.0 billion, or what we view as a strong 8.3%, as the BSF receives a portion of surplus revenue and excess capital gains tax. Combined BSF and other operating funds balances are estimated at $4.0 billion, or 8.5% at fiscal year-end 2019, and budgeted to increase to $4.1 billion, also 8.5%, at fiscal year-end 2020.

The governor has proposed a fiscal 2021 budget with a consensus revenue forecast of 2.80% tax revenue growth, including an already enacted statutory reduction in the individual income tax rate to 5.00% from 5.05% and reinstatement of a charitable deduction. The governor's proposed budget projects spending growth of 2.3% and a $310 million increase in the BSF, including interest earnings. If the commonwealth follows recent trends, the final 2021 budget is likely to be adopted in the summer.

We view the accumulation of budget reserves during good economic times as especially important from a credit perspective in that the state has historically shown some cyclicality in its finances and we view its fixed costs as moderately high. Massachusetts drew down its BSF in fiscal years 2013 and 2014, even while revenues were increasing, and then essentially level-funded the BSF with small deposits until fiscal 2018, when revenues began to come in substantially above budget. We view the retention of BSF reserves, despite projected slow revenue growth in fiscal 2020 as a credit strength, but note that the commonwealth was able to budget the fiscal 2020 BSF increase, while simultaneously increasing spending at a faster pace than budgeted revenue growth, by using the unexpected excess surplus that occurred in fiscal 2019. Of interest is whether Massachusetts retains reserves in the year following closer to a breakeven yearly operating result, or if it reduces the BSF even while revenues are still growing strongly, as it did in fiscal years 2013 and 2014.

Although revenue growth has been strong in recent years, earlier the commonwealth had to make midyear budget adjustments in each fiscal year from 2015-2017, particularly because of Medicaid spending pressures. Health care spending has since been mitigated, in part, by greater scrutiny of Medicaid eligibility, which caused Medicaid enrollment member months to decline 1.9% in fiscal 2018 and 2.8% in 2019 as adults moved to the commonwealth's Health Insurance Connector Authority. Massachusetts projects 0.7% growth in enrollment in fiscal 2020, and only 0.9% growth in Medicaid total expenditures due in part to pharmacy reforms. We believe that the commonwealth's Medicaid costs are a significant entitlement expenditure, at about 34% of fiscal 2020 budgeted expenditures and other uses.

Other potential long-term challenges include growth in scheduled annual state pension payments of 9.63% per year through 2036--a pace we believe will likely exceed revenue growth. Although we recognize that Massachusetts has made budgeting its fixed costs a priority, we also view the growth in these areas as placing increased stress on its ability to maintain structural balance because each year funding less than the ARC will raise future years' ARC levels. The state currently projects that it won't reach ARC under its funding schedule until fiscal 2026.

On a generally accepted accounting principles (GAAP) basis, Massachusetts ended fiscal 2019 (the most recent audited year) with an available assigned and unassigned general fund balance of $2.44 billion, plus a BSF balance of $3.42 billion. This led to a combined available balance plus BSF of $5.87 billion, which we view as strong at 14.1% of general fund expenditures and transfers out, up from 8.7% at fiscal year-end 2018.

By most measures, we believe Massachusetts' debt burden remains high compared with that of other states, in part due to the commonwealth's support for local infrastructure. At audited fiscal year-end 2019, we calculate GO debt of $23.7 billion and total tax-supported debt of $39.0 billion, producing total tax-backed debt per capita of $5,644, and 7.9% of 2018 personal income. Tax-backed debt includes GO debt, sales and gas tax-supported debt, including Massachusetts Bay Transportation Authority and Massachusetts School Building Authority debt supported from state resources, capital leases, and general fund contract assistance-supported debt that supports Massachusetts Department of Transportation. We calculate fiscal 2019 total tax-backed debt service at 6.9% of general governmental spending on a GAAP audited basis, a level we view as moderately high. Planned debt issuance remains within the parameters of Massachusetts' debt affordability policy and bond cap, and we don't anticipate significant change in its debt ratios. As of Nov. 30, 2019, the commonwealth had $23.7 billion of GO debt outstanding.

Other long-term liabilities are also large, in our opinion. We believe Massachusetts' share of the net pension liability for combined state pensions systems is high at $37.7 billion as of the Jan. 1, 2019, valuation date on a GASB Statement Nos. 67 and 68 basis, or $6,028 per capita, and 8.4% of 2018 personal income. The aggregate funded ratio fell slightly to 59.3% in 2019 from 60.7% in 2018, with a 60% three-year average. Some of the reason net pension liabilities have not shown much improvement is that Massachusetts decided to lower its assumed actuarial return to a less aggressive

7.25% as of Jan. 1, 2019, from 7.35% in 2018, 7.50% in 2016, and 7.75% in 2015, which increased the actuarial liabilities. Massachusetts sets its annual pension contribution based on its own methodology under state statute; it has not fully funded its ARC since fiscal 2011, but expects to reach full ARC funding by 2026 under its plan to increase annual pension contributions 9.63% per year to fully amortize the unfunded liability by 2036. It only re-evaluates its annual pension funding schedule every three years, and recently raised the scheduled rate of annual increase from 8.9%, as well as pushed back the year of full ARC funding by two years.

In our opinion, Massachusetts' unfunded OPEB is also moderately high, although it has decreased significantly following recent deposits into an OPEB trust fund. The state's net OPEB liability on a GASB No. 74 basis has decreased to $12.2 billion as of a June 30, 2019, valuation date, or $1,771 per capita (using 2018 population), from $17.5 billion as recently as fiscal 2017, as offsetting OPEB trust fund assets rose to $1.4 billion. In 2018 and 2019, the commonwealth originally budgeted to transfer 10% of tobacco settlement revenue into its OPEB trust fund, but subsequent legislation after the close of each fiscal year increased the percentage to 30%. In fiscal 2019, $42.4 million of excess capital gains tax was also transferred into the OPEB trust fund. As of fiscal 2019, the OPEB trust fund was 10.1% funded on a GASB basis, with assets of $1.4 billion.

Based on the analytic factors we evaluate for states, on a scale of 1.0 (strongest) to 4.0 (weakest), we have assigned a composite score of 1.9 to Massachusetts, which is consistent with a 'AA' indicative rating.

Outlook

The stable outlook reflects our view that Massachusetts' steady economic growth and proactive management will allow the commonwealth to continue to manage potential budgetary challenges, even if midyear budget shortfalls develop in future fiscal years. We believe the current increase in fiscal year-end 2019 reserves and that projected in fiscal 2020 are the result of small budgeted additions to reserves and extra funds from stronger-than-budgeted revenues. Our stable outlook also anticipates that the commonwealth will budget for close-to-breakeven operations during our two-year outlook horizon, and make midyear budget corrections should revenues weaken, as well as bank a portion of unexpected revenue windfalls in its BSF. At this point in the economic cycle and at the current rating level, we expect Massachusetts to modestly improve its BSF and maintain good balances to prepare for a potential recession.

Upside scenario

Improvement in the rating or outlook could occur if the commonwealth strengthened its pension funding discipline based on a prudent actuarial footing, while retaining material budget reserves during periods of economic growth as a matter of budgetary policy.

Downside scenario

We could lower the rating if Massachusetts fails to maintain near-structural balance during periods of economic expansion. Such factors that could further pressure the rating include

Medicaid costs outpacing revenue growth, reduced revenues in recessions due to income tax cyclicality from above-average high technology sector employment, the effect of federal tax reform on state and local tax deduction caps in high-tax states, and increasing state fixed costs in excess of revenue growth that might lead to significant structural imbalance and rapidly diminishing reserves.

More specifically, these factors could stress the state's structural balance to the extent that Massachusetts fails to adhere to its plan to increase annual pension contributions by 9.63% per year to amortize unfunded pension liabilities or, if this proves insufficient, to keep GASB pension funded ratios from materially declining.