FITCH RATES $1.1 BILLION MASSACHUSETTS GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-23 February 2016: Fitch Ratings has assigned an 'AA+' rating to $1.1 billion in Commonwealth of Massachusetts general obligation (GO) bonds, consisting of:

--$600,000,000 GO bonds, consolidated loan of 2016, series A;
--$500,000,000 GO refunding bonds, 2016 series A.

The bonds are scheduled to sell via negotiated sale beginning on March 2, 2016.

In addition, Fitch affirms the 'AA+' ratings on the following GO or GO-linked bonds of the Commonwealth:

--Approximately $20.4 billion in GO bonds;
--Approximately $359 million in Commonwealth guaranteed bonds;
--Approximately $72 million in Massachusetts Development Finance Agency special obligation bonds (Commonwealth contract assistance).

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 DIRECT 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 Commonwealth employees and teachers statewide, contributing to a combined burden of debt and pensions well above the median for U.S. states.

RATING SENSITIVITIES

The rating is sensitive to shifts in fundamental credit characteristics including the Commonwealth of Massachusetts' commitment to strong financial management practices.

CREDIT PROFILE

Massachusetts' 'AA+' GO rating reflects its 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 the Commonwealth retains significant flexibility to address operating under-performance and has repeatedly demonstrated its commitment to maintaining budgetary balance. Mechanisms for maintaining balance include the governor's requirement to reduce allotments or identify alternative balancing measures in the event of a mid-year forecast deficiency. The Commonwealth has established clear mechanisms for setting aside resources in the stabilization fund (the Commonwealth's rainy day fund). Additionally, the Commonwealth has reduced the budgetary impact of volatile revenue collections, particularly capital gains-related tax collections, through mechanisms that cap the collections available to the budget and reserve excess amounts in the stabilization fund.

Massachusetts relied on allotment cuts, federal stimulus and draws on the stabilization fund during the last recession; the stabilization fund balance fell to $670 million in fiscal 2010, from a high of $2.34 billion in fiscal 2007. Although subsequent deposits returned the stabilization fund balance to $1.65 billion by fiscal 2012, draws since then and the more recent suspension of most deposits in fiscal years 2015 and 2016 have reduced the balance to a still adequate $1.26 billion estimated at fiscal 2016 year-end, equal to 4.9% of fiscal 2016 tax revenues. The governor's executive budget for fiscal 2017 proposes another partial suspension of deposits, although a deposit of as much as $283 million is proposed, which would bring the balance to 5.7% of the fiscal 2017 consensus forecast tax revenues.

Since fiscal 2011, the budget has included a mechanism for limiting capital gains-related 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%). The threshold is $1.087 billion in fiscal 2016 and $1.128 billion in fiscal 2017.

Pursuant to this mechanism capital gains-related tax revenue contributed $468 million and $45 million to the fund in fiscal years 2013 and 2014, respectively. Fiscal 2015 capital gains would have exceeded the mechanism's threshold by an estimated $621 million based on the department of revenue's July 2015 certification; ultimately only $124 million was deposited, with the remainder redirected in response to budgetary underperformance. As part of the fiscal 2016 budget, the transfer of a forecast $300 million in capital gains over the threshold was also suspended, and the governor's executive budget for fiscal 2017 proposes transferring $206 million of capital gains over the threshold, with the remaining $150 million held for budgetary needs.

A similar mechanism covers one-time judgments and settlement payments. Since a fiscal 2014 statutory change, deposits are based on whether total collections exceed a five-year benchmark for historical collections ($263 million in fiscal 2016). The stabilization fund benefited from deposit of $375 million of such payments in fiscal 2012, although the Commonwealth redirected the bulk of such revenues in fiscals 2013 and 2014 for other purposes. Fiscal 2015 payments of $226 million fell short of the $263 million benchmark. For fiscal 2016, the Commonwealth assumes payments of $125 million, also below the $267 million benchmark.

CAREFUL FISCAL MANAGEMENT

Massachusetts has maintained a solid financial position in recent fiscal years, including taking proactive steps to address emerging revenue and spending challenges. In fiscal 2015, underperformance in non-tax revenues early in the fiscal year and the unexpected triggering of an additional personal income tax (PIT) 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 current 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 outpaced earlier 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 allotment cuts and a legislative package of 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 ultimately exceeded forecast expectations. The enacted fiscal 2015 budget had assumed tax revenue growth of 4.9% over then-preliminary fiscal 2014 tax revenues, to $24.4 billion, while actual figures show tax revenues up 6.7%, to $24.9 billion.

CURRENT FISCAL PERFORMANCE STEADY

The fiscal 2016 tax revenue forecast, based on the January 2015 consensus and subsequent budgeted adjustments, assumed tax revenues of $25.6 billion, rising 2.7% from actual fiscal 2015 collections. The forecast estimated almost $1.4 billion in capital gains, higher than the $1.087 billion capital gains threshold. Rather than transferring the resulting $300 million in excess collections to the stabilization fund, the budget retained the excess for current-year spending needs. The budget also conservatively assumed an additional triggered reduction of the income tax rate to 5.1%, from 5.15%, effective Jan. 1, 2016.

Fiscal 2016 generally has tracked near expectations, although a forecast deficiency of $320 million was identified in early January due to slower non-tax revenue collections and unexpected spending needs. Ultimately higher forecast tax revenues and other non-tax revenue actions and allotment cuts allowed the Commonwealth to address the deficiency.

Budgeted expenditures and other uses, currently estimated at nearly $41.1 billion, is 7.8% higher than the prior year, a growth rate above the 6.2% level reported for fiscal 2015. The majority of fiscal 2016 expenditure increases are directed to Medicaid and health and human services needs even as the Commonwealth continues to focus on slowing the Medicaid spending growth that surged in early 2014 with health care expansion.

Year-to-date through January, fiscal 2016 tax revenue collections are 4.5% over the prior year and $48 million over the forecast benchmark. Year-to-date PIT collections are 3.7% over the prior fiscal year, although January estimated payments dropped from the prior year, eroding some of the year-to-date excess.

The state's January 2016 consensus forecast assumes fiscal 2017 tax revenues of nearly $26.9 billion, 4.3% higher than the current estimate for fiscal 2016; the forecast assumes that a further 0.05% PIT rate drop takes effect on Jan. 1, 2017, lowering the rate to 5.05%. The governor released the executive budget for fiscal 2017 in late January. The proposal includes depositing a

$206 million portion of excess capital gains to the stabilization fund along with $77 million from gaming license fees, if realized.

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 suffered 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%.

For much of the expansion, employment gains in Massachusetts have approximated the national trend, although 2014 employment rose 1.6%, below the 1.9% national rate of growth. More recently job gains appear to have accelerated, with December 2015 employment rising 2.2% annually in the Commonwealth, vs. 2% for the nation. As of December 2015, the unemployment rate remains well below the U.S., at 4.7% in the Commonwealth compared to 5% nationally.

DEBT HIGH BUT MANAGEABLE

The Commonwealth's net tax-supported debt equals a comparatively high 9.4% of personal income as of Jan. 31, 2016, 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 direct debt level is partially explained by the Commonwealth's above-average role in funding local government capital, relative to most other states. Fitch expects direct debt to remain high for a U.S. state but still manageable.

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 18.9% of personal income, well above the 5.8% median for U.S. states, as of Fitch's 2015 state pension update report.

The Commonwealth is responsible for the pension benefits of not only Commonwealth employees but also teachers statewide. As of Jan. 1, 2015, the latest valuation date, the systems covering state employees and teachers (except in the City of Boston) were funded at 67.5% and 54.3%, respectively. Using Fitch's more conservative 7% return assumption would result in lower funded ratios of 62.3% and 50.1%, respectively.

Massachusetts has undertaken some pension reforms and continues to gradually shift toward more conservative assumptions while maintaining a statutorily closed amortization target for achieving full funding in 2040. A 2014 agreement accelerated the schedule for full pension prefunding by increasing contributions 10% per year through fiscal 2017 and 7% in subsequent years. Full prefunding is projected for fiscal 2036 based on current assumptions. The fiscal 2016 contribution of $2 billion includes the additional cost associated with the early retirement plan implemented in fiscal 2016.

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 the applicable criteria specified below, this action was informed by information from CreditScope and IHS.

Fitch recently published exposure drafts of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015 and Exposure Draft: Incorporating Enhanced Recovery Prospects into U.S. Local Tax-Supported Ratings, dated Feb. 2, 2016). The drafts include a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to less than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published in the first quarter of 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
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