Fitch Ratings

FITCH RATES MASSACHUSETTS' $490MM GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-19 May 2011: Fitch Ratings assigns an 'AA+' rating to the following Commonwealth of Massachusetts general obligation (GO) bonds:

--$485,000,000 consolidated loan of 2011 series B;
--$5,000,000 consolidated loan of 2011 series C (Build Massachusetts Bonds).

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 bonds are expected to sell through negotiation the week of May 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. A limitation on the use of capital gains-related tax revenue reduces the volatility of the Commonwealth's budget and, although reduced, reserves remain to provide a hedge against underperformance of economically sensitive revenues.
--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. After significant declines in the downturn, recent revenue performance has been strong. With fiscal 2011 tax revenues overperforming budget estimates, in January the Commonwealth raised its revenue forecast for the year by $706 million, to $19.8 billion. Revenue receipts through April have significantly exceeded even this upwardly revised forecast, with taxes 9.9% (baseline) above fiscal 2010 results and $732 million above the January estimate for the fiscal year, which ends on June 30. The overperformance is due primarily to strength in the personal income tax, which is up 15.4% year-over-year (baseline) through April, reflecting 6.7% growth in withholding revenue, 20.3% growth in estimated payments, and 53.4% growth in final payments. Although some of this remarkable growth may be due to a delayed filing schedule in the prior year following a flooding-related deadline extension, the Commonwealth expects to remain well above forecast once May results are in. Sales and use taxes through April are up 3.6% (baseline) year-to-date, in line with the January forecast.

The Commonwealth, which has 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, 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.

The consensus tax revenue forecast for fiscal 2011 assumed baseline growth of 2.5% from fiscal 2010. The governor's budget proposal closed an estimated gap of $2.75 billion via measures including 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 $769 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 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 budget has not been finalized, but the legislature seems likely to pass a budget similar to the governor's proposal. Assuming that fiscal 2011 year-to-date revenue performance holds up for the remainder of the year, there is significant upside potential for the fiscal 2012 forecast. Although under current law the state income tax rate will automatically drop from 5.3% to 5.25% effective Jan. 1, 2012 if current strong revenue trends continue, the Commonwealth estimates the impact of such a change at only approximately $54 million in fiscal 2012, rising to about $115 million in fiscal 2013.

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 budget over time. The fiscal 2011 enacted budget included a new mechanism for budgeting capital gains-related tax revenue that limits the amount of such revenue that can be included in the Commonwealth's budget, 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. Although there is not yet an estimate of the amount of fiscal 2011 revenue that is attributable to capital gains, given very strong personal income tax receipts through April there appears to be a strong possibility that this mechanism could result in additional reserve funding above the $769 million currently assumed for fiscal 2011 year-end.

Massachusetts has a fundamentally strong and wealthy economy, with the second highest personal income per capita in the nation (127% 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 March 2011, year-over-year growth of 1.0% in Massachusetts matched the increase for the nation. The Commonwealth's unemployment rate of 8.0% in March 2011 was 87% 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.

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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