FITCH RATES MASSACHUSETTS GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-20 December 2017: Fitch Ratings has assigned a 'AA+' long-term rating to $600 million in Commonwealth of Massachusetts general obligation (GO) bonds, consisting of:

--$200,000,000 GO bonds, consolidated loan of 2018, series A;
--$400,000,000 GO bonds, consolidated loan of 2018, series B.

The bonds will be offered by competitive sale on Jan. 9, 2018.

The Rating Outlook is Stable.

SECURITY
The bonds are general obligations of the Commonwealth, to which its full faith and credit are pledged. A statutory state tax revenue growth limit does not exclude principal and interest on debt obligations from the limit.

ANALYTICAL CONCLUSION

Massachusetts' 'AA+' Issuer-Default Rating (IDR) reflects its considerable economic resources, strong budget controls and a record of careful financial management. The Commonwealth carries a long-term liability burden that is well above average for a U.S. state but remains a moderate burden on resources. 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.

Economic Resource Base
The Commonwealth has a broad and diverse economy. Employment growth is solid, education levels are high, and population growth has approximated that of the U.S. this decade. The Commonwealth's economic fundamentals include significant strength in the health care, technology and education sectors, leaving it well positioned for solid gains going forward. Measured by per capita personal income, Massachusetts is the second wealthiest state in the nation.

KEY RATING DRIVERS

Revenue Framework: 'aaa'
Tax revenues, while diverse, are dominated by personal income taxes (PIT), which are sensitive to economic conditions, particularly those related to capital gains. Baseline growth prospects for taxes are strong, driven by the Commonwealth's solid economic fundamentals.

Expenditure Framework: 'aaa'
Consistent with most states, the natural pace of spending growth is expected to marginally exceed expected revenue growth over time, requiring ongoing cost control. The Commonwealth has ample ability to reduce spending throughout the economic cycle.

Long-Term Liability Burden: 'aa'
Liability levels in Massachusetts, while high for a U.S. state, are a moderate burden on resources. The Commonwealth's above average liability position is partly the result of state funding for needs that are more commonly funded at the local level.

Operating Performance: 'aaa'
The Commonwealth has exceptional fiscal resilience, with strong gap-closing capacity stemming from a practice of building solid reserve balances and making revenue and spending changes as needed in response to changing circumstances. The Commonwealth's fiscal flexibility is supported by conservative budgeting, ongoing economic and revenue monitoring, and mechanisms to protect the general fund from economically sensitive PIT and judgment and settlement receipts.

RATING SENSITIVITIES
The rating is sensitive to Massachusetts' consistent commitment to strong financial management practices, including preserving budgetary flexibility and actively managing its relatively high long-term liability position.

CREDIT PROFILE

Massachusetts has a fundamentally strong economy with solid growth prospects. Its dynamic, service-oriented economy includes numerous institutions of higher education and health care that lend stability, in addition to supporting development and innovation in other sectors. At 130% of the U.S. average, per capita personal income is the second highest of the states. Educational attainment is very high, and population growth has approximated that of the U.S. during this decade, a shift from historical experience of slow population gains. Despite this shift, the Commonwealth's population profile remains older than the U.S. average, consistent with other states in the region.

Economic performance has been highly sensitive to national trends. In the most recent recession, economic performance 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 the most recent recession were slightly less severe than those of the U.S. (down 6% in Massachusetts versus 6.3% for the U.S.), and employment since then has risen slightly more than the U.S. (up 14.2% in Massachusetts versus 13.3% for the U.S.).

Revenue Framework
General fund resources derive primarily from PIT, sales tax and corporate income tax. The former two are particularly important, with an estimated 58% of tax revenues from PIT and another 24% from sales tax in fiscal 2018. The PIT is levied at flat rates based on type of income, with a 5.1% rate currently applicable to most categories. Under current law the Commonwealth has been gradually lowering the PIT rate to 5%, from a previous level of 5.3%, in 0.05% increments based on a statutory mechanism incorporating Boston-area inflation and baseline revenue growth; no reduction was triggered as of Jan. 1, 2017 and none is budgeted for Jan. 1, 2018. Revenues are economically sensitive, particularly PIT receipts from capital gains as well as receipts from judgments and settlements.

Solid economic fundamentals and a revenue system that captures economic growth are the basis for a revenue profile that is likely to grow at or above the national average over time, in Fitch's view.

The Commonwealth has no significant legal limitations on its ability to raise revenues. A statutory tax revenue growth limit based on average wage and salary growth is present but has not hindered the Commonwealth's ability to manage its revenue resources. The initiative environment has periodically been active, and certain revenues have been affected by past initiative petitions, notably property taxes. Importantly, the legislature retains the ability to make changes to successful initiative petitions.

Expenditure Framework

Massachusetts' expenditure profile is very broad, driven by an expansive scope of services. Medicaid and other social services are the largest single spending commitment in the general fund at about half of total spending. Rising needs, including those emerging from implementation of the Affordable Care Act, have pressured spending in recent years. Education is also a significant commitment, with extensive funding of local schools and a broad higher education network. The Commonwealth's education commitment extends to covering the pension liabilities of local teachers. Consistent with practices in many smaller states, the Commonwealth is responsible for delivering or funding many services routinely funded at local levels in other states.

As with most states, spending in the absence of policy actions is expected to be in line with to marginally above expected revenue growth, driven by social services, particularly Medicaid.

The Commonwealth retains considerable ability to cut spending; statute allows for swift response in the event of forecast revenue underperformance, including the governor's statutory powers to unilaterally cut allotments under Section 9C of Commonwealth General Law, Chapter 29.

Federal action to revise Medicaid's programmatic and financial structure, including a basic restructuring of federal Medicaid funding to a capped amount, remains a possibility. Whether a change in federal Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increase liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Long-Term Liability Burden

Debt and pension liabilities are high for a state. On a combined basis, the burden of net tax-supported debt and net pension liability for employees and teachers equaled 20.2% of personal income, well above the 6% median for U.S. states as of Fitch's 2017 state pension update report, which recalculates reported net pension liabilities using a 6% return assumption per Fitch's "U.S. Public Finance Tax-Supported Rating Criteria".

The Commonwealth's net tax-supported debt equals a comparatively high 9.1% of personal income as of Nov. 30, 2017, including sales tax-backed obligations of the Massachusetts Bay Transportation Authority and the Massachusetts School Building Authority and annual contract assistance commitments that support the Massachusetts Department of Transportation. GO bonds continue 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 needs, relative to most other states. Fitch expects direct debt to remain high for a U.S. state but still manageable.

As of their June 30, 2016 financial reports, pension systems covering state employees and teachers (except in the City of Boston) held fiduciary assets covering 63.5% and 52.7% of their total pension liabilities, respectively, based on their 7.5% discount rate assumptions. At Fitch's more conservative 6% return assumption ratios would fall to 54.2% and 45.2%, respectively. Some pension reforms have been undertaken, including shifting to more conservative assumptions while maintaining a statutorily closed amortization target for achieving full funding in 2040. Currently, the Commonwealth expects contributions to rise 8.9% per year until the projected date of full prefunding, in fiscal 2036.

Operating Performance

Fitch believes the Commonwealth retains significant flexibility to address cyclical downturns and operating under-performance and has repeatedly demonstrated its commitment to maintaining a solid financial position. 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, under Section 9C of Commonwealth general statute, Chapter 9.

The Commonwealth has established mechanisms to cap the impact of volatile capital gains-related PIT receipts and judgment and settlement payments on the general fund, with excesses devoted to the stabilization fund (the Commonwealth's rainy day fund) or to retirement liabilities. Since fiscal 2011, capital gains have been budgeted in the general fund at $1 billion maximum, rising annually based on U.S. GDP growth; as of fiscal year 2018 the figure is $1.169 billion. Judgments and settlements are budgeted in the general fund based on a five-year rolling benchmark, at $213 million for fiscal 2018.

In the last recession, the Commonwealth relied on allotment cuts, federal stimulus and draws on the stabilization fund in response to revenue shortfalls. While the Commonwealth did not fully deplete the fund, the balance fell to $670 million in fiscal 2010, from a high of $2.34 billion in fiscal 2007. Thereafter, improved revenue performance quickly rebuilt the fund, to $1.65 billion by fiscal 2012.

The Commonwealth has continued to demonstrate ample flexibility both in the form of the rebuilt stabilization fund as well as its ability to cut expenses in response to unforeseen weakness. Similar to many states, the Commonwealth has faced budgetary challenges at several points in the current economic expansion, including from the impact of shifting federal tax law and from unexpected demands for Medicaid triggered in part by federal health reform. Although these factors have weighed on consistent progress in rebuilding the stabilization fund balance to prerecession levels, the existing balance is adequate and considerable flexibility remains.

The stabilization fund balance retains $1.3 billion as of fiscal 2017, equal to 5.1% of fiscal 2017 tax revenues; there was no deposit made during the fiscal year given a provision in the enacted budget retaining $150 million in collections above the capital gains threshold within the general fund. In fiscal 2018, the Commonwealth currently expects to deposit $70 million into the Stabilization Fund, bringing its balance to nearly $1.4 billion.

Recent Operating Performance

In fiscal 2017, which ended on June 30, actual tax revenue collections underperformed expectations, with the Commonwealth taking balancing actions in response. The January 2016 consensus forecast originally assumed nearly $26.9 billion in fiscal 2017 revenues, lowered to $26.1 billion, in October 2016. Actions by the Commonwealth included voluntary separations, balance transfers, and implementation of $95 million in Section 9C reductions. Thereafter, PIT collections during spring 2017 were well under earlier expectations, consistent with the experience of many states. Fiscal 2017 tax revenues, including tax-related settlements and judgments, ultimately totaled just under $25.7, 0.9% above the fiscal 2016 level. No draws were made from the stabilization fund to close the fiscal year.

Fiscal 2018 tax revenues as of the January 2017 consensus revenue forecast were expected to rise 3.9% over the then-expected fiscal 2017 level, to nearly $27.1 billion. Forecast changes since then, notably the impact on fiscal 2018 of PIT weakness in fiscal 2017, and a various tax law changes in the adopted fiscal 2018 budget have reduced expected tax collections, including judgments and settlements, to $26.6 billion, 3.7% above the fiscal 2017 level. Year to date through November, fiscal 2018 tax collections are 4.8% over the comparable prior year figure, and 2.4% over the benchmark including judgments and settlements. The adopted fiscal 2018 spending plan totaled $39.4 billion (1.7% above the fiscal 2017 estimated spending levels at the time of its approval), after accounting for $193 million in net-line item vetoes and excluding transfers to the Medical Assistance Trust Fund.

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
Karen Krop
Senior Director
+1-212-908-0661

Date of Relevant Rating Committee: July 26, 2017

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email: sandro.scenga@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
https://www.fitchratings.com/site/re/898466