FitchRatings

Fitch Rates Massachusetts' $650MM GO Bonds; Affirms IDR at 'AA+'; Rating Outlook Stable

Fitch Ratings - New York - 11 February 2020:

Fitch Ratings has assigned a **'AA+'** rating to $650 million in Commonwealth of Massachusetts general obligation (GO) bonds consisting of:

--$100,000,000 GO bonds, consolidated loan of 2020, series A.

--$200,000,000 GO bonds, consolidated loan of 2020, series B.

--$350,000,000 GO bonds, consolidated loan of 2020, series C.

The bonds are scheduled to be offered by competitive sale on or about Feb. 19, 2020.

In addition, Fitch has affirmed the Commonwealth's Long-Term Issuer Default Rating (IDR) at 'AA+' and the long- and short-term ratings on GO and GO-linked bonds of the state as detailed at the end of this release.

The Rating Outlook for the long-term ratings is Stable.

SECURITY

The GO 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

The credit quality of Massachusetts is linked to 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 on the long-term ratings reflects the expectation that the Commonwealth will continue to act as needed to ensure budget balance and maintain an adequate reserve position.

Economic Resource Base

The Commonwealth has a broad and diverse economy. Employment growth is solid, education levels are high, and population growth continues to lead the region despite falling below the U.S. average. 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 individual income taxes, 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. Conservative budgeting, ongoing economic and revenue monitoring, and mechanisms to protect the general fund from economically sensitive individual income tax and judgment and settlement receipts, support the Commonwealth's fiscal flexibility.

RATING SENSITIVITIES

COMMONWEALTH CREDIT QUALITY: The Long-TermIDR and GO bond rating are sensitive to Massachusetts' consistent commitment to strong financial management practices, including preserving budgetary flexibility and actively managing its relatively high long-term liability position.

GO-LINKED BONDS TIED TO IDR: The rating on the commonwealth's various GO-linked bonds are sensitive to changes in the commonwealth's IDR and will move in tandem.

CURRENT DEVELOPMENTS

The Commonwealth's operating performance has been solid, consistent with recent experience and with Fitch's expectations. Tax revenues in fiscal 2019, which ended on June 30, outperformed forecast expectations, driven by strong increases late in the fiscal year. Collections ultimately totaled $29.7 billion, 7% higher than actual fiscal 2018 collections and 4.7% over the enacted budget level.

Through the first seven months of fiscal 2020, steady performance continues, driven by ongoing strength in the economy. Year-to-date tax collections are 4.9% ahead of the corresponding collection period last year, and 0.6% ahead of benchmark.

For fiscal 2020, the Commonwealth forecasts tax collections of $30.3 billion (including judgments and settlements). These figures reflect the state's January 2020 consensus forecast update, under which collections would rise 1.8% from the final fiscal 2019 level. The fiscal 2020 forecast incorporates a 0.05% drop in the individual income tax rate, which took place on Jan. 1, 2020 (discussed below). Other revenue changes captured in the forecast were approved with the last budget, including extending sales taxes on online vendors and excise taxes on short-term rentals. Total expenditures before interfund transfers in fiscal 2020 are budgeted to rise 3.9%, with K-12 education up 7.1% driven by formula aid and state-funded Medicaid slowing to only 0.9%, a pace similar to recent years given limited changes in enrollment and the Commonwealth's emphasis on cost controls.

Budget deliberations for fiscal 2021, which begins on July 1, have started. The January consensus revenue forecast anticipates tax collections rising a modest 2.8%, to $31.2 billion, from the fiscal 2020 figure. The governor's executive budget, released last month, projects spending growth of 2.3%, with a sizable increase in education spending as the state begins to implement provisions of the Student Opportunity Act, a revamp of formula funding for school districts passed in November 2019. Funding increases will be phased in over seven years. Proposed funding increases for other program categories are minimal, including Medicaid. The proposal also includes a $310 million increase to the stabilization fund, the Commonwealth's budget reserve.

CREDIT PROFILE

Massachusetts has a fundamentally solid economy with strong growth prospects. Its dynamic, service-oriented economic profile is anchored by numerous institutions of higher education and health care that lend stability, in addition to supporting development and innovation in other sectors. Wealth levels are high, with per capita personal income at 131% of the U.S. average in 2018. Educational attainment is very high, and population growth has been stronger in Massachusetts than the region, although its population remains older than the U.S. average, consistent with other New England states.

Economic performance has been highly sensitive to national trends. In the most recent recession, Massachusetts performed significantly better than the national experience, in contrast to 2002-2004 when it suffered among the steepest employment drops in the country. Employment losses in the Great Recession were slightly less severe than those of the U.S. (down 6% in Massachusetts versus 6.3% for the U.S.). Employment growth since then has been consistently solid.

Revenue Framework

General fund resources derive primarily from individual income, sales and corporate income taxes. The former two are particularly important, with an estimated 58% of tax revenues from individual income taxes and another 24% from sales taxes in fiscal 2020. The individual income tax is levied at flat rates based on type of income. A 5% rate is applicable to most income categories. This rate includes a 0.05% decline implemented as of January 1, 2020 under a statute that gradually reduced the rate from 5.3% beginning Jan. 1, 2012, under a statutory mechanism incorporating Boston-area inflation and baseline revenue growth. The effect of the final 0.05% rate cut is forecast at $88 million in fiscal 2020 and $185 million in fiscal 2021. The statute also reinstates the state charitable deduction as of January 1, 2021, a change forecast to lower individual income tax receipts by $64 million in fiscal 2021 and $300 million in fiscal 2022.

Revenues are economically sensitive, particularly individual income tax receipts from capital gains and receipts from judgments and settlements. Consistent with the experience of many other states, individual income tax collection trends have also been affected in recent years by federal tax law changes, most recently those associated with the Dec. 2017 Tax Cut and Jobs Act (TCJA).

Strong 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 national economic growth 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 also 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 statutes passed by 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 the last decade. Education is also a significant commitment, with extensive funding of local schools and a broad higher education network. Funding formula changes for local schools, intended to address needs in districts with higher concentrations of poverty, were passed in 2019 and are expected to result in a ramp-up of Commonwealth spending over several years. The Commonwealth's education commitment extends to covering the pension liabilities of local teachers, although not the liability associated with their other post-employment benefits (OPEB). Consistent with practices in many smaller states, the Commonwealth is responsible for delivering or funding many services routinely funded at local levels elsewhere.

As with most states, spending in the absence of policy actions is expected to be in line with to marginally above expected revenue growth, primarily driven by social services, particularly Medicaid. Fitch believes significant federal action to revise Medicaid's fundamental programmatic and financial structure, which had appeared to be possible in recent years, now appears less likely given divided control in the U.S. Congress. As with all federal initiatives, Medicaid remains subject to regulatory changes that could affect various aspects of the program.

The Commonwealth retains ample 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.

Carrying costs for long-term liabilities, including debt service, actuarially determined pension contributions, and other post-employment benefit (OPEB) pay-go appropriations, are elevated, at 12% of governmental expenditures in fiscal 2018. Under state finance law, revenues available for budgeting are net of statutory pension contributions and transfers for the Massachusetts Bay Transportation Authority (MBTA) and the

Massachusetts School Building Authority (MSBA). Pension reforms were undertaken in 2011, and the state maintains a relatively conservative statutorily closed amortization target for achieving full funding in 2040. Pension contributions have risen in part due to experience updates and shifts to more conservative actuarial assumptions. Based on a funding schedule that it updates every three years, most recently in 2020, the Commonwealth forecasts contributions rising about 9.6% per year until the projected date of full prefunding, in fiscal 2036. Fitch views this trajectory of contribution increases as high, but manageable within the Commonwealth's fiscal framework.

Long-Term Liability Burden

Debt and Fitch-adjusted net pension liabilities are high for a state. On a combined basis, the burden of direct debt and the adjusted net pension liability for employees and teachers equaled 19.5% of personal income, well above the 5.7% median for U.S. states, as of Fitch's 2019 state pension update report. Fitch recalculates reported net pension liabilities using a standard 6% discount rate assumption per Fitch's U.S. Public Finance Tax-Supported Rating Criteria.

As of Nov. 30, 2019, Fitch estimates the Commonwealth's direct debt at a comparatively high 8.5% of 2018 personal income, including sales tax-backed obligations of the MBTA and the MSBA and annual contract assistance commitments that support the Massachusetts Department of Transportation. GO bonds 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, 2019 financial reports, pension systems covering state employees and teachers (except in the City of Boston) held fiduciary assets covering 66.3% and 53.9% of their total pension liabilities, respectively, based on the 7.25% discount rates implemented as of their 2019 valuations; the rates have been lowered twice from the 7.5% used for the 2017 valuation. Using Fitch's standard 6% return assumption, the 2019 ratios would fall to 58% and 47.3%, respectively.

The Commonwealth carries a net OPES liability for state employees, but not local teachers, measuring $17.4 billion, based on a 3.95% discount rate and net of prefunding built in recent years from tobacco settlement monies, excess capital gains collections and other sources; the net OPES liability measures 3.5% of 2018 personal income.

Operating Performance

Fitch believes the Commonwealth retains a high capacity 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 Law, Chapter 29, noted above.

Additionally, since 2011 the Commonwealth has operated under a mechanism to reduce the impact of volatile capital gains-related tax revenues on its budget. Capital gains-related revenue that can be included in the budget is capped annually at a level that rises by U.S. GDP, with excesses dedicated to the stabilization fund (90%) and retiree benefit obligations (10%). The threshold was $1.212 billion in fiscal 2019, is $1.26 billion in fiscal 2020 and will rise to $1.312 billion in fiscal 2021. A similar mechanism covers one-time judgments and settlement payments.

The Commonwealth has consistently supported financial 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 effect of shifting federal tax law and from unexpected demands for Medicaid. Although these factors initially weighed on progress in rebuilding the stabilization fund balance to prerecession levels, more recently the budgetary mechanisms to shift cyclical windfalls to the stabilization fund have raised its balance considerably.

As noted earlier, the stabilization fund balance is forecast to reach $4 billion as of fiscal 2020 (13.2% of projected fiscal 2020 tax revenues) following a net deposit of over $1.4 billion in fiscal 2019 and the expected net deposit of $565 million in fiscal 2020, including from capital gains in excess of the threshold.

Related Affirmations

Fitch affirms the ratings on the Commonwealth's GO and GO-linked bonds of the Commonwealth as follows:

--Approximately $23.7 billion in GO bonds at 'AA+';

--Approximately $182 million in Massachusetts Development Finance Agency (MDFA) special obligation bonds (Commonwealth contract assistance) at'AA+';

--Approximately $178 million in Commonwealth guaranteed bonds, issued by the University of Massachusetts Building Authority (UMBA) and the MBTA, at 'AA+';

--Approximately $94 million in UMBA (Commonwealth Guaranteed) refunding revenue bonds, series 2011-2 at 'AA+'/'F1+';

--Approximately $772 million in Massachusetts Department of Transportation (MassDOT) metropolitan highway system (MHS) revenue bonds (subordinate), Commonwealth contract assistance secured at AA+.

The Rating Outlook on the long-term ratings is Stable.

The long-term GO bonds carry the Commonwealth's full faith and credit pledge.

For the Commonwealth contract assistance bonds issued by MDFA and Commonwealth guaranteed bonds issued by UMBA and MBTA, the Commonwealth's obligation under the contract to make payments equal to debt service is a general obligation of the Commonwealth, to which its full faith and credit are pledged.

The short-term 'F1+' rating on the UMBA series 2011-2 bonds is based on the long-term 'AA+' rating of the Commonwealth.

For the MassDOT MHS subordinate revenue bonds, the Commonwealth's annual fixed, dedicated payments are a full faith and credit obligation of the Commonwealth and are expected to cover all subordinated debt service, linking the rating to the 'AA +' rating of the Commonwealth, rather than to the MHS toll revenues, which are also pledged to the bonds on a subordinated basis. Although about half of outstanding debt is variable rate and thus exposed to potential, though unlikely, risks associated with variable rate debt, Fitch expects that MassDOT would work with the commonwealth if necessary to ensure that the annual payments are sufficient for debt service.

CRITERIA VARIATION

There were no criteria variations.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3 - ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Massachusetts, Commonwealth of (MA) [General Government]	**LTIDR** AA+ **O** Affirmed		**AA+ O**
Massachusetts Turnpike Authority	LT		**AA+ O**

Metropolitan Highway System **(MA)** /Metro Highway System Revenues - Subordinated Obligations/1 LT	**AA+ O** Affirmed		
Massachusetts, Commonwealth of **(MA)** /Commonwealth Guaranteed Revenues/1 LT	LT AA+ **O** Affirmed		**AA+** O
Massachusetts, Commonwealth of (MA) /General Obligation - Unlimited Tax - MDFA/1 LT	LT AA+ **O** Affirmed		**AA+** O
Massachusetts, Commonwealth of (MA) /General Obligation - Unlimited Tax/1 LT	LT AA+ **O** Affirmed		**AA+** O
Massachusetts, Commonwealth of (MA) /General Obligation - Unlimited Tax/1 ST	ST F1+ Affirmed		F1+

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Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 10 Jan 2020)

Additional Disclosures

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