# FITCH RATES MASSACHUSETTS GO RANS 'AA +/F1+', GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-16 August 2016: Fitch Ratings has assigned 'AA+' long-term and 'F1+' short-term ratings to $1.5 billion in Commonwealth of Massachusetts general obligation (GO) revenue anticipation notes (RANs), consisting of:

--$500,000,000 2016 series A;
--$500,000,000 2016 series B;
--$500,000,000 2016 series C.

In addition, Fitch has assigned 'AA+' ratings to approximately $835 million in long-term GO bonds, consisting of:

--$550,000,000 GO bonds, consolidated loan of 2016, series G;
--$284,545,000 GO refunding bonds, 2016 series C.

The GO RANs and GO bonds will be offered by competitive sale, with the GO RANs scheduled to sell on Aug. 24 and the GO bonds scheduled to sell on Aug. 25, 2016.

The par amount of the GO refunding bonds is subject to change prior to the final sale.

In addition, Fitch affirms the Commonwealth's long-term Issuer Default Rating (IDR) at 'AA+', and the ratings on related bonds of the state, as noted at the end of this release.

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

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

KEY RATING DRIVERS

The long-term 'AA+' and short-term 'F1+' ratings on Massachusetts' series 2016 RANs reflects the GO pledge carried by the notes. Massachusetts routinely issues notes for intra-year cash flow needs. Projected receipts provide strong coverage of note repayment and the balance in the Commonwealth stabilization fund provides substantial additional cushion.

Massachusetts' 'AA+' 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.

Revenue Framework: 'aaa' factor assessment
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' factor assessment
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' factor assessment
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' factor assessment
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 PIT and judgment and settlement receipts support the Commonwealth's fiscal flexibility.

RATING SENSITIVITIES
The rating is sensitive to shifts in fundamental credit characteristics including Massachusetts' consistent commitment to strong financial management practices.

CREDIT PROFILE

Massachusetts has a fundamentally strong economy with solid growth prospects. A 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 areas. At 128% 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 11.7% in Massachusetts versus 11.1% 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 57% of tax revenues from PIT and another 24% from sales tax in fiscal 2017. 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.

Revenues have been 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 total spending in recent years, although growth is expected to slow going forward. 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 state 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.

Long-Term Liability Burden

Debt and pension liabilities are high for a state but represent only a moderate burden on resources. On a combined basis, the burden of net tax-supported debt and unfunded pension liability for employees and teachers 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's net tax-supported debt equals a comparatively high 9.4% of personal income as of July 31, 2016, 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 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 needs, relative to most other states. Fitch expects direct debt to remain high for a U.S. state but still manageable.

As of their most recent valuations, pension systems covering state employees and teachers (except in the City of Boston) were funded at 63.5% (as of Jan. 1, 2016) and 54.3% (as of Jan. 1, 2015), respectively. Using Fitch's more conservative 7% return assumption would result in lower funded ratios of 60.2% and 50.1%, 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. 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 2037 based on current assumptions.

## 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.

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 2017 the figure is $1.128 billion. Judgments and settlements are budgeted in the general fund based on a five-year rolling benchmark, currently at $267 million.

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.

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 the impact of shifting federal tax law and unexpected demands for Medicaid triggered in part by federal health reform. Although these factors have weighed on progress in rebuilding stabilization fund balances to prerecession levels, the existing balances remain solid and considerable flexibility remains.

With initial recovery, the stabilization fund balance rose to $1.65 billion by fiscal 2012, driven by capital gains and judgment and settlement receipts in excess of their respective caps. Unexpected Medicaid needs and underperformance on PIT receipts has resulted in draws and partial suspensions of planned stabilization fund deposits in recent fiscal years. The stabilization fund balance remains a still adequate $1.296 billion estimated at fiscal 2017 year-end, equal to 4.9% of fiscal 2017 tax revenues. The fiscal 2017 budget assumes that the first $150 million in capital gains above the $1.128 billion statutory threshold will be held in the general fund, with any excess transferred to the stabilization fund; under the current forecast no such transfers are expected.

### Recent Operating Performance Steady

Consistent with recent years, in fiscal 2016 the Commonwealth faced fiscal underperformance relative to budget targets. Slower non-tax revenue collections and unexpected spending needs resulted in the state implementing Section 9C allotment cuts and revenue actions in January 2016. Despite these actions, tax revenues were below expectations during the latter half of fiscal 2016, notably the non-withholding components of PIT. Preliminary tax revenues excluding certain large tax settlements are currently forecast at $25.3 billion, below the $25.6 billion forecast assumed at the start of fiscal 2016. Although fiscal 2016 tax revenues were 2% higher than fiscal 2015 actuals, PIT receipts were 0.4% lower. Total expenditures were nearly $40.6 billion in fiscal 2016, below the $40.9 billion assumed at budget adoption.

Given recent tax revenue trends, the outlook for fiscal 2017 tax revenues has been lowered since the January 2017 consensus forecast of nearly $26.9 billion. Projected on the same basis, fiscal 2017 tax revenues are forecast at $26.2 billion. PIT is expected to rise 4.2% and sales taxes 5.2%. The current forecast assumes that the next incremental, 0.05% PIT rate cut will not be triggered.

Total budgeted expenditures, at $41.6 billion, are 2.6% over the preliminary fiscal 2016 figure, with slowing growth linked to a considerably slower increase in Medicaid spending.

Coverage of GO RANs Solid

Massachusetts routinely issues RANs to cover intra-year cash flow needs, with commercial paper periodically providing additional cash resources as needed in some fiscal years. The $1.5 billion 2016 series RANs issued for fiscal 2017 cash needs is higher than the $1.2 billion in 2015 series RANs issued for fiscal 2016 cash needs. Although not originally expected, the Commonwealth also issued $200 million in commercial paper in fiscal 2016. No commercial paper issuance is currently forecast in fiscal 2017.

Forecast coverage for the 2016 series RANs is strong at about 5.6x for the series A maturity in April 2017, 5x for the series B maturity in May 2017, and 5.6x for the series C maturity in June 2017. The current official cash flow forecast projects a fiscal 2017 non-segregated operating cash ending balance of $2.3 billion, up only slightly from the nearly $2.3 billion beginning balance as of July 1, 2016.

The Commonwealth's stabilization fund is a segregated fund and thus is not included in the coverage numbers above. However, Fitch notes that the stabilization fund can be drawn on via legislative appropriation fairly expeditiously and, as such, provides substantial additional cushion. The stabilization fund balance, at $1.29 billion at June 30, 2016, is projected to rise slightly, to $1.3 billion, as of June 30, 2017.

A variation from Fitch's short-term criteria, 'Rating U.S. Public Finance Short-Term Debt,' was applied to this analysis. The short-term criteria, dated November 2015, state that bonds with a maturity under one year are eligible only for a short-term rating. The assignment of Issuer Default Ratings (IDRs) to U.S. state and local government ratings pursuant to revised tax-supported criteria, released in April 2016, facilitates assignment of both a long-term 'AA+' rating and a short-term 'F1+' rating to the RANs. Previously, Fitch only assigned security ratings to U.S. state and local government credits.

Related Affirmations

Fitch affirms the ratings on the Commonwealth's Long-Term IDR at 'AA+', and the ratings on GO or GO-linked bonds of the Commonwealth, as follows:

--Approximately $22.3 billion in GO bonds at 'AA+';
--Approximately $52 million in Massachusetts Development Finance Agency special obligation bonds (Commonwealth contract assistance) at 'AA+';
--Approximately $329 million in Commonwealth guaranteed bonds issued by the University of Massachusetts Building Authority and the Massachusetts Bay Transportation Authority, at 'AA+';
--University of Massachusetts Building Authority (MA) (Commonwealth Guaranteed) refunding revenue bonds, series 2011-2 at 'AA+'/'F1+'.

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

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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 Lumesis and InvestorTools.

Applicable Criteria
Rating U.S. Public Finance Short-Term Debt (pub. 17 Nov 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=873508
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=879478