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Ratings

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Summary:

Massachusetts; General Obligation

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Credit Profile		
US$178.0 mil GO rfdg bnds ser 2019 C due 05/01/2031		
Long Term Rating	AA/Stable	New

Rationale

S&P Global Ratings has assigned its 'AA' rating to the Commonwealth of Massachusetts' $178 million general obligation (GO) refunding bonds, 2019 series C. The outlook is stable.

In addition, S&P Global Ratings has affirmed its 'AA' rating on approximately $23 billion of parity GO bonds outstanding, and its 'A' rating on Boston Housing Authority housing project bonds (West Broadway Homes IV project), series 2003, supported by a commonwealth annually appropriated state-operating subsidy, subject to the terms of a trust agreement. Finally, S&P Global Ratings has affirmed its 'A-1+' short-term rating on the state's GO-secured commercial paper. The outlook on all long-term ratings is stable.

Factors supporting the 'AA' GO rating include what we view as Massachusetts':

- Deep and diverse economy, which continues to outperform the nation on several economic indicators;
- High income levels, with per capita income at 131% of the nation in 2017, the second-highest among the states;
- Timely monitoring of revenues and expenditures and swift action when needed to make adjustments;
- Strong financial, debt, and budget management policies, including annualized formal debt affordability statements, and multiyear capital investment planning; and
- Good budget stabilization fund (BSF) balance, equal to an estimated 4.5% of expenditures and other uses at fiscal year-end 2018, and projected at 5.4% at fiscal year-end 2019.

Offsetting factors include high debt, pension, and other postemployment benefit (OPEB) liabilities. Combined debt, unfunded pension, and OPEBs to gross state product ranked sixth highest among all the states in fiscal 2017, according to our pension commentary "U.S. State Pensions Struggle For Gains Amid Market Shifts And Demographic Headwinds" (published Oct. 30, 2018, on RatingsDirect).

In particular, the commonwealth has a low 60.7% combined pension funded ratio on a Governmental Accounting Standards Board (GASB) basis and has contributed less to its pension funds than the actuarial annual required contribution (ARC) in every fiscal year since 2011; however, Massachusetts has put in place a plan to increase annual pension contributions 8.9% per year to fully amortize unfunded pension liabilities by 2036; furthermore, the $892 million shortfall against ARC in fiscal 2019, which we view as a structural deficit, is only about 1.9% of estimated budgetary operating expenditures. The commonwealth has budgeted to pay 75% of the ARC in fiscal 2019, about the same level as the 73% paid in fiscal 2018.

Massachusetts' economy remains strong, even after steady growth in recent years that has outpaced national and regional trends by most measures. IHS Markit reports private-sector employment growth over the past three months (through July 2018) averaged a strong 4%. The professional, scientific, and technical services sector accounted for 20% of overall payroll growth, important in that these tend to be higher paying jobs, although perhaps contributing to rising home prices. Massachusetts has an above-average high-technology employment sector, which IHS Markit estimates at about 10% of state employment, compared with 6.5% for the country as a whole. State personal income rose 3.3% in 2017, rising to 131% of that of the nation (second only to Connecticut) from 130% the year before. The commonwealth's average annual unemployment rate in 2018 was low at 3.3%, compared with 3.9% for the nation. Despite strong recent growth, IHS Markit forecasts slightly lower state employment growth than the nation in the next few years at 1.0%, 0.8%, and 0.4% in calendar years 2019, 2020, and 2021, respectively, compared with 1.5%, 1.0%, and 0.5% for the nation for those respective years. In our view, Massachusetts' economic fundamentals and key anchors, which center on higher education, technology, finance, and health care, should contribute to continued expansion.

The commonwealth's operating revenues have come in better than budgeted over the past two years. Fiscal 2018 tax collections increased 8.3% over the previous year, much better than the 4.2% originally budgeted, excluding one-time tax settlements and judgments.

Massachusetts' originally adopted fiscal 2019 budget projected 2.2% growth in operating funds tax revenue and 2.1% overall growth in total budgeted operating funds revenue and other sources, including federal revenue and transfers in, and 4.0% growth in total budgeted operating expenditures and other uses, including transfers out. Actual year-to-date state tax collections for the first nine months of fiscal 2019 through March 2019 have come in 4.1% higher than the previous year. The state currently projects full-year fiscal 2019 growth in total budgeted revenues and other sources of 3.7% (including 3.1% growth in tax revenues), while projecting growth in expenditure and other uses of 5.2%, including additional midyear supplemental appropriations. The net result is that the state is projecting a small fiscal 2019 operating surplus of $285 million, or 0.6% of expenditures and other uses, instead of an originally budgeted slight operating deficit. However, this does not include an additional $494 million deposited to its BSF from excess capital gains tax and a consolidated operating surplus that was carried over from fiscal 2018, for a BSF deposit that is $126 million more than in the original budget forecast due to unexpectedly high capital gains tax and surplus carried over from fiscal 2018. If the 2019 current state forecast is realized, the BSF would rise to $2.5 billion at fiscal year-end 2019, or a good 5.4% of budgeted operating funds expenditures and other uses, up from 4.5% at fiscal year-end 2018.

We view the accumulation of budget reserves during good economic times as especially important from a credit perspective in that the state has historically shown some cyclicality in its finances and we view its fixed costs as moderately high. The state drew down its BSF in fiscal years 2013 and 2014, even while revenues were increasing, and then essentially level-funded the BSF with small deposits until fiscal 2018, when revenues began to come in substantially above budget. A key credit consideration in our view is whether the commonwealth will retain the build-up of the BSF above budgeted levels in fiscal years 2018 and 2019, or if it will draw it down again when tax growth slackens. In this respect, the upcoming fiscal 2020 budget might provide guidance.

The governor's proposed fiscal 2020 budget would add $225 million to the BSF from excess capital gains tax, and $297 million overall. However, the legislature has overridden the governor's BSF proposals in recent years. The latest version of the Massachusetts house budget would retain recent gains in the BSF and add a similar $221 million to the BSF from excess capital gains tax. The state projects tax revenue growth of 2.7% in fiscal 2020 over the revised fiscal 2019 revenue forecast, including a statutory reduction in the personal income tax rate to 5.00% from 5.05%. The governor's budget proposal would increase operating spending by 1.5% over projected 2019 spending.

Although revenue growth has been strong in recent years, one contributor to the state's decision to level the fund or draw down the BSF during fiscal years 2013-2017 has been various spending pressures, particularly from healthcare costs that were rising faster than revenue before fiscal 2017. As a consequence, Massachusetts had to make midyear budget adjustments in each of the three fiscal years 2015-2017. At fiscal year-end 2017, the BSF was 3.1% of budgetary expenditure and other uses. Healthcare spending has since been mitigated in part by greater scrutiny of Medicaid eligibility, which caused Medicaid enrollment member months to decline 1.9% in fiscal 2018 and 1.8% in 2019, particularly as adults moved to the commonwealth's Health Insurance Connector Authority.

Additional potential long-term stresses include a state pension payment schedule that increases annual pension contributions by 8.9% compounded annually through 2036, a pace we believe likely to exceed revenue growth. Although we recognize that Massachusetts has made budgeting its fixed costs a priority, we also view the growth in these areas as placing increased pressure on the commonwealth's ability to maintain structural balance. We calculate that combined fiscal 2018 operating funds debt service, state pension contributions, and OPEB were about $5.3 billion on a budgetary basis, or about 12% of operating expenditures and other uses. Medicaid was an estimated additional $15.7 billion in fiscal 2018 (36%), while transfers to the commonwealth's Medical Assistance Trust Fund are projected to be $586.6 million.

On a generally accepted accounting principles (GAAP) basis, Massachusetts ended fiscal 2018 (the most recent audited year) with an available assigned and unassigned general fund balance of $1.51 billion, plus a BSF balance of $2.0 billion. This led to a combined available balance plus BSF of $3.52 billion, which we view as strong at 8.6% of general fund expenditures and transfers out, up from 5.9% at fiscal year-end 2017.

By most measures, we believe Massachusetts' debt burden remains high compared with that of other states. At fiscal year-end 2018, we calculate GO debt of $23.1 billion and total tax-supported debt of $38.8 billion, producing total tax-backed debt per capita of $5,622, and 8.4% of 2017 personal income. As of Feb. 28, 2019, the commonwealth had $22.9 billion of GO debt outstanding. Planned debt issuance remains within the parameters of Massachusetts' debt affordability policy and bond cap. A capital and debt affordability committee includes seven voting and eight nonvoting members from the legislature and is charged with formally reviewing the CIP and providing an estimate of debt authorization for each year to stay within certain debt parameters. Massachusetts anticipates selling about $2.3 billion of new money capital debt in fiscal 2019 (including the current sale), similar to issuance levels in each of the past two years. We calculate fiscal 2018 total tax-backed debt service at 7.1% of general governmental spending on a GAAP audited basis, a level we view as moderately high.

Other long-term liabilities are also large, in our opinion. We believe Massachusetts' share of the net pension liability for combined state pensions systems is high at $37.7 billion as of the Jan. 1, 2018, valuation date on a GASB 67/68 basis, or $5,460 per capita, and 8.1% of 2017 personal income. The aggregate funded ratio improved slightly to 60.7% in

2018 from 59.5% the year before on a GASB basis, but the three-year average remained at 59%. Some of the reason net pension liabilities have not shown much improvement is that Massachusetts decided to lower its assumed actuarial return to a less aggressive 7.35% as of Jan. 1, 2018, which increased the total actuarial accrued liability by $1.52 billion. The rate was previously reduced earlier from 7.50% in 2016, and from 7.75% in 2015. The assumed rate of return will further decline to 7.25% as of Jan. 1, 2019, which the state estimates will increase actuarial accrued liability by $1.0 billion. Massachusetts sets its annual pension contribution based on its own methodology under state statute; it has not fully funded its ARC since fiscal 2011, but expects to reach full ARC funding by 2024 under its plan to increase pension contributions 8.9% per year to fully amortize the unfunded liability by 2036.

In our opinion, Massachusetts' unfunded OPEB is also moderately high, although it has decreased significantly following recent deposits into an OPEB trust fund. The state's net OPEB liability on a GASB 74 basis decreased to $14.9 billion as of a June 30, 2018, valuation date, or $2,160 per capita, using a 3.95% discount rate. This represents a large decrease from a net OPEB position of $19.8 billion in 2017, when the OPEB trust fund was smaller. The state's fiduciary OPEB net position was $1.2 billion in 2018, up from $996 million the year before. In 2018, the commonwealth originally budgeted to transfer 10% of tobacco settlement revenue into its OPEB trust fund, but subsequent legislation after the close of the fiscal year increased the percentage to 30%. The enacted fiscal 2019 budget reverts this back to 10% of tobacco settlement revenue, or approximately $25.1 million. In fiscal 2018, $16.1 million of excess capital gains tax was also transferred into the OPEB trust fund.

Based on the analytic factors we evaluate for states, on a scale of '1.0' (strongest) to '4.0' (weakest), we have assigned a composite score of '1.9' to Massachusetts, which is consistent with a 'AA' indicative rating.

For more information on the Commonwealth of Massachusetts, please see our full analysis published April 18, 2019.

Outlook

The stable outlook reflects our view that Massachusetts' strong economic growth and proactive management will allow the commonwealth to continue to manage potential budgetary pressures, even if midyear budget shortfalls develop in future fiscal years. We believe the current increase in projected fiscal year-end 2019 reserves is the result of small planned additions to reserves plus extra funds from unexpectedly strong revenues above budget. Our stable outlook anticipates that the commonwealth will budget for break-even operations during our two-year outlook horizon, and make midyear budget corrections should revenues turn downward, as well as bank a portion of unexpected revenue windfalls in its BSF. At this point in the economic cycle and at the current rating level, we expect Massachusetts to modestly improve its BSF and maintain good balances to prepare for the next recession.

Upside scenario

Should the commonwealth both make progress on its pension funding and set aside material budget reserves during periods of economic growth as a matter of budgeted policy, with the aim of sustainably achieving what we view as strong reserve levels, we could raise the rating or revise the outlook. If the final adopted budget for fiscal 2020 retained the recent unbudgeted increases in its BSF and further built reserves to what we consider strong levels on a budgeted basis (generally 8% of expenditures or more), we could also potentially raise the rating or revise the outlook.

Downside scenario

The rating could see downward pressure if Massachusetts fails to maintain near-structural balance during periods of economic expansion. Among the factors that could further pressure the rating are Medicaid costs outpacing revenue growth, reduced revenues in recessions due to income tax cyclicality because of the above-average presence of high-technology sector employment, the economic impact of federal tax reform state and local tax deduction caps on high tax states, and growing state fixed costs in excess of revenue growth that might lead to significant structural imbalance and greatly diminished reserves. Structural balance could specifically be pressured to the extent that Massachusetts fails to adhere to its current plan to increase annual pension contributions by 8.9% per year to amortize unfunded pension liabilities or if this proves insufficient to keep GASB pension funded ratios from materially declining.