S&P Global Ratings

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Summary:

Massachusetts; General Obligation

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Table Of Contents

Credit Highlights

Outlook

Related Research

Summary:

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Credit Profile		
US$500.0 mil GO bnds cons loan of 2022 ser E due 11/01/2052		
Long Term Rating	AA/Positive	New
US$200.0 mil GO bnds cons loan of 2022 ser D due 11/01/2033		
Long Term Rating	AA/Positive	New

Credit Highlights

- S&P Global Ratings assigned its 'AA' long-term rating to Massachusetts' general obligation (GO) consolidated loans of 2022, series D and E.
- The outlook on the bonds in positive.

Security

Massachusetts' full faith and credit are pledged to the GO bonds. Proceeds from the 2022 series D and E consolidated bonds will fund or reimburse the commonwealth for various capital expenditures authorized in its capital investment plan (CIP).

Credit overview

Strong revenue growth, combined with extra federal aid, helped the state rebound strongly from the 2020 pandemic and end its last two fiscal years in an extremely strong financial position with the highest level of reserves in its history. At fiscal year-end June 30, 2021, the budget stabilization fund (BSF) stood at $4.6 billion, or a strong 9.4% of operating expenditures and other uses on a budgetary basis of accounting, higher than the 5.3% originally budgeted. The trend of adding to reserves continued in fiscal 2022, with the year ending with a preliminary BSF balance of $6.9 billion, or a strong 12.4% of budgeted operating expenditures and other uses.

Nevertheless, the commonwealth still faces headwinds as national recessionary pressures persist, with long-term liabilities remaining among the highest in the nation and persistent underfunding of its pensions, which could lead to budgetary pressures as revenue growth softens and tests the commonwealth's commitment to strong BSF levels in the next two years.

Our rating on Massachusetts reflects a strong economy, with the second-highest per capita income level in the nation, partly due to an above-average presence of high-technology companies in the Boston metropolitan statistical area (MSA). The rating further reflects some historical cyclicality in financial results, although recent strong growth in tax collections and federal aid have led to large operating surpluses and reserves. This has also resulted in high debt, pension, and other postemployment benefit (OPEB) liabilities, with a history in recent years of funding its pension and OPEB funds below full annual actuarial recommendations.

The state enacted its 2023 budget in July, after its June 30, fiscal year-end (using an interim budget in the meanwhile).

The budget is based on a 3.9% decline in tax revenue, reflecting conservative projections of historically more volatile tax revenue as well as the moderating effects of the pass-through entity provisions (which boosted 2022 tax revenue). Total operating expenditure and uses is expected to increase by 11%, but the budget is structurally balanced after adjusting for nonrecurring appropriations. The budget projects that the BSF will increase to $8.4 billion (13.5% of budgeted expenditures and other uses) at the end of fiscal 2023. State tax revenue exceeded revenue limits pursuant to Chapter 62 of the commonwealth's general laws in fiscal 2022, leading to about $2.9 billion in tax rebates to be distributed as refunds to taxpayers by the Department of Revenue in fiscal 2023. In a fiscal year close out bill for 2022, the Legislature set aside funds sufficient to pay for the tax rebates in fiscal 2023.

Despite the commonwealth's strong finances and economy, financial risks remain. We believe Massachusetts has an above-average dependence on cyclical capital gains tax revenue, which has benefited from the high stock market, but could recede with national economic contraction and pressure the state's commitment to its financial goals. The state has also had large recent increases in Medicaid enrollment, a potential budgetary concern if the federal government no longer pays the higher Medicaid reimbursement rate it implemented during the pandemic. S&P Global Economics currently factors a recession into its baseline forecast and expects national GDP growth to decelerate to about 0.2% for 2023. However, the recent build-up of reserves should position the commonwealth well to mitigate disruption from the currently escalating economic pressures (see "Economic Outlook U.S. Q4 2022: Teeter Totter," published Sept. 26, 2022, on RatingsDirect).

Other long-term pressures for the commonwealth include its high debt levels and moderately high OPEBs, exacerbated by persistent underfunding of its annual actuarial pension contribution, which we believe could significantly increase liabilities. At fiscal year-end 2021, the last audited fiscal year, we calculate the commonwealth had net total tax-backed debt per capita of $5,825 and 7.1% of personal income, including tax-supported revenue debt. Also, Massachusetts has been chronically underfunding its actuarially required annual pension contribution. Pension contributions are statutorily determined, and the state has made contributions in accordance with its schedule set in 2020. The schedule assumes a fully funded retirement system by 2036, but only if it increases annual contributions by 9.63% per year through 2035, a steep increase that we believe postpones current pension pressure to future years. We calculate the pension underfunding amounts are equivalent to about 1% of operating expenditures or higher for the past five years, if excluding restricted federal revenue from the budget denominator. The commonwealth has contributed less than its actuarial annually recommended contribution since 2011, funding only an estimated 86% (including supplemental contributions) of its annual actuarial recommendation in fiscal 2022, which has contributed to what we consider a relatively low combined three-year average pension-funded ratio on a Governmental Accounting Standards Board (GASB) basis of 61%. A strong investment return of 29.9% in fiscal 2021 temporarily improved funded levels to 68.7%, but preliminary estimates show that fiscal 2022 returns were extremely weak at negative 2.8% and could lead to lower funded levels for 2022. At fiscal year-end 2021, the commonwealth's net pension liability (NPL) (on a GASB basis) was a high $5,006 per capita, or 6.1% of state personal income. Net OPEB liability (on a GASB basis) at fiscal year-end 2021 was also high, at $2,639 per capita, although the state has made efforts in recent years to prefund a portion of OPEBs through a trust fund.

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

- Deep and diverse economy;

- High income levels, with per capita income at 130% of the nation in 2021, the second-highest among the states;
- History of 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;
- Strong BSF balance, equal to 12.4% of expenditures and other uses on a budgetary basis at fiscal year-end 2022, and an estimated increase in 2023 to 13.4%, in part due to currently strong capital gains tax; and
- High debt, pension, and OPEB liabilities.

For more information on the commonwealth, please refer to our most recent full analysis on Massachusetts, published Oct. 7, 2022, on RatingsDirect.

Environmental, social, and governance

ESG Credit Indicators: E-3, S-2, G-2

We consider Massachusetts' environmental risks moderately negative in our credit rating analysis because of the commonwealth's coastal exposure, with about two-thirds of its population in the Boston MSA and substantial property value in the combined Boston and Cape Cod area exposing the state to significant economic disruption following a high-impact event. However, we also note that the commonwealth has been addressing environmental risks since 2004 through its Climate Protection Plan and has historically maintained a stable management and policy framework to respond to developing risks. We view social and governance as neutral to the credit rating analysis.

Outlook

The positive outlook reflects our view that Massachusetts' underlying economy and currently very strong reserves could support a higher rating if sustained. We believe that there is a one-in-three chance that we could raise the rating over the next two years if future budgets show continued commitment to maintaining reserves at very strong levels and a goal of structural balance as it progresses to fully funding its pensions.

Downside scenario

We could return the outlook to stable if we believe Massachusetts will fail to make budget adjustments to maintain structural balance or maintain strong reserves if revenue growth weakens. Other factors that could reverse the outlook back to stable include overly optimistic revenue projections, significant increases in debt or other fixed costs, or a significant decline in pension-funded levels due to the commonwealth falling significantly behind static pension funding contribution levels.

Upside scenario

If Massachusetts' budget in the next two years reflects continued commitment to maintaining reserves at strong levels as a matter of budgetary policy, especially during periods of strong economic activity, we could raise the rating. While we understand that the BSF reserves could be drawn on in periods of economic contraction, we expect the commonwealth to demonstrate commitment to rebuilding reserves as the economy recovers to maintain a higher rating.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022