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## Summary:

# Massachusetts; General Obligation

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| US$310.0 mil GO rfdg bnds ser 2021B due 11/01/2025 | | |
| *Long Term Rating* | AA/Stable | New |

## Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to the Commonwealth of Massachusetts' $310 million general obligation (GO) refunding bonds, 2021 series B. The outlook is stable.

Massachusetts' full faith and credit are pledged to the GO bonds and commercial paper.

Proceeds from the 2021 series B refunding bonds will refund the commonwealth's outstanding series 2007A bonds, at which time Massachusetts expects to terminate an interest-rate swap agreement associated with the series 2007A bonds.

### Credit overview

Massachusetts' finances did well through the COVID-19 pandemic-related recession with the aid of a strong budget stabilization fund (BSF) going into the downturn, and adopted budgets with conservative revenue forecasts. The state also benefited from a strong base of upper-income individuals, who were less affected by the recession than lower-income workers, and continued to provide strong income tax returns. The state's BSF equaled 7.3% of operating expenditures and other uses at the end of fiscal 2019, while strong revenues in fiscal 2020 before the pandemic hit in March 2020 enabled Massachusetts to maintain a similar BSF balance at fiscal year-end June 30, 2020, although with only a very small operating surplus. The state did not pass a final fiscal 2021 budget until December 2020, almost six months into the fiscal year, using successive short-term interim budgets while it re-evaluated its revenue forecast. The final enacted 2021 budget assumed 11.4% less tax revenue than the commonwealth's pre-pandemic 2021 projection, as well as budgeting a substantial drawdown in the BSF. However, tax revenues and federal aid came in much better than expected, and preliminary fiscal 2021 tax collections grew strongly above both the prior-year level and the budgeted 2021 forecast, rising 15.3% above 2020 tax receipts. Although the commonwealth budgeted a drawdown in its BSF in fiscal 2021, above-forecast tax revenue increased the BSF to $4.6 billion, or what we view as a strong 8.9% of budgeted expenditures and other uses, compared with 7.3% at fiscal year-end 2020. The buildup in the BSF in 2021 is largely attributable to excess capital gains tax that came in above a budgetary formula threshold. In addition, the commonwealth received $2.5 billion in federal CARES Act money, and $5.3 billion in direct American Recovery Plan Act money. The commonwealth's fiscal 2022 budget anticipates a further increase in its BSF to $5.8 billion, or what we view as a strong 10.5% of expenditures and other uses, based on relatively flat growth in tax revenue over 2021.

Some financial risks remain. We believe Massachusetts has an above-average dependence on cyclical capital gains tax revenue, which has benefited from the currently high stock market, but which could recede in future years. Also, the state has been chronically underfunding its annual pension contribution. It 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 delays current pension pressure to future years. We calculate the pension underfunding amounts to a structural deficit of about 2% per year--higher if excluding restricted federal revenue from the budget denominator.

We believe that Massachusetts' economy, with a substantial tech sector presence in the Boston area, has been a bright spot, with a substantial proportion of well-educated workers that were able to work at home during the pandemic and contribute to the state's income tax. Massachusetts has the second-highest per capita income in the nation, at 133% of the nation. State economic growth appears to be on track for growth similar to the nation's, following extensive restrictions on economic activity during the height of the recession. IHS Markit forecasts that real gross state product will increase 6.2% in calendar 2021 and 4.5% in 2022, compared with the nation's GDP growth of 6.0% and 4.4%, respectively. The state's monthly unemployment rate has come down from a peak of 17.7% in June 2020, to 4.9% as of July 2021.

While Massachusetts has high income levels and a good rainy-day fund, this is partially offset by high debt, moderately high other postemployment benefits (OPEB), and persistent underfunding of its annual actuarial pension contribution. At fiscal year-end 2020, we calculate the commonwealth had net total tax-backed debt per capita of $5,697 and 7.1% of personal income, including tax-supported revenue debt. The commonwealth reports a slight increase of GO debt only, from $24.0 billion at fiscal year-end 2020 to $24.8 billion at fiscal year-end 2021. Massachusetts has contributed less than its actuarial annually recommended contribution since 2011, funding only 76% of its actuarial recommendation in fiscal 2021, and has not been able to catch up in its annual contributions, in part due to retirement fund investment returns that are below actuarial assumptions and a funding mechanism that only resets contribution amounts every three years. However, funded levels might improve, at least temporarily, when high preliminary investment returns of 29.9% in fiscal 2021 are incorporated into the next actuarial valuation. At fiscal year-end 2020, the commonwealth's net pension liability on a Governmental Accounting Standards Board (GASB) basis was a high $6,871 per capita, or 8.6% of state personal income. OPEB at fiscal year-end 2020 was also high, at $3,002 per capita, although the state has made efforts in recent years to ramp up prefunding of OPEB through a trust fund.

The stable outlook reflects our view that Massachusetts has had a history of rebuilding its BSF after economic drawdowns and generally conservative budget forecasting, and that the commonwealth's economy will largely track national growth trends in the next two years.

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

- Deep and diverse economy, which has outperformed the nation on several economic indicators in recent years, although unemployment spiked above national levels during the depth of the last recession, before receding again;
- High income levels, with per capita income at 133% of the nation in 2020, 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; and
- Good BSF balance, equal to an estimated 7.3% of expenditures and other uses on a budgetary basis at fiscal

year-end 2021, and a budgeted increase in 2022, in part due to currently strong capital gains tax.

Offsetting factors include high debt, pension, and OPEB liabilities.

In particular, the commonwealth's pension funded ratio on a GASB basis has had a long-term declining trend and stood at only 56.2% on a combined basis as of a June 30, 2019, measurement date for fiscal 2020. Massachusetts has contributed less than its ARC to its pension funds in every fiscal year since 2011. However, Massachusetts has put in place a plan to increase annual pension contributions by a steep 9.63% per year to fully amortize unfunded pension liabilities by 2036, and a large preliminary investment return of 29.9% in fiscal 2021 could at least temporarily improve funded levels. The $1.01 billion shortfall against the ARC budgeted in fiscal 2022, which we view as a structural deficit, is only about 2.0% of estimated fiscal 2022 budgeted operating expenditures. The commonwealth is paying 76% of the ARC in fiscal 2022, about the same level as the year before, and we calculate that pension contributions in fiscal 2020 to Massachusetts' employee retirement system were only 81% of static funding requirements, and 80% of static funding for the teachers' pension system. Massachusetts projects state pension contributions will increase by $2.1 billion above the fiscal 2020 level by 2026, the year when the commonwealth projects annual payments will equal the ARC, assuming it continues to increase payments 9.63% per year and pension returns meet actuarial assumptions. (In fiscal 2020, the last audited year, the actual return was 2.38%, compared with the 7.25% assumed return, although the preliminary return in fiscal 2021 of 29.9% is yet to be reflected in the next audited financial report.)

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.

### Environmental, social, and governance (ESG) factors

We consider Massachusetts' environmental risks elevated because of the state's coastal exposure, while social and governance risks are generally in line with the state sector, and the commonwealth has historically maintained a stable management and policy framework to respond to developing risks.

## Stable Outlook

### Upside scenario

An upgrade would require the state take measures to strengthen its pension funding discipline based on a prudent actuarial footing, while maintaining a strong BSF balance as a matter of budgetary policy during periods of strong economic activity.

### Downside scenario

We could lower the rating if we believe Massachusetts will fail to make budget adjustments to maintain structural balance or rebuild its BSF after periods of economic softness. Factors that could pressure the rating include overly optimistic revenue projections; significant unexpected growth in Medicaid costs, even with increased federal reimbursement; significant increases in debt or other fixed costs; or material drawdowns of its BSF, even when underlying economic activity is strong. In particular, weak liquidity, significant deficit borrowing, or a significant fall in pension funded levels due to the commonwealth falling significantly behind static pension funding contribution levels could trigger a negative outlook or downgrade.

## Credit Opinion

For more information on the commonwealth, please refer to our most recent full analysis, published April 27, 2021, on RatingsDirect.

## Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020