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Bad Fiscal Reputation Hikes Rates on Illinois Bonds-Study.

(Reuters) - Illinois is paying an extra premium in the U.S. municipal bond market because of its poor fiscal reputation, according to a study released on Monday.

The state's general obligation bonds fetch higher yields in secondary market trading than other states as festering fiscal problems, including a big backlog of unpaid bills, have given Illinois the lowest credit ratings among U.S. states.

Illinois' GO bonds due in 10 years yielded 120 basis points over Municipal Market Data's benchmark triple-A yield scale in the week ended Feb. 28. Illinois has the widest so-called credit spread after Puerto Rico among major muni debt issuers tracked by MMD, a unit of Thomson Reuters.

But an analysis by the Fiscal Futures Project at the University of Illinois' Institute of Government and Public Affairs found that even after controlling for different credit ratings and fiscal, economic and financial factors between Illinois and other states that sold GO bonds between 2005 and 2010, the yields on Illinois bonds were still higher.

"These findings suggest the presence of a reputational risk premium on Illinois debt that is in excess of the risk premium associated with the state's actual default risk," the analysis said.

The premium for Illinois was 21 basis points for bonds due in five years, 12 basis points in 10 years and 7 basis points in 20 years, according to the analysis. It added that the premium's present value cost "could be well over \$80 million" on the more than \$10.4 billion of GO bonds Illinois sold between 2005 and 2010.

Martin Luby, an assistant professor at DePaul University's School of Public Service who co-wrote the study, noted that Illinois' fiscal standing deteriorated after 2010 as the state failed to address its huge unfunded public pension liability, prompting downgrades from the credit ratings agencies.

"We think this risk premium is a conservative estimate," he added.

In December, the state finally enacted comprehensive pension reforms aimed at easing a \$100 billion pension funding shortfall.

However, state workers, retirees and labor unions have filed five lawsuits challenging the law on state constitutional grounds.

As the muni market waits to see if the law will be upheld by state courts, Illinois must also deal with income tax rate hikes enacted in 2011 that will partially expire halfway through the state's next fiscal year.

A rollback in the rates would cut revenue by an estimated \$1.4 billion in fiscal 2015.

