

# Bond Case Briefs

*Municipal Finance Law Since 1971*

---

## Stalemate Over Tax Increases Pushes Pennsylvania Yields Higher.

As Congress races to avert a government shutdown, what may be a more prolonged political fight over the budget is dragging on in the state capital 120 miles (193 kilometers) to the north.

In Harrisburg, Pennsylvania, the state government is almost three months into the fiscal year without an agreement on what it can spend because of a divide between the Republican-led legislature and Governor Tom Wolf, a Democrat. At least two school districts say they may soon have to close. Some debt has been downgraded. And investors have pushed yields on the Keystone State's bonds close to recent highs over top-rated securities, a measure of the perceived risk.

Pennsylvania is the only state aside from Illinois that's still locked in a stalemate over the budget, a standoff reminiscent of those that once played out in statehouses around the nation after the recession. While public finances have recovered along with the economy, Pennsylvania lawmakers are contending with a \$53 billion pension-fund shortfall that's threatening to hit the state with rising bills, as well as pressure to steer more money into schools.

As a result, investors are demanding yields on 10-year Pennsylvania bonds of 2.71 percent, 0.56 percentage point more than AAA municipal securities, according to data compiled by Bloomberg. That's just shy of the 0.61 percentage point reached in June, which was the highest since the data began in 2013. Only Illinois and New Jersey, which have even larger pension shortfalls, pay more, according to data on 20 states.

"Pennsylvania is not in as bad a situation as New Jersey or Illinois," said Scott McGough, director of fixed income for Glenmede Trust Co. in Philadelphia, who is reducing his holdings of Pennsylvania debt. "But clearly, the trend is poor at this point."

The legislature took a step to temporarily ease the crunch last week, when it passed a budget to provide about four months of funding to schools and other agencies. Wolf, who took office in January, rejected it on Tuesday, saying he wants a comprehensive spending plan.

"The citizens of Pennsylvania want more than half measures, and they deserve better than the status quo," Wolf said in his veto message to the legislature. The temporary budget locks in human services cuts and is "an avoidance maneuver that fails to adequately fund education."

### **Pension Politics**

Since March, Wolf and Republicans have been at loggerheads over how to shore up the retirement system, which has less than two-thirds of the assets needed to cover the benefits promised to about 700,000 employees. Wolf vetoed a Republican bill that would have put new workers into defined-contribution plans similar to 401(k)s. He wants to sell \$3 billion of debt to inject cash into the retirement system to make up for years of shortchanging it.

Republicans have also balked at his proposal to implement a new tax on natural-gas drillers and

raise levies on income and retail sales to fund schools.

The effects are starting to be felt beyond the capital. This month, Moody's Investors Service lowered the credit ratings of schools that sell bonds through a program that diverts state aid to investors if the districts default. The credit rater said the lack of a budget has cast uncertainty over the funding, heightening the risks to bondholders. Standard & Poor's has put the districts' ratings on watch, a first step toward a downgrade.

## **School Closings**

School districts in Carbondale, in the northern part of the state, and to the west in Erie, have warned that they may temporarily close without funds if the budget impasse continues. By October, 41 school districts may see "significant cash-flow difficulties," according to a senate Republican committee memo. Another 120 would be added to the list by December.

By next month, school districts would be running without more than \$3 billion in state aid that was anticipated for the year, according to the Pennsylvania Association of School Business Officials. Administrators have been tapping reserves and lines of credit to compensate, the Harrisburg-based group said.

Schools have borrowed at least \$347 million so far and may run up an additional \$122 million of debt in October to keep classrooms open, State Auditor General Eugene DePasquale said Tuesday.

Some are pushing down the pain to charter schools. About 24 school districts have eliminated or reduced payments to charter schools, said Tim Eller, executive director of the Keystone Alliance for Public Charter Schools.

Pennsylvania is graded two steps below the state average, in part because of the deficit in its retirement system. S&P and Fitch Ratings cut the state last year to AA-, the fourth-highest level. Moody's grades Pennsylvania Aa3, the same rank.

Glenmede's McGough said investors may continue to demand higher yield premiums if the Pennsylvania's leaders don't repair the government's finances.

"You have to address the budget as is, given the revenue coming in, and really right-size your budget," he said.

## **Bloomberg News**

by Romy Varghese

September 28, 2015 — 9:01 PM PDT Updated on September 29, 2015 — 9:25 AM PDT