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Pennsylvania to Test Investor Demand as Budget Wounds Remain Raw.

Pennsylvania may soon get a sense of investors' appetite for another year of likely budgetary battles between its Democratic governor and Republican-led legislature.

The Keystone State is selling almost $1 billion in general-obligation debt Wednesday in what is the first sale of the securities since Governor Tom Wolf allowed a budget to be put in place without his signature in March. The first-term leader conceded after failing to sway lawmakers to endorse his tax and spending proposals for the fiscal year ending in June.

Even after the resolution to the budget impasse -- the longest since 1956 — Pennsylvania still faces nearly a $2 billion shortfall in the next fiscal year and an economy growing more slowly than the rest of the nation. Moody's Investors Service and S&P Global Ratings have warned of further credit-rating downgrades unless they see progress away from one-time budget balancing maneuvers. Investors appear to agree.

"You have a slow-growing state with high legacy costs and a somewhat contentious political process that we fear will result in the state being able to do just the minimum that's acceptable," said Paul Mansour, head of municipal research at Conning, which oversees $11 billion of state and local debt. "I really don't see a catalyst right now for any improvement in credit quality."

Conning "probably" won't buy any of the securities unless the yields are more in line with that of debt graded a step lower than Pennsylvania, which has the fourth-highest rank, said Mansour.

High Yielders

Yields on Pennsylvania's 10-year bonds are 0.64 percentage point above benchmark securities, near the three-year high of 0.72 percentage point in March, data compiled by Bloomberg show. Only Illinois, New Jersey and Connecticut pay more, according to data on 20 states tracked by Bloomberg.

That may serve as a saving grace for Wednesday's sale. With tax-exempt mutual funds flush with cash from the longest stretch of inflows in six years and overall tax-exempt market yields not far from record lows, managers have poured money into higher-yielding securities, pushing up demand.

Randy Albright, Pennsylvania's budget secretary, said the bond sale Wednesday is attracting a "fair amount of interest."

Pension Funding

"Despite the budget impasse of last year, we continue to have a pretty exemplary track record of taking seriously all of our debt obligations and always being careful in terms of making sure that we're able to make payments when they're required to be made," Albright said.

Even after the compromise following the nine-month budget delay, Wolf and the legislature remain at odds over raising taxes and fixing the underfunded pension system to create another impasse for the next fiscal year beginning in July.

Pennsylvania, the sixth-most populous state, has struggled to fully recover from the recession that ended in 2009. Over the past few years, it has raided reserves and anticipates ending the year with just $232,000 in a rainy day balance that's supposed to account for 6 percent of its general fund. It's coping with rising costs from its pension system, which has about 60 percent of the assets needed to cover the benefits promised to about 700,000 employees.

Tax Plan

At Aa3, Pennsylvania already has a Moody's grade lower than the median of Aa1, second highest. Lowering it one step would make it third-worst ahead of New Jersey and Illinois.

"The commonwealth's credit challenges are likely to worsen in the near term absent political compromise," Moody's said in a May 20 report.

Wolf wanted to raise levies on income and retail sales and implement a new tax on natural-gas drillers. Resistant Republicans pressed to put new state workers into defined-contribution plans similar to 401(k)s, a measure Wolf vetoed.

Moody's cut the state's grade and those of school districts. S&P withdrew its ratings of debt issued by schools through a state program that diverts aid to the obligations. Schools and social service agencies were forced to take out loans.

Wolf is pushing a similar spending plan for the new fiscal year that raises $2.7 billion in taxes, and Republicans are again stressing avenues such as reducing pension costs and selling the state liquor operations.

"We believe that we shouldn't turn to taxpayers first when we're looking in trying to fix the deficit," said Jennifer Kocher, a spokeswoman for Senate Republicans in Harrisburg. "There are still other areas where we can generate revenue for the state."

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