ASSET PRESERVATION ADVISORS

COMMONWEALTH, COMMON PROBLEMS

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The interior of the State Capitol Rotunda

Pennsylvania's Nine Month Budget Impasse

Long-term budgetary issues have become a common problem for many states and municipalities in recent years. Despite having a balanced budget and fully funded pension plans as recently as 2003, the Commonwealth of Pennsylvania has seen its credit profile decline considerably. The commonwealth, plagued by underfunded pension liabilities and an underperforming economy, has had difficulty passing timely budgets which has led to financial challenges, particularly for primary education funding.

At 12:01 a.m. on March 28th, 2016, a Republican-crafted appropriations bill became law despite the missing signature of Governor Tom Wolf. “We need to move on,” said Wolf, “we need to confront the real challenges we have in the (2016-2017) budget.” This statement came after the governor released approximately $6 billion in state funding, ending a nine month budget impasse. While this may have been a victorious day for the public schools who rely on appropriations and had been contemplating closure, the budget failed to address the looming pension crisis. The long-term liability that has contributed to six downgrades of the commonwealth’s credit rating by three ratings agencies in less than four years.

The State of the State

Over the past 13 years, the state of Pennsylvania has passed only three budgets on-time. The state has a history of challenged financial operations and political strife amplified more recently by below average economic growth. S&P reported that Pennsylvania’s gross state product (GSP) and employment growth are both below national averages. In 2015, projected GSP growth was only 1.3% compared to U.S. GDP growth of 1.7% and employment growth was 1.1% versus the national average of 1.9%.[1]

A relatively prosperous state, Pennsylvania’s wealth levels are in line with the U.S. as a whole and the individual poverty rate is still below the U.S. average, despite a 13.4% increase since 2005. This, along with the ability to raise revenues through base broadening, rate increases, or the assessment of new taxes and fees without the burden of legal limitations, has contributed to the state’s AA-rating. Strengths aside, Pennsylvania’s real Achilles heel is its underfunded pension liability. Once a relatively well funded program, in 2005 its pension funding ratio was 87.4%. Since then, the ratio has dropped by 26%, reflecting unfunded pension liabilities of $56 billion.[2]

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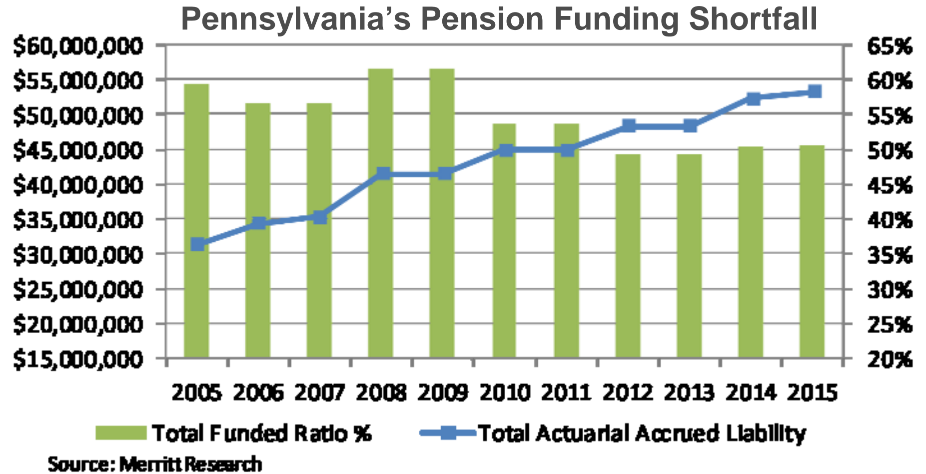
Furthermore, the state's actuarial accrued pension liability is up from $89 billion in 2005 to $136 billion through fiscal year 2014, a staggering 52% increase.[3] According to Fitch's rating report in May of 2016, "the commonwealth has been consistently short of its actuarially calculated annual contribution for both systems for many years, but the percentage paid has been steadily increasing."



Impact of the Budget Impasse

There is typically a cost associated with inaction.
Both direct and indirect, Pennsylvania's budget impasse and budget gaps have cost the commonwealth and certain state programs in the form of delayed operating revenue for its school districts as well as downgrades to its credit ratings by all three ratings agencies.

School districts in Pennsylvania receive on average, about 38% of their operating revenue from the state, with a range of 10% to 83%.[4] As the budget impasse dragged on, the cost was greatest to those school districts that rely most heavily on state aid. Some public schools even considered closing their doors until appropriations were made. The governor, despite not yet having a budget in place, approved a stop-gap measure on December 29, 2015 to provide half of the state's basic education funding.

The Pennsylvania State Intercept Program for school districts created a level of support beyond many school districts' underlying credit, giving most Pennsylvania (PA) districts an opportunity for a credit boost and higher enhanced ratings. However, during the budget impasse the ratings agencies called into question the ability of the program to prevent or cure a default since there was not any state aid to intercept without an appropriation of education funding. S&P withdrew their A-rating of the program on December 11, 2015 and Moody's followed two weeks later with a downgrade to Baa1. APA generally recommends staying away from bonds issued by school districts that have challenged financial operations, low reserve levels and/or a heavy reliance on state aid.

The Road Ahead

In May of 2016, S&P modified its outlook on the Commonwealth of Pennsylvania from stable to negative stating "the negative outlook reflects our view that despite enactment of a complete fiscal 2016 budget, it is not structurally aligned and given current expenditure trends, we do not consider it balanced."

While the current budget gap may be manageable, and recent improvements in pension funding promising, the real issue lies in the political gridlock and the resulting protracted deliberations over the commonwealth's budget. It is not likely the inability to pay, but rather a pattern of weak fiscal management and failure to address long-term structural solutions that could lead to further downgrades of the state's credit rating in the future.

Despite the double-A category of the commonwealth's credit rating, APA continues to remain highly selective when purchasing bonds within the state. We continue to monitor our internal rating for continued improvement in the pension funding ratio or indications of further downgrades should the management of the 2016-2017 budget follow the path of last year's nine month budget impasse.

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[1] Bureau of Economic Analysis, U.S. Department of Commerce; http://www.bea.gov/REGIONAL/bearfacts/action.cfm?geoType=3&fips=42000&areatype=42000; accessed June 23,2016
[2] Merritt Research ; June 2016
[3] Merritt Research; June 2016
[4] Merritt Research; June 2016

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