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Investment Insights

State of the State: Pennsylvania

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Overview

Pennsylvania's revenues are tracking in line with its budget. Conservative budgeting and ample reserves should mitigate any deficit that may arise.

The commonwealth’s creditworthiness is tied to the ability to pass timely, balanced budgets while maintaining healthy reserve levels, and continued progress on pension funding.

Our team is positive on the Pennsylvania Turnpike Commission due to its sufficient liquidity cushion, access to financial markets, and manageable debt level.

State Overview

Due to consistent revenue outperformance, conservative budgeting, and a concerted effort to build up reserves, we believe that the Commonwealth of Pennsylvania is in a solid financial position.

Pennsylvania benefits from a large and diverse economy that has seen consistent growth in the last several years,[1] as well as access to liquidity through the state treasury or issuance of tax-anticipation bonds,[2] and near-record levels of reserves.[3]

Detracting credit factors include underfunded pensions and the state’s history of budget impasses. Despite contributing over 100% of the tread water rate* for the last five years,[4] Pennsylvania’s pensions continue to be funded under the 80% mark that the US Government Accountability Office deems to be sound for government pensions.[5]

Pennsylvania has a history of passing late budgets, and both the fiscal 2024 and fiscal 2025 budgets were approved after the start of the fiscal year.[6,7] We view these budget delays as a sign of governance weakness, and while fiscal 2024’s budget impasse didn’t impact debt payments,[8] it did delay the statutorily required deposit to Pennsylvania’s rainy day fund.[3] Fiscal 2025 revenues are tracking in line with the budget, and despite a projected general fund deficit in the fiscal 2026 executive budget, the commonwealth’s conservative budgeting and ample reserves should mitigate the expected deficit if it occurs.

Key to maintaining credit quality will be Pennsylvania’s ability to pass structurally balanced, timely approved budgets, maintain sufficient reserve levels to provide financial flexibility, and continued progress on the state’s pension funding.

Fiscal Year 2024

The commonwealth entered the 2024 fiscal year in a strong financial position after several years of revenue outperformance and subsequent transfers to reserve funds. At the beginning of the fiscal year, Pennsylvania’s general fund** and rainy day fund balances totaled $18.2 billion, up 36% year over year. This figure is much improved compared to pre-pandemic levels of $835 million in fiscal 2019.[9]

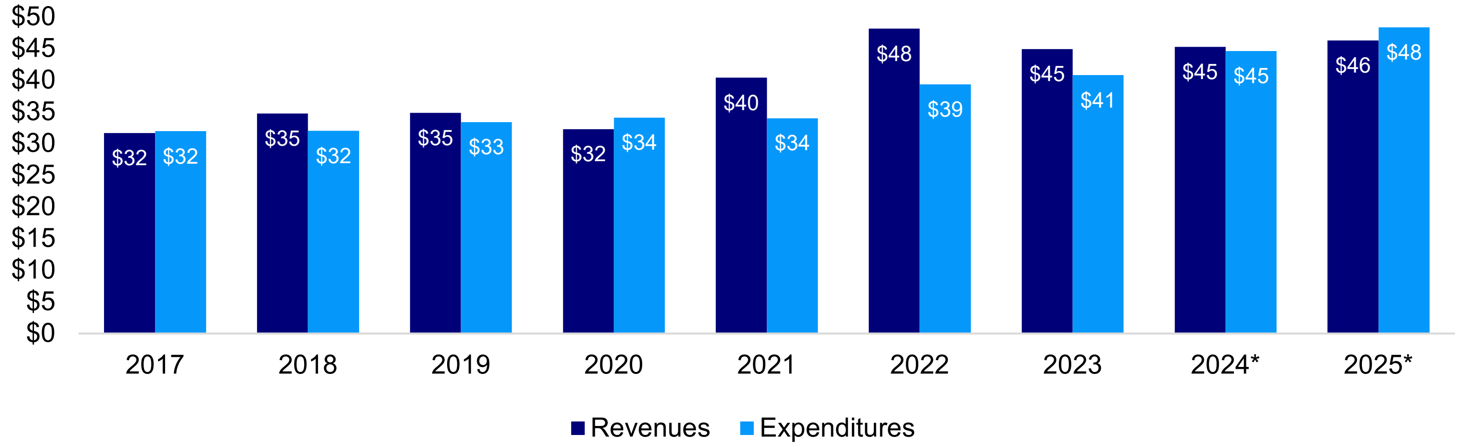
The fiscal 2024 budget was enacted on August 3rd, 2023—several weeks into the fiscal year—highlighting Pennsylvania’s history of budget impasses.[7] However, general fund revenues were 2% above budget at fiscal year end, which was driven by smaller revenue streams such as corporation taxes and inheritance tax revenues.[10] Pennsylvania’s two largest revenue sources are sales and use tax (SUT) receipts and personal income tax (PIT) receipts, which comprised 39% and 31% of general fund revenues in fiscal 2024.[1] These revenue streams had mixed performance with SUT receipts coming in 2% above budget estimates and PIT receipts coming in 1% below budget estimates.[10]

Fiscal 2025 Enacted Budget

The enacted 2024 budget for fiscal 2025 includes General Fund expenditures of $47.6 billion, a 6% increase year-over-year.[11] Historically, education and health and human services comprised the majority of the General Fund budget. This continues to be true in fiscal 2025 with these categories accounting for 37% and 40% of the General Fund budget, respectively.[11] Education spending is budgeted to increase 9% year over year, while health and human services spending is expected to increase 2% compared to fiscal 2024 levels.[11]

* Tread water rate refers to the amount of annual pension contribution required to hold the funded rate at current levels, all else being equal. A rate of more than 100% will increase the funded rate, whereas a rate of less than 100% will decrease the funded rate.
** The general fund is the major operating fund of the State. It receives all state income not earmarked for a particular program or activity and not specified by law to be deposited in another fund.

Figure 1: Fiscal Year General Fund Operations ($Billions)



Source: Pennsylvania Governor's Executive Budget 2024-2025, published February 2024
*Fiscal 2024 and 2025 are estimates based on the fiscal 2025 Executive Budget

Per the Independent Fiscal Office, general fund revenues are expected to total $46 billion, a 1.1% increase over fiscal 2024.[1] PIT and SUT receipts are expected to increase 4% and 2%, respectively.[1] Despite the growth in these revenue streams, Pennsylvania is facing a $3.3 billion operating deficit which is equal to 7% of projected revenues.[1]

That said, the recent accumulation of reserves should allow Pennsylvania to close the budget gap without significantly reducing financial flexibility. Fiscal 2020 ended with a budget stabilization fund balance equal to 3.6 days of general fund expenditures.[12] This figure was up to 49 days in fiscal 2024 and is expected to increase to 54 days in fiscal 2025, well above the 50-state median of 46 days.[12]

This increase in the rainy day fund balance was driven from revenue outperformance and an influx of federal funds, both of which have bolstered Pennsylvania's budget stabilization fund to record levels. Overall, we are cautiously optimistic that management can find new revenue streams to match revenues to expenditures, however the continued use of reserves to close budget gaps may weaken overall creditworthiness in the longer term.

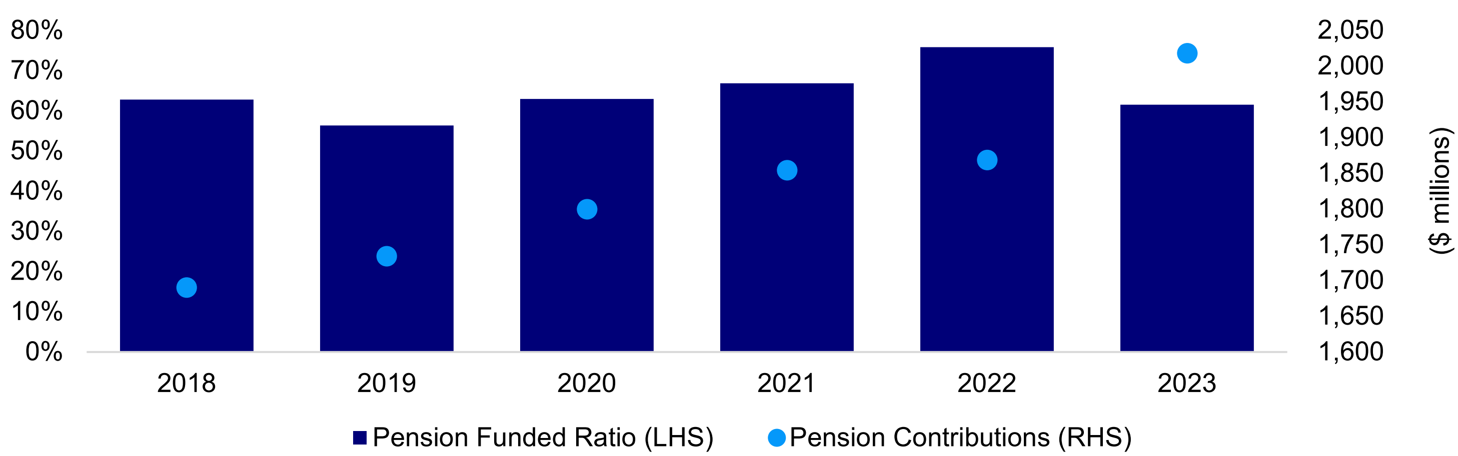
Liquidity

Pennsylvania benefits from strong access to liquidity. In the past, the state had relied on the state treasurer for liquidity, borrowing $1.5 billion in November 2019.[13] In January 2020, the treasurer increased the line of credit to $2 billion, but Pennsylvania hasn't sold any cash flow notes since October 2020.[13] Since then, cash and investments have increased from 13% of total governmental revenues in fiscal 2020 to 30% by fiscal year-end 2023.[4] Fiscal 2024's general fund cash position remained relatively unchanged at $15.2 billion, or 33% of general fund revenues.[12,1]

Pension Funding

The state's pension has been consistently underfunded, although Pennsylvania has been making steady progress to combat weakness, increasing their funded ratio from 56% in fiscal 2019 to 62% in fiscal 2023 (Figure 2).[4] We are positive on management's demonstrated commitment to improving its pension funding practices, including contributing the full amount of its actuarially required contribution since fiscal 2019.[4]

Figure 2: Pension Overview



Source: CreditScope, as of June 2023, latest data available. .

Economic Update

Pennsylvania is the nation's 5th most populous state,[14] with a population of $13 million as of 2023;[4] however, the commonwealth's population growth has been flat for the last decade[4] and is expected to remain flat through 2030.[1]

Pennsylvania is highly urbanized with two major metropolitan areas, Philadelphia and Pittsburgh.[15] While the commonwealth is still the second largest natural gas producer in the nation, the growth of this industry has plateaued since 2021.[16] Pennsylvania's post-pandemic economic recovery has lagged that of the nation,[3] but we are encouraged that the state's unemployment rate has trended lower than the national rate through March 2024.[17]

Per estimates from the Independent Fiscal Office, economic activity is expected to cool in fiscal 2024, with real Gross Domestic Product (GDP)* growth of 0.9% compared to 2.1% in fiscal 2023.[1] Real GDP growth is estimated to average of 1.2% through 2028.[1] Wealth indicators for the commonwealth are slightly below those of the country.[18]

Pennsylvania General Obligation Update

Moody's: Aa2 / Stable, as of October 8, 2024
S&P: A+ / Positive, as of September 22, 2023
Fitch: AA / Stable, as of October 7, 2024

Moody's upgraded the commonwealth's GO rating from Aa3 to Aa2 in October 2024, citing increases in Pennsylvania's budget stabilization fund and a decrease in long-term liabilities. The outlook changed to stable from positive.

S&P has maintained an A+ rating for the State since 2017. Reasons cited for the outlook change from stable to positive include the commonwealth's progress toward a structurally balanced budget and increased reserves.

Fitch upgraded the Pennsylvania's general obligation bonds to AA/Stable from AA-/Positive in December of 2023. Fitch said that increased reserve levels and improved operating performance were major drivers for the rating change.

Spotlight on a Pennsylvania Revenue Bond: Weather Pennsylvania Turnpike Commission (Senior)

Moody's: Aa3, as of August 5, 2024
S&P: AA-, as of June 4, 2024
Fitch: AA-, as of August 5, 2024

The Pennsylvania Turnpike Commission was created with powers to construct, operate, and maintain the turnpike system and to issue turnpike revenue bonds, repayable solely from tolls and other commission revenues. The turnpike system is large, spanning roughly 565 route miles. It consists primarily of the 359-mile Mainline, which runs east to west and connects the New Jersey and Ohio Turnpikes on either end, as well as the 110-mile Northeastern Extension that runs north to south from Scranton to Philadelphia. The tollway continues to serve as a major use of transportation with over 170 million passenger vehicle transactions in fiscal year 2023.[19]

The turnpike commission continues to recover from the decline in vehicle transactions due to the COVID-19 pandemic and the subsequent transition to remote work. In fiscal year 2023, vehicle transactions rebounded to 206 million, an increase of 21.6% from the low reached in 2021.[20] Furthermore, preliminary unaudited fiscal 2024 transactions have increased to 209 million, which are above projections and have led to a 4.4% year-over-year increase in net toll revenue.[20] Based on the annual traffic study conducted by CDM Smith in 2023, total vehicle transactions are expected to surpass the previous 2019 high of 214 million by fiscal 2028.[21] With multiple improvements to the system such as electronic tolling and stricter enforcement for those who fail to pay their tolls, the system managed to end fiscal 2023 with a positive profit margin of 3.52%, the first positive profit margin in several years.[21]

Monitoring the financial performance of credits is a primary focus for the Invesco Municipal Bond team as borrowers continue to manage operating and economic challenges post pandemic, as well as the interest rate volatility over the past three years. We believe the Pennsylvania Turnpike Commission continues to maintain a strong balance sheet with ample liquidity and appropriate financial leverage.[22] Additionally, current debt service coverage has rebounded post-pandemic and rose to a level not reached since fiscal 2009.[22] Having characteristics such as a sufficient liquidity cushion, the ability to access financial markets, and having a manageable debt level are likely to help the Pennsylvania Turnpike Commission successfully navigate through this challenging economic environment and maintain an investment grade rating.[22]

*GDP measures the monetary value of final goods and services produced in the state annually.

Sources:

1. Pennsylvania Independent Fiscal Office, dated April 5, 2024.
2. S&P, dated August 22, 2022.
3. Fitch, dated December 5, 2023.
4. CreditScope, as of June 30, 2023.
5. U.S. Government Accountability Office, dated July 10, 2008.
6. WHYY.org (National Public Radio), dated July 12, 2024.
7. WHYY.org (National Public Radio), dated August 3, 2023.
8. Moody's, dated September 11, 2023.
9. Pennsylvania Annual Financial Report, as of June 30, 2019.
10. Pennsylvania Revenue Department, as of July 1, 2024.
11. Enacted General Fund Tracking Run, dated July 12, 2024.
12. Pennsylvania Treasury, Fiscal Health Scorecard, as of September 23, 2024.
13. Moody's, dated June 30, 2020.
14. US Census Bureau, as of December 31, 2023.
15. Pennsylvania Official Statement, dated December 6, 2023.
16. Pennsylvania Executive Budget 2024-2025, dated February 6, 2024.
17. Bureau of Labor Statistics, as of March 31, 2024.
18. Credit Scope, as of December 31, 2023.
19. Pennsylvania Turnpike Commission 2024 Offering Statement, dated September 5, 2024.
20. S&P, dated September 11, 2024.
21. CDM Smith 2023 Traffic Study, dated March 22, 2024.
22. Merritt Research Services, as of May 2023.

Invesco Municipal Bond team

The Invesco Fixed Income Municipal Bond team's investment philosophy is based on the belief that creating long-term value through comprehensive, forward-looking research is the key to providing clients with diversified portfolios that aim to maximize risk-adjusted returns.

Proprietary credit research and risk management are the foundations of our investment process, supported by a deep and experienced team of investment professionals with expertise that spans the entire municipal investment universe. We maintain an integrated, team-based investment process that combines the strength of our fundamental credit research analysts with the market knowledge and investment experience of our portfolio managers.

Our position among the top five municipal investment managers by assets in the US* enables us to access preferred market opportunities and gain valuable market insight. Our team has established relationships with more than 120 national and regional municipal debt dealers in the US. We believe these established relationships, as well as our size, allow us to achieve fluid execution in daily transactions. Our ability to aggregate trades across multiple portfolios also enables us to obtain lower institutional pricing, which can contribute to portfolio performance.

About risk

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer's ability to make payments of principal and/or interest.

Junk bonds involve greater risk of default or price changes due to changes in the issuer's credit quality.

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. The values of junk bonds fluctuate more than those of high-quality bonds and can decline significantly over short time periods.

All fixed income securities are subject to two types of risk: credit risk and interest rate risk. Credit risk refers to the possibility that the issuer of a security will be unable to make interest payments and/or repay the principal on its debt. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Municipal bonds are issued by state and local government agencies to finance public projects and services. They typically pay interest that is tax-free in their state of issuance. Because of their tax benefits, municipal bonds usually offer lower pre-tax yields than similar taxable bonds. The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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Past performance does not guarantee future results.

A credit rating is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of the creditworthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other debts. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. NR indicates the debtor was not rated and should not be interpreted as indicating low quality.

For more information on Standard and Poor's rating methodology, please visit www.standardandpoors.com and select 'Understanding Credit Ratings' under 'About Ratings' on the homepage.

For more information on Moody's rating methodology, please visit https://ratings.moodys.io/ratings and select 'Rating Methodologies' on the homepage.

For more information on Fitch Ratings rating methodology, please visit www.fitchratings.com and select 'Criteria' under 'Resources' on the homepage. Then select 'Rating Definitions' under 'Resources' on the 'Contents' menu.

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

*Source: Simfund as of March 31, 2025