

## ISSUER IN-DEPTH

30 March 2017

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### RATINGS

#### Illinois (State of)

General Obligation Bonds	Baa2 negative
Build Illinois Sales Tax Revenue Bonds	Baa2 negative
Metropolitan Pier & Exposition Authority	Baa3 negative
Civic Center Program Bonds	Baa3 negative

Source: Moody's Investors Service

### Contacts

Ted Hampton 212-553-2741  
VP-Sr Credit Officer  
ted.hampton@moody's.com

Marcia Van Wagner 212-553-2952  
VP-Sr Credit Officer  
marcia.vanwagner@moody's.com

Emily Raimes 212-553-7203  
VP-Sr Credit Officer  
emily.raimes@moody's.com

Nicholas Samuels 212-553-7121  
VP-Sr Credit Officer  
nicholas.samuels@moody's.com

Timothy Blake 212-553-4524  
MD-Public Finance  
timothy.blake@moody's.com

## Illinois (State of)

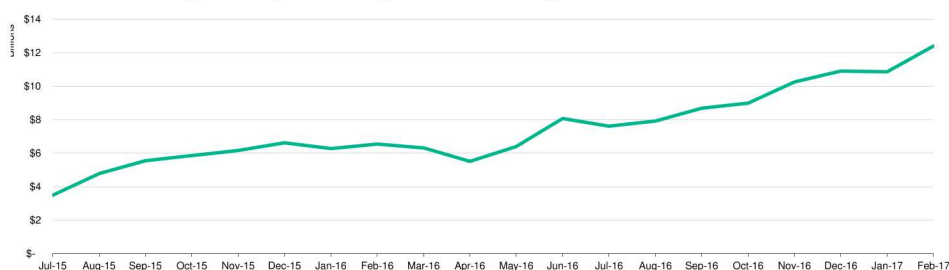
### Record Backlog of Unpaid Bills Signals Critical Juncture for State Leaders

On March 20, the [State of Illinois'](#) (Baa2 negative) backlog of unpaid bills, a proxy for unmet cash requirements, rose to a record \$13 billion.<sup>1</sup> Two days later, the state legislature passed the halfway point of its session without approving a "grand bargain" package of measures to end the state's two-year budget standoff. State leaders are at a critical juncture, facing a choice between further credit deterioration without a compromise or potential credit stabilization with a budget agreement.

- » **With a budget consensus, Illinois could quickly stabilize its financial position.** The state can start to restore operating liquidity promptly because political gridlock, not fundamental economic conditions or factors beyond the government's control, largely drive its financial pressures.
- » **The state's already weak credit will erode further if the impasse enters a third year.** Failure to reach a consensus before the current legislative session adjourns on May 31 would signal deepening political paralysis, heightening the risk of creditor-adverse actions. The state could resort to borrowing from debt service funds, depleting available non-operating cash or, eventually, prioritizing core operating needs over debt service.
- » **The state's ability to defer payments is already reaching its limits.** Liquidity pressure has intensified during the two-year budget impasse; the state's backlog of bills has increased by about \$9 billion since July 2015 (see Exhibit 1). The budget standoff has caused mounting operating difficulties for public service providers and for public universities and other governmental units.

Exhibit 1

#### State's Bill Backlog Has Tripled During Protracted Budget Standoff



Backlog shown as of month end from July 2015 through February 2017

Source: Governor's Office of Management and Budget

### The "grand bargain," or something like it, could still happen

The grand bargain is a package of 13 bills, each of which takes effect only if the other bills also are passed. This interdependent legislative package, which suffered a setback four weeks ago, seeks to simultaneously address the state's most pressing challenges: pension underfunding, a lack of structural budget balance and associated operating fund liquidity pressures. It also includes provisions aimed at improving economic conditions and government efficiency. Efforts to pass the bills in the Illinois Senate fizzled in early March, reportedly because of a loss of support from Republican senators allied with the state's governor.

Goals of the grand bargain are far-reaching and deal with issues that are both politically and financially complex. To ease pension funding pressure, the package includes legislation that seeks to reduce the share of pension plan participants who will be entitled to compounded annual 3% cost-of-living adjustments in retirement. To balance the budget, the bills propose raising taxes, most notably returning state's flat rate on individual incomes to about 5%, where it was before being lowered to 3.75% in January 2015. To spur the economy, the package would reshape the state's workers compensation system.

Grand bargain components also feature a local government property tax freeze, pension funding assistance for the Chicago Public Schools ([Chicago Board Education](#), B3 negative), expansion of gaming, a framework for local governments to issue debt secured by funds received from the state, and authorization for the state to sell as much as \$7 billion of bonds to help pay off overdue bills to service providers, vendors and governmental entities. Legislators still have time to fashion a bipartisan deal that has a positive fiscal impact, even if it lacks some of the "grand bargain" elements that are politically more contentious. There are legislative sessions scheduled through much of April and most of May.

If no deal is reached by May 31, the last scheduled day of the current session, any fiscal legislation taking immediate effect in the coming budget year would require passage by three-fifths majorities in the legislature, reducing the odds of success.

### With consensus on the budget, Illinois could quickly stabilize its financial position

After more than 21 months without a full enacted budget, Illinois could start to stabilize its finances quickly once the legislature and governor agree on budget-balancing measures. The state's current-year operating deficit amounts to \$5.69 billion.<sup>2</sup> Restoring the state's individual income tax rate to almost 5%, from the current 3.75%, would generate about \$5 billion on an annual basis, and the new rate could be imposed with a retroactive start date. Additional new revenue could come from increasing the corporate income tax rate, broadening the sales tax base and imposing targeted taxes on certain products, such as sugary drinks.

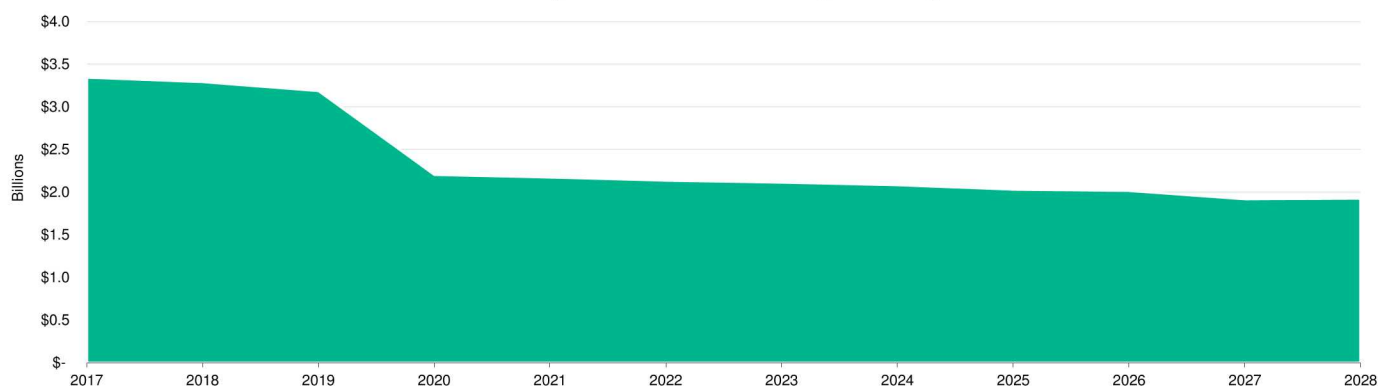
To rapidly alleviate the operating fund liquidity pressure from the bill backlog – and to support service providers, vendors and public agencies awaiting overdue payments – Illinois could issue long-term debt. Replacing the state's massive accounts payable debt with bonds would reduce exposure to interest fees accruing at as much as 1% a month under the state's prompt payment law.<sup>3</sup>

The state Senate's "grand bargain" legislation (see blue box above for details) included authorization of as much as \$7 billion of GO debt to reduce outstanding bills. While that borrowing would amount to a 26% increase in the state's outstanding GO debt, the state has capacity to absorb the resulting debt service, in our view. After the final maturity of the state's 2011 pension funding notes, in fiscal 2019, the state's annual GO debt service burden will decline by about one-third from current levels, as shown in Exhibit 2. A key consideration in evaluating the credit impact of such a deficit financing will be the extent to which it is combined with spending restraints that will keep unpaid bills from recurring.

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Exhibit 2

**Debt Service Decline After 2019 Affords Some Flexibility to Accommodate Backlog Borrowing**

Source: State of Illinois General Obligation Bonds, Series of November 2016; offering document

Lack of political will, rather than a recession or other factors beyond the government's control, caused the state's budget deficits and accounts payable to soar. In January 2015, the state allowed higher income tax rates to expire without agreeing how to replace or offset the lost revenue. Efforts to implement a comprehensive solution to Illinois' growing unfunded pension burden, the largest among US states to date have been stymied by benefit protections in the state constitution.<sup>4</sup>

The likelihood that both the state's debt burden and its tax rates will head higher raises questions about the capacity of the Illinois economy. We view the state's economy as sufficiently strong and diverse to generate the additional tax revenues and to support the additional debt that may be incurred as a result a fiscal compromise to balance the budget and pay down the state's bills. Gross state product grew 4.2% in 2015, compared with the nation's 3.7% increase, and median household income has risen at an annual average pace of 4.5% since 2011, outpacing the 3.1% US pace. The state's personal income per capita remains higher than the nation's, at 105%.<sup>5</sup> However, the state's population has shown an accelerating trend of [out-migration](#) during the last three years.

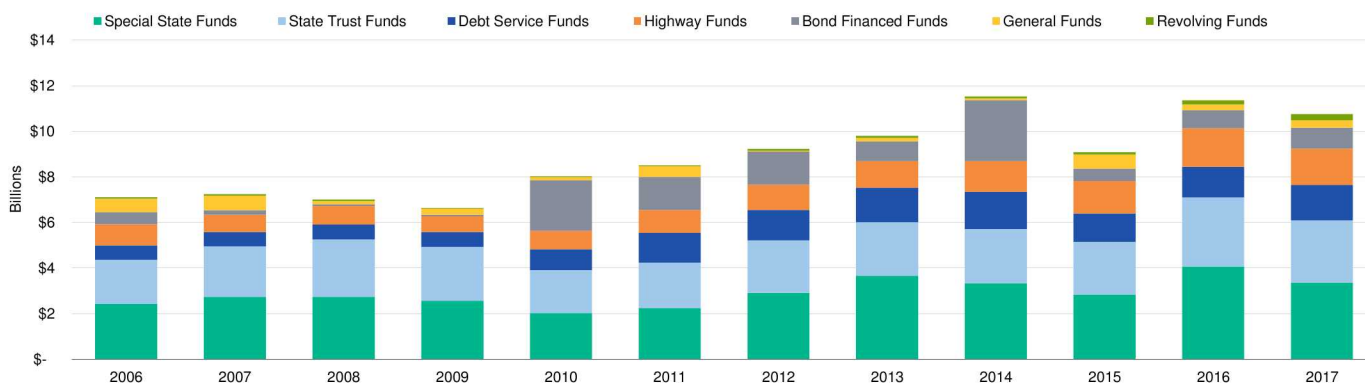
**If budget consensus remains elusive, liquidity pressure will further erode credit**

Direct repercussions for bondholders from the budget impasse have been limited largely to the widening yield spreads – or falling prices – of the state's bonds. However, if state lawmakers do not agree to budget-balancing measures before the current legislative session adjourns, Illinois' credit quality will keep deteriorating.

Potential pitfalls from ongoing political paralysis are highlighted by past near-misses, such as the state's temporary [failure](#) to enact required appropriations for subject-to-appropriation debt at the beginning of fiscal 2016. Another episode with credit implications was the decision in 2009 to execute a short-term \$335 million cash-flow borrowing from its GO bond retirement and interest fund, the statutorily created fund into which Illinois sets aside funds for debt service on a monthly basis.<sup>6</sup>

In an extended political paralysis scenario, state leaders will become increasingly likely to repeat similar actions, perhaps on a grander scale. Thus far, the state has continued to make monthly deposits to debt service funds for its GO bonds and for its sales tax-backed "Build Illinois" bonds (Baa2 negative). But, suspending this monthly set-aside practice, or borrowing from the debt service funds, could begin to appear attractive in the face of pressure to provide core services. As shown in Exhibit 3, the state maintains substantial cash in numerous non-operating funds, amounting to \$10.8 billion as of January 31. As it stands, this cash – which includes \$1.56 billion in debt service funds – enhances GO bondholder security, because it is all legally available to pay GO debt service, if needed. It is not available for general operating purposes without legislative actions.

Exhibit 3

**Illinois Retains Large Sums of Cash Available to Pay GO Debt Service**

2017 data is through January 31, 2017.

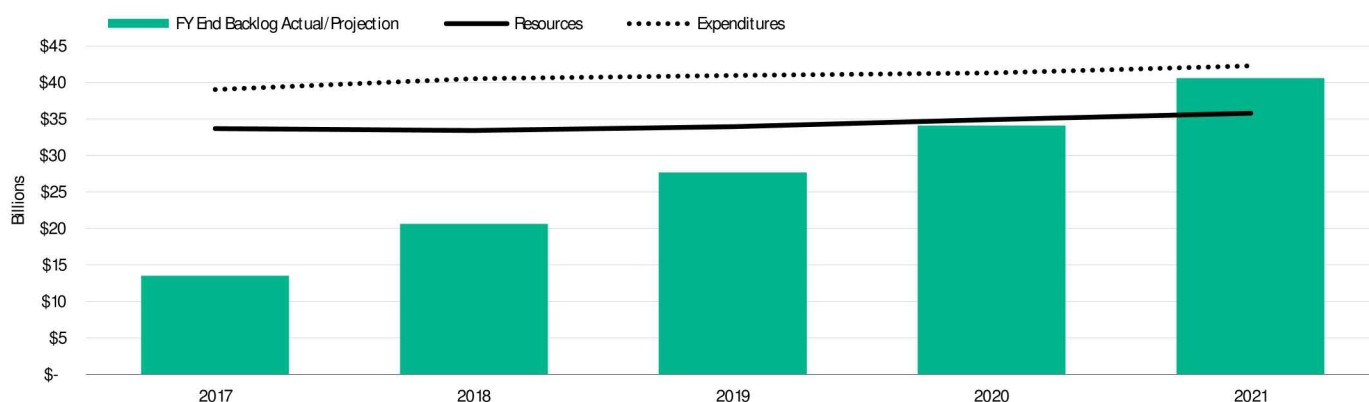
Sources: State bond offering documents, Governor's Office of Management and Budget

A protracted impasse could also encourage the state to consider reducing annual pension contributions, even in the absence of reforms that would otherwise create long-term budgetary savings. Cutting annual pension contributions in our view would be credit negative for bondholders. It could nevertheless prove tempting, given that about a fifth of state operating expenditures are attributable to pension payments. In fiscal 2017, total state contributions amount to almost \$8 billion. Pension payments account for 18% (or \$6.9 billion) of the state general funds' estimated \$38 billion of total expenditures this year, and the sums allocated to pensions are on a rising trajectory for future years. Amending Illinois statute to allow lower contributions would accelerate growth in the state's already high net pension liabilities and heighten the risk that the cost of benefits will ultimately be unsustainable.

**The state's ability to defer payments is testing practical and legal limits**

If Illinois remains on its current course, the Governor's Office of Management and Budget [projects](#) that at the end of fiscal 2019 the accounts payable backlog will approach \$28 billion, or about 79% of the following year's projected general fund resources (see Exhibit 4). The total backlog surpassed \$13 billion for the first time on March 20. If the state remains on this track, its prioritized payment streams, such as pension contributions and possibly even debt service, would be subject to significant risk.

Exhibit 4

**Continued Impasse Would Drive Backlog to Almost \$28 billion in Two Years**

Source: Governor's Office of Management and Budget, Five-Year Forecast dated 11/15/2016.

For more than a decade, Illinois has engaged in a practice of delaying payments to vendors, service providers and public entities to manage revenue shortfalls and cash-flow pressures. Throughout the current budget impasse, the state has relied on its ability to defer payments, to an unprecedented extent. As a result, the state comptroller's office has had to engage in an ongoing triage process to allocate available operating cash. The state comptroller estimates the size of the payment backlog by assessing the unprocessed

payment vouchers it holds at any time, in addition to vouchers estimated to be with state agencies and not yet submitted for processing.

By not fully paying its bills, Illinois is facing a growing risk of long-term damage to the state's public higher education system and its network of human service providers. While this pressure might fuel urgency for legislators and the governor to reach a fiscal compromise, there are signs already that protracted payment delays are causing perceived harm to these public programs. The state has appropriated approximately \$2.2 billion less for public higher education for the current and preceding fiscal years than it would have if normal trends had continued. The resulting budget pressures led [Governors State University](#) (Ba1 negative) impose a 15% tuition increase and take other [belt-tightening actions](#). [Northeastern Illinois University](#) (Ba2 negative) began furloughing employees.

Not-for-profit organizations that provide human services to the state, meanwhile, are suing for payment and grappling with whether to keep underfunded facilities in operation. The Pay Now Illinois Coalition, a group of 64 human and social service agencies, on March 13 filed an amended [complaint](#) in state court contesting the state government's failure to pass appropriations for human services provided in fiscal 2017. The coalition argued that its members were suffering "irreparable harm" and that the state's lack of a full budget is undermining their "ability to function at all."

## Moody's Related Research

[Illinois' Credit Negative Population Loss Underscores State's Comparatively Weak Economic Growth](#), January 2017

[Illinois Cash Crunch Threatens Credit-Negative Delays in State Pension Contributions](#), October 2016

[Partial Budget Threatens to Widen Deficit, Exacerbate Liquidity Pressures in Fiscal 2017](#), August 2016

[Illinois' Budget Gridlock Blocks Debt Service Transfer for Appropriation Bonds, a Credit Negative](#), August 2015

## Endnotes

- <sup>1</sup> State of Illinois Comptroller Susana A. Mendoza.
- <sup>2</sup> Source: Governor's Office of Management and Budget. Reflects state's general funds, on a budgetary basis.
- <sup>3</sup> The State Prompt Payment Act applies a 1% monthly charge to certain bills that have not been paid within 90 days. Payments to local governments are not subject to this penalty, and penalties on payments to healthcare providers accrue at a rate of 9% per year.
- <sup>4</sup> Illinois State Constitution, Article XIII, Section 5.
- <sup>5</sup> Source: US Department of Commerce, Bureau of Economic Analysis, Regional Data.
- <sup>6</sup> The transaction reduced a backlog of payments owed to Medicaid providers, allowing Illinois to meet a deadline for federal Medicaid reimbursements. The borrowed funds were repaid with interest after less than a month.



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