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Fitch: Recent Labor Board Ruling Highlights Implementation Risk in Illinois' Enacted Budget.

Fitch Ratings-New York-22 June 2018: A decision last week by the Illinois Labor Relations Board (ILRB) could open up a $400 million hole in Illinois' fiscal 2019 budget, highlighting the implementation risks in a budget reliant on one-time items and policy measures with uncertain fiscal benefits, according to Fitch Ratings. While the state avoided immediate political stalemate, the on-time budget fails to make material progress in addressing the state's sizable accounts payable backlog. Given the potential that budget performance will fall short of expectations, Fitch anticipates the governor and legislature may need to revisit the 2019 plan as soon as this fall.

For the first time in four years, Illinois enacted an on-time budget for the coming fiscal year when the governor signed the $38.5 billion (general funds) budget and accompanying legislation into law on June 4th. Despite the implementation risks, enacting an on-time budget with bipartisan support allowed the state to enter the new year with a clear fiscal plan, and provided clarity for the state's key fiscal partners, including municipal governments, school districts, and public higher education institutions.

Illinois' 'BBB' Issuer Default Rating (IDR) reflects many years of weak operating performance and fiscal decision making. The state continues to benefit from a solid economic base and still substantial independent legal ability to control its budget. The Negative Outlook reflects Fitch's assessment that fiscal pressures may accelerate in the near term. The state avoided a budget impasse, but the enacted budget entails significant implementation risk. Fitch's rating on the state will be lowered if the state returns to a pattern of deferring payments for near-term budget balancing and materially increases the accounts payable balance; while stabilization of the rating is contingent on the state's ability to maintain budgetary balance over multiple years, indicating more sustainable fiscal management. Upward rating momentum is unlikely until the state more comprehensively addresses its accumulated liabilities.

STEP PAY DECISION ADDS TO BUDGETARY UNCERTAINTY

The state could face an unbudgeted spending increase of roughly 1% in fiscal 2019 due to the recent litigation and ILRB's resulting actions. In 2015, the governor halted step pay increases under an expired labor contract. The AFSCME union challenged the suspension on the grounds that state law required current work conditions to continue in the event of contract expiration. Illinois' Supreme Court ruled in March 2018 in favour of AFSCME. Last week, the ILRB rejected the governor's request to send the issue to an administrative law judge for a hearing. Fitch anticipates a final remedy to be determined as soon as early this fall by the ILRB. Based on the Supreme Court ruling, it will likely require the state to provide for unpaid step-pay increases going back to 2015. Based on estimates provided by the administration to the ILRB, the state could face an additional $412 million in expenses in fiscal 2019 if AFSCME's recommended 'make-whole' remedy is implemented immediately.

ONE-TIME MEASURES AND UNADDRESSED ISSUES

The fiscal 2019 budget relies on $800 million in interfund borrowings, which under current law must eventually be repaid. This is more than, and in addition to, the approximately $400 million in interfund borrowings included in the budget for the current fiscal year (ending June 30) that are still outstanding.

Illinois also did not make material progress in addressing its sizable accounts payable backlog with the enacted fiscal 2019 budget. As of April 30, the state comptroller reported a general funds bill backlog of $7.2 billion, or nearly 20% of the fiscal 2019 enacted general funds budget. With only a very narrow budgeted $14 million general funds surplus for fiscal 2019, Fitch anticipates no material progress in reducing the backlog, absent robust and unanticipated revenue growth. The recent favourable decision in Wayfair v. South Dakota provides some potential upside for state revenues in Illinois and elsewhere. But the state reports that its enacted budget already assumes benefits from a favorable Wayfair decision.

The bills backlog and interfund borrowings could total between $8 billion to $9 billion by the end of fiscal 2019. These liabilities are in addition to the state's approximately $200 billion long-term liability burden for debt and unfunded pension obligations as estimated by Fitch (roughly 30% of state personal income).

BUDGET ASSUMPTIONS CREATE RISK

Fitch remains concerned that several elements of the enacted fiscal 2019 budget may be delayed beyond the fiscal year or could fall short of estimates. For the second year in a row, the budget assumes approximately $300 million in one-time revenues from the sale of the Thompson Center office building in downtown Chicago – the governor also included the sale as part of his fiscal 2017 executive budget. The facility sits atop several lines of the Chicago Transit Authority's subway system and a final sale requires close negotiation and coordination with the city of Chicago. The administration notes that the timing of a sale is also somewhat contingent on legislative approval of a change in the state's procedures around surplus property sales; absent that approval the sale process would likely extend beyond the fiscal year.

Uncertain pension savings are also a key component of the enacted budget, accounting for approximately $400 million in expenditure reductions or 1% of the enacted general funds budget. The budget includes three pension proposals; two to buy out some portion of current members' future benefits at a reduced long-term cost, and one to shift a limited amount of costs to school districts and public universities. The buyout proposals account for the bulk of the savings.

The two buyout proposals will require significant administrative work by the pension systems. Based on initial reports from the state and the systems, the buyouts may not be fully implemented for several months and potentially well into the new fiscal year which could limit the savings the state is able to accrue. The savings estimates also rely on assumptions of the portion of eligible members that will opt into the buyouts which adds to the unpredictability of actual savings. While the state intends to use general obligation bonds to fund the buyouts, Fitch does not consider that a material concern as the new debt will essentially replace reduced net pension liabilities.

The third pension change will require employers in the state university retirement system and teachers retirement system (public universities and school districts, respectively) to assume a portion of the pension contribution for retiring employees if they grant salary increases in excess of 3% during the period used to determine the employee's final average salary in pension benefit calculations. This anti-spiking measure is expected to generate a modest $20 million in savings in fiscal 2019.

IMPROVEMENTS IN STATE AID

State aid for school districts will increase roughly 5% year-over-year, with a $350 million increase tied to the state's evidence-based funding formula that was first implemented last year. K-12 spending overall is up nearly 6% with a sizable $300 million increase in state pension payments to the Teachers Retirement System. For municipal governments, the enacted budget rolls back a portion of cuts to various shared tax revenues that were first implemented in fiscal 2018. The budget reduces the state's withholding of the local share of income and sales tax revenues to 5% from 10%, providing an additional $66 million and $31 million respectively for municipalities. The state also reduced its administrative fee for collections to 1.5% from 2% on various local taxes, providing an additional $15 million for local governments.

Higher education appropriations increase as well, by 2%, or roughly $60 million in fiscal 2019. The pension cost shift noted above will somewhat reduce the benefits of these aid increases for school districts and public universities. The estimated $20 million in savings are well short of the nearly $600 million in pension cost shifts that were proposed in the governor's executive budget.

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