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Illinois Rating Unchanged for Now, Amid Budget Impasse Between State Executive and Legislative Branches.

NEW YORK (Standard & Poor's) July 6, 2015—Illinois begins fiscal 2016 without an adopted budget as the stalemate between the executive and legislative branches intensifies. On June 25, Gov. Bruce Rauner vetoed 19 of the 20 budget bills that encompass the fiscal 2016 spending proposal sent to him by the Illinois legislature, identifying a $4 billion budgetary gap. As Standard & Poor's Ratings Services noted in its report, "Late State Budgets: Summer Cliffhangers No One Wants To See," (published June 4, 2015, on RatingsDirect) it expects Illinois' budget negotiations to drag out through the summer. Actions both sides have taken so far suggest that they are digging in for a protracted budget negotiation. The governor's signed education bill, which will ensure that schools open, asked agencies to stock up on critical supplies before the end of fiscal 2015, and the governor is making efforts to ensure state employees continue to get paid in the absence of an adopted fiscal 2016 budget. Likewise, the legislature attempted to pass a one-month budget that would keep government spending in place and provide more time for negotiations.

From a credit standpoint, the absence of a budget does not have an immediate impact on the state's ability to pay debt. General obligation (GO) debt service in Illinois benefits from a continuing appropriation and the state has made provisions to ensure payment of its moral obligation debt coming due through August. Pension payments and spending tied to federal consent decrees also benefit from continuing appropriations and can still be paid. Because the state has a backlog of payments (estimated at $4.25 billion as of May), it is paying its vendors several months in arrears. Illinois' ability to continue making payments owed from fiscal 2015 will delay the cash flow impact on vendors, at least while these vendors continue to collect back payments from fiscal 2015. However, to the extent that budget adoption is delayed, the state will continue to build on its payables as payments that require appropriations cannot be made. Furthermore, protracted budget negotiations could have a detrimental effect on the state's economy due to reduced and delayed spending and investment. Illinois already ranks 48th in year-over-year change in personal income in first-quarter 2015, 49th in year-over-year population change as of July 1, 2014, and 38th in year-over-year employment change as of May 2015.

In our view, the absence of a budget, while not affecting debt service, reflects a failure in the fiscal policymaking process. The legislature is looking for the governor to propose tax increases to close the budgetary gap. Gov. Rauner has indicated his willingness to increase income taxes and expand the sales tax base to tax services, but only in exchange for several reforms he is proposing and which haven't garnered significant support from the legislature. These measures include worker's compensation and tort reform, and a property tax freeze tied to limits on prevailing wage requirements and collective bargaining. We have yet to see either side exhibit flexibility on their core policy objectives. And while an extended legislative session can sometimes result in an improved structural alignment or adoption of substantive policy reforms, it can also lead states to resort to budgetary gimmicks. On May 8 we placed our Illinois ratings, including our 'A-' GO rating on the state, on CreditWatch with negative implications. In our view, the outcome of the fiscal 2016 budget deliberations will be pivotal to the state's credit trajectory given the magnitude of structural imbalance, pension spending burden, and overall liquidity. As we indicated in our CreditWatch, we could take a rating action within the next two months, even in the absence of an adopted budget if, in our view, there is limited progress in budget deliberations or if credit fundamentals weaken.

Under Standard & Poor's policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.Standard & Poor's Ratings Services, part of McGraw Hill Financial (NYSE: MHFI), is the world's leading provider of independent credit risk research and benchmarks. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 26 countries, and more than 150 years' experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information and independent benchmarks that help to support the growth of transparent, liquid debt markets worldwide.

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