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Fitch Rates Illinois GOs 'BBB+'; Outlook Stable.

Fitch Ratings-New York-23 December 2015: Fitch Ratings has assigned a 'BBB+' rating to the following general obligation (GO) bonds of the state of Illinois:

-$480 million GO bonds, series of January 2016.

The bonds are expected to sell competitively on Jan. 14, 2016.

In addition, Fitch affirms the following rating:

-$26.2 billion in outstanding GO bonds at 'BBB+'.

The Rating Outlook is Stable.

SECURITY
Direct general obligation, full faith and credit of the state of Illinois.

KEY RATING DRIVERS

REDUCED FLEXIBILITY: The rating reflects the continued deterioration of the state's financial flexibility during its extended budget impasse. Illinois' inability to balance its operations, eliminate accumulated liabilities, and grow reserves during a period of economic expansion leaves it vulnerable to the next economic downturn.

ONGOING BUDGET GAPS: After four years of nominally balanced operations that benefitted from temporary tax increases, the fiscal 2015 budget was only balanced through extensive one-time action and a budget has not been enacted for fiscal 2016, which began on July 1. The state continues to spend in most areas at the fiscal 2015 rate, which is expected to lead to a sizeable deficit. As was the case during the most recent recession, this deficit spending is likely to be addressed by deferring state payments and increasing accumulated liabilities.

LONG-TERM LIABILITIES HIGH: The state's debt burden is above average and unfunded pension liabilities are exceptionally high. The state has limited flexibility with regard to pension obligations following the May 2015 Illinois Supreme Court decision that found the 2013 pension reform unconstitutional. Pensions remain an acute pressure on the state's fiscal operations.

ECONOMY A CREDIT STRENGTH BUT RECOVERY WEAK: The state benefits from a large, diverse economy centered on the Chicago metropolitan area, which is the nation's third largest and is a nationally important business and transportation center. Economic growth through the current expansion has lagged that of the U.S. as a whole.

RATING SENSITIVITIES

NEED FOR STRUCTURAL BALANCE: The Stable Outlook incorporates the expectation that the state of Illinois will use one-time solutions to nominally balance the fiscal 2016 budget but will not achieve more permanent, structural solutions in a time frame that will have a significant impact on fiscal 2016.

Failure to enact measures that lead to ongoing budget balance beyond fiscal 2016 could lead to negative rating action. Successful implementation of measures to enact a structurally balanced budget and reduce accumulated budget liabilities may lead to positive rating action.

CREDIT PROFILE

The 'BBB+' rating on the GO bonds of the state of Illinois reflects the deterioration of the state's financial flexibility as its budget stalemate continues deep into the current fiscal year. With the national economic expansion now extending into a sixth year, Illinois has failed to capitalize on economic growth to restore flexibility utilized during the last recession or to find a solution to its chronic mismatch of revenues and expenditures. Once again, the state has displayed an unwillingness to address numerous fiscal challenges, which are now again increasing in magnitude as a result.

Temporary increases in personal and corporate income tax rates in place for four years, from Jan. 1, 2011 through Dec. 31, 2014, closed or partially closed the budget gap across five fiscal years. However, with their expiration, and the failure to enact a spending plan within expected revenues, the budget gap has ballooned. As a result, the state finds itself with a current operating deficit, structural budget deficit, cash crunch, and accumulation of accounts payable that approaches its highest level at the depth of the recession. As the fiscal year progresses, fewer options remain for closing the gap on a current year basis, pushing the potential solutions into fiscal 2017.

ONE-TIME SOLUTIONS CLOSED 2015 GAP

The current budget stalemate follows a fiscal 2015 when a significant gap was closed primarily through the use of one-time fund sweeps rather than on-going spending or revenue action. The enacted budget for fiscal 2015 relied on approximately $2 billion in one-time revenues to achieve balance, given the anticipated expiration of the temporary taxes half-way through the fiscal year. These included interfund borrowing, use of prior year surplus to prepay fiscal 2015 Medicaid expenses, underfunding of specific budget line-items, and an increase in anticipated accounts payable.

Upon taking office in January 2015, and finding a budget gap that was larger than expected, the current administration proposed, and the legislature enacted, an additional $1.3 billion in fund sweeps and approximately $300 million in budget reductions. However, despite some revenue overperformance, particularly in personal income tax collections, the lack of a structural solution in fiscal 2015 left the state in a weak fiscal position in developing the fiscal 2016 budget.

FISCAL 2016 SPENDING SUBSTANTIALLY ABOVE EXPECTED REVENUES

The governor and state legislature have not come to agreement on a spending and revenue plan for the current fiscal year, which began July 1, 2015, for which there is a large projected deficit that reflects the full-year impact of the temporary tax expirations.

Despite the absence of an enacted budget, due to continuing and permanent appropriations, court orders and consent decrees, and an enacted appropriation for schools, the state is spending approximately 86% of its budget at the fiscal 2015 enacted rate during the budget impasse. Continuing to spend at this rate, without further appropriations or other changes, is forecast to almost fully expend currently anticipated revenues. However, Fitch believes a significant portion of the remaining 14% of the budget, which includes major funding items such as group health insurance and higher education, will ultimately have to be covered with state revenue. Based on currently expected revenues, and without further adjustments to spending, this would lead to as much as a $4 billion to $4.7 billion operating deficit, or 13% to 15% of revenues. This deficit would most likely be addressed by an increase to the accumulated accounts payable balance. The state notes that it has already taken approximately $1 billion in actions to reduce spending in funds other than the general revenue funds, to reallocate to the general revenue fund, although the latter requires legislative action.

HIGH LONG-TERM LIABILITIES; STRONG RETIREE BENEFIT PROTECTIONS

Illinois' long-term liabilities, particularly pension liabilities, are very high for a U.S. state. Illinois is the weakest of the states in terms of its ratio of debt and unfunded pension liabilities to personal income, at 24.7% as of 2014, is well above the median for states. This compares to Fitch's calculated median of 5.8% for U.S. states.

As reported under the new reporting requirements of GASB 67, the PERS fiduciary net position as a percentage of the total pension liability was 40% as of June 30, 2015. Annual pension contributions, which total almost $7 billion in fiscal 2016, or 22% of expected revenues, have been increasing significantly but remain below actuarially-calculated levels. Growing pension contributions have been crowding out other expenditure growth and absorbing revenue growth, in Fitch's view.

Illinois has no ability to unilaterally modify retiree benefits, as legal protections in the state are exceptionally strong. In May 2015 the Illinois Supreme Court found 2013 pension reform unconstitutional in a strongly worded decision. The ruling left pensions as an acute pressure on the state's fiscal operations, with spending demands that are more inflexible than is the case for other states.

There is an irrevocable and continuing appropriation for all GO debt service, and continuing authority and direction to the state treasurer and comptroller to make all necessary transfers from any and all revenues and funds of the state. The state funds debt service in advance by setting aside 1/12 of principal and 1/6 of interest every month for payments due in the ensuing 12 months.

TEPID ECONOMIC GROWTH

Illinois' economic performance, while positive, has lagged that of the U.S. as a whole. Employment growth has been well below the national average through the recovery/expansion period and has weakened relative to the U.S. in recent months. Non-farm employment grew at just a 0.6% year-over-year rate in November 2015. Through November 2015, the state has recovered only 72% of jobs lost in the downturn, among the weakest of the states at less than half the national recovery rate. Both GDP and personal income declined at a steeper rate in Illinois during the recession and have been increasing at a slower rate during the expansion.

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