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S&P Downgrade Brings Illinois Debt One Step Closer to Junk.

Illinois may become the first U.S. state to be given a junk rating

Illinois is on the verge of becoming the first U.S. state with a junk-bond rating following downgrades from two of the world's largest ratings firms.

S&P Global Inc. warned that Illinois could be downgraded to junk status next month if it doesn't solve its partisan gridlock. Illinois hasn't had a budget for two years due to a standoff between the Republican governor and Democratic legislature.

Illinois is one of many cities and states that, despite a generally strong U.S. economy, are struggling to close budget gaps because of pensions and other entitlements. State and local retirement liabilities have ballooned after the financial crisis, and most governments don't have enough assets to cover all future obligations.

S&P on Thursday dropped its grade on the state's general-obligation bonds one level to BBB-minus, the lowest possible investment-grade rating, citing Illinois's inability to pass a budget. Moody's Corp. also dropped its Illinois rating to one notch above junk. Fitch Ratings has rated Illinois at two notches above junk.

A downgrade to a junk rating would worsen Illinois's financial straits by likely increasing interest rates on all future borrowings.

"By letting the state get downgraded, Illinois's government is only making its own budget problems worse," said Matt Fabian, a partner at Municipal Market Analytics

Gov. Bruce Rauner and the state's Democratic House speaker, Michael Madigan, have been deadlocked over taxes and spending since Mr. Rauner took office in 2015.

"Madigan's majority owns this downgrade because they didn't even attempt to pass a balanced budget, get our pension liability under control, and other changes that would put Illinois on better financial footing," a spokesman for Mr. Rauner said Thursday.

A spokesman for Mr. Madigan couldn't be reached for comment, but a spokesman for Illinois Senate President John J. Cullerton, a Democrat, said "our worst fears are being realized daily as this impasse lingers…I urge the governor to recognize the need for compromise…and end this chaos that has gone on far too long and hurt far too many."

State lawmakers can continue to work toward a budget in the coming weeks, but they will need more votes. After the regular session of the General Assembly ended Wednesday, three-fifths of both houses must support the budget, instead of a simple majority.

Investors didn't react severely to Thursday's actions from the Wall Street ratings firms. Prices on some Illinois general-obligation bonds fell to about 99 cents on the dollar Thursday after trading as high as 105 cents earlier in May.

Even in the face of high pension costs and stretched budgets, most U.S. states maintain high ratings in large part because they have the power to tax residents and lack the ability to declare bankruptcy.

New Jersey, the next lowest-rated state after Illinois, is pegged at four notches above junk by both S&P and Moody's despite burdensome pension liabilities and a persistently imbalanced budget. Moody's also rates Connecticut at that level.

Other states have had their ratings fall nearly as low and been able to engineer a turnaround. California has largely recovered from fiscal distress that drove its rating down to two notches above junk by S&P in 2003 and kept it low for much of the next 10 years.

The state regained the confidence of rating analysts in part by making regular deposits to a rainy-day fund, according to reports from S&P.

Puerto Rico last month was placed under court protection in what amounts to the largest-ever municipal bankruptcy, owing $73 billion to creditors. That dwarfed the roughly $9 billion in bond debt owned by the city of Detroit when it entered what was previously the largest municipal bankruptcy in 2013.

Puerto Rico created problems for itself by borrowing money to buy time while its economy deteriorated.

But no state had gone without a budget for over a year since the Great Depression until Illinois. The stalemate originated with ideological differences between two major political figures in the state. Gov. Rauner has called for broad changes, including curbs on unions he argues would save the state and businesses money. Democrats, who are led by Mr. Madigan, have said those issues are unrelated to the budget.

In the meantime the state's backlog of bills has swelled to roughly $15 billion, or 40% of the state's operating budget, according to Moody's. The state's budget deficit is more than $5 billion, according to S&P and Moody's.

The current problems are aggravated by burdensome debts that eat into the money available to run the state. Illinois's pension debt last year reached $251 billion, according to Moody's calculations. Retirement and health benefits combined with debt payments now absorb 29% of the state's general fund expenditures, S&P said.

"Legislative gridlock has sidetracked efforts not only to address pension needs but also to achieve fiscal balance," said Ted Hampton, a Moody's analyst, in a release. "During the past year of fruitless negotiations and partisan wrangling, fundamental credit challenges have intensified enough to warrant a downgrade, regardless of whether a fiscal compromise is reached in an extended session."

The budgetary issues in Illinois have rippled well beyond the state capital of Springfield, denting everything from infrastructure spending to the amount of books in elementary schools.

Public universities have been among the hardest hit with many schools pausing on any new construction and forced to stop hiring for vacant positions. Some universities including Northeastern Illinois, Governors State and Southern Illinois are weighing fixes such as raising tuition, cutting academic programs or laying off student workers.

While the state is still funding certain core functions, many nonprofits have had to shut down or reduce operations and lay off staff after going without payments from the state.

If Illinois does get downgraded to junk it would have to make millions of dollars in termination payments on contracts designed to stabilize interest payments on some state debt, according to S&P.

Those penalties would be about $10 million in the event of a downgrade to junk by one rating firm, would reach $19 million if two firms gave the state a junk rating and could reach $108 million in the event of further downgrades, according to estimates by S&P based on current market conditions.

“In our view, the unrelenting political brinkmanship now poses a threat to the timely payment of the state’s core priority payments,” S&P analyst Gabe Petek said in his ratings report Thursday.

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