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[Fitch Ratings: Illinois Governor's Budget Plan Would Make Insufficient Progress]

Fitch Ratings-New York-26 February 2019: The fiscal 2020 executive budget plan recently introduced by Illinois' governor would not materially address the state's structural budget issues in the current fiscal year or the next, says Fitch Ratings.

Illinois' 'BBB' Issuer Default Rating (IDR) reflects an ongoing pattern of weak operating performance and irresolute fiscal decision-making. The Negative Rating Outlook reflects our assessment that near-term fiscal challenges will pressure the rating.

Fitch has indicated that we would lower the state's IDR if Illinois returned to a pattern of deferring payments for near-term budget balancing. Elements of the governor's proposal, including a $1.5 billion GO bill backlog borrowing that reduces but leaves largely unresolved the 2019 deficit and numerous one-time measures in fiscal 2020, appear to do that without a clear path toward long-term balance. The legislature will take up the executive budget, a multi-part pension proposal, and a possible capital improvements bill over the next several months, with the goal of enacting a final budget by June 30. Fitch plans to review the state's rating and Negative Outlook following passage of a final budget for fiscal 2020.

A return to single-party control could ease the legislature's budget review and adoption process this year, but unified control is not a panacea for Illinois. It also would not mean the end of the state's credit challenges, which have persisted regardless of the political make-up of the state government. Illinois faces significant fiscal problems that will likely take multiple years to fully address, but the executive budget does not provide enough clarity on how the state will deal with them.

The governor's fiscal 2020 budget plan relies heavily on non-recurring revenues and large savings from an uncertain pension proposal that poses risks for the state. The budget plan could also be challenged from the start if the sizable fiscal 2019 gap is not adequately addressed. The governor framed the $38.7 billion general funds ($77 billion all funds) plan as a bridge budget that would buy time until the state is able to implement his proposed graduated income tax and then achieve more substantive fiscal progress. This new tax requires a state constitutional amendment that must be approved by legislative super-majorities (which Democrats have in both chambers) and then by voters, also by a super-majority. Fitch estimates the earliest it could be approved would be in the November 2020 general election and notes that prospects for passage at both levels are uncertain.

Fiscal 2019's gap, estimated at $1.1 billion in the general funds, poses a particular challenge for the state, and the administration's budget plan leaves it largely unresolved. The governor proposes a $1.5 billion general obligation (GO) bond sale to reduce backlogged bills. $600 million of the proceeds would be deposited directly in the general revenue fund to pay down remaining interest accruing bills. After accounting for other adjustments to the budget, the general funds deficit declines modestly to an estimated $900 million. The remaining $900 million from the GO sale would be deposited in the Health Insurance Reserve Fund (outside of the general funds) to cover unpaid employee health insurance bills.

While potentially beneficial economically by trading high-interest backlogged bills for likely lower-cost GO debt, the state's liability profile would be essentially unchanged with the proposed GO sale. The administration's $1.1 billion fiscal 2019 deficit estimate reflects elimination of several items from the enacted budget that Fitch previously noted as questionable, including the sale of the Thompson Center and savings from pension buyouts.

Fitch anticipates the administration will continue working with agencies and the legislature to seek additional measures to address the fiscal 2019 general funds deficit. But those measures have not been articulated, and only four months remain in the year.

For fiscal 2020, the executive budget includes an estimated $1.1 billion in new revenues, with roughly one-third ($370 million) coming from non-recurring sources. Initial licensing fees from legalization of cannabis ($170 million) and sports wagering ($200 million) are assumed to accelerate into fiscal 2020 supported by related tax credits included in the budget plan. Separately, the governor also proposes a delinquent tax payment incentive (amnesty) plan estimated to generate $175 million in one-time revenue.

On a recurring basis, the most significant revenue source proposed by the governor is nearly $400 million from a new assessment fee levied on healthcare managed care organizations that should generate additional federal matching revenues under Medicaid. The combined revenues would be deposited outside of the general fund into the Healthcare Provider Relief Fund and used for Medicaid, thereby reducing the general funds support of Medicaid. The governor noted that other states including California and Ohio use similar fees.

Separately, the governor estimates sports wagering could generate between $77 million and $136 million annually in future years from a 20% tax on gross wagers – only $12 million of tax revenue is included in the fiscal 2020 budget. The governor did not provide an estimate of ongoing cannabis tax revenue.

The only material expenditure reduction is in the state's pension contributions which the governor proposes to decrease from the current year by $400 million to a general funds total of $7.1 billion, by implementing a five-part pension proposal outlined earlier this month (see "Fitch Ratings: IL Pension Plan Frames the Rating Picture; Budget Details Still Key," Feb. 19, 2019). This would also be $1.1 billion below the required contribution based on the 26-year closed amortization to 90% funding set out in current law.

$878 million in savings comes from a potentially costly extension of the pension amortization by seven years to 2052, while maintaining the comparatively weak 90% funding target. Without committing to full actuarially determined contributions, the re-amortization could cost the state more over time by perpetuating an already inadequate funding approach. $125 million derives from the administration's estimate of savings by extending the pension buyout programs permanently.

Over the long term, Fitch considers the proposed open-ended buyouts as indirect pension benefit changes that could gradually reduce the long-term pension liability but would require an ongoing funding source. The enacted fiscal 2019 budget anticipated issuance of up to $1 billion in GO bonds to fund pension buyouts and the governor proposes issuing the first tranche of $300 million by April. Absent a constitutional amendment, Illinois' ability to more directly reduce already-accrued retiree benefits appears sharply limited.

Education funding is a key area of growth in the governor's budget plan. K-12 funding under the evidence-based formula increases by $375 million (a robust 5.5%) to $7.2 billion. The minimum wage increase recently signed into law by the governor drives more than $100 million in proposed spending growth (combined state and federal) for providers paid through the state's Departments of Human Services and Aging. Like Pennsylvania's executive budget, Illinois' assumes $25 million in individual income tax revenue growth tied to increased economic activity supported by the higher minimum wage.

The governor also called for a capital improvements bill to fund new infrastructure projects but did not offer a specific plan or revenues to support new issuance. The state maintains between $3 billion and $4 billion in unused GO authorization for various capital projects, and the governor proposes using $1.1 billion over the next year. Illinois also has roughly $370 million in remaining authorization for the Build Illinois sales tax-backed bonding program.

The budget plan also does not make material progress on reducing liabilities as it trades accounts payable for GO debt to repay bills. By the end of fiscal 2020, the governor projects reducing year-end general funds accounts payable by 10% from fiscal 2018, or $900 million over two years, while issuing $1.5 billion in GO bonds to repay bills.

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