Bond Case Briefs

Municipal Finance Law Since 1971

Fitch Rtgs: Illinois Governor's Budget Highlights Importance of Income Tax Vote

Fitch Ratings-New York-02 March 2020: The fiscal 2021 executive budget recently introduced by Illinois' governor includes a significant $1.4 billion contingency tied to voter approval of a constitutional amendment in November that would allow the state to implement graduated income tax rates, which are already statutorily approved. Under the governor's budget proposal, failure of the income tax amendment would trigger fiscal actions that could exacerbate the state's structural budget challenges and pressure local governments, particularly school districts, says Fitch Ratings. The proposal now moves to the legislature for consideration, and Fitch will evaluate the final budget once enacted.

Illinois' 'BBB' Issuer Default Rating (IDR) reflects an ongoing pattern of weak operating performance and irresolute fiscal decision-making that has produced a credit position well below the level that the state's broad economic base and substantial independent legal ability to control its budget would otherwise support. The state's elevated long-term liability position remains a key credit challenge. As of Fitch's December 2019 State Pension Update report, the state's combined debt and Fitch-adjusted pension burden was 27.5% of personal income, well above the 5.7% state median and the highest of the states. Fitch estimates the state's total long-term liabilities at approximately $200 billion with pensions accounting for 80% of the total.

Response to Income Tax Amendment Vote Will be Critical

Fitch has indicated that the credit implications of the November 2020 vote on the income tax amendment depend on whether Illinois uses any increased revenues to address structural budget challenges, or if the state can adequately adjust its budget to work toward structural balance if the amendment fails. In his executive budget, the governor proposes to hold $1.4 billion of budget actions in reserve, dependent on voters' decision. If the amendment fails some of the governor's proposals, including deferral of up $400 million in employee health insurance costs and more than $500 million of interfund transfers or borrowings, would risk exacerbating the state's structural budget challenges. If voters approve the constitutional amendment the governor's executive budget would avoid such non-recurring measures and appears to continue recent progress towards structural balance.

Pensions Pose Structural Budget Challenge

Importantly, Fitch notes that pension contributions remain a point of structural weakness for the state, regardless of the income tax amendment vote, as the governor's proposal continues the practice laid out in current law of underfunding the systems relative to actuarial determinations. The state currently structures its contributions to pension systems to target 90% funding by 2045, short of the actuarially determined contributions (ADCs), which target 100% funding. Fitch considers full ADC contributions to be a crucial element of structural balance.

Based on analysis of the state's fiscal 2018 CAFR, Fitch estimates Illinois' actual pension contributions totalled approximately $7.7 billion, 71% of the ADC of $10.9 billion that year, a gap of more than $2.0 billion; the gap likely increased since then given the underfunding embedded in the statutory 90% target. Fitch believes the supplemental annual pension contributions of $100 million-$200 million proposed by the governor if the income tax amendment passes would be helpful. But on their own, they would not materially affect Fitch’s view that the state’s budget remains structurally unbalanced given the sizable gap between actual contributions and the ADC. As with other states, Illinois retains substantial budgetary powers allowing it to manage the associated fiscal challenges at a level commensurate with its ‘BBB’ IDR.

Executive Budget Implications for Local Governments

For local governments, and particularly school districts, the $1.4 billion of reserved items in the governor’s budget proposal pose risks. The 2017 statute establishing the revised evidence-based funding formula (EBF) for K-12 school aid established a target of annual increases of $350 million. In the current year, the enacted budget included slightly more than that, with a $379 million increase. For fiscal 2021, the governor’s executive budget holds $150 million of the suggested $350 million increase, or more than 40%, in reserve, to be released only if voters approve the income tax amendment. The governor’s office notes that a $200 million increase would still reflect a higher annual growth rate than school districts have received over the past decade and the total increase in EBF funding since fiscal 2018 would total $1.3 billion.

Several additional measures could also affect local governments, but generally to a much less significant degree. The governor proposes holding approximately $100 million in combined income tax and sales tax revenue shared with local governments in reserve, pending voters’ decision on the income tax amendment. Additionally, $40 million in increased state funding for school districts for certain mandated categorical items is likewise held in reserve in the executive budget plan.

Contact:

Eric Kim
Senior Director
+1-212-908-0241
Fitch Ratings, Inc.
Hearst Tower
300 W. 57th St.
New York, NY 10019

Karen Krop
Senior Director
+1-212-908-0661

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com