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S&P: Illinois Fiscal 2021 Budget Anticipates, And Needs, Additional Federal Aid

BOSTON (S&P Global Ratings) June 1, 2020—S&P Global Ratings believes that Illinois' (BBB-/Negative) adopted budget continues to be precariously balanced, and does not include measures to meaningfully address structural instability. We consider the fiscal 2021 budget structurally misaligned, as along with an outstanding \$7.2 billion bill backlog, the pension and other postemployment benefit obligations are not funded based on actuarial recommendations. On a budgetary basis, the total resources exceed the total expenditures, but the revenue side anticipates an additional \$5 billion in either additional direct federal aid or borrowings through the Federal Reserve's Municipal Liquidity Facility (MLF). Whereas we believe that additional direct federal aid is possible, the amount, timing, and potential restrictions on use are unclear at this point, and so budgeting potential use introduces risk.

Should additional federal aid not be received or not be received to provide liquidity in time for budgetary use, the state passed legislation allowing for MLF borrowing, with potential repayment over up to a 10-year period, although the current MLF authorization allows only for 36-month repayment schedules. Management indicates that the \$5 billion may not be borrowed at one time, but if needed, could be tapped in various borrowings from the MLF over the fiscal year. There is capacity in the MLF authorization legislation for an additional \$5 billion from Illinois, but such a borrowing simply shifts the repayment to future budget years, and the hope for additional aid is a precarious assumption. The state recently sold \$800 million in tax-exempt general obligation (GO) bonds on the open market, demonstrating some level of market access, and the MLF is designed to provide liquidity when other market conditions would be uncertain or costly.

The new budget has a \$39.0 billion operating component and then another \$3.9 billion in additional expenditures, including statutory transfers out, debt service, and other borrowing repayments (including those needed to fund operations in fiscal 2020). All spending considered, the \$42.9 billion budget is 5.8% larger than the fiscal 2020 budget. Illinois entered into this recession slowly working toward budget stability, but with little to no money in the budget stabilization fund (BSF). Where many other states had taken advantage of the long economic expansion following the Great Recession, Illinois faced political gridlock through multiple fiscal years, built a significant bill backlog, delayed action to reduce a sizable pension obligation, and could not accumulate a rainy day fund. We consider the state's current options available to address the pandemic to be limited, compared to those of other states.

In the 2021 budget, the revenue side introduces more risk. Compared with the draft executive budget presented in January, the adopted budget reflects over a \$4 billion decrease in recurring revenues, or 10.5% lower. The nominally largest revenue decrease is in the individual income tax line: the \$1.8 billion decrease is 8.8% off the January estimate. But the sales tax estimate decrease is a larger percentage decline, with the almost \$1.6 billion reduction reflecting a 17.5% decrease in assumed receipts for the fiscal year. These, and all other, revenue declines are offset through an increase of \$300 million in interfund borrowing, the previously mentioned \$5 billion MLF borrowing or federal aid receipts, and \$1.274 billion in potential new individual income taxes, should a

constitutional amendment pass in November instituting a graduated income tax. The original estimate of additional revenue receipts attributable to the graduated income tax was \$1.435 billion, and so the state is reflecting a reduction caused by the recession.

So, in order to fully meet the total expenditure obligations in the budget, the state is relying on interfund borrowing, either federal aid or further federal borrowing, and the support of the electorate to vote to revise the tax structure to raise more revenue. Should any of those not materialize as expected, the state will need to look to more significant expenditure cuts through later legislative action. We believe the state has capacity to make cuts to close a gap, as there are no cuts in the current budget.

Illinois expects that the \$5 billion MLF borrowing would be tapped if direct federal aid is not sufficient in terms of timing or amount. Should the direct federal support not materialize as hoped, the security for the MLF borrowing is the state GO, and we would view this borrowing on parity with existing GO debt. Currently the outstanding GO debt has a relatively rapid maturity with 74% retired within the next decade, and so there is some replacement capacity, but by our calculations, Illinois already has the fifth-highest debt per capita in the nation. Debt service on existing debt declined from fiscal 2020 by 11% or \$211 million in the adopted fiscal 2021 budget.

The expenditure side of the fiscal 2021 budget holds most line items to the fiscal 2020 spending levels, but there are no layoffs or program eliminations being adopted to help balance the budget. Level funding, though, will extend personnel and purchasing controls put in place at the outset of the pandemic, into fiscal 2021. The school funding formula is set equal to fiscal 2020; however, this is \$350 million less than the state intended to fund for fiscal 2021 when it revised its school funding formula several years ago, and \$462 million or 5.2% less than the governor's original budget earlier this year. The college and university system, although funded \$129 million less than in the January draft budget, is also level funded to the fiscal 2020 budget. So, the state is holding the districts to level funding assumptions, but with existing teacher contracts and other obligations, we do expect cuts to be passed down to the local school level decision-makers.

There are a couple of credit positives in the adopted budget. First, the statutorily set annual pension contribution is being fully met. As the statutory pension funding is designed to attain a 90% funded status in 2045, this is one of the least conservative funding methodologies in the nation among state peers, and so anything less than meeting this obligation would have been seen as a notable credit negative. Second, the state appropriated the necessary amounts to support the priority lien ratings we have tethered to the state, Build Illinois (BBB/Negative), Metropolitan Pier and Exposition Authority (MPEA) (BBB/Negative), and Illinois Sports Facility Authority (BBB/Negative), with additional provisions to support the MPEA operations.

As we have noted in past reports, Illinois has a history of leaving difficult fiscal choices to future budgets, and to the extent that expected federal aid does not materialize and the state does not adjust expenditures to reflect available resources, the fiscal 2021 budget could weaken the state's credit trajectory.

Fiscal Year 2020 Closeout

The state expects a \$2.7 billion shortfall through the end of the fiscal year and is closing that gap predominantly through federal aid and borrowing. Not all of this is lost revenue, however, as income taxes will be due in the next fiscal year, on July 15, conforming with the federal change to the tax filing date. The largest component of the resources needed to close the fiscal 2020 gap is a \$1.2 billion borrowing likely through the MLF. The contemplated GO Certificate Series of June 2020 would need to be repaid in June 2021. This borrowing provides immediate cash flow support, but does create a cash flow pressure for the time of repayment. Additionally, the state is using other

interfund borrowings to close out the fiscal year, including \$400 million through the Treasurer's Investment Pool. In times of fiscal challenge, we often see budget gaps closed with use of reserves, expenditure cuts and deferrals, new revenues, and debt. As Illinois entered the recession without reserves to tap, and believes state government services critical to responding to the pandemic, the solutions to date have all been on the debt and federal assistance side of the ledger.

The state has over the past three months received more than \$5 billion in federal aid. Much of that has restrictions on use, in that it has to be used to cover costs associated with fighting COVID-19. As the state's expenditures to date have not been to this level, and the state has until Dec. 31, 2020 to account for the spending, the receipt of these funds has been helpful in addressing the unbudgeted costs associated with the pandemic.

Unemployment Insurance Fund

The state has been authorized by the federal government to borrow up to \$5 billion in May and \$6.4 billion in June to help pay claims or replenish unemployment insurance funds. This shows the severity of social distancing measures affecting the economy. Federal law mandates that if a state fails to fully repay a loan after approximately two years, the state unemployment tax credit on employers in that state decreases in each subsequent year in favor of a greater allocation of the tax rate to the federal government, until the state repays the loan. States also have the ability to issue bonded debt to repay such loans, and Illinois issued \$1.5 billion in the series 2012 A, B, and C bonds for this purpose. Therefore, the federal borrowing aids in immediate liquidity and supporting the ability to pay claims, and S&P Global Ratings does not consider this federal loan as debt, until it is repaid through a public bond sale, but it does introduce another potential longer term credit pressure.

We recently revised the outlook on the State of Illinois to negative. For further detail, please see our full analysis published April 28, 2020.

Related Research

Illinois Fiscal 2019 Audit Shows Little Improvement, As Expected, May 8, 2020

State of Illinois, full analysis, April 28, 2020

This report does not constitute a rating action.

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