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Illinois credit downgrade—is the sky falling?

By Jim Nowlan

Last week another credit rating agency downgraded State of Illinois credit worthiness yet another notch, down close to "junk bond" status. What does this mean for you and me, and is the sky falling, as some observers would have you believe?

Illinois has two state budgets: the operating budget for the coming year, which is the one reported on in the news, and a capital infrastructure plan budget, which is invisible to readers, as this budget is generally not in peril.

The capital budget finances new construction and major repairs and renovation of highways, university buildings and public schools, local environmental waste water treatment plants and many other projects that have generally long life spans. For example, my beloved Lincoln Hall classroom building on the University of Illinois campus in Urbana was recently renovated at a cost of $40 million and paid for by bond borrowing.

Rather than pay for these big ticket costs on a pay as you go basis, as a few states do, Illinois and most states borrow money in the municipal bond market to finance the projects, generally, but not always, over a 30 year period, similar to many home mortgages.

States (and local governments) sell bonds to investors, promising to pay the investors back with tax-free interest.

At any one time the State of Illinois has from $25-30 billion in outstanding principal and interest owing on bonds, and in 2010 that amounted to $2,383 per person in Illinois. The state is 9th highest in the nation in per capita debt. But if we added in the $120 billion in unfunded state

pension and health care obligations, the amount of state debt equals about $10,000 per person in the state, and we would probably be near the top in per capita debt and obligations.

[There are several types of bond debt. “General obligation” debt is the most secure, as the debt is backed by the full faith and credit of the state, meaning that the state promises to use all its resources to pay off the debt. “Revenue bonds” are bonds backed by certain streams of revenue such as university dormitory rentals or by tolls on highway usage.]

In 2009, Illinois enacted a $31 billion construction program called Illinois Jobs Now, which is supported by new taxes on soft drinks, candy and liquor. In addition, the bonds are to be supported by online lottery sales and video gaming, which are not yet up and running.

The cost of borrowing, that is the rate of interest the state must pay the bond holders, generally varies according to the perceived ability of the governments to pay back their loans, as evaluated by three rating agencies: Moody’s, Fitch, and Standard and Poor’s Rating Services. The ratings range from AAA (the best) to BBB or lower, the latter being “junk bond” status, that is, much more risky for investors. There are many notches in between the best and worst ratings, such as AA+ or AA-, which are combined with outlooks for the future, such as positive, stable, or negative; each service uses slightly different rating scales.

Last week, Standard and Poor’s downgraded Illinois bonds from A+ to A, which is close to the dreaded Bs. Our ratings have been downgraded several times in recent years, from AA to A, and are lower than for any state but California.

If all things were equal—each bond sale is structured differently— Illinois would have to pay an interest rate of 1.5 percent more than would a triple-A state. This can amount to scores of millions of dollars in additional state interest payments to bondholders on a major bond issue.

The sky-is-falling observers worry that Illinois will simply not be able to borrow at all if the ratings decline too far, or at least not at sustainable rates of interest.

And yet, last year the State of Illinois issued bonds for 3.09 percent, which one knowledgeable observer called a great interest rate.

One reason Illinois continues to sell at reasonable rates of interest is that Illinois promises in law that investors will be made good before anything else is paid.

The two budgets I mentioned above overlap. Debt payments are made from the operating budget and represent about 10 percent of all such dollars, so the more debt the less that remains available for education and other operating purposes.

The ratings agencies are signaling Illinois that we have major financial problems, as noted in a recent Moody's rating statement that the state has "weak management practices reflected in pension under-funding and bill payment delays."

Yet clearly the sky is not falling at the moment. But the ratings agencies hover over Illinois, threatening to downgrade again if we don't get our act together. Look for the legislature and governor to try to address the pension problem after the upcoming election.