Illinois enters a state of insolvency

By: Paul Merrion, Greg Hinz and Steven R. StrahlerJanuary 18, 2010

As Illinois' fiscal crisis deepens, the word "bankruptcy" is creeping more and more into the public discourse.

"We would like all the stakeholders of Illinois to recognize how close the state is to bankruptcy or insolvency," says Laurence Msall, president of the Civic Federation, a fiscal watchdog in Chicago.

"Bankruptcy is the reality that looms out there," Republican gubernatorial candidate Andrew McKenna Jr. says.

While it appears unlikely or even impossible for a state to hide out from creditors in Bankruptcy Court, Illinois appears to meet classic definitions of insolvency: Its liabilities far exceed its assets, and it's not generating enough cash to pay its bills. Private companies in similar circumstances often shut down or file for bankruptcy protection.

"I would describe bankruptcy as the inability to pay one's bills," says Jim Nowlan, senior fellow at the University of Illinois' Institute of Government and Public Affairs. "We're close to de facto bankruptcy, if not de jure bankruptcy."

TAX DRAIN

Illinois is projecting a decline of almost $1 billion in cash receipts for fiscal 2010. Here's where some of the biggest losses are:

- **$460 million** Sales tax
- **$417 million** Income tax
- **$42 million** Public utility tax
- **$28 million** Inheritance tax
- **$18 million** Investment income

Source: Illinois comptroller's office

Legal experts say the protections of the federal bankruptcy code are available to cities and counties but not states.

While Illinois doesn't have the option of shutting its doors or shedding debts in a bankruptcy reorganization, it seems powerless to avert the practical equivalent. Despite a budget shortfall estimated to be as high as $5.7 billion, state officials haven't shown the political will to either raise taxes or cut spending sufficiently to close the gap.

As a result, fiscal paralysis is spreading through state government. Unpaid bills to suppliers are piling up. State employees, even legislators, are forced to pay their medical bills upfront because some doctors are tired of waiting to be paid by the state. The University of Illinois, owed $400 million, recently instituted furloughs, and there are fears it may not make payroll in March if the shortfall continues.

Without quick corrective action or a sharp economic upturn, Illinois is headed toward a governmental collapse. At some point, unpaid vendors will stop bidding on state contracts, investors will refuse to buy Illinois bonds and state employees will get paid in scrip, as California did last year.

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— Jim Nowlan, University of Illinois

"The crisis will come when you see state institutions shutting down because they can't pay their employees," says David Merriman, head of the economics department at the University of Illinois at Chicago.

A record $5.1 billion in state bills was past due at yearend, almost doubling to 92 days from 48 days a year earlier the average amount of time it takes the state to pay vendors such as doctors, hospitals, non-profit service providers and other contractors.

"I don't see any light at the end of the tunnel," says Dan Strick, CEO of SouthStar Services, a Chicago Heights non-profit that helps people with developmental disabilities. "It seems to be getting worse and worse, and the delays longer and longer." SouthStar hasn't been paid since July, forcing him to borrow to keep afloat.

State tax receipts from July through December last year were running more than $1 billion behind 2008, including a $460-million plunge in sales taxes and a $349-million drop in personal income taxes. Even with a 22% increase in money from the federal government, thanks largely to the stimulus program, total state revenues were down 2.1%, or $284 million, from the previous year.

While new spending is down nearly 2% in the six months ended in December, the state started the fiscal year $3.9 billion in the hole from the previous year's unpaid bills, which means actual spending was up 2.2%, according to the Illinois comptroller's most recent report.

The resulting $5.1-billion backlog of unpaid bills doesn't include $1.4 billion in Medicaid and group health bills that haven't been processed, plus $2.25 billion in short-term borrowing that must be repaid soon.

Illinois is living hand to mouth, paying bills as revenues come in each day, building up cash when special payments are coming due. Cash on hand varies from day to day, sometimes dipping below $1 million, says a spokeswoman for Illinois Comptroller Dan Hynes.

The state's credit rating has been steadily worsening since 1997, with three downgrades in the past 13 months. "The absence of recurring solutions in the next year to deal with the current budget challenges and begin to stabilize liquidity will likely result in a further downgrade of Illinois," Standard & Poor's said last month.

As credit ratings dropped, the state has to pay more to borrow. The state also has to pay interest on bills unpaid after 90 days, adding further to its costs.

The real fear is that the state could eventually be unable to plug its budget gaps with short-term borrowing. Illinois is still a long way from Arkansas during the Great Depression, believed to be the only instance in the past century when a state defaulted on its debt. But California was forced to seek a federal guarantee for its borrowing last year when credit dried up. It didn't get the guarantee, and state officials are now seeking a $6.9-billion federal bailout.

While California has an even bigger budget hole to fill, Illinois ranks dead last among the states in terms of negative net worth compared with total expenditures. The state's liabilities, including future pension payments, exceed its unrestricted assets by $39 billion, more than 72% of its total expenditures as of mid-2008, according to Richard Ciccarone, managing director and chief research officer at McDonnell Investment Management LLC, an Oak Brook money manager that invests in bonds. "It's probably higher now," he adds.

Investors like Mr. Ciccarone already are starting to wonder if Illinois' shaky finances and rising debt are a threat to the regular, on-time payments bond investors expect. "You really can't just look at default risk," he says. "For an investor looking for stable performance, Illinois leaves you waiting. There are tremendous unresolved issues."

In addition to its day-to-day budget, Illinois faces rising pension expenses in coming years. Lawmakers have skimped on required contributions to employee pension funds and even borrowed to make those smaller payments. Unfunded liabilities and pension debt are projected to reach $95 billion by June 30. The state must contribute $5.4 billion to the pension funds next year, and more than $10 billion a year in the future. Required contributions will soon start increasing dramatically because the state has repeatedly pushed back a payment schedule enacted in 1995 to set aside enough to cover 90% of its pension obligations by 2045, up from 43% today, one of the worst unfunded liabilities in the nation.

The sharp rise in pension payments is the biggest factor pushing Illinois toward what a legislative task force last November called "a 'tipping point' beyond which it will be impossible to reverse the fiscal slide into bankruptcy." The little-noticed report on the state's pension problems warned that "the radical cost-cutting and huge tax increases necessary to pay all the deferred costs from the past would become so large that many businesses and individuals would be driven out of Illinois, thereby magnifying the vicious cycle of contracting state services, increasing taxes, and loss of the state's tax base."

While the Illinois Constitution protects vested pension benefits, that promise, like all the state's obligations, is only as good as its ability to pay. The Civic Federation warned lawmakers last fall that "there is mounting evidence that a judge could find the state is already insolvent. If the state is found to be insolvent under the classical cash-flow definition of insolvency, which is 'the inability to pay debts as they come due,' it is not only the pension rights of non-vested employees that will be in jeopardy. All the obligations of the state, whether vested or not, will be competing for funding with the other essential responsibilities of state government. Even vested pension rights are jeopardized when a government is insolvent."

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