State of Illinois Review

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The State of Illinois currently carries the worst credit ratings of any state in the country (Baa1 by Moody's, A- by S&P, and BBB- by Fitch) and could be downgraded even further in the near term. The steady decline in the State's credit quality has been ongoing for the past ten years due to its financial mismanagement, growing long-term liabilities and poor demographics and declining wealth levels.

Financial Mismanagement

The three largest sources of revenue for Illinois' operating fund are personal income taxes (43.5% of total revenue), sales tax (16.8% of total revenue) and federal revenue (20% of total revenue). The three largest expenditures in the State's operating fund are health and social services (51.6% of total expenditures), education (35.2% of total expenditures) and public protection and justice (6.2% of total expenditures). Operating revenue, in 2014, totaled $42.7 billion and operating expenditures totaled $40.3 billion, resulting in a surplus of $2 billion (before transfers to other funds).

Despite balanced operations in 2014, Illinois has had an expanding operating deficit for more than a decade, as shown in Chart I. Currently, the State's cumulative deficits represent *negative* 14% of operating revenue. The amount of operating balance held by other states varies, but it is extremely uncommon for a state to maintain a negative balance for such a long length of time.

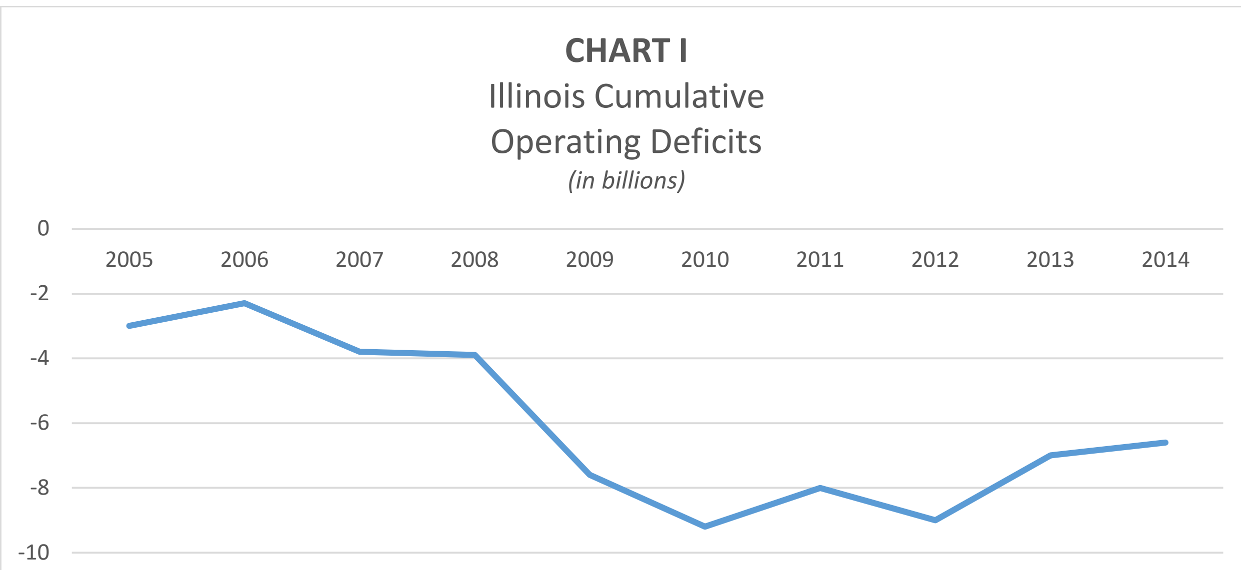
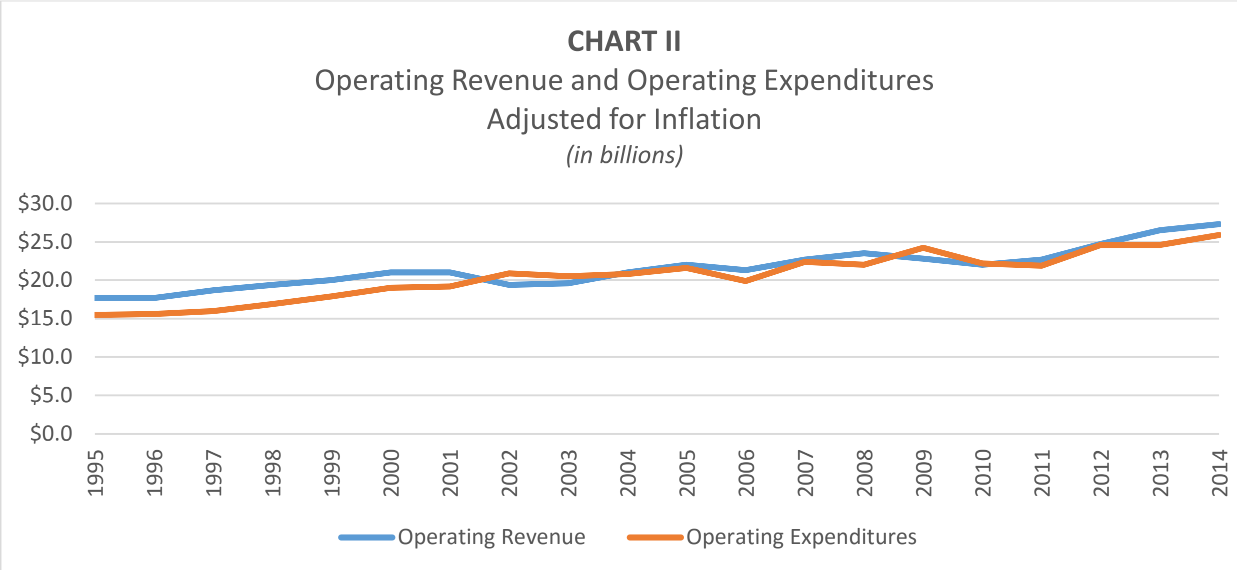


Chart II shows the change in total operating revenue and total operating expenditures (in 1995 dollars) between 1995 and 2014. As is shown, Illinois' finances became imbalanced around the turn of the 21st Century due to the faster growth in expenditures as compared to revenues. The compound annual growth rate for operating revenues between 1995 and 2014 was 2.19%, while, during the same period, Illinois' expenditures grew at a 2.44% annual rate. Over time this difference in the rate of growth between revenues and expenditures has created a substantial budget gap. Assuming that these growth rates remain unchanged, deficits should continue to increase, reaching $1.6 billion by 2030.



**NOTE: The spike in operating revenues that occurred in 2013 was due to a large income tax increase, which has since been rescinded. Expenditures are currently expected to be greater than revenues again at the end of 2015.*

Illinois has experienced rapid expenditure growth in all three of its largest expenditure categories. On an annual basis between 1995 and 2014, when adjusted for inflation, health and social services expenditures grew by 2.97%; education by 2.6% and public protection and justice by 2.41%. In comparison, the State's primary revenue sources (income tax, sales tax, and federal revenue) have lagged far behind these rates of growth[1].

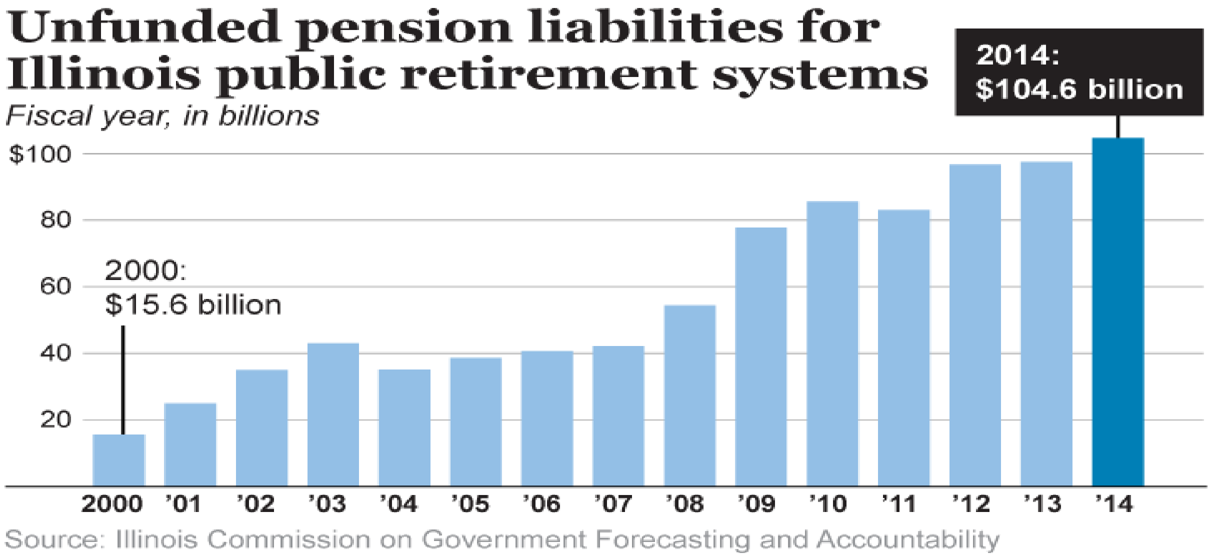
This imbalance is expected to continue and grow, as the State has not attempted to control expenditure growth or provide long-term revenue increases. Even if revenues are enhanced it may not be sufficient to address this budgetary gap over the long-term, as growth in Illinois' largest expenditure, health and human services, is far outpacing the rate of inflation. Additionally, growth in health and human services expenditures, which are primarily costs associated with Medicaid, are expected to accelerate as Illinois recently expanded its Medicaid system in conjunction with federal health care reform.

Long-Term Liabilities

Illinois currently manages five pension systems: the General Assembly Retirement System (GARS) which is 16% funded; the Judges' Retirement System (JRS) is 31.6% funded; the State Employees' Retirement System (SERS) is 33.7% funded; the Teachers' Retirement System (TRS) is 40.6% funded and the State Universities Retirement System (SURS) is 42.3% funded. The total retirement system unfunded liability exceeds $100 billion, as shown in Chart III. The unfunded liability is likely to increase given that all of these systems are forecasting a generous rate of return at, or exceeding, 7%. At a more realistic rate of return of 5 ½%, across all pension systems, the unfunded liability doubles to roughly $200 billion.

[1] Revenue growth rates were calculated between 1995 and 2012. A temporary state income tax increase, which has since been rescinded, was in place between 2013 and 2014

CHART III



The State's unfunded pension liability remains a long-term liability, but meeting the required annual contributions for these pension systems will have a growing budgetary impact. In 1995, the legislature passed a law mandating an increase in pension funding levels in order to make the systems financially solvent. As of 2014, pension required payments represented 20% of total operating expenditures. Under current law, and considering the significant underfunding of the systems, pension costs are expected to consume more than a third of the State's operating expenditures by 2025.

The State attempted to implement modest pension reform in 2013 that included cost of living adjustments and an increase in the retirement age. These reforms were meant to both reduce the long-term liability and reduce current pension costs. However, in 2015 the Illinois Supreme Court ruled these changes to be unconstitutional. The likelihood of future pension reform legislation being enacted and found constitutional is minimal.

Poor Demographics and Declining Wealth Levels

In the last census, Illinois' population grew 3.3%, in the ten years ended in 2010, which was below the national average of 9.7% and one of the lowest growth rates for any state. Additionally, Illinois remains one of the top three states experiencing outmigration.

The unemployment rate in Illinois is 5.7% (as of January 2016), which is higher than the national average of 4.9%. The State has also become less wealthy. Prior to 2007, Illinois' median income was greater than $60,000, but currently the median income averages $54,000. In comparison, nearby Wisconsin's median income of $58,000 has not seen as steep of a decline and now boasts wealth levels stronger than Illinois'.

Outmigration, higher unemployment and lower wealth levels in the State will impact Illinois' finances and constrain the amount of revenue that any tax increase may garner.

Other Factors

Further impacting the outlook is the fact that Illinois is currently embroiled in a budget shutdown between the governor and the General Assembly. Despite the lack of a budget many expenditures are being paid, primarily due to court injunctions. The State's comptroller currently estimates that these expenditures are far exceeding expected revenues and the State's backlog of unpaid bills will continue to grow. Currently, this backlog exceeds $6 billion (representing 17% of the State's operating revenue) and the comptroller estimates this total will increase to $8 billion at the end of the fiscal year.

The State is also confronted with the fact that its largest city, Chicago, is also financially weak and the State's largest school system, Chicago Public Schools, is near insolvency. Both Chicago and its school system are currently rated below investment grade. Currently, the State has rebuffed requests for financial assistance from Chicago and Chicago Public Schools, but continued financial deterioration of these entities may necessitate state support.

Conclusion

C.W. Henderson does not believe that the State of Illinois' credit quality will improve anytime in the near future. Poor financial management, increasing health care costs, growing pension liabilities, declining wealth levels, and a budget stalemate are all contributing factors in our outlook. We recommend avoiding all future purchases connected with the State's general obligation and full faith.