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Fitch: Illinois Budget Mixed News For Locals.

Fitch Ratings-New York-28 July 2017: The recently passed state of Illinois budget will affect local government finances, including those of the city of Chicago, Issuer Default Rating (IDR) 'BBB-'/Stable Outlook, the Chicago Board of Education (IDR 'B+'/Negative Outlook), and Cook County ('A+'/Stable Outlook), according to Fitch Ratings. Fitch does not expect the budget to result directly in any rating changes for local governments in the state, although school districts remain exposed to a potential impasse in finalizing school funding distributions.

Chicago Impacts: Removes Pension Uncertainty; Places Fee on Sales Taxes

For the city of Chicago, a big benefit of the state budget was the inclusion of the city's Municipal and Laborers' funds pension reform legislation, which had previously been passed by the legislature and vetoed by the governor. The passage of this legislation removes the uncertainty associated with the implementation of the reform plans for those two pension funds. It commits the city to a higher contribution schedule, with a gradual ramp up to an amount that would achieve 90% funding by 2060, according to actuarial projections. It also creates an additional tier for new employees, which allows the choice of a lower retirement age in exchange for higher employee contributions.

The budget imposes a two percent administrative fee on local sales taxes to generate additional revenue for the state. This should not result in a change to the Chicago sales tax bond ratings ('BBB-'/Stable Outlook), which are capped by the city's IDR. The underlying sales tax revenue stream supporting those bonds would support a much higher rating if bondholders were not exposed to the operating risk of the city. New legislation discussed below gives the city a new tool that could accomplish this. In addition, the budget includes a 10% reduction in local government distribution funds (LGDF), which are statewide income taxes distributed to local governments; although, the state believes that more frequent remittance of those funds via direct deposit will offset to some extent the impact of the cut on a cash flow basis. Neither of these changes will have a significant budget impact on the city.

School District Impacts: Potential for Improved Cash Flow, Increased Funding

The biggest impact to the Chicago Board of Education is the presumption that a fully funded state budget will result in more prompt distribution of state aid to districts, although it is likely that the flow of categorical block grants will only improve to the extent the state's own payment backlog improves. Currently, the district is owed $304.5 million in categorical block grants. Existing state statutes require that the block grants be paid no later than Dec. 31, 2017; if not paid by then, the appropriation expires, unless the Governor and Comptroller agree to extend the appropriation.

School Funding Vulnerable to Additional Legislation

The budget includes large increases in funding for preK-12 education, but distribution of most education funding is contingent upon the passage of what the budget refers to as an evidence-based education funding reform. The legislature has passed such legislation, Senate Bill 1 (SB 1), but has not yet sent it to the governor. He has stated that he intends to use an amendatory veto to bring the legislation closer to the Republican plan. The governor called the legislature into a special session, starting July 26th, to encourage the legislature to pass a new school funding bill by the end of July.

If passed into law, SB 1 would provide for $221 million of pension aid and $71 million of new state aid to Chicago schools for a total increase of $292 million. The Republican plan would result in a state aid reduction of $73 million and also separate the $221 million of pension aid out of the base formula and grant it in separate legislation, for a net increase of $148 million. Chicago schools is the only district in the state which is responsible for paying its own pension costs; other districts participate in the state-run plan and the state bears most of their pension costs. Separating out the $221 million pension aid would be less advantageous for Chicago schools, as it would make the aid vulnerable to budget appropriation each year. Either version represents a large increase in funding for the CBOE, whose financial position is characterized by chronic structural imbalance, slim reserves and a weak liquidity position.

Fitch is concerned that the requirement for agreement on an evidence-based education funding reform legislation before school monies can flow represents a vulnerability to all Illinois school districts. The state board of education has said that the legislation must be passed by August 3rd in order for state aid to flow to districts before the start of the school year. Fitch will closely monitor the potential impact this may have on Illinois school district ratings and if no legislation is passed by that date, will take action on a case by case basis as necessary.

New Pension Tier, Cost Shift to Schools

Another big impact of the state budget on school districts and universities/community colleges is the creation of a third tier in the pension system for new hires. New employees will be given a choice between participation in the tier 2 defined benefit plan with a more modest cost of living adjustment or a hybrid plan with a small defined benefit for those employees not covered by social security, plus a defined contribution component. With either choice, the local employer rather than the state will pay the normal cost and also determine the amount of the employer match. This, of course, is a bigger change for school districts outside Chicago, whose pension costs have been mostly borne by the state, than it is for Chicago Schools, which already is responsible for the payment of its pension costs.

Other Effects on Local Governments

Other effects of the state budget on local governments include a 10% reduction in funding for higher education, although the budget does provide full funding for grants to low income students which should particularly benefit community college districts, like City Colleges of Chicago.

Cook County should benefit from a reduction in delayed Medicaid payments to its health system, which threatened to strain liquidity. The county will also be affected by the 2% administrative fee on sales taxes, a 9% reduction in personal property replacement taxes (PPRT), and the 10% reduction in LGDF payments which may be partially or fully offset by catch up payments on a cash flow basis. While these are all relatively small impacts on the county’s overall budget, they come at a time when the county is still trying to solve for the loss of its sweetened beverage tax, which has been temporarily blocked by the courts.

New Capital Financing Option

Away from annual budget flows, the state budget made a change that could be significant to capital financing in the state. An amendment to the Illinois Municipal Code (65 ILCS 5) included in the state’s fiscal 2018 budget agreement provides a structure by which Chicago and other home rule municipalities in the state can create entities to issue debt that would not be constrained by the Issuer Default Rating (IDR) assigned to the local government by Fitch Ratings. If properly applied by a home rule municipality, the structure could result in ratings higher than and without regard to the IDR. For further information, please see 'Fitch: Illinois Legislation Gives Chicago New Financing Tool' (July 2017), available at www.fitchratings.com.

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