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S&P: Chicago Ratings Hinge On Its Ability To Achieve Structural Balance By 2022.

CHICAGO (S&P Global Ratings) Oct. 25, 2019–On Oct. 23, the mayor of Chicago (BBB+/Stable) detailed her proposal to close a projected historic $838 million budget gap, or approximately 21.8% of forecast revenue, for fiscal 2020. Her budget would rely on roughly $313 million in one-time measures, leaving the city with a deep 7% structural imbalance before accounting for actuarial pension funding shortfalls. Looking beyond fiscal 2020, S&P Global Ratings notes that the mayor also stated in her budget speech that if the city secures revised legislation for a Chicago casino and a graduated real estate transfer tax, it will be on a path to structural balance, funding all four pension plans on an actuarial basis by 2022. Based on our understanding of estimates for these two revenue streams, we think that these sources, coupled with continued moderate savings measures or revenue growth, could feasibly address the next two outyear gaps. However, we believe that these revenues carry significant implementation risk, and while the mayor asserts that a property tax increase remains on the table as a contingency, it still would require council support.

In S&P Global Ratings' opinion, the significant use of one-time revenue to close the fiscal 2020 budget gap is a reasonable one-year approach to closing such a sizable gap, particularly at the current Chicago rating level, even if it does not represent best fiscal practices. The current proposal buys the city time to execute structural revenue enhancements and operational efficiencies that require a longer time frame to implement. The city's ongoing ability to demonstrate a credible path to structural balance, including fully funding its pension ramp by 2022, whether it be through garnering state support for new revenue streams or evidence of political willingness to execute such contingent measures as a property tax increase, will be critical to our rating analysis.

Proposed fiscal 2020 structural revenue and savings appear feasible despite implementation risks

The mayor's budget proposal includes a number of structural revenue increases. Highlights include $163 million from emergency medical transportation and ambulance services reimbursements; $47 million from congestion initiatives such as increases to certain rideshare fees and new parking meters; $37.2 million in increases to existing service and sales taxes, including $20 million from restaurants and $17 million from lease transaction; and an $18 million library property tax levy increase. The proposal also assumes $50 million from a graduated real estate transfer tax (RETT), which is predicated on simple-majority state legislative approval for a July 1, 2020, implementation date. Other revenues totaling $23.6 million include a modest $3.5 million in estimated cannabis tax receipts.

While we don't expect that the city council will "rubber stamp" the mayor's proposal, we think that the proposed revenues are more politically feasible than alternatives such as a large property tax increase. Also, the assumption that the RETT would get a simple majority approval for a July 1 implementation is more conservative than assuming the two-thirds majority required for the law to take effect earlier, on Jan. 1. Although less attractive, the city has the option to enact a graduated RETT for fiscal 2021 without needing state support. In our view, current revenue estimates appear reasonable based on historical performance and implementation time frames.

The budget also identifies $249 million in structural savings and efficiencies. Highlights include $148.7 million from zero-based budgeting changes, $141.0 million from improved fiscal management, $19.7 million from vacancy reductions and reallocations, $25.0 million from improved revenue collections, and $3.2 million from department mergers. Based on underlying details behind savings assumptions, we view the city's expectations as reasonable. Also, in our opinion, efforts to control expenditures not only demonstrate good management but could also prove politically beneficial as the mayor asks for support for new revenue sources.

Identified one-time measures do not impair the city's liquidity or liability profile
Proposed one-time measures include $200 million from general obligation and Sales Tax Securitization Corp. (STSC) debt refunding, $31.4 million from a tax-increment finance (TIF) surplus, $43 million of the proposed ground emergency medical transportation fee, and fund balance sweeps. While we do not look favorably on the use of one-shot sources to close the budget gap, these measures do not materially impair the city's finances beyond prolonging structural imbalance into fiscal 2021.

The city has no plans to extend final maturity dates as part of the refunding structure, and the bonds would still have net present value savings, distinguishing this structure from past "scoop-and-toss" practices. We also expect that the city will preserve capacity within the STSC structure for future capital needs and understand that it maintains sufficient liquidity such that planned further securitization of sales taxes would not result in cash-flow pressures.

Notably, the city did not include certain measures that we have identified as potential contributors to downward rating pressure. We would view negatively any measure that would lower annual contributions into Chicago's pension systems. Particularly given the city's low funded ratios (weighted average of 23%) and the fact that it already must liquidate assets to make annual benefit payments, reductions to annual contributions would increase the likelihood of asset depletion, necessitating contribution spikes in the not-too-distant future. We also consider the city's substantial reserves and liquidity crucial to the current rating, and we would view the significant use of reserves to offset ongoing expenses–rather than for "rainy day" or one-time purposes, such as a temporary shortfall during a recession–negatively.

Lingering structural imbalance is daunting but not insurmountable for 2021 and beyond
We consider the proposed structural imbalance as sizable relative to the city's budget, but manageable relative to potential available revenue sources. The mayor's budget speech identified $100 million of ongoing annual graduated real estate transfer taxes, potential casino revenue, and a property tax increase as potential revenue measures. In addition to these sources, we expect that the city will benefit from a full year of cannabis revenues although receipts will likely remain small relative to the budget. It also could receive a share of a statewide graduated income tax if the amendment passes in November 2020. In addition, we understand that the city is looking to identify other expenditure reductions that could offset revenue needs and that some of the structural changes it has already taken will result in additional outyear savings, providing a better course for structural alignment.

Looking ahead to fiscal 2022, the city's projected budget gap actually decreases by $30 million, even when accounting for $250 million in increased municipal/laborer contributions for the pension ramp. Therefore, to the extent that Chicago structurally addresses the next two fiscal year gaps, it will have largely tackled the fiscal 2022 budget. Even should an economic slowdown or mild downturn occur, based on its past performance, diverse revenue streams, and limited pension plan invested assets, we don't expect that the city's budget gap will significantly widen over this period.

Potential revenue from a casino remains uncertain given that tax structure negotiations are ongoing.

Casino revenue often misses forecasts and takes longer than expected to realize. That said, we understand that if the state were to authorize revised casino legislation, the city could benefit from temporary casino revenues as early as fiscal 2021, providing the same type of short-term boost seen in other municipalities that added casino gaming tax revenues.

In our view, a modest property tax increase still remains a viable part of the solution to closing Chicago's budget gap. We recognize that city residents have property tax fatigue and have voiced a preference for other revenue streams. However, Chicago's property tax rates still remain competitive with those of neighboring suburbs, and its costs of doing business and housing remain affordable relative to those of other large cities such as New York, Los Angeles, Denver, Washington, and Boston. If Chicago were to raise property taxes by $300 million, this would increase the average tax rate by 0.34% from its current average tax rate of 6.79%.

While the mayor discussed pension reform, it is our understanding that the city's current budget plan does not count on legislated pension savings and that the city remains committed to funding pensions according to the current statutory amortization schedule. To the extent that the city could either trim liabilities through benefit reductions or secure a dedicated revenue stream toward pensions, this would improve its budget sustainability and bode well for long-term credit stability. However, in our view, these measures may prove challenging to attain and may not occur within the 2022 time frame.

Chicago teacher strike could pose indirect risks to the budget plan

The mayor did not propose additional funding for Chicago Public Schools (CPS) in her budget address despite an ongoing teacher strike although we understand that the schools will receive approximately $66 million more than CPS budgeted of the city's declared TIF surplus in 2020. We note that this is a one-time revenue source. Although the mayor appoints the school board, city and school finances have largely remained separate. The city has historically provided CPS minimal financial support, and the current budget proposal is in line with past practices. However, given the shared tax base, education's causal effects on city demographic and economic trends, and potential consequences for the mayor's political capital, we consider the relationship between the city and CPS significant.

In our opinion, the Chicago Teacher's Union strike has more potential to reverse CPS' recent financial gains than hurt the city's budget in the near term. Given Chicago's history of limited financial support for CPS and challenged financial position, we do not expect it to provide significant, if any, additional funding for CPS. Higher-than-budgeted contract costs for CPS would not necessarily result in the board levying property tax hikes, especially since they are subject to property tax limitations and would need special authorization from the state for additional property taxes. Therefore, we are not assuming that the strike would measurably reduce the city's tax capacity. The mayor's budget proposal, however, relies on council approval, and the resolution of the strike could potentially undermine public and council member support.

Rating stability hinges on the demonstrated ability to execute any necessary contingency plans

The Illinois General Assembly's veto session begins Oct. 28, and the city will then know whether it has secured state support for both the RETT and new casino tax structure prior to a planned budget vote at the end of November. Given that the city is not relying on casino revenue in the 2020 budget, this provides more time to either consider legislation during a later session or detail a contingency plan for the next two budget years.

Our analysis of rating stability extends well beyond the next fiscal year. If the city fails to receive legislative approval for new revenue streams or if revenues fail to materialize as the city has projected, we will be looking to see if not only the mayor, but also the city council, has the willingness to execute any necessary contingency plans to structurally close the gap by the identified 2022 target, including full statutory pension contributions. As stated in our current outlook (please refer to our full analysis on Chicago, published on RatingsDirect on March 14, 2019) increasing evidence of political resistance to raising revenues or an inability to make expenditure cuts could result in downward rating pressure. The city's long-term fiscal health also depends on major structural changes, and even if it is able to balance its budget by fiscal 2022, we expect that its financial position will remain challenged.

This report does not constitute a rating action.

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