Bond Case Briefs

Municipal Finance Law Since 1971

As Illinois Runs Out of Options in Budget Crisis, Tax Rises Seen in the Cards.

NEW YORK/CHICAGO — With no easy way to financially engineer or negotiate its way out of a budget and pensions crisis, Illinois is likely to dish out some unpleasant medicine to its residents in the next few years. And investors say that is most likely to come in the form of higher taxes.

Given the Democrats' control of the state legislature and their opposition to many proposals for spending cuts, municipal bond fund managers see little alternative for Republican Governor Bruce Rauner other than eventually agreeing to hike taxes, such as raising the state's income tax or broadening its sales tax base.

The state has a chronic structural budget deficit, as well as the lowest credit ratings and worst-funded pension system among the 50 states. Chicago, the third biggest U.S. city and the place where about one in five of the state's residents live, is suffering from similar pension issues and may have to take additional pain, the investors said.

"What is quite simple a solution is to raise taxes," said Tom Metzold, senior portfolio manager at Eaton Vance Management, which has been paring down its Illinois exposure. "You're going to have a game of chicken over who blinks first – the cutting expenditure side or raising taxes side."

Rauner got into office in a November election after campaigning for eliminating a temporary 2011 personal income tax hike to 5 percent from 3 percent enacted under former Democratic Governor Pat Quinn. That was largely rolled back in January to 3.75 percent.

Rauner has ruled out hiking taxes unless he can get pension cuts and other reforms, including creating areas where employees in unionized workplaces can opt out of joining unions or paying union dues. The Democrat-controlled House rejected this so-called right-to-work proposal last week.

Balancing Illinois' out-of-whack budget without raising taxes for the next fiscal year is already proving difficult. While Rauner got spending cuts passed by lawmakers to help plug a $1.6 billion hole in the current year, his $32 billion proposed budget for the fiscal year beginning July 1 met resistance from Democrats.

The contentious point is $6.6 billion in proposed spending cuts, and a key component of the budget – slashing $1.2 billion in spending from its human services department (which includes housing and child care services) – has already been voted down by the House.

SKIPPING AND SKIMPING

By far the biggest problem facing Illinois and Chicago are their grossly underfunded pension funds, the result of years of skipping and skimping on contributions and sweetening benefits for a mainly unionized workforce.

That already dire situation got a lot worse on May 8 when the Illinois Supreme Court threw out the state’s landmark 2013 pension reform law, saying it violated a clause in the state constitution. The reform attempted to rein in costs by reducing and suspending cost-of-living increases for pensioners, raising retirement ages and limiting salaries on which pensions are based.

“The court ruling will increase the likelihood of new revenue eventually becoming part of the budget solution,” said Nuveen analysts in a research note. “This could mean an expanded sales tax base or income tax increase.”

Illinois’ unfunded pension liabilities total $105 billion and the funded ratio is only 42.9 percent.

The day of reckoning is approaching as Rauner and legislators have to balance the budget for the next fiscal year. If they fail to agree on tax increases or spending cuts to make required payments to its pensions of $7.6 billion for 2016, the state risks further downgrades in its credit rating.

Rauner’s budget for next fiscal year relies in part on moving current state workers into less-generous pensions – now harder after the Supreme Court’s ruling. State contributions are ratcheting higher every year and are projected to grow to more than $10 billion a year in 12 years.

“New revenue cannot be discussed until we address the underlying structural issues that contributed to Illinois’ fiscal crisis,” said a spokeswoman for Rauner when asked about any possible tax increases.

A spokesman for powerful House Speaker Michael Madigan, a Democrat, said the budget plan should be a balance between spending cuts and revenue. Madigan scheduled a House vote this week on a proposal for a 3 percent additional tax on income over $1 million.

Illinois Senate President John Cullerton, also a Democrat, is hoping for a bipartisan budget solution that addresses both income and expenses, said his spokeswoman.

APPEAL SEEN UNLIKELY

Legal experts largely dismiss the idea of an appeal of the ruling, noting that the U.S. Supreme Court might decline to hear a case that is so tied to Illinois state law. A spokesperson for Illinois’ attorney general did not respond to a request for comment.

Rauner wants to amend the constitution to ensure his pension proposal sticks – but it is a formidable challenge to get the three-fifths majority vote required and even if successful would take years to take effect.

“Until citizens begin paying for the services they receive at the right price, the problems of the past 30-plus years will continue,” said Marti Kopacz, a restructuring consultant who advised the judge in Detroit’s historic bankruptcy.

“It doesn’t take much of a tax increase and/or a combination of some spending cuts to solve their problems, it just takes the political will,” said Guy Davidson, director of Municipal Fixed Income at AllianceBernstein, which owns some Illinois state general obligation bonds.

While Illinois ranks 31st among the states in terms of its state business tax climate for 2015, according to the Tax Foundation research group, its flat personal income tax rate is well below many other states, particularly for higher-income earners.

The state’s sales tax is 6.25 percent, though there are exemptions for some goods. Consumers also face additional sales taxes from local authorities – taking the total rate in Chicago, for example, to

9.25 percent.

The recent high court ruling could breathe new life into pension proposals that have previously been floated.

In one, Illinois would shift some costs from the Teachers Retirement System to local school districts. But this would likely pass an increased tax burden on in a different way and meet resistance from some state lawmakers.

SCOOP AND TOSS

As Illinois' woes pile up, bankers are likely to pitch creative solutions such as pushing out debt maturities or privatizing assets. Those options each face major political or legal obstacles and cannot alone fill the unfunded liability, investors say.

Extending debt maturities can buy time. Debt service costs account for 5.6 percent of the state's budget, according to Nuveen. However, the Illinois constitution prohibits "scoop and toss," a practice used to free up revenue by pushing principal and interest payments into future years.

Privatizations could be a possibility, say some bankers, noting that selling Illinois' toll roads and interstate highways is one option. This would, though, risk a political backlash. Privatizations got a bad name after the company that leased Chicago's parking meters immediately tripled rates.

The state could also issue pension obligation bonds to boost funding levels – though critics say they just add to the burden of future taxpayers. Illinois already has $13.8 billion of outstanding pension obligation bonds, according to S&P.

Despite all the problems, Illinois state bonds with a 5 percent coupon trade at or above par, reflecting a sense that Illinois will avoid a default or a haircut for investors.

"The legal framework as it exists right now is that the bonds get paid in full, and there's no talk yet of changing that," said Emanuel Grillo, bankruptcy attorney and muni restructuring expert from Baker Botts.

There is no provision for U.S. states to file for bankruptcy under federal law – which means there is less pressure for everyone to get around the bargaining table.

In a corporate or municipal bankruptcy, stakeholders may fight hard to protect their investments, but often wind up in a deal that spreads the pain. In state finance, bondholders and pensioners can resist haircuts until the state "has exhausted its tax base," Grillo said.

By REUTERS
MAY 20, 2015

(Reporting by Megan Davies and Nick Brown in New York and Karen Pierog in Chicago; Editing by Martin Howell)