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News

Chicago Budget Doesn't Affect Rating: S&P

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Chicago's Mayor Rahm Emanuel unveiled his proposed 2016 budget for the city on Sept. 22, ahead of the Oct. 15 due date. Although Standard & Poor's Ratings Services' ratings are unaffected by the proposed budget, it considers Chicago's budgetary problems to be substantial, particularly regarding how it will accommodate growing pension contributions in its budget--and this is one of the primary drivers of the rating.

The extent of the city's structural imbalance, when factoring in pension contributions, will take multiple years to rectify. The proposed budget lays out a path to address the issue of rising pension contributions.

If the final budget that is adopted by the end of the calendar year fails to cover the larger pension payments with an identifiable and reliable revenue source, it would likely strain the rating--potentially resulting in the rating being lowered by multiple notches. Given the uncertainty regarding the reform of its police, fire, municipal and laborers pension plans, the rating agency expects city management to consider contingency plans for addressing its pension liabilities.

The biggest challenge in the 2016 budget is how to accommodate the statutorily required increased police and fire pension contributions. The mayor's proposed 2016 budget calls for increased property taxes to bear the bulk of the rising pension contributions to the police and fire funds and to close the roughly $233 million corporate fund budget gap. The plan proposes only modest expenditure cuts. While raising taxes is politically unpopular and could limit the city's future flexibility, it views property taxes as one of the more predictable and reliable choices of revenues.

The 2016 proposed budget calls for $978 million in total pension contributions across all funds, compared with $550 million in 2015. The majority of the year-over-year increase is due to increased contributions to the police and fire pension plans.

Current state statutes call for a roughly $550 million increase in contributions to the police and fire plans in 2016 to achieve 90% funding by 2040.

In its budget, the city--perhaps optimistically--is relying on the state approving SB 777, which calls for a five-year step up to the actuarially required contribution, to the police and fire pensions, starting with $328 million in 2016 and ultimately reaching $792 million in the final year of the phase-in, with a goal to reach 90% funding by 2055.

Under the proposed budget, the majority of the increased police and fire contribution will be covered by $318 million of additional property taxes, and the enterprise funds are called on to contribute $10 million. Overall, the mayor has mapped in the budget a multi-year plan to raise property taxes to meet what the city expects will be the state-approved, phased-in approach to contributions to the police and fire pension plans.

The budget also assumes that the Illinois Supreme Court will uphold the city's changes made in the reformed municipal and laborers pension plans, which the Illinois Circuit Court previously struck down for being in violation of Illinois' constitution. The downside to this optimism is that pension contributions and liabilities may worsen, putting even more stress on the budget.

Although the phased-in approach (which is also found in the municipal and laborers pension plans) allows for larger contributions and is an improvement compared with the city's historic method of funding pensions, overall, this is still deferring payments because the contributions are less than the actuarial required amount and may show artificially positive outcomes.

Furthermore, it is possible that future market conditions might not match actuarial assumptions, which could negatively affect funding levels and create uncertainty around the viability of the city's pension solution.

With respect to the municipal and laborers' pension plans, the city budgeted increased contributions to these plans as required by current statutes, but it is possible that the benefit changes that accompany the increased contributions may not survive court challenge.

If a legal challenge to these accompanying benefit changes is successful the city's contributions to the municipal and laborers' pension plans would revert to the original, and lower, formula.

In the short-term, this would benefit the city's budget, but it would have negative ramifications because it would set the stage for greater budgetary pressure in the medium to long term as pension plan assets are depleted.

Additional credit concerns could be raised if the final 2016 budget does not fully address the increase to the city's police and fire pension plan contributions under either the hoped-for phased approach or the statutes as they currently are written.

Historically, the city council has made few changes to proposed budgets and has no recent history of adopting late budgets; however, the currently proposed budget is very different when it comes to the degree of tax increases embedded in it. The city levied about $840 million of property tax revenue to pay for pensions, debt service, and library operations in fiscal 2014, according to its audited financial statements. In the proposed budget, property taxes overall would increase to about $1.26 billion to accommodate the larger police and fire pension contributions.

The 2016 corporate fund budget is $3.63 billion, up from 2015's $3.5 billion.

Overall, the city's corporate fund revenue stream relies on a diverse array of tax revenue, as well as other fees and charges, but it does not include property tax revenue. Revenue enhancements in the corporate fund budget total $125.3 million, which is mostly on account of a new garbage fee and increased revenues from taxi and rideshare fees.

The corporate fund budget does not include service cuts; instead, the city has focused on lowering costs by about $118.2 million through efficiencies, such as: eliminating 150 vacant positions; savings from changes to retiree and employee health care; a zero-based approach in non-personnel portions of departmental budgets, which lowers expenses; savings from the extension of the grid-based system of garbage collection to street sweeping; and making further enhancements to the garbage collection system for additional cost savings.

The net result in the corporate fund is a balanced budget on a budgetary basis, which differs from generally accepted accounting principle accounting.

Within the corporate fund, the city's budget recognizes the prior year's surplus as an available resource to balance the budget. However, the city plans to increase the rainy day fund, which is held outside the corporate fund, by $5 million in 2016.

The rating agency expects the city to continue to address the structural cracks in its corporate fund budget, as exemplified by budget gaps, which the city forecasts will continue for the next two years, and to find additional solutions to manage its pension and debt obligations in a structural and sound way.
