Illinois Government Finance Officers Association

In partnership with the Illinois Municipal League

First Quarter Municipal Revenue Update

MFY 2017 REVISED AND MFY 2018

BY NATALIE DAVILA AND JOANNA KOH, KDM, INC.

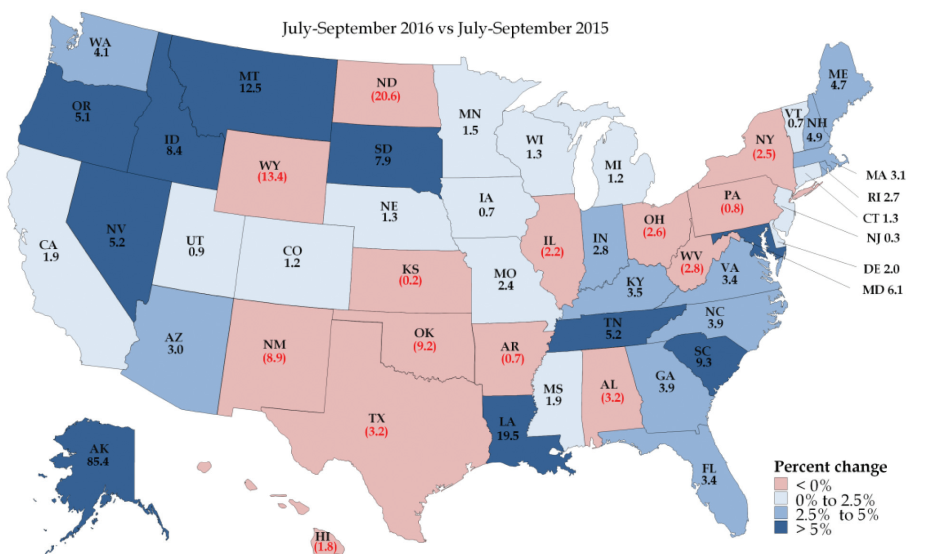
In this article, we update our January analysis based on recent revenue data and updates from the Illinois Department of Revenue (IDOR). Understanding what is happening with the Local Government Distributive Fund (LGDF) and Corporate Personal Property Replacement Tax (CPPRT) Fund continues to give us a headache largely because of evolving tax administration changes occurring at IDOR. While our underlying economic forecasts remain unchanged, we observe that major tax revenues remain weak. For this reason we include a summary of a recent report published by the Rockefeller Institute that analyzes trends in major revenue sources during 2016 and concludes that weak revenue performance is prevalent across the 50 states.[1]

STATE TAX REVENUE TRENDS

Illinois is not alone when it comes to poor state tax revenue performance. A report issued in March 2017 by the Rockefeller Institute suggests that recent state tax revenue from major sources has been weaker almost across the board compared with what would be expected at this point in the business cycle.[2] The authors suggest that recent state tax revenue weakness is being driven by several factors:

- Weakness in individual income tax is being caused by declines in estimated payments and final returns in the second, third and fourth quarters of 2016. The declines in estimated

FIGURE 1: STATE TAX COLLECTIONS: THIRD QUARTER OF 2016 COMPARED WITH THIRD QUARTER OF 2015



Source: Rockefeller Institute, Weak Tax Revenue Growth in the Third and Fourth Quarters of 2016 Amid Uncertainty About Federal Tax Changes, March 2017, page 5.

and final payments in the second quarter of 2016, when tax returns were filed, were likely caused by the weak stock market in 2015. After a weak start to 2016, the stock market rebounded in the second half of the year making the declines in estimated taxes in the third and fourth quarters a bit surprising.

- Outright declines in corporate income taxes are being experienced. State corporate income taxes on average declined 10.4% in the third quarter of 2016. Preliminary data for the fourth quarter of 2016 suggest corporate taxes declined once again, by 2.0%, marking the fifth consecutive quarterly decline.
- There has been substantial weakness in the sales tax, consistent with weak growth in taxable consumption. State sales tax revenue grew on average 2.0% in the third quarter of 2016, down from an average of 2.3% in the four previous quarters. Preliminary data for the fourth quarter indicate growth of only 1.7%.
- Due to declines in prices and production, most states with economies heavily concentrated in oil and mineral production had year-over-year declines in total state tax revenue in the third and fourth quarters of 2016.

Figure 1 below illustrates that Illinois is one of 14 states suffering an actual decline in revenues in Q3 2016 compared with Q3 2015. As a result of weak revenue performance, several states, including Illinois, have reduced their revenue forecasts for fiscal 2017 in the post-election period.

ILLINOIS SPECIFIC REVENUE ISSUES

In addition to generally weak state tax revenue collections, the split between Corporate Income Tax (CIT) and CPPRT along with monthly distribution patterns are being heavily impacted by the implementation of a new ledger system within IDOR. The emergence of these issues can be traced back to March 2016 when the IDOR switched to the new system. As part of the implementation process two issues were discovered, although not simultaneously. Below is a brief summary of our current understanding of these issues which have evolved over the last 12 months as part of ongoing meetings and conversations with IDOR staff.

1. When transitioning to the new system, IDOR staff made a determination that, over a two-year period, the old ledger system had over allocated an estimated $170 million to CPPRT that should have been deposited in Individual Income Tax (IIT). This issue was resolved prospectively beginning with April 2016 distributions.
2. A few months after the new system was implemented, it became clear that the ratio with which receipts were being allocated between CIT and CPPRT had fundamentally changed. After an extensive series of conversations with IDOR staff, the Illinois Municipal League (IML) discovered that the new system was allocating payments received in "real time" rather than in an estimated fashion. At a very high level, our understanding is that under the new system voucher payments are split between CIT and CPPRT based on specific business return data compared with the old system, which estimated the split and then reconciled in aggregate at the end of any given state fiscal

Distribution to Municipalities

	MFY 2015 ACTUAL	MFY 2016 ACTUAL	MFY 2017 ORIGINAL FORECAST (DECEMBER 2015)	MFY 2017 REVISED FORECAST (AUGUST 2016)	MFY 2017 REVISED FORECAST (DECEMBER 2016)	MFY 2017 REVISED FORECAST (APRIL 2017)	MFY 2018 FORECAST (DECEMBER 2016)	MFY 2018 REVISED FORECAST (APRIL 2017)
Income Tax (Per Capita)	$97.11	$106.78	$102.00	$102.50	$97.20	$95.22	$101.00	$99.50
State Use Tax (Per Capita)	$19.26	$23.02	$23.50	$23.50	$24.20	$24.20	$25.30	$25.30
Motor Fuel Tax (Per Capita)	$24.03	$25.63	$25.90	$25.90	$25.60	$25.60	$25.75	$25.75
Total Per Capita	$139.72	$155.43	$151.40	$151.90	$147.00	$145.02	$152.05	$150.55
CPPRT ($ thousand)	$1,372,283	$1,390,078	$1,426,600	$1,100,000	$1,300,000	$1,370,000	$1,225,000	$1,154,000

year. Our current understanding is that the initial allocation procedure established under the new ledger system changed in March 2017. This is discussed in more detail below.

The combined net effect of these two issues has been to exert downward pressure on LGDF and upward pressure on CPPRT.

FORECAST ASSUMPTIONS

The following analysis of MFY 2018 forecasts is based on sustained but moderate economic growth along with the following assumptions:

- All MFY 2018 allocations will be made in a timely manner.
- Income tax refund rates increase from 17.25% in SFY 2017 to 17.50% in SFY 2018 for Corporate Income Tax and Corporate Personal Property Replacement Taxes and decrease from 11.2% to 10% for Individual Income Tax.[3]
- LGDF will be paid to municipalities within 60 days of being vouchered.
- Based on information received from the IDOR, total business income taxes will be allocated: 52.26% to CIT, 38.42% to CPPRT, and 9.32% to Pass-Through Withholding tax.
- The ratio of estimated final payments from businesses received in March and April 2017 remains the same for 2018.
- CPPRT administration expenses are appropriated at $139.9 million.[4]
- Zero transfer from the Refund Fund to the CPPRT Fund in MFY 2018.
- No municipal government revenue fund sweeps occur during the forecast period.
- $70 million will be diverted from the CPPRT Fund in an allocation from the Administration and General Assembly to community colleges and K-12 during MFY 2018.[5]

CORPORATE PERSONAL PROPERTY REPLACEMENT TAXES (CPPRT)

We made our first MFY 2017 forecast in December 2015. In March 2016, IDOR identified $170 million in CPPRT overpayments that should have been deposited in IIT. In order to rectify past errors, it was eventually decided that the $170 million would be used to help finance Illinois community colleges, with $100 million being appropriated in SFY 2017 and the remaining $70 million to be appropriated in SFY 2018. This caused us to revise our MFY 2017 estimate in August 2016. Note that the original proposal by the administration had been to make downward adjustments for errors prior to April 2016 distributions over a two-year period starting with January 2017 disbursements. Once IDOR acknowledged this accounting error, they made adjustments to correct the formula going forward, beginning with April 2016 distributions.
Shortly after IML made its initial revised MFY 2017 estimates in August 2016, we reached out to IDOR to try to understand why CPPRT receipts for the first few months of SFY 2017 were extremely high relative to CIT receipts. We eventually learned that the method of distributing business income tax receipts changed with the implementation of the general ledger system in March 2016. This divergence was not apparent to the external observer for the first three months after the new system was up and running because IDOR was making significant monthly adjustments to address the over-allocation to CPPRT that they had identified when the new system was first being implemented. This caused us to revise our MFY 2017 estimate in December 2017. IML has been in regular communication with IDOR since we first observed this disparity, and our current understanding is that while the proportion of total Business Income Tax (BIT) receipts allocated to CPPRT should normalize in the next 12 months, we will have to wait until toward the end of SFY 2018 before we have clean information that will allow us to project monthly cash flow. Starting in March 2017, in order to allow for a more predictable cash flow, IDOR began allocating fixed percentages of BIT receipts to CIT, CPPRT and Pass-Through withholding and make adjustments quarterly, starting with April 2018 receipts, which will be distributed in MFY 2019.

Since December MFY 2017 CPPRT receipts have, inexplicably, continued to outperform expectations. Based on year-to-date revenue and appropriated expenditures from the CPPRT fund, we revise the MFY 2017 estimate upward from $1.3 million to $1.37 million. We develop our revised MFY 2018 CPPRT estimate based on information received last month from IDOR that going forward 38.42% of all business income tax receipts will be allocated to CPPRT. It is our current understanding that these estimates will be reconciled with actual return information on an annual basis, with the first reconciliation occurring at the end of March 2018. This reconciliation amount will then be applied to CPPRT's allocation of estimated payments received in April, June, September and December 2018. Based on this information from IDOR, along with CIT projections for the remainder of SFY 2017 and SFY 2018 from the Commission on Government Forecasting and Accountability (CGFA) and IDOR, we develop a revised MFY 2018 CPPRT tax estimate of $1.155 million, and a net estimate for CPPRT Fund available resources of $1.150 million. We acknowledge that this seems low given recent historic CPPRT Fund receipts. However, at this time, we feel that to be prudent we must take guidance from IDOR on how they will make allocations during MFY 2018.

LOCAL GOVERNMENT DISTRIBUTIVE FUND (LGDF)

As anticipated in our original estimate, underlying growth in non-withholding revenue has been weaker in MFY 2017 compared with MFY 2016. However, economic forecasts indicated that growth in individual income tax would be driven by increases in wages and salaries. While growth in wages and salaries has occurred, it has not translated into significant increases in associated tax revenue. Compounding this weakness has been the huge decline in CIT receipts. Our original forecast had assumed CIT revenue would decrease slightly in MFY 2017 compared with MFY 2016. It became apparent by December that CIT, in particular, was going to fall short of the forecast, causing us to revise our MFY 2017 downward. With receipts already in for MFY 2017, the IIT component decreased by 4.2% while the CIT component decreased by a whopping 40.1%. While March receipt data suggests that IIT is back on track, the same cannot be said for CIT. Economic conditions cannot explain such a huge decline.

The cumulative impact of these declines yields a MFY 2017 LGDF per capita of $95.22 (we should note that because of the way the over-allocation of CPPRT monies was corrected the estimated back payments of $2.00 per capita included in our initial estimate did not occur). Based on these significantly lower than anticipated LGDF revenues for MFY 2017, and the Administration and CGFA forecasts for SFY 2018, we revise our MFY 2018 estimate down from $101 to $99.50 per capita.

MUNICIPAL/COUNTY SHARE OF ILLINOIS USE TAX

MFY 2016 is the first full year where Amazon collected and remitted tax to the IDOR. As a result, we assumed that this growth rate would fall for MFY 2017 and MFY 2018. Driven by continued growth in online sales, we are on track to meet our revised MFY 2017 Use Tax per capita estimate of $24.20. Our MFY 2018 forecast of $25.30 per capita also remains unchanged.

MUNICIPAL SHARE OF MOTOR FUEL TAX (MFT)

With gas prices remaining within the forecast range, we are on track to meet our MFY 2017 MFT revised estimate of $25.60 per capita. Our MFY 2018 forecast of $25.75 per capita also remains unchanged.

[1] http://www.rockinst.org/pdf/government_finance/2017-03-27-By_numbers_brief_no7.pdf
[2] http://www.rockinst.org/pdf/government_finance/state_revenue_report/2017-03-09-srr_106.pdf
[3] 2018 refund rates are taken from the State of Illinois' 2018 Operating Budget
[4] The $139.3 million in administrative expenses can be found in the State of Illinois' 2018 Operating Budget
[5] This $70 million diversion can be found in the State of Illinois' 2018 Operating Budget

Natalie Davila and Joanna Koh have 50 years' combined experience in state and local government finance. KDM, Inc. specializes in state and local finance, fiscal policy and economic analysis.
Natalie is a public finance economist and can be contacted at ndavila@jdmichael.com.