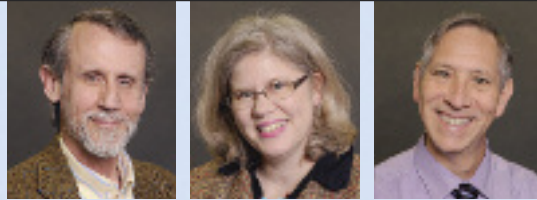


Peering Over Illinois' Fiscal Cliff: New Projections from IGPA's Fiscal Futures Model

*Editor's Note:
This article was originally published in October 2013 as part of IGPA's State Summit 2013: Illinois' Fiscal Cliff. It has been edited and updated for publication in The Illinois Report 2014. For the Fiscal Futures Project's latest projections and analysis, visit igpa.uillinois.edu/fiscalfutures.*



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Are we looking at a crisis or a chronic condition?

Illinois' fiscal situation has been precarious for at least a decade – and much longer if pension liabilities are considered. From FY 2003 to 2008, which were good years for economic activity and revenue collection, the General Assembly and governor approved budgets with spending well in excess of revenue. From that shaky starting point, the Great Recession of 2008 triggered several years of fiscal crisis for the state. It is reasonable to ask whether the situation can still be defined as a crisis, “an unstable condition...involving an impending abrupt or decisive change,”¹ but that would miss a more important point. It is clear that Illinois is still mired in a chronic condition that predates the recession and constrains government's ability to implement and administer policies. Illinois' fiscal condition contributes to economic and policy uncertainty for citizens, businesses, nonprofit organizations, and local government.

After the recession tipped the state from chronic shortfall to crisis, Illinois muddled through several years by taking on more debt, using one-time sources of revenue, paying bills late, and with substantial fiscal help from the federal government. By late 2010 it had become clear that major adjustments would be necessary to operate in a fiscally responsible manner. Faced with intense pressure

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to take some corrective action, the Illinois legislature and governor agreed on a package of fiscal policies in January 2011. The policies included temporary increases in the personal and corporate income tax rates and limits to General Funds spending.² In terms of revenue, the most important changes were the increase in the personal and corporate income tax rates. The income tax rates scheduled in the January 2011 law are:

Calendar Year	Pre-2011	2011-2014	2015-2024	Post-2024
Personal Rate	3.0%	5.0%	3.75%	3.25%
Corporate Rate	4.8%	7.0%	5.25%	4.8%

Since January 2011, Illinois has faced continued severe fiscal problems but has navigated annual budget challenges by making use of borrowing, one-time revenue, fund balance reductions, inter-fund transfers, and other short-term fixes.³ On some matters, in some years, the legislature has given the governor increased discretion to make budget cuts. Most government functions have continued to operate, there has been limited public outcry, and political leaders have, for the most part, retained their positions.

Despite the appearance of normalcy, Illinois' fiscal difficulties have had important and tangible negative effects. Perhaps the most visible has been the large backlog of unpaid bills (discussed below) that has greatly inconvenienced many vendors that supply the state government with goods and services. Another important effect has been a steady deterioration in the state's credit rating. Illinois now has

the lowest credit rating and highest borrowing costs of the 50 states. The "Illinois effect" on borrowing costs⁴ has also affected local governments. Illinois' state workforce has shrunk and many government tasks are performed more slowly, or less completely, than in the past.

In parallel with its chronic and nagging structural imbalance, the long-term challenges that Illinois faces due to its unfunded liabilities⁵ – particularly liabilities for pensions promised to teachers and state workers – have received heightened public and legislative attention. Largely due to many years of scheduled underfunding, Illinois accumulated unfunded pension obligations on the order of \$100 billion. Pension payments were scheduled to rise rapidly over the next several years, exacerbating an already difficult state financial situation. Even these escalating pension contributions were too small to keep Illinois' unfunded pension liabilities from growing over the next decade. The enactment of a two-tiered system with higher contributions from, and lower benefits to, employees hired starting in 2011 was a huge step, but is already factored into these projections.

In December 2013, important legislation dramatically revised Illinois' public pension systems. Should this legislation survive a constitutional challenge, unfunded liabilities will be reduced to zero in 25 years. Unfortunately, it did not solve the state's fiscal problems.

Since 2008, the Fiscal Futures Project has carefully tracked the state of Illinois' revenue and expenditures and developed an empirical model of the state budget.⁶ Using this historical budget data, information about past economic performance,

¹ The Free Dictionary <http://www.thefreedictionary.com/crisis>

² More detail on legislative actions are given at <http://igpa.uillinois.edu/IR12/pdfs/ILReport2012Ch4budgetW.pdf>.

³ See <http://igpa.uillinois.edu/IR13/chap02.php> for more details.

⁴ See: Luby and Moldogaziev, "The Scarlet Letter in the Municipal Bond Market: 'Unpacking' the Risk Premium on State of Illinois' Debt." Forthcoming.

⁵ For more details see *Report of the State Budget Crisis Task Force: Illinois Report*. 2012. <http://www.statebudgetcrisis.org/wp-content/images/2012-10-12-Illinois-Report-Final-2.pdf>.

⁶ For more details see <http://igpa.uillinois.edu/fiscalfutures>.

projections of future economic activity, and well-documented standard analytical techniques, we are able to calculate measures of Illinois' past fiscal health and are able to project its future fiscal performance under a variety of policy choices and economic conditions. We believe that it is crucial that public leaders and the general public understand the implications of the fiscal policy choices currently being discussed in Illinois, and here we use our model to analyze some of them. In particular, we calculate the baseline fiscal situation under current Illinois law – if the temporary tax increases expire as scheduled – and an alternative scenario, which assumes that the higher rates are made permanent.

Our looking glass: the structural gap in the consolidated funds budget

Assessments of Illinois' fiscal condition and changes in that condition can vary greatly depending on the frame of reference used to do the analyses, as we have documented elsewhere.⁷ In our analyses, we use a carefully chosen and consistent frame of reference that provides a realistic assessment of Illinois' fiscal situation. In particular, our Fiscal Futures Model uses a budget concept we call Consolidated Funds, which is much broader than the more commonly reported General Funds. The rationale is that with the broader measure, accounting changes or transfers between funds will not be confused with a real change in the state's revenue or expenditures.

Structural budget gap. The Illinois Constitution limits appropriations for the upcoming budget year to "funds estimated to be available," which is interpreted to include pre-existing account balances or new borrowing, in addition to projected tax collections, federal grants, and various fees. Our preferred measure of the state's fiscal condition is:

$$\text{Structural Budget Gap} = \text{Total Revenue} - \text{Total Spending}$$

where "total revenue" includes the annual flow of taxes, grants and fees but not the one-time use of

Starting from an estimated deficit of roughly \$1 billion in FY 2014, the state's fiscal situation is projected – under current law and estimated rates of growth in revenue and spending – to deteriorate steadily and reach a structural deficit of \$14 billion in FY 2025.

asset balances or new borrowing. This measure focuses on sustainable revenue and thus the underlying or structural fiscal situation.

Note that the gap can be either positive, zero or negative. A positive gap (revenue > spending) is called a structural surplus; a zero gap is called a structurally balanced budget; and a negative gap (revenue < spending) is called a structural deficit.

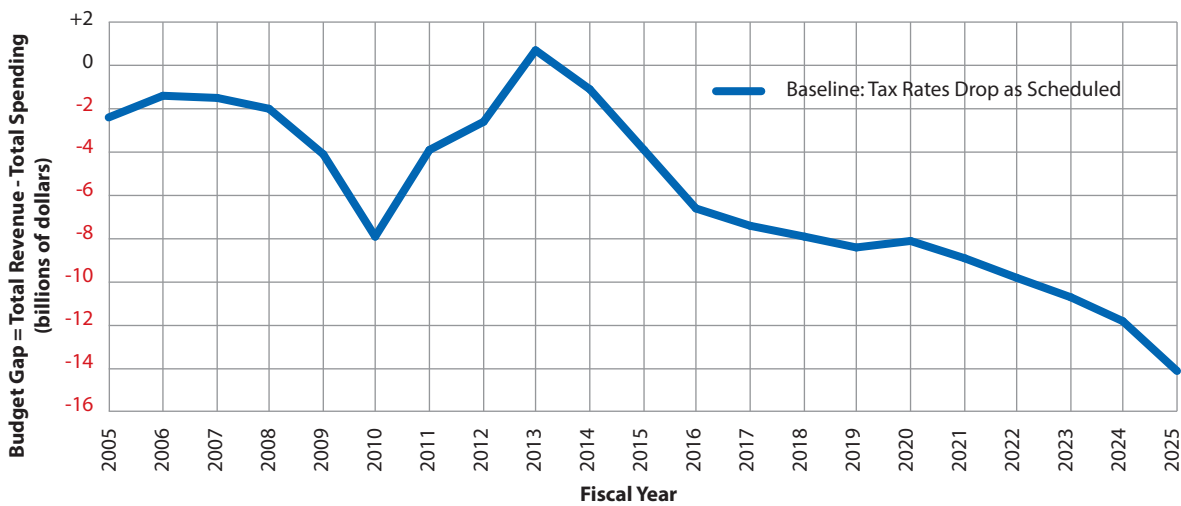
Baseline projections of Illinois' structural budget gap. Figure 1 presents projections of the structural gap in the

consolidated funds budget from the most recent version of the Fiscal Futures Model.⁸ Illinois had a structural gap of about -\$2 billion (a deficit of \$2 billion) in FY 2005 to 2008. With the nationwide crisis in financial, housing, and employment markets, the structural deficit grew to \$8 billion in FY 2010. The state's budget gap was less negative – the deficit was smaller – in FY 2011 and 2012. Preliminary figures for 2013 suggest a small positive gap or surplus in the Consolidated Funds budget (which, as is explained later, was used to reduce the backlog of unpaid bills from previous years).

Starting from an estimated deficit of roughly \$1 billion in FY 2014, the state's fiscal situation is projected – under current law and estimated rates of growth in revenue and spending – to deteriorate steadily and reach a structural deficit of \$14 billion in FY 2025. Each year, growth in revenue that is less than growth in spending adds \$1 billion or so to the deficit, and the scheduled decline in tax rates makes the declines from 2014-2016 and 2024-2025 even larger.

The Consolidated Funds budget gap does not capture the full extent of the state's fiscal problems. The baseline Fiscal Futures Model (Figure 1) projects a negative structural budget gap for each year from 2015 to 2025. These are projections of "would be" deficits with "current trends" or "current policy" which do not account for how a deficit in one year could affect the budget in following years. A deficit can be *avoided* with tax increases or spending cuts; or a deficit has to be *funded* with decreases in asset holdings or increases in liabilities (such as new debt).

Figure 1.
Illinois Consolidated Funds Structural Budget Gap FY 2005 to 2025



Source: IGPA's Fiscal Futures Project

Avoiding or funding a deficit affects the fiscal situation in future years. Higher taxes diminish the public's ability to pay in the future. Lower spending now could increase the need for services later. Decreases in financial asset holdings diminish investment income and reserves in the future. Failure to keep up with depreciation of infrastructure and government buildings means higher costs or lower services in the future. Explicit borrowing backed by bonds means a greater claim on future government revenue to pay contractual debt service. It also means higher interest rates. Borrowing by delaying payment to vendors raises costs to the state in the future as some suppliers are driven out of business and others become reluctant to do business with the state. Increases in unfunded pension or retiree health care liabilities are implicit forms of borrowing that represent a greater claim on future government revenue, thus crowding out the ability to pay for other things.

An ideal measure of the fiscal situation would combine the flow of current revenue and spending with changes in assets and changes in liabilities. Assets would include both financial accounts or holdings and physical assets properly adjusted to include depreciation or deterioration. Liabilities would include explicit borrowing and also implicit borrowing like the increases in unfunded pension promises that have contributed so much to the state's current situation.

⁷ For more information, please see work by The Fiscal Futures Project on transparency in budgeting: <http://igpa.uillinois.edu/system/files/Fiscal%20Futures%20Budget%20Transparency%20Report.pdf>

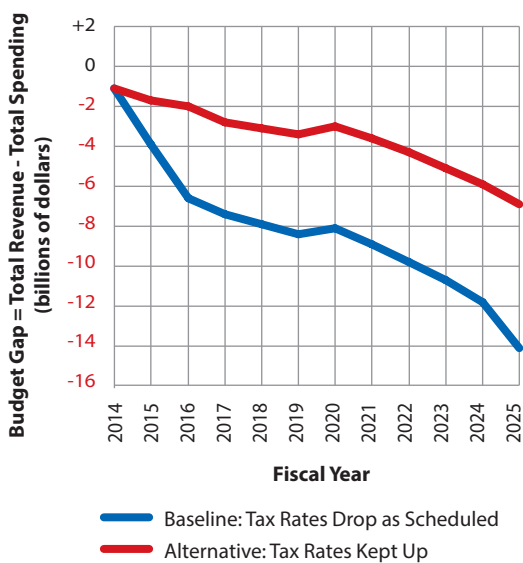
⁸ Please see *Fiscal Futures Project Documentation* (October 2013), http://igpa.uillinois.edu/system/files/fiscal_futures_documentation_21oct13.pdf for details on the model and citation of sources of data. The projections in Figures 1 and 2 do not include the impact of the December 2013 pension changes, but Figure 3 does.

On the fiscal cliff looking at the sunset of higher tax rates

The phase-out of the higher income tax rates is scheduled to begin January 1, 2015, which affects half of FY 2015. Figure 2 presents projections of the Fiscal Futures Model for 2014-2025 with two scenarios. The blue line repeats the baseline – current tax law – projections already presented in Figure 1. The red line presents an alternative scenario where the law is changed to keep the higher rates permanent (personal income tax rates remain at 5 percent and corporate tax rates remain at 7 percent).

Figure 2 illustrates that tax collections at the higher rate would be about \$5 billion more – the deficit would be about \$5 billion lower – each year for the FY 2016 to 2024 period. Maintaining the higher rates would also avoid another decline in revenue in FY 2025. Note, however, that even if the higher tax rates were made permanent, the budget gap will continue to worsen – going from -\$1 billion in 2014 to -\$7 billion in 2025. Higher tax rates alone will not solve the state’s structural fiscal problems.

Figure 2
Illinois Consolidated Funds Structural Budget Gap Projections to FY 2025 With and Without Phase-Out of Higher Income Tax Rates after 2014 and 2024



Source: IGPA's Fiscal Futures Project

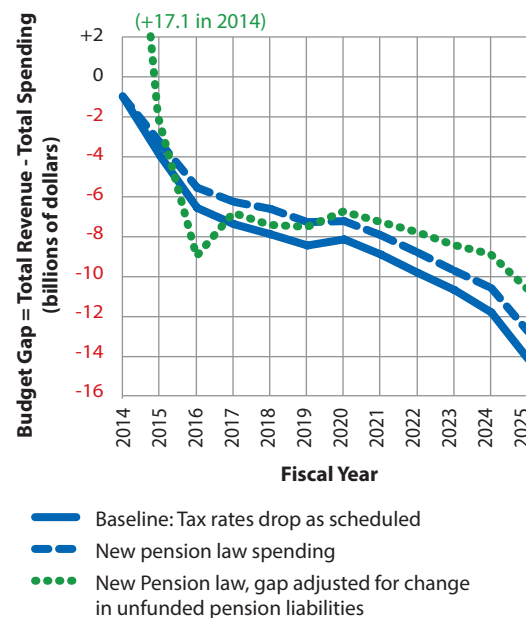
Pension payments and unfunded liabilities: before and after pension law changes

Prior to the December 2013 changes, the state of Illinois had unfunded pension liabilities on the order of \$100 billion and was scheduled to make large payments to the pension systems each year (growing from about \$7 billion in FY 2015 to \$17 billion in FY 2045). Should the pension law changes survive a constitutional challenge, the fiscal impact will be:⁹

- A large initial reduction in unfunded liabilities in the year of adoption;
- Elimination of the remaining unfunded liabilities over the next 25 years;
- A large reduction in payments by the state to the pension systems after 20 or 25 years;
- BUT, only a small reduction in scheduled payments over the next 10 years.

Figure 3 illustrates the last point. The solid blue line is the same baseline projection as in Figures 1 and 2.

Figure 3
Illinois Consolidated Funds Structural Budget Gap Projections to FY 2025 with (1) Baseline Gap, (2) New Pension Law Spending, (3) New Pension Law and Gap Adjusted for Change in Unfunded Pension Liabilities (With Existing Tax Law in All Cases)



Source: IGPA's Fiscal Futures Project

The dashed blue line shows the smaller gap due to the roughly \$1 billion annual reduction in scheduled pension spending under the new law for each of the next 10 years.

An alternative measure of the budget gap. Direct payments for salaries are clearly part of current spending. But an increase in IOUs for future pensions – either for new pension benefits earned by workers in the current year or by getting farther behind on funding benefits earned from past years of work – also represents a real cost to future taxpayers. Recognition of this new liability as part of the fiscal burden suggests an alternative measure of the budget gap:

$$\text{Alternative Budget Gap} = \text{Total Revenue} - \text{Total Spending} - \text{Change in Unfunded Pension Liability}$$

Official projections for pre-December 2013 pension law are that for the next 10 or more years unfunded pension liabilities will get \$2-3 billion larger each year.¹⁰ The dotted green line in Figure 3 shows the alternative budget gap with official projections of post-December 2013 pension payments and the change in unfunded liabilities. The large initial reduction in unfunded liabilities due to the December 2013 pension law changes results in a (literally off-the-chart) surplus of \$17.1 billion in FY 2014. From FY 2020 to FY 2025 there are additional reductions in unfunded liabilities ranging from \$0.5 billion to \$2.0 billion – seen as the smaller adjusted gap (dotted green line) compared to the cash gap (dashed blue line) for post-December 2013 pension rules.

⁹ For details and sources of information, see Dye, Richard F., Nancy Hudspeth and David Merriman, “Illinois Still Has Serious Fiscal Problems After December 2013 Pension Law Changes,” <http://igpa.uillinois.edu/system/files/Pension-Reform-Will-Not-Fix-Deficit.pdf>.

¹⁰ This case is not shown in Figure 3, but the alternative gap would \$2-3 billion larger than the cash gap represented by the solid blue line. See Dye, Richard F., Nancy Hudspeth and David Merriman, “Illinois Still Has Serious Fiscal Problems After December 2013 Pension Law Changes,” <http://igpa.uillinois.edu/system/files/Pension-Reform-Will-Not-Fix-Deficit.pdf>.

¹¹ Illinois Office of the Comptroller, *Comptroller’s Quarterly*, FY 2002-2007.

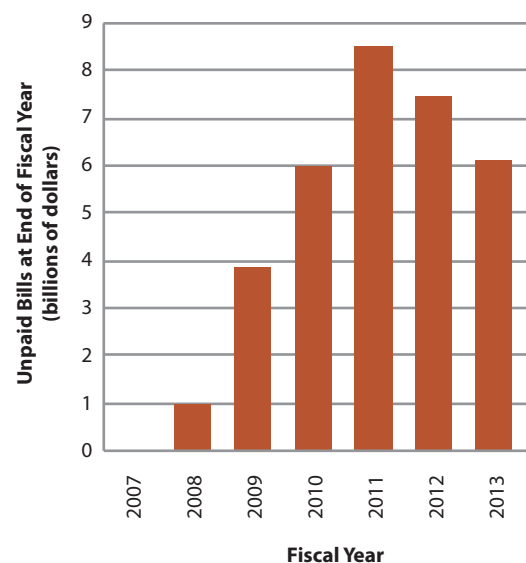
The projected cash budget gap for 2025 is \$13 billion with lower state contributions in the new pension law or \$11 billion if additional adjustment is made for pay-down of unfunded liabilities. Pension law revision is crucial for the state, but the recent pension law changes alone will not cure the state’s chronic fiscal imbalance.

Another cloud in the budget picture: year-to-year changes in unpaid bills

Increases in unpaid bills are an implicit form of borrowing, a way to finance a negative budget gap. Illinois was able to meet its obligations (other than pensions) through the early 2000s, but experienced a period of fiscal stress following the recession in 2001. The state ended FY 2003 with unpaid bills of \$900 million, but the backlog declined to zero by the end of FY 2007.¹¹

As the economy and tax collections slowed again at the start of the Great Recession, there was a surge of about \$1 billion in unpaid bills in FY 2008. Figure 4 shows the year-end backlog of unpaid bills (for

Figure 4
Unpaid Bills for All Funds (Not Just General Funds) from FY 2007 to FY 2013*



Source: IGPA's Fiscal Futures Project
* Illinois Office of the Comptroller, *Comptroller’s Quarterly*, FY 2007-2013. Does not include invoices held at agencies before warrants (authorizations to pay) are issued. 2008 is an estimate.

all funds, not just the General Funds) for FY 2007 to 2013. The increase in unpaid bills in each year from FY 2008 to 2011 allowed Illinois to finance part its negative budget gap – ranging from \$1 billion to \$3 billion – and to spend more than it was receiving in revenue.

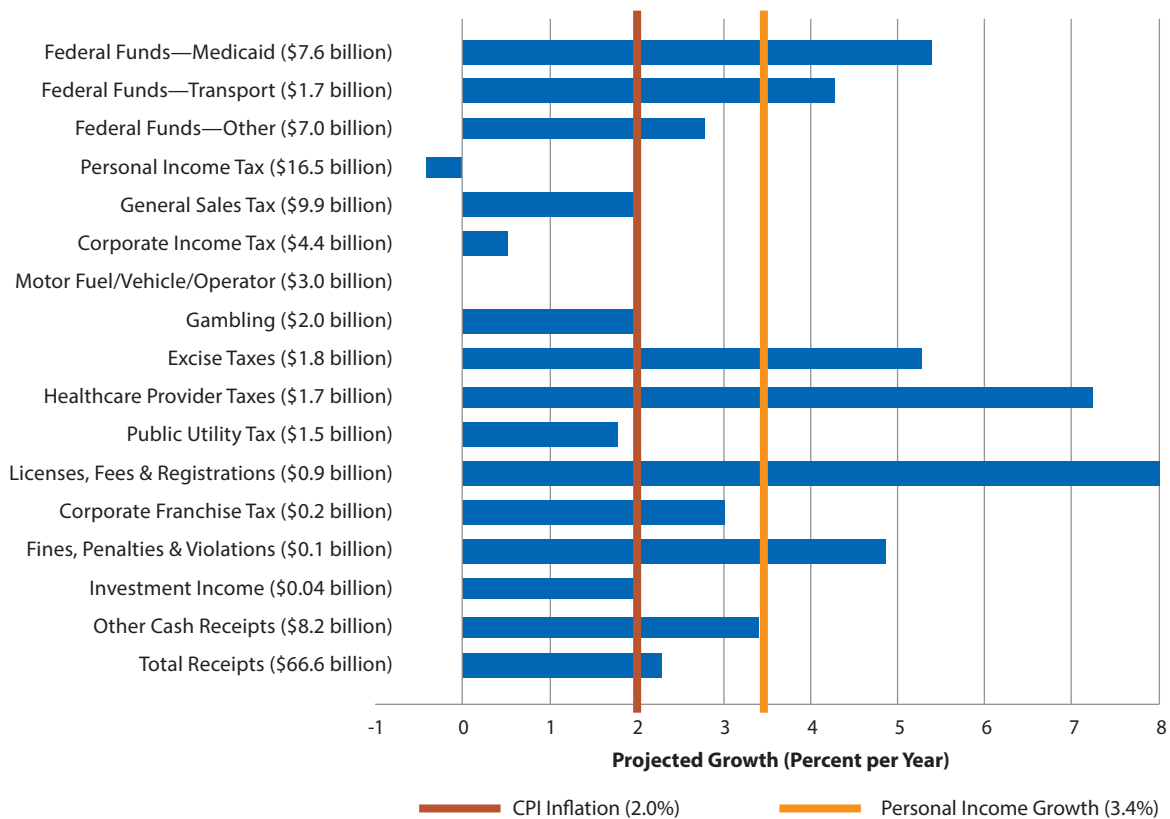
With the tax increase and spending cuts beginning in FY 2011, the backlog of unpaid bills *decreased* by \$1 billion from FY 2011 to 2012, and by another \$1.4 billion from FY 2012 to 2013. This improvement was possible only by running a surplus – by spending less than revenue – in the rest of the budget. This is also why the \$700 million Consolidated Funds budget surplus for FY 2013 shown in Figure 1 was not a reason to declare an end to Illinois’ long-running fiscal crisis. At the end of FY 2013 there were still \$6.1 billion in unpaid bills from previous years that must be paid from future revenue, thus crowding out future spending on other priorities.

Projections: growth in revenue and spending

Projected growth rates. In order to better understand the options that Illinois has to rectify its current and potential future fiscal imbalances, it is important to look at the forces driving government revenue and expenditures. We obtain our projections of Illinois’ future fiscal condition by projecting growth in 16 components of revenue and 17 components of spending. Each budget component has one or more variables (such as personal income growth, or demographic change) that drive our projection.¹² Projections of the state’s fiscal future are based on past statistical relationships between the driver variables and the budgetary components and the future paths of the driver variables.

Figure 5 shows our projections of the annual average nominal growth rates of revenue components from 2015 to 2025. We compare these growth rates

Figure 5
Projected Growth Rates by Revenue Category for FY 2015-2025



Source: IGPA's Fiscal Futures Project

to the projected rate of inflation (2 percent) and personal income growth (3.4 percent). Based on historical data and current law, we project that revenue from the personal income tax and public utility tax will grow more slowly than the CPI. Three of the revenue sources with the highest projected growth rates – federal funds for Medicaid, federal funds for transportation, and health care provider taxes – grow only because the model links them to a high-growing expenditure category.¹³ Only the relatively small revenue categories of excise taxes; licenses, fees and registrations; and fines, penalties, and violations are projected to grow more rapidly than personal income. Total receipts will grow just a little faster than inflation but considerably slower than personal income.

Figure 6 shows growth projections on the expenditure side. Based on historical data, we project that the large categories of Medicaid, elementary and secondary education, and transportation will grow

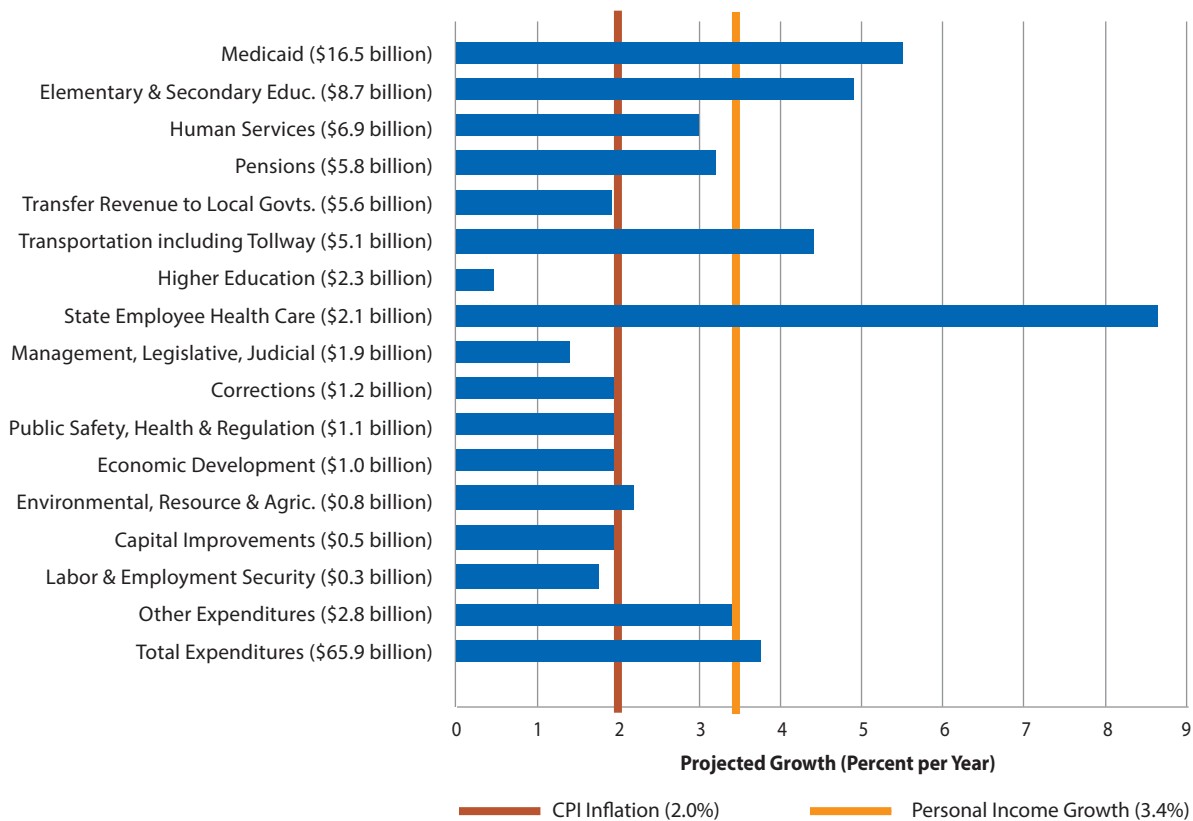
faster than personal income. State employee health care is currently a relatively small category but is projected to grow at the astonishingly rapid rate of more than 8 percent per year. Only four categories of spending are projected to grow more slowly than inflation. Together these slow-growing spending categories accounted for less spending than Medicaid. We project total expenditures to grow slightly faster than personal income.

The fiscal challenge facing Illinois is made clear by Figures 5 and 6. Almost two-thirds of Illinois'

¹² See Fiscal Futures Project Documentation, October 2013, http://igpa.uillinois.edu/system/files/fiscal_futures_documentation_21oct13.pdf for more detail.

¹³ Ibid.

Figure 6
Projected Growth Rates by Spending Category for FY 2015-2025



Source: IGPA's Fiscal Futures Project

revenue comes from federal funds, the personal income tax and the general sales tax. Of these, only federal funds are likely to grow as fast as personal income and, considering the fiscal pressures facing the federal government, that may not happen. In contrast, the largest components of spending (Medicaid and elementary and secondary education) are both likely to grow faster than personal income.

Sensitivity of budget gap projections to changes in revenue growth. Projections of the future growth of spending and revenue categories are based on projections of the highly uncertain future growth path of Illinois' economy. A better economy could mean both higher revenue from income and sales taxes, and slower growth in counter-cyclical expenditure components such as Medicaid and human services.

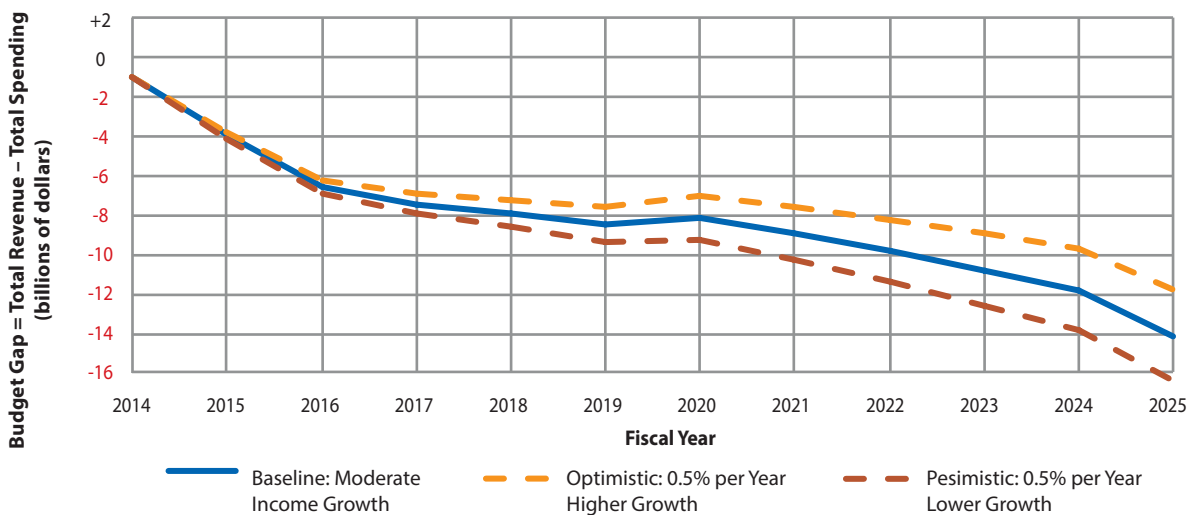
To explore this possibility, we projected both revenue and spending assuming that personal income grew one-half of 1 percent per year faster (or slower) than our baseline projections. One-half of 1 percent additional growth per year is quite optimistic from a baseline growth rate of only a little more than 3 percent per year.¹⁴ Unfortunately, our calculations suggest that even if Illinois' economy

performed better than our forecast there would be little improvement in its net fiscal situation compared to the baseline. The reason is that, based on historical experience as incorporated in our model, higher economic growth raises both revenue and spending by roughly the same amount, so the net impact on the projected budget gap (revenue minus spending) is small.

Perhaps the future could be different from the past. Illinois faces extreme fiscal challenges, and policy-makers might be able to restrain spending even if economic growth raised revenue. We altered our simulations to assume that baseline spending was unaffected, but that revenue was altered by changes in personal income. Figure 7 shows baseline results (the solid line) and optimistic (one-half percent additional growth in personal income) and pessimistic (one-half percent reduction growth in personal income) scenarios assuming baseline growth in expenditures. Even in the optimistic case presented here, Illinois'

¹⁴ Trustees of Social Security increase productivity by only 0.3 percent per year when running their optimistic scenario (<http://www.ssa.gov/OACT/tr/2013/tr2013.pdf>, Table V.B1).

Figure 7
Sensitivity of Consolidated Funds Structural Budget Gap Projections to One-Half of One Percent Per Year Higher or Lower Growth in Revenue Drivers (With Existing Tax Law and Pre-December 2013 Pension Law)



Source: IGPA's Fiscal Futures Project



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fiscal balance would improve only modestly – even after 10 years of compounding higher revenue growth. Instead of a \$14 billion deficit in 2025 we project a deficit of just under \$12 billion. This exercise illustrates the fact that Illinois has a chronic structural fiscal imbalance.

Another look: summary and conclusion

The use of Consolidated Funds improves our understanding of Illinois' fiscal picture because movements from General Funds to non-General Funds are not confused with real changes in the state's expenditures and revenue. The elimination of one-time revenue sources from the budget gap calculation improves our understanding of Illinois' fiscal condition because it focuses on spending relative to *sustainable* revenue.

The Fiscal Futures Model estimates a current structural budget gap of -\$4 billion and projects that under current law the gap will get progressively worse, reaching -\$14 billion by FY 2025 (Figure 1). Keeping income tax rates at their current levels, rather than letting them decline as scheduled, would raise only about half of the extra revenue that would be needed to eliminate the gap (Figure 2).

In addition to the large projected gaps between the annual flows of revenue and spending, the state began FY 2014 with short-term liabilities of \$6 billion

in unpaid bills, and in the longer term has to deal with unfunded pension liabilities on the order of \$100 billion. The December 2013 revisions to Illinois pension law will, if they survive a constitutional challenge, eliminate the unfunded liability, but it will take 25 years. The new pension law is projected to reduce state payments to the pension funds by only about \$1 billion each year over the next decade, which reduces the gap for FY 2025 to -\$12.4 billion. Pension changes are crucial to the state, but alone do not eliminate the structural imbalance.

Thus, it seems clear that Illinois' current revenue and spending policies are unsustainable. Illinois has a chronic, structural fiscal problem and must either take action to reduce spending, increase revenue, or some combination, to avoid facing fiscal imbalances for many years to come.

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