



## FISCAL PROJECTIONS

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

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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 revenues. 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,”<sup>1</sup> but that would miss a more important point. It is clear that Illinois is still mired in a chronic condition which 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 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.<sup>2</sup> 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	2011-14	2015-24	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.<sup>3</sup> 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 impacts. Perhaps the most visible impact has been the large backlog of unpaid bills (discussed below) that has greatly inconvenienced (or driven out of business) many vendors that supply the state government with goods and services.

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

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

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

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 costs<sup>4</sup> 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 liabilities<sup>5</sup>—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’ has accumulated unfunded pension obligations on the order of \$100 billion. Pension payments are scheduled to rise rapidly over the next several years, exacerbating an already difficult state financial situation. Even these escalating pension contributions are 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. Despite major legislative and gubernatorial efforts to further reduce unfunded liability and state contributions, there has been no action as of October 2013.

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.<sup>6</sup> Using this historical budget data, information about past economic performance, 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 in this paper 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

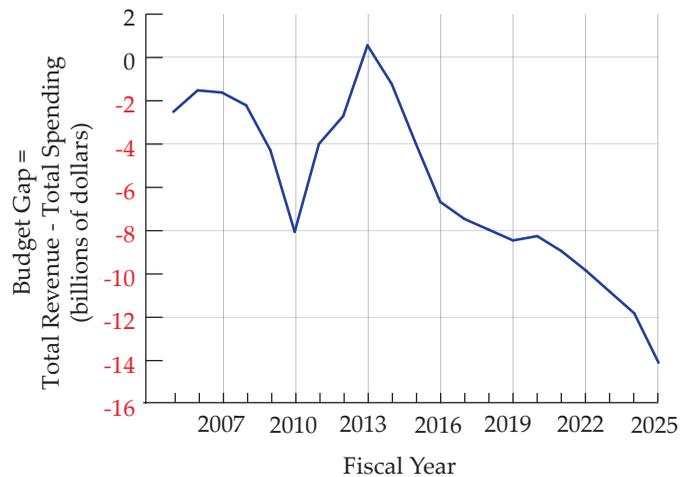
Assessments of Illinois’ fiscal condition and changes in that condition can vary greatly depending on the frame of reference used to do the analyses, as we have documented

<sup>4</sup>See: Luby and Moldogaziev, “The Scarlet Letter in the Municipal Bond Market: ‘Unpacking’ the Risk Premium on State of Illinois’ Debt.” Forthcoming.

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

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

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



elsewhere.<sup>7</sup> 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 revenues 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 asset balances or new borrowing*. This measure focuses on sustainable revenue and thus the underlying or structural fiscal situation.

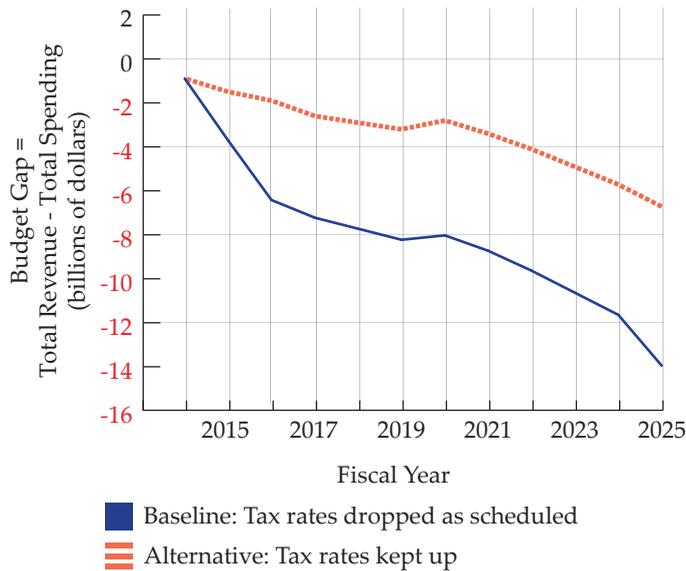
Note that the gap can be either positive, zero or negative. A positive gap (revenue > spending) is called a structural surplus; a zero gap is called a structurally balanced budget; and a negative gap (revenue < spending) is called a structural deficit.

### 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

<sup>7</sup>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>

**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**



of the Fiscal Futures Model.<sup>8</sup> 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 2013. 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 (i.e. a gap of -\$1 billion, Figure 1), 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).

<sup>8</sup>Please see *Fiscal Futures Project Documentation* (October 2013), [http://igpa.uillinois.edu/system/files/fiscal\\_futures\\_documentation\\_21oct13.pdf](http://igpa.uillinois.edu/system/files/fiscal_futures_documentation_21oct13.pdf) for details on the model and citation of sources of data.

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.

**ON THE FISCAL CLIFF LOOKING AT THE SUNSET OF HIGHER TAX RATES**

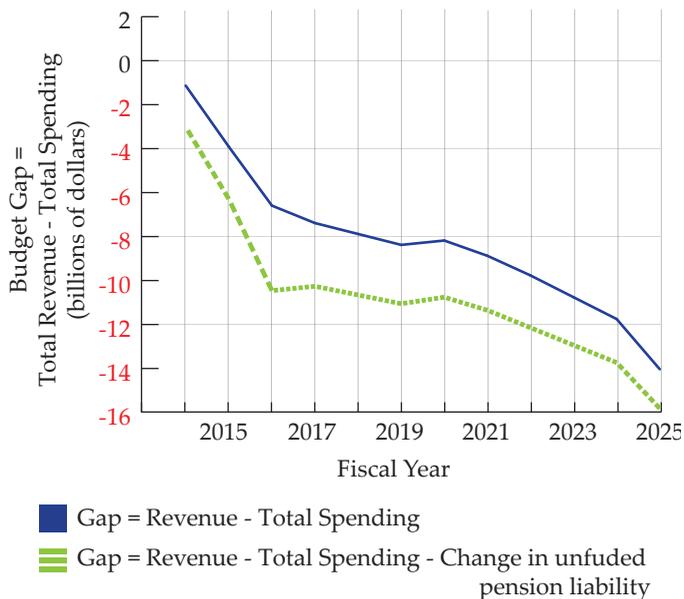
The phase-out of the higher income tax rates is scheduled to begin January 1, 2015, which affects half of FY 2015. Figure 2 presents projections of the Fiscal Futures Model for 2014-2025 with two scenarios. The blue line repeats the baseline—current tax law—projections already presented in Figure 1. The red line presents an alternative scenario where the law is changed to keep the higher rates permanent (personal income tax rates remain at 5.0 percent and corporate tax rates remain at 7.0 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.

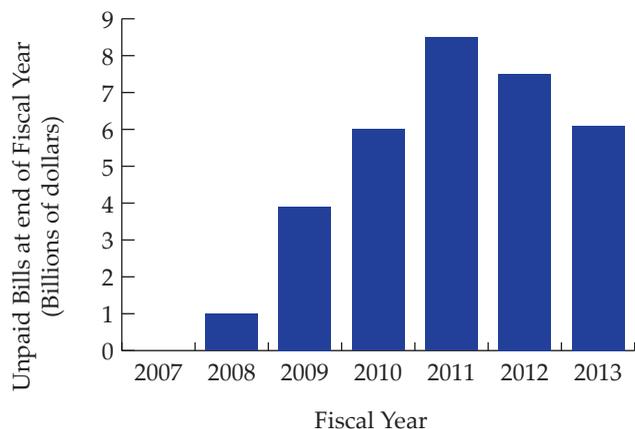
**UNFUNDED PENSION LIABILITIES: LOOKING BAD AND GETTING WORSE**

The state of Illinois has unfunded pension liabilities on the order of \$100 billion. Many people in the state have become aware of that fact, but fewer may know that under current law those unfunded liabilities are scheduled to grow each year for the next decade or so. Since the 2010 enactment

**Figure 3:** Illinois Consolidated Funds Structural Budget Gap Projections to FY 2025 With Budget Gap Defined in Two Ways: (1) Baseline and (2) Subtraction for New Unfunded Pension Liabilities



**Figure 4:** Unpaid bills for all funds (not just General Funds) from FY 2007 to FY 2013\*



\*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.

of a two-tier system for new hires, policies that would reduce the state's unfunded pension liability have not been adopted.

Figure 3 presents an alternative measure of the budget gap which includes the scheduled year-to-year growth in pension liabilities as part of spending. Direct payments for salaries are easy to count as 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.

The blue line in Figure 3 is the same baseline projection (current revenue – current spending) as in Figures 1 and 2. The green line subtracts \$2-3 billion per year in implicit spending on unfunded pension liabilities. This is the amount that official projections of the pension plans have calculated for the year-to-year change in unfunded liabilities under existing law.

We believe that the alternative (green) budget gap concept is a more meaningful measure of Illinois' structural fiscal situation. With current tax law, current pension law, and spending based on current levels and past growth patterns, Illinois has a deficit of \$3 billion in FY 2014 which is projected to grow to \$16 billion by 2025.

Pension reform could improve the state's fiscal situation through three separate channels:

- A large one-time reduction in unfunded liabilities due to the present value of reduced pension benefits in all future years;
- A reduction in explicit payments by the state to the pension systems each year;
- A decrease (or smaller increase) in unfunded pension liabilities each year.

Pension reform is crucial for the state, but pension reform alone will not cure the state's chronic fiscal imbalance.<sup>9</sup>

### LOOKING AT 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. The state of 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 \$0.9 billion, but the backlog declined to zero by the end of FY 2007.<sup>10</sup>

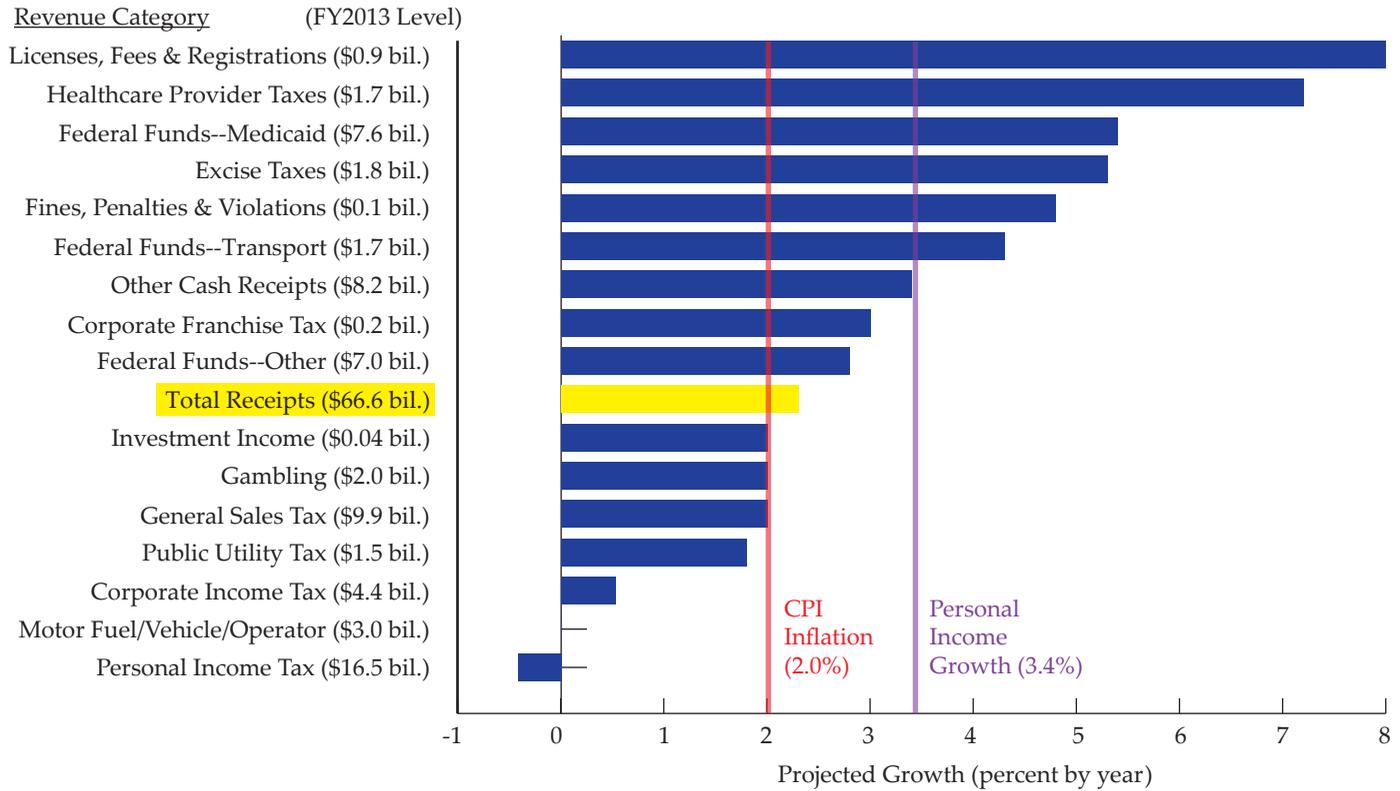
As the economy and tax collections slowed again at the start of the Great Recession, there was a surge of about \$1 billion in unpaid bills in FY 2008. Figure 4 shows the year-end backlog of unpaid bills (for all funds, not just the General Funds) for FY 2007 to 2013. The increase in unpaid bills in 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

<sup>9</sup>See our June 2013 analysis of recent proposals, <http://igpa.uillinois.edu/system/files/Comparing-SB1-and-SB2404.pdf>

<sup>10</sup>Illinois Office of the Comptroller, *Comptroller's Quarterly*, FY 2002-2007.

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



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 \$0.7 billion 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.

**LOOKING AT THE PROJECTIONS OF GROWTH IN REVENUE AND SPENDING**

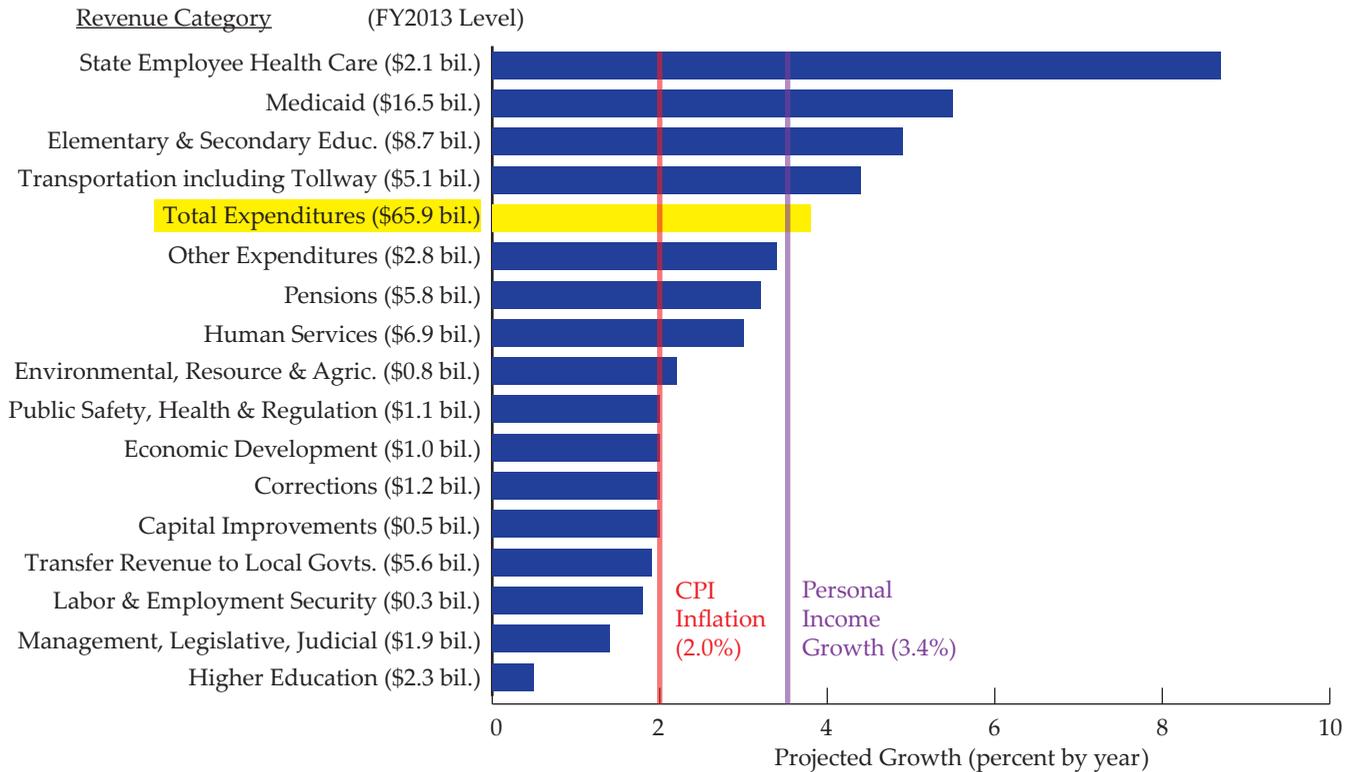
**Projected growth rates.** In order to better understand the options that Illinois has to rectify its current and potential future fiscal imbalances, it is important to look at the forces driving government revenue and expenditures. We obtain our projections of Illinois’ future fiscal condition by projecting 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.<sup>11</sup> 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 to the projected rate of inflation (2.0 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 (see *Fiscal Futures Project Documentation*, Table 1, 2013). Only the relatively small revenue categories of excise taxes; licenses, fees & 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 (see page 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.

<sup>11</sup>See *Fiscal Futures Project Documentation*, October 2013, [http://igpa.uillinois.edu/system/files/fiscal\\_futures\\_documentation\\_21oct13.pdf](http://igpa.uillinois.edu/system/files/fiscal_futures_documentation_21oct13.pdf) for more detail

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



The fiscal challenge facing Illinois is made clear by Figures 5 and 6. Almost two-thirds of Illinois’ 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 (or reduced) growth per year is quite optimistic from a baseline growth rate of only a little more than 3 percent per year.<sup>12</sup> 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 – spending) is small.

Perhaps the future could be different from the past. Illinois faces extreme fiscal challenges, and policymakers 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 (see page 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.

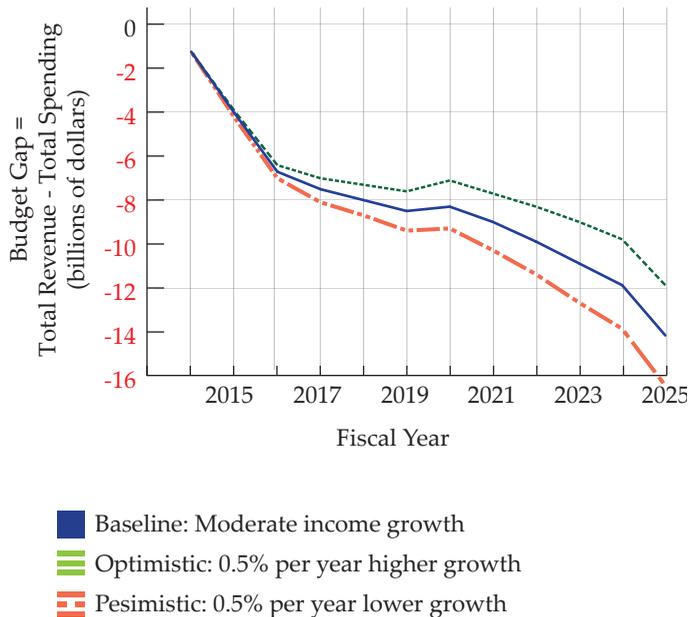
Even in the optimistic case presented here, Illinois’ fiscal balance would improve only modestly—even after 10 years of compounding higher revenue growth. Instead of a \$14 billion deficit in 2025 we project a deficit of just under \$12 billion. This exercise illustrates the fact that Illinois has a 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 to non-General Funds are not confused with real changes in the state’s expenditures and revenues. The

<sup>12</sup>Trustees of the 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**



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* revenues.

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).

A more meaningful picture of the state's fiscal plight is presented in Figure 3, which shows the extra \$2 billion to \$4 billion annual shortfall over the next decade if projected increases in unfunded pension liabilities are included. 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. 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. •



*The Fiscal Futures Project* began in 2008 out of concern that the state of Illinois lacked sufficient capacity to project its fiscal demands and revenue streams into the future. A longer term perspective is needed due to:

- The structural deficit: state expenditures have been growing faster than revenue
- The serious consequences of making policy choices while ignoring the impact on the budget in future years
- The relentless pressure on future budgets from an aging population and continuing increases in the cost of health care



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