Fiscal Fallout

No 5: The large tax increase just enacted falls short of closing the state's enormous budget gap

On January 11, 2011 the Illinois General Assembly imposed a large income tax increase, modest caps on spending growth, and approved borrowing to fund the FY 2011 pension payment:

- Retroactive to January 1, 2011, **personal income tax rate** goes from current 3.0% **to 5.0%** through 2014, then to 3.75% through 2024, and 3.25% after that.
- **Corporate income tax rate** goes from current 4.8% **to 7.0%** through 2014, then to 5.25% through 2024, and back down to 4.8% after that.
- General Fund **spending growth capped at +2% per year** for next four fiscal years.
- **Borrow** $3.7 billion **for FY 2011 pension payment** and pay off that debt over eight years. Our simulations assume a 5% interest rate.

The Fiscal Futures Model uses a measure of the state budget that consolidates the more commonly reported General Funds with other state funds. This broader scope shows a more meaningful picture of the state's activities. With a consolidated funds budget, transfers from non-General to General Funds are not confused with new receipts; and switching spending from General to non-General funds is not seen as a cut. Also, by assuming that there is no future borrowing, the model removes another non-recurring receipt from the budget gap measure.

Figure 1 shows budget gap projections with and without the January 2011 policy changes. The baseline projection is a consolidated funds budget gap of $10.9 billion in FY 2011 that grows to $29.1 billion in FY 2022.[1] **The new policies significantly reduce—but do not eliminate—the projected budget gaps.** With the higher tax rates in place for the entire year, the projected deficit drops to $4.4 billion in FY 2012. But when the higher rates are phased out the deficit could be close to $10 billion in FY 2016.

Even with the new taxes and spending caps, the budgetary crisis in Illinois is worse than depicted in Figure 1. Here's why:

- As of December 31, 2010 the state had $6.5 billion in unpaid bills from the prior 2½ years. The backlog was not addressed in the new policies.
- Because the 2% growth cap is specified in terms of General Funds, it will still be possible to increase spending more than that by shifting expenditures to non-General funds.
- The projections assume only 2% growth in expenditures even after the cap expires.

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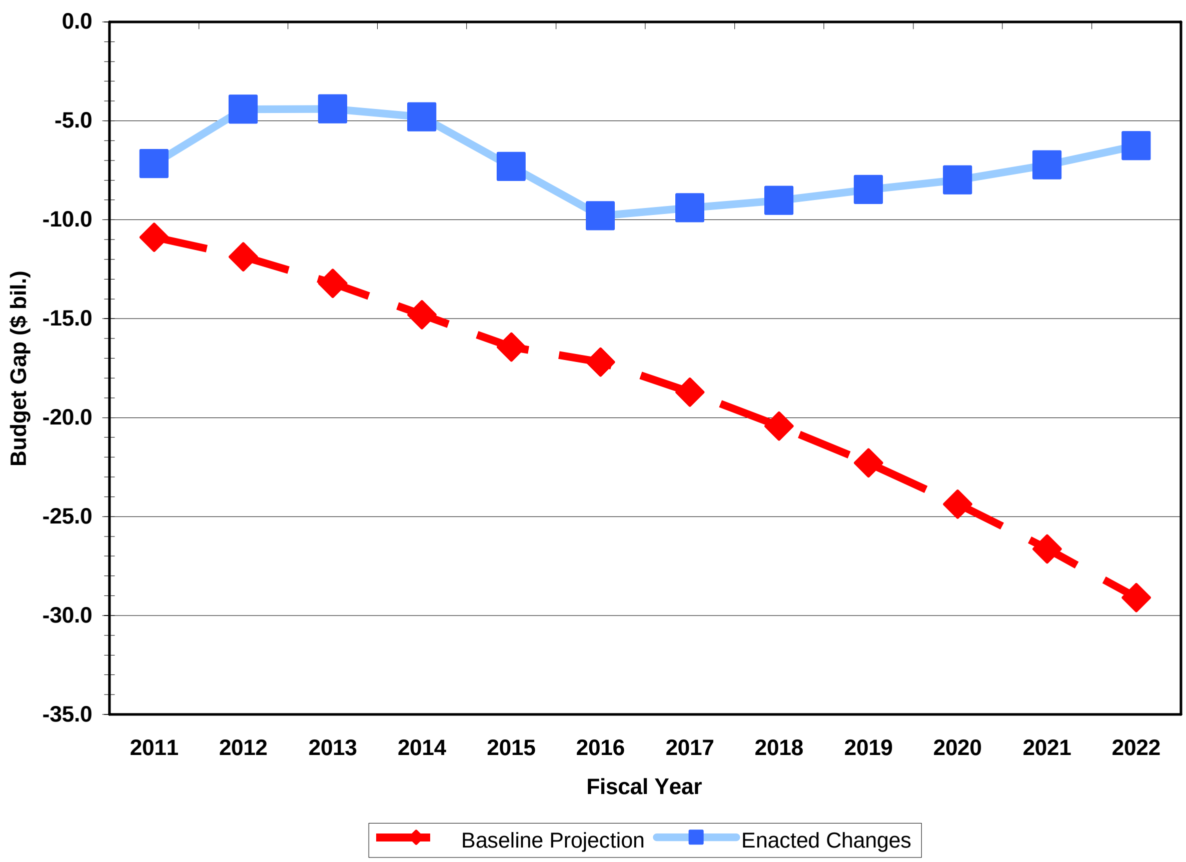
[1] Richard Dye, Nancy Hudspeth and David Merriman, "Titanic and Sinking: The Illinois Budget Disaster," *The Illinois Report 2011*, Institute of Government and Public Affairs, University of Illinois (forthcoming in February). The chapter is now available at http://igpa.uillinois.edu/IR11/Titanic-and-sinking.

The **Fiscal Fallout** series presents findings from IGPA's *Fiscal Futures Project*. The project is supported by a generous grant from the John D. and Catherine T. MacArthur Foundation. For more on the project and links to documents, please go to: http://igpa.uillinois.edu/content/fiscal-futures-project.

- Our calculations do not take account of pension liabilities that will be unfunded even if Illinois makes the statutorily required pension payments.
- The $5-10 billion gaps will have to be dealt with somehow, and
  - Longer payment backlogs will increase service costs as some venders cease to do business with the state, and others raise their prices to compensate for the delay.
  - New borrowing will mean new debt service obligations in future years.
  - Underfunding pension obligations even more than now will increase future gaps.
  - Revenue from the new tax rates might be lower than projected because businesses or workers could leave the state to avoid the higher Illinois burden.

The fiscal crisis in Illinois is far from over, even after the tax increases.

Figure 1: Projected Gap in Consolidated Budget with and without Enacted Changes



Source: IGPA Fiscal Futures Model, January 17, 2011.

Note: Assumes no additional borrowing or debt service other than existing and enacted amounts.

Disclaimer: IGPA's Fiscal Futures Model is a long-term trend projection model and is not designed to do short-term revenue forecasting. The Governor's Office of Management and Budget, the Illinois Department of Revenue, and the General Assembly's Commission on Government Forecasting and Accountability all have more detailed and more current information for short-term revenue forecasts.

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