



FISCAL PROJECTIONS

Apocalypse Now? The Consequences of Pay-Later Budgeting in Illinois: Updated Projections from IGPA's Fiscal Futures Model

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**"Illinois has been doing backflips on a high wire, without a net."
—Donald Boyd, Executive Director of the State Budget Crisis Task Force**

PAY-LATER BUDGETING is our term for Illinois' persistent practice of *spending more than the inflow of taxes and other sustainable revenue can cover*. Call it what you will—*spending more than we can afford; borrowing; putting it on the tab; kicking the can down the road; sending the bill to our kids; letting some future governor and General Assembly deal with it; ducking the check—it is the source of the state's fiscal problems.*

As we begin a new calendar year, the state of Illinois continues to be in ever-more-dire financial straits. This fiscal crisis is not new, of course. Indeed, four years ago, Illinois faced "the most dangerous fiscal conditions in modern history,"¹ prompting lawmakers to adopt a temporary tax increase. That tax increase was ratcheted back on January 1, 2015, well before the state's shaky finances were stabilized. As 2015 dawns, the state's fiscal situation is about to get dramatically worse.

While a number of factors have played a role in creating the ongoing fiscal crisis, the root of Illinois' problems is state government's long-established practice of **pay-later budgeting**. Over the years, Illinois has repeatedly avoided making the difficult decisions necessary for the state to live within its means, preferring temporary solutions and gimmicks over substantive, permanent, and prudent changes in taxes and spending. Continuously spending more money than comes in as revenue and pushing the bills farther and farther into the future is very risky behavior. In 2012, a national expert on state finance observed, "Illinois has been doing backflips on a high wire, without a net."² In 2015, the situation is more bleak, and the potential consequences for every person in Illinois more dire.

¹Illinois Comptroller Daniel W. Hynes. (January, 2010). Fiscal position continues downward slide. *Comptroller's Quarterly*. <http://www.ioc.state.il.us/index.cfm/resources/comptrollers-quarterly/edition-34-january-2010-fiscal-position-continues-downward-slide/>.

²Donald Boyd, Executive Director of the State Budget Crisis Task Force. (October, 2012). *Report of the State Budget Crisis Task Force: Illinois Report*. Retrieved February 19, 2014, from <http://www.statebudgetcrisis.org/wp-content/images/2012-10-12-Illinois-Report-Final-2.pdf> (Archived by WebCite® at <http://www.webcitation.org/6CS0WV10v>). [Dye, Hudspeth and Crosby wrote the report with Boyd.]

Deficits—spending more than sustainable revenue—are the core problem. Illinois has essentially been running deficits since the early 2000s, even during relatively good economic times. This practice of pay-later budgeting has put increasing pressure on the state’s ability to provide current services, because year after year, today’s revenue is paying for last year’s bills. Absent major policy changes, Illinois will continue to face huge deficits in the years ahead.

In this report, we present updated results from the *Fiscal Futures Model*, which projects Illinois’ revenue and spending policies into future budget years.³ Illinois has:

- Large and growing budget deficits: We project a \$9 billion deficit in the FY 2016 budget, escalating to a \$14 billion annual deficit by FY 2024, if no changes are made;
- Huge liabilities from past deficits: IOUs accumulated from past deficits are more than twice the revenue the state collects in one year.

What can Illinois do to avoid financial catastrophe? In this report, we present a number of available policy options. A combination of several of these options will almost certainly be necessary to solve the state’s serious fiscal troubles. Easy answers do not exist. All Illinoisans will feel the pain of these many years of fiscal imprudence, in fewer services from state government and in higher taxes.

THE YEAR IN REVIEW: TOUGH FISCAL CONDITIONS BUT NO TOUGH POLICY ACTIONS

Fiscal year 2014 and the beginning of FY 2015 have been a challenging time for the state of Illinois. In addition to temporary tax revenue phasing out, the state’s hard-won attempt to reform its public pension systems is at risk. In response to these problems—and further exacerbating them—the state’s credit rating has dropped and its cost of borrowing has increased.

³This is our seventh annual update of the Fiscal Futures Model used to analyze Illinois’ fiscal condition:

Dye, R. F., Hudspeth, N. W., & Merriman, D. F. (2014). *Peering Over Illinois’ Fiscal Cliff: New Projections from IGPA’s Fiscal Futures Model*. University of Illinois Institute of Government and Public Affairs. Available at http://igpa.uillinois.edu/system/files/IR2014D_PeeringOverIllinoisFiscalCliff.pdf;

Dye, R. F., Merriman, D. F., Hudspeth, N. W., & Crosby, A. (2013). And Miles to Go Before It’s Balanced: Illinois Still Faces Tough Budget Choices. *The Illinois Report 2013*. Available at http://igpa.uillinois.edu/IR13/pdfs/IR13_CH2c_Fiscal.pdf;

Dye, R. F., Hudspeth, N. W., & Merriman, D. F. (2012). Through a Dark Glass: Illinois’ Budget Picture is Dire and Distorted. *The Illinois Report 2012*. Available at <http://igpa.uillinois.edu/IR12/pdfs/ILReport2012Ch4budgetW.pdf>;

Dye, R. F., Hudspeth, N. W., & Merriman, D. F. (2011). Titanic and Sinking: The Illinois Budget Disaster. *The Illinois Report 2011*. Available at http://igpa.uillinois.edu/sites/default/files/ILBudget_IR-2011b.pdf;

Dye, R. F., Hudspeth, N. W., & McMillen, D. P. (2010). Fiscal Condition Critical: the Budget Crisis in Illinois. *The Illinois Report 2010*. Available at http://igpa.uillinois.edu/IR_2010/PDF/pg14-27z_FiscalCondition.pdf;

Dye, R. F., & McMillen, D. P. (2009). Illinois’ Fiscal Future and the State’s Economy. *The Illinois Report 2009*. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/IR09/text/ch2-fiscal.pdf>.

Sharp drop in tax revenue. Temporary income tax rate increases implemented in 2011 began their scheduled phase-out as of January 1, 2015 (see table below). Personal income taxes dropped from 5 percent to 3.75 percent, and corporate tax rates dropped from 7 percent to 5.25 percent. This rollback will cost the state roughly \$1.8 billion in FY 2015 and \$4 billion in FY 2016.

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%

Pension law changes at risk. Implementation of a law passed in late 2013 to improve the financial stability of the state pension systems, reduce the state’s annual contributions, and eventually eliminate the \$100+ billion unfunded pension liability is highly uncertain. Sangamon County Circuit Court Judge John Belz ruled in November 2014 that the pension reform law was unconstitutional, noting: “The state of Illinois made a constitutionally protected promise to its employees concerning their pension benefits. Under established and uncontroverted Illinois law, the state of Illinois cannot break this promise.”⁴ The constitutionality of the law is now before the Illinois State Supreme Court, but that court may have established a precedent when it struck down an attempt to reduce retiree health care benefits in July 2014.⁵

Bond ratings and borrowing costs at risk. In addition to—and because of—Illinois’ other fiscal problems, the state’s bond rating is also suffering. Illinois now has the lowest bond rating of any state in the nation. Lower ratings lead to higher borrowing costs. Worse, this rating may be headed even lower. In July 2014, *Standard and Poor’s* noted:

“If the pension reform is declared unconstitutional or invalid, or implementation is delayed and there is a continued lack of consensus and action among policymakers on the structural budget gaps and payables outstanding, we believe there could be a profound and negative effect on Illinois’ budgetary performance and liquidity over the next two years and that this could lead to a downgrade.”⁶

Lawmakers’ Response: Fiscal Backflips

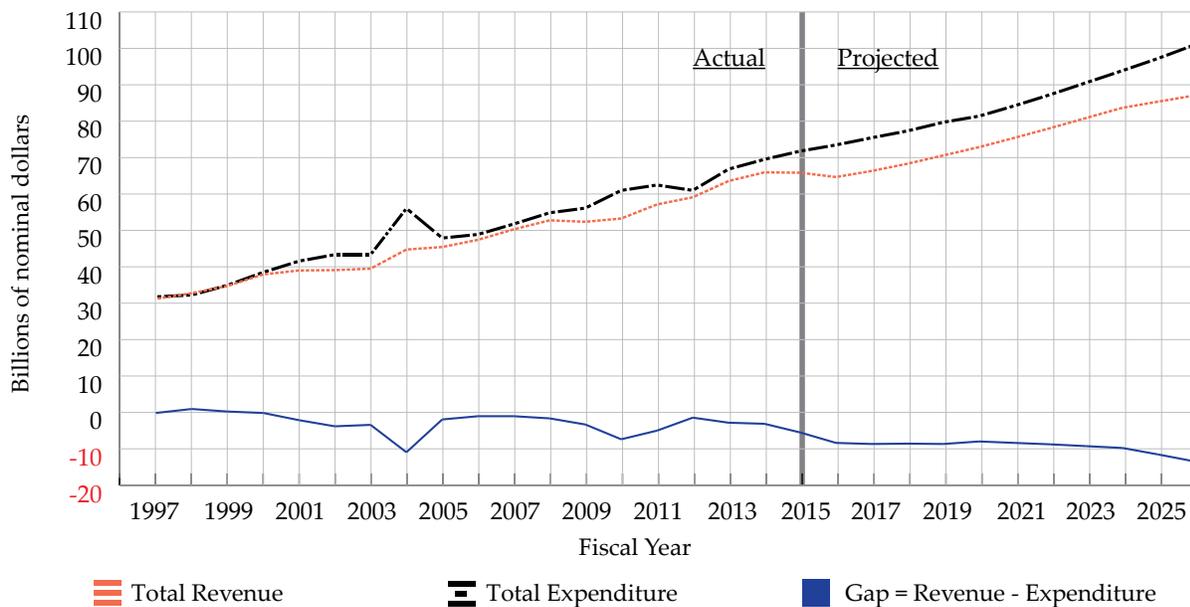
With the variety of financial challenges facing state government, lawmakers had a tall task in balancing the FY 2015 budget. Unfortunately, they did not rise to the occasion. Although then-Governor Quinn did propose making the higher income tax rates permanent,

⁴Merrion, P. (November 21, 2014). Illinois pension reform struck down. *Crain’s Chicago Business*. Retrieved from <http://www.chicagobusiness.com/article/20141121/NEWS02/141129953/illinois-pension-reform-struck-down>.

⁵Merrion, P. (November 21, 2014). Illinois pension reform struck down. *Crain’s Chicago Business*. Retrieved from <http://www.chicagobusiness.com/article/20141121/NEWS02/141129953/illinois-pension-reform-struck-down>.

⁶Reuters. (July 23, 2014). S&P puts negative outlook on Illinois credit rating. *Chicago Tribune*. Retrieved from <http://www.chicagotribune.com/business/breaking/chi-illinois-credit-rating-negative-outlook-20140723-story.html> [emphasis supplied].

Figure 1: Historical and Projected Totals for Illinois All-Funds Budget



Source: IGPA's *Fiscal Futures Model*, January 2015.

Notes: 1. Historical values for FY 1997 to 2014; estimates for FY 2015; projections for FY 2016 to 2026. 2. Total Revenue includes sustainable sources, and excludes borrowing or other one-time sources. 3. Budget Gap is defined as: Total Sustainable Revenue minus Total Spending.

the legislature did not do so, nor did lawmakers make sufficient cuts to state spending to align it with the reduced revenue estimates. Instead, lawmakers approved a budget for FY 2015 that offset the drop in tax revenue with several pay-later devices: fund-balance shifting (\$600 million), borrowing from special funds (\$650 million), and supplemental spending approved after the budget was enacted (\$237 million).⁷

Even though the FY 2015 budget did not make significant spending cuts, it provided insufficient funding for state agencies to maintain service levels, reportedly underfunding agencies by about \$470 million.⁸ Lawmakers have warned that thousands of state employees may need to be laid off.⁹ Given the mismatch between revenue and service-level costs, many analysts expect more delays in state payments to vendors and service providers, which will increase the amount of unpaid bills. Increases in unpaid bills—paying for today's spending with tomorrow's revenue—are another form of pay-later financing.

⁷Hudspeth, N. W. (2015). *The 2015 Budget in Review—What Happened?* University of Illinois Institute of Government and Public Affairs. Available at http://igpa.uillinois.edu/system/files/Hudspeth_2015_budget_in_review.pdf. State of Illinois Office of the Governor. (March 26, 2014). *State Budget: Fiscal Year 2015*. Retrieved January 8, 2015, from <https://www2.illinois.gov/gov/budget/Documents/Budget%20Book/FY%202015%20Budget%20Book/FY%202015%20Illinois%20Operating%20Budget%20Book.pdf>.

⁸The Civic Federation. (October 9, 2014). *State of Illinois Enacted FY2015 Budget: A Review of the Operating and Capital Budgets for the Current Fiscal Year*. Page 3. Retrieved January 8, 2015, from http://www.civicfed.org/sites/default/files/REPORT_StateofIllinoisEnactedBudgetFY2015.pdf.

⁹Finke, D. (June 4, 2014). House advances 2015 budget plan. *The State Journal-Register*. Retrieved from <http://www.sj-r.com/article/20140527/News/140529472>.

As bad as the budget for FY 2015 is, FY 2016 will be even more challenging, because it will represent a full year of reduced income tax revenue—an estimated drop of \$4 billion from FY 2014. And in future years, the shortfall between revenue and spending will continue to grow.

Below, we present projections of Illinois' deficit under current policy and examine the magnitude of alternative policies that would move Illinois toward fiscal sustainability.

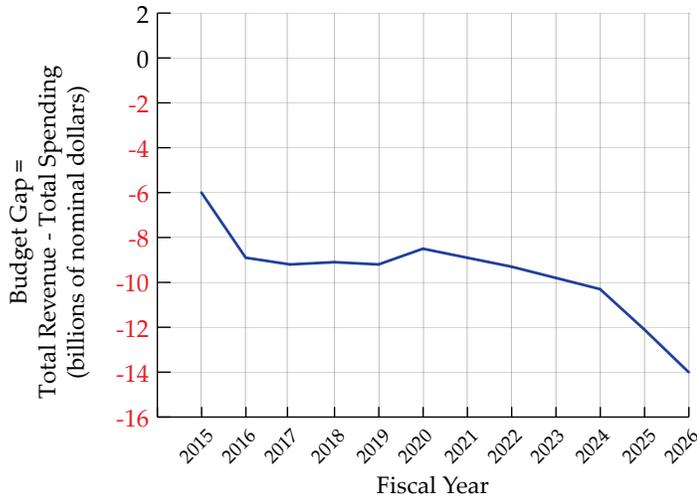
UPDATED ALL-FUNDS BUDGET PROJECTIONS FOR ILLINOIS FROM THE FISCAL FUTURES MODEL¹⁰

The *Fiscal Futures Model* has been developed over seven years with the objective of informing the public and policymakers about long-term fiscal concerns and budget transparency issues in the state of Illinois. The model has three essential elements:

- An “all-funds” measure of the Illinois state budget that is broadly comprehensive and consistently defined over time (as opposed to the more commonly reported General Funds budget);
- The capacity to project state spending and revenue streams into the future under current or alternative policies; and
- Attention to sustainable revenue streams, not one-time revenue sources like borrowing.

¹⁰For a detailed description of the model, see *Fiscal Futures Documentation January 2015* available at http://igpa.uillinois.edu/system/files/FF_Documentation_Jan_2015.pdf.

Figure 2: Illinois All-Funds Budget Gap Projections for FY 2015-2026



Source: IGPA’s *Fiscal Futures Model*, January 2015.
 Notes: 1. Estimates for FY 2015; projections for FY 2016 to 2026.
 2. Total Revenue includes sustainable sources, and excludes borrowing or other one-time sources. 3. Budget Gap is defined as: Total Sustainable Revenue minus Total Spending.

Figure 1 (page 3) shows total sustainable revenue, total spending, and the budget gap between them for the historical period FY 1997 to 2014, estimates for FY 2015, and model projections for FY 2016 to 2026. The budget gap is defined as:

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

A negative budget gap is a deficit and positive gap is a surplus.¹¹

Note from Figure 1 the generally increasing deficits since FY 2007, the large deficit in FY 2015, and the larger deficits after that. For FY 2016 the *Fiscal Futures Model* projects total sustainable revenue of \$65 billion, and total spending of \$74 billion, for a deficit (negative gap) of \$9 billion. Because the model projects greater growth in spending than revenue, the deficit will get larger over time, reaching \$14 billion in FY 2026.

Figure 2 shows the same information as Figure 1, but just for the projection period (FY 2015 to 2026) and just for the budget gap (not the totals from which the gap/deficit is calculated). Showing just the deficit allows changes to be seen more clearly.

These numerical projections illustrate what our analyses have shown for some years: **Illinois has a large structural budget deficit and, absent major policy changes, annual deficits will grow larger over time.** In the next section, we explore the consequences of continuing deficits by

¹¹For purposes of exposition, we will continue to use the commonly understood terms “deficit” and “larger deficits” rather than the more awkward “negative budget gap” and “more negative budget gap.”

enumerating the types and amounts of pay-later IOUs accumulated to date.

CROWDING OUT: THE COST OF PAY-LATER BUDGETING

Legacy Costs: Accumulated Liabilities From Financing Past Deficits

The stack of IOUs. The term “legacy costs” is sometimes used to describe obligations to pay for services purchased by the state in previous years. Figure 1 shows that the state of Illinois has run deficits in every fiscal year since 2001. A portion of these shortfalls were covered by asset sales and other one-time revenue sources, but most were covered by some form of borrowing. We look first at the total value of these legacy costs in Illinois, separated by type:

- **Pension obligation bonds.** Illinois issued bonds in FY 2003, 2010 and 2011 to cover scheduled contributions to its pension funds. At the end of FY 2015, the remaining principal on these bonds will be \$12.7 billion.
- **Unfunded liabilities for pensions.** As of the end of FY 2014, the state of Illinois’ five retirement systems had assets to cover only 42.9 percent of liabilities, leaving an unfunded liability of \$104.6 billion.¹²
- **Unfunded liabilities for retiree health costs.** As of the end of FY 2013, the state had unfunded liabilities for retiree health costs of \$34.5 billion.¹³
- **Short-term inter-fund borrowing in FY 2015.** Authorizing legislation for FY 2015 permits the General Funds to borrow \$650 million from other funds to be paid back within 18 months.¹⁴
- **Unpaid bills.** As of December 2014, unpaid bills for services already provided to the state totaled \$6.5 billion.¹⁵

The total value of these obligations to pay for past deficits is \$159 billion.

Pay-back of these IOUs affects annual budgets—how does the *Fiscal Futures Model* handle these? When a portion of these legacy-cost liabilities is paid off in a particular year, those payments will crowd out the capacity

¹²Commission on Government Forecasting and Accountability; Illinois General Assembly. (November, 2014). *Special Pension Briefing*. Table 2, p. 2. Retrieved January 8, 2015, from <http://cgfa.ilga.gov/Upload/1114%20SPECIAL%20PENSION%20BRIEFING.pdf>.

¹³State of Illinois Comptroller. (February 28, 2014). *Comprehensive Annual Financial Report: Fiscal Year Ended June 30, 2013*. Table 17-4, p. 143. Retrieved January 8, 2015, from <http://www.ioc.state.il.us/index.cfm/resources/reports/cafr/fy-2013/>.

¹⁴Illinois General Assembly. (n.d.). *30 ILCS 105/5k: Cash flow borrowing and general funds liquidity; FY15*. Retrieved January 8, 2015, from <http://www.ilga.gov/legislation/ilcs/documents/003001050K5k.htm>.

¹⁵The exact figure on December 9 was \$6,545,568,736. Topinka, J. B. (December 9, 2014). Illinois’ Bill Backlog 12/09/14. #ILbillbacklog pic. twitter.com/x1yM14eADR [Twitter.] Retrieved January 8, 2015, from <https://twitter.com/CompTopinka/status/542355755287191552> (Archived by WebCite® at <http://www.webcitation.org/6VB1P7UWL>). [Note that this was the last tweet from Illinois Comptroller Judy Baar Topinka before her December 10, 2014 death.]

to spend on other programs or priorities in that year. Some of the legacy costs detailed above have pay-off schedules and are included in the model projections, but others do not.

- **Pension obligation bonds.** Scheduled payments of principal and interest on pension obligation bonds of roughly \$1 billion each year until FY 2033 are included in model projections.
- **Unfunded liabilities for pensions.** Scheduled payments to the pension funds are included in model projections. This schedule takes 30 years to get the unfunded portion of pension fund liabilities down to 10 percent.¹⁶
- **Unfunded liabilities for retiree health costs.** Since no payments to reduce the liability are scheduled by the state, these costs are not included in the model.
- **Short-term inter-fund borrowing in FY 2015.** The model includes these costs by assuming that two-thirds of this borrowing will be paid back in FY 2016, one-third in FY 2017.
- **Unpaid bills.** Since no payments to reduce the liability are scheduled by the state, these costs are not included in the model.

The lack of a pay-off schedule can conceal, but does not change, the fact that legacy liabilities will crowd out other spending. In Appendix A, we simulate the magnitude of those “hidden” effects of past deficits by assuming pay-off schedules. Doing so increases the deficit by \$4 billion in FY 2016-2020 and by \$2 billion thereafter (see Figure A1 in Appendix A).

A second simulation in Appendix A looks at the cost of avoiding the tough choices now and continuing to borrow to pay for deficits in future years. The increase in crowding-out from the new borrowing costs is dramatic (see Figure A2 in Appendix A).

As our analysis shows, pay-later financing makes things worse going forward. Pay-back obligations compound over time and increasingly crowd-out the capacity to spend on other priorities in the future. Pay now or pay later, with interest. Have the pain now or have even more pain later.

TOUGH CHOICES AHEAD: HOW MUCH WOULD IT TAKE TO RESTORE FISCAL BALANCE IN ILLINOIS?

Fiscal year 2015 presents some immediate problems because authorized spending levels cannot be supported by the drop in post-tax-cut revenue flows. And in future years,

¹⁶Unfunded liabilities are pension fund liabilities for future benefits minus pension fund assets. The pension contribution schedule is based on a 1995 law that seeks to achieve a 90 percent funded ratio (assets/liabilities) by 2045, with payments “ramped up” over time. In the most recent projections for Illinois’ five state retirement systems, unfunded liabilities continue to get larger until 2029, then fall until 2045 when the target of 90 percent funded (i.e., 10 percent unfunded) is achieved. Commission on Government Forecasting and Accountability; Illinois General Assembly (November, 2014). *Special Pension Briefing*. Retrieved January 8, 2015, from <http://cgfa.ilga.gov/Upload/1114%20SPECIAL%20PENSION%20BRIEFING.pdf>.

even larger spending cuts or revenue increases will be needed to address the tendency for spending to grow more than revenue, as well as to deal with legacy costs. Thus, tough policy choices are ahead for Illinois.

Getting Through FY 2015

Large mid-year adjustments will be necessary to get through the remaining half of FY 2015. This will probably require some combination of all of the following: temporary revenue increases, temporary spending cuts (e.g., across the board cuts in multiple agencies), permanent spending cuts (e.g., elimination of programs), explicit short-term borrowing (e.g., inter-fund), implicit short-term borrowing (e.g., unpaid bills), explicit long-term borrowing (e.g., refinancing existing debt over more years), and implicit long-term borrowing (e.g., allowing unfunded retirement liabilities to increase).

In the next sections, we look at what it would take to address the underlying structural deficit. We examine the structural deficit using numbers from FY 2016 and later, because of FY 2015’s unique and short-term problems.

Eliminating the Deficit with New Revenue

First, how much is needed overall? Figure 2 shows a projected deficit of \$9 billion for FY 2016 to 2022, so we will use \$9 billion as a target for what must be done to address the state’s underlying fiscal problems. In this section, we compare revenue options to that target.

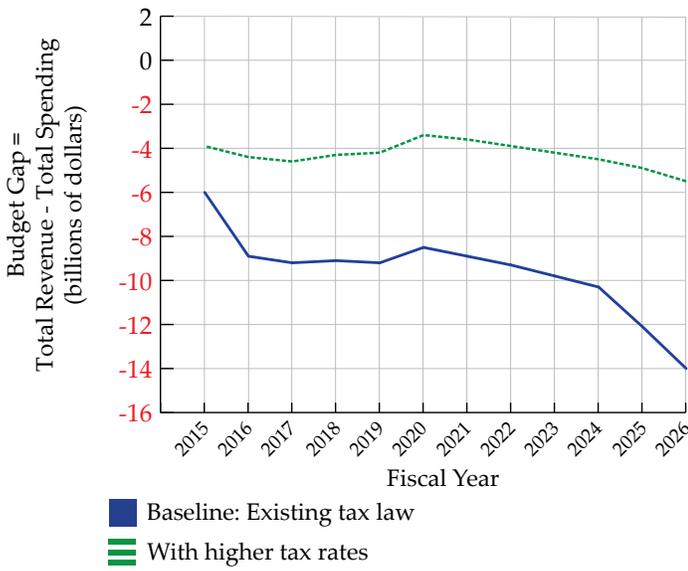
Illinois is projected to have total sustainable revenue in FY 2016 of \$65 billion, but a much smaller amount represents state-controlled revenue. If we eliminate federal grants, health provider fees (linked to Medicaid spending), and the portion of sales, income, and other taxes transferred back to local governments,¹⁷ the state’s own share of total revenue in FY 2016 is only \$36.3 billion. The \$9 billion deficit represents 25 percent of that revenue. Raising all of Illinois’ taxes and fees by 25 percent would be extremely difficult politically.

What about bringing back the 2011 tax increase? The largest single source of revenue for the state of Illinois is its income tax. One option for Illinois could be to make permanent the higher tax rates that were effective from 2011 until the end of 2014 (see table on page 2).

Figure 3 (page 6) compares the deficit that will exist under the baseline case of existing law (the solid line, identical to Figure 2) to the deficit that would exist if the higher personal and corporate rates were made permanent (shown with the dashed line). Maintaining the higher tax rates for the second half of FY 2015 would cut the projected deficit for FY 2015 from \$6 billion to around \$4 billion and would cut the projected deficit by a little more than half in FY 2016 through FY 2024. The deficit would be reduced by more than half in FY 2025 and 2026 when the second

¹⁷Transfers to local government are treated as spending in the model.

Figure 3: Illinois All-Funds Budget Gap Projections for FY 2015-2026 With Current Law and With the Higher Tax Rates of 2011-14 Made Permanent



Source: IGPA's *Fiscal Futures Model*, January 2015.

Notes: See text for assumptions for this scenario. Also see notes 1-3 to Figure 2.

round of rate cuts would have occurred (see the table on page 2). These large increases in income tax rates would have a significant effect, but would not be enough—by themselves—to eliminate the underlying deficit.

Tax policy changes of this magnitude also need to be evaluated carefully on criteria other than the amount of revenue raised. For example, Illinois' 5 percent personal rate placed a relatively high burden on lower income residents compared to other states¹⁸ and compared to high-income residents of Illinois (due to the flat rate structure). Also, the higher any tax rate is, the more it can be expected to discourage economic activity. With the exception of Iowa, Illinois' 2011 corporate tax rates were higher than those in neighboring states.¹⁹ As such, reinstating higher rates could be politically and economically challenging.

What about encouraging economic growth to raise sales and income tax collections? Raising the level of economic activity and employment in Illinois is extremely important for many reasons. Economic growth increases incomes and spending, which in turn increases income tax and sales tax revenue. This would reduce the state's fiscal

¹⁸Dye, R. F. (February 18, 2014). Tools to Address Revenue: Making the 2011 Tax Increase Permanent. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Dye-Keeping-the-Tax-Increase_web.pdf.

¹⁹Dye, R. F. (February 18, 2014). Tools to Address Revenue: Making the 2011 Tax Increase Permanent. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Dye-Keeping-the-Tax-Increase_web.pdf.

problems. But even rosy assumptions about economic growth in Illinois show that this will not even come close to eliminating the deficit. In a recent study, we found that an increase in the growth rate of personal income by an extra one-half percent every year for 10 years had only a modest effect on the projected deficit.²⁰

Additional cautions go with relying solely on policies targeted to encourage more economic activity to raise the revenue to eliminate the deficit. First, evidence is mixed as to the effectiveness of incentives in increasing business activity.²¹ Second, such policies usually involve some upfront cost to the state. So it is not clear whether business incentives will generate enough new money to pay back these costs, much less make a meaningful contribution to state revenue.

Other revenue-side options. Our objective in this section is to underscore the enormous magnitude of Illinois' fiscal problems. We do not propose specific, detailed solutions, nor do we present an exhaustive list of potential options. That said, here are few additional revenue-side options and references, a number of which are from The University of Illinois' Institute of Government and Public Affairs' recent *Illinois Budget Policy Toolbox* project. We provide revenue impacts where available.

- **The personal income tax.** The state has a number of options for changing the personal income tax, each with different effects.

–Eliminate special tax credits and subtractions.

Illinois could eliminate a number of tax credits currently available. One recent proposal that would eliminate most credits (except for the Earned Income Credit) would raise about \$2.7 billion per year.²²

–Tax retirement income. The Illinois Comptroller estimated that the state missed the opportunity to collect \$2.23 billion in FY 2013 by not taxing retirement income.²³

–Implement a graduated income tax structure. Amending the Illinois Constitution to permit a graduated or “progressive” rate structure is one possible approach to addressing the state's fiscal problems. The specific amount of revenue

²⁰Dye, R. F., Merriman, D. F., Hudspeth, N. W., & Crosby, A. (2013). And Miles to Go Before It's Balanced: Illinois Still Faces Tough Budget Choices. *Illinois Report 2013*. University of Illinois Institute of Government and Public Affairs. Available at http://igpa.uillinois.edu/IR13/pdfs/IR13_CH2c_Fiscal.pdf.

²¹Bartik, Timothy J. (1991). *Who Benefits From State and Local Economic Development Policies?* Kalamazoo, MI: W. E. Upjohn Institute for Employment Research.

²²McGuire, T. J. (February 19, 2014). Tools to Address Revenue: The Personal Income Tax. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/McGuire-Personal-Income-Tax-web.pdf>.

²³State of Illinois Comptroller. (2014, April). *Tax Expenditure Report: Fiscal Year 2013*. Retrieved January 8, 2015, from <http://www.ioc.state.il.us/index.cfm/resources/reports/tax-expenditure/fy-2013/>.

generated by this option would depend on rates and structure, but could be in the billions.²⁴

- **The sales tax.**

- Increase the sales tax rate.** Illinois could increase its sales tax rate using its current structure. However, among the 45 states that impose sales taxes, Illinois sales taxes are already above the midpoint.²⁵

- Increase the sales tax base.** Illinois currently taxes most goods, but it taxes relatively few services, especially compared to other states. A recent report estimated that expansion of sales taxation in Illinois to include services could generate an additional \$4 billion in revenue.²⁶

- **Alcohol and casino taxes.** Modest increases in the tax rates on alcohol and casinos would raise about \$150 million in annual revenue.²⁷

- **Business Taxes.** Although Illinois taxes businesses similarly to other states, there are options for changes. For example, Illinois could:²⁸

- Broaden the corporate tax base.** Illinois currently identifies \$319 million a year in tax expenditures (sometimes known as “loopholes”), and it could raise revenue by eliminating some or all of these expenditures.

- Create a new tax on business activity** (such as a gross receipts tax or value added tax). One proposal estimated that implementing a gross receipts tax could bring in \$7 billion in revenue. This revenue could be used to supplement or replace the Illinois corporate income tax.

- Create a new statewide property surtax on business.** Assuming a relatively small rate, this option could raise approximately \$1 billion a year.

- **The cigarette tax.** Increasing the cigarette tax by 50

cents could raise up to \$175 million per year.²⁹

- **Cap and trade** could create almost \$2 billion in annual revenue.³⁰

ELIMINATING THE DEFICIT WITH SPENDING CUTS: HOW MUCH? WHERE?

How much would need to be cut? What can and cannot be cut? Again, we use \$9 billion—the approximate size of the deficit projected for FY 2016 to 2022—as the target number for the size of the deficit that needs to be closed. Projected Total Spending in FY 2016 is \$74 billion, but not all types of spending should be, or can be, cut.

Debt service spending is a contractual obligation and cannot be cut without the state defaulting on its bonds. Scheduled payments to the pension funds should not be cut, because reducing these payments would increase unfunded liabilities. Furthermore, cuts in some types of spending will lead to corresponding cuts in matching revenue from the federal government. The *Fiscal Futures Model* includes offsetting adjustments for three types of revenue—federal Medicaid matching grants, healthcare provider assessments, and federal transportation matching grants.

Allowing for the revenue offsets included in the model, it would take across-the-board cuts of 19 percent in all spending (excluding debt service and pension) to close a \$9 billion deficit. It follows that if allowance could be made for the unknown amount of other spending that cannot be cut at the state’s discretion and the many smaller programs with revenue offsets, **it would take across-the-board cuts well in excess of 20 percent to eliminate the deficit.**

How about a spending freeze? According to the *Fiscal Futures Model*, total spending on an all-funds basis has grown by an average of 4.7 percent per year since 1997 and is projected to grow at an average of 3.2 percent per year for the next 10 years. If the state were able to freeze spending at FY 2015 levels, how many years would it take for revenue growth to match the total spending and eliminate the deficit?

We apply the *Fiscal Futures Model* to this question using the same assumptions about off-the-table spending (debt service and pensions) and revenue offset (for Medicaid and transportation) as the previous section. If nominal spending levels could be frozen (the growth rate held to zero) after

²⁴Center for Tax and Budget Accountability. (February, 2012). *The Case for Creating a Graduated Income Tax in Illinois*. Retrieved January 9, 2015, from http://www.ctbaonline.org/sites/default/files/reports/ctba.limeredstaging.com/node/add/repository-report/1385494205/R_2012.02_CTBA%20Graduated%20Income%20Tax%20FINAL%20Report%20Feb%202012.pdf.

²⁵Giertz, J. F. (February 18, 2014). Tools to Address Revenue: The Sales Tax. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Giertz-Sales-Tax-web.pdf>.

²⁶Commission on Government Forecasting and Accountability; Illinois General Assembly. (April, 2011). *Service Taxes: 2011 Update*. Retrieved January 8, 2015, from <http://cgfa.ilga.gov/upload/servicetaxes2011update.pdf>.

²⁷Reif, J., & Schneider, J. (February 18, 2014). Tools to Address Revenue: Alcohol and Casino Taxes. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Reif-Schneider-Alcohol-Gambling-Taxes-web.pdf>.

²⁸Merriman, D. F. (February 18, 2014). Tools to Address Revenue: Business Taxes. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Merriman-Business-Tax-web.pdf>.

²⁹Reif, J. (February 18, 2014). Tools to Address Revenue: The Cigarette Tax. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Reif-Cigarette-Tax-web.pdf>.

³⁰Fullerton, D., & Karney, D. H. (February 18, 2014). Tools to Address Revenue: A Permit Trading Program for Carbon Dioxide (Cap and Trade). *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Fullerton-Cap-And-Trade_web.pdf.

FY 2015, balance would be achieved in FY 2022. Asking the same question but allowing for inflation: If real spending levels could be frozen (the growth rate held to inflation) after FY 2015, balance would be achieved in FY 2034.³¹

Across-the-board cuts or freezes are a good way to understand the magnitude of the problem, but they are not feasible policy solutions. In the short-term, like in the middle of FY 2015, they may be expedient. But in the longer term, across-the-board cuts distort priorities about which functions are most essential, important, and cost-effective for the state.³² Structural balance should be achieved by cutting the lowest-priority programs first. But whose priorities should determine these cuts? And based on what information? Answering these questions is the political challenge.

APOCALYPSE NOW?

Illinois' fiscal problems are enormous and have been long in the making. For decades, the state has been spending billions of dollars more each year than could be supported by sustainable sources of revenue, and it has been borrowing to cover the deficit. Like a consumer living on a credit card, we have been spending beyond our means, pushing off the day of reckoning.

We characterize this practice as pay-later budgeting. As a result of this practice, the state's fiscal problems have gotten worse over time. The IOUs issued to pay for past deficits represent a large and growing claim on state resources. Each year, more of the state's revenue must be devoted to pay for past borrowing, leaving less available to spend on current priorities. The term for this brutal consequence is "crowding out."

³¹For more on achieving balance over time by changing the growth rate of spending, see: Winkel Jr., R. J. (February 18, 2014). Tools to Address Spending: Ameliorating Illinois' Structural Deficit by Bending the Cost Curve. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Winkle-Bend-the-curve-web.pdf> and Mooney, C. Z. (February 18, 2014). Tools to Address Spending: Across the Board Cuts. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Mooney-Across-the-board-cuts-web.pdf>.

³²Reports in IGPA's recent *Illinois Budget Toolbox* series examined cost savings in Higher Education, Medicaid, and Human Services: McMahon, W. W. (n.d.). Tools to Address Spending: Benefits and costs of state budget changes to higher education. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/McMahon-Higher-Education.pdf>; Lo Sasso, A. T. (February 25, 2014). Tools to Address Spending: Options for Health Care Policy. *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Lo-Sasso-Health-Care-web.pdf>; Powers, E.T. (February 28, 2014). Tools to Address Spending: Is it possible to make 'easy' cuts in human services by attacking waste, fraud and abuse? *The Illinois Budget Policy Toolbox*. University of Illinois Institute of Government and Public Affairs. Available at <http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/toolbox-budget/files/Powers-Human-Services-web.pdf>.

The *Fiscal Futures Model* projects a deficit—a shortfall in sustainable revenue—on the order of \$9 billion, or about 12 percent of all-funds spending of \$74 billion in FY 2016. Absent policy changes, the model projects that the deficit will grow over time and reach \$14 billion in FY 2026. To eliminate a deficit of this magnitude will require painfully large tax increases, painfully large spending cuts, or some combination thereof. As deficits have grown, so have the political difficulties with reaching solutions.

Borrowing to fund past deficits has taken many forms—unfunded retiree pension and health care costs, bond issues, increases in unpaid bills, shifting revenue from next year's budget, and more. The total accumulation of IOUs issued to pay for past deficits is \$159 billion. This is more than twice the flow of revenue in one year.

Pay-later budgeting has been perpetuated by a political willingness to ignore the fact that every dollar borrowed to pay the bills in one year must be paid back with interest, thus crowding out what the state can spend on other priorities in future years.

Illinois' fiscal problems are huge, structural, and escalating quickly. The state's deficits cannot be eliminated by quick, temporary fixes, or by waiting for the economy to grow. Solving Illinois' problems means that the state must use all the fiscal tools it has available. This means a combination of cuts in spending and increased revenue. These will be politically difficult and unpopular, and implementing them will require strong leadership and vision. Ultimately, to avoid a fiscal apocalypse, Illinois must create a long-range plan to dig itself out of the mess, and adhere to this plan for many years. Illinois' fiscal problems are looming so large that one single policy option will not be enough to offset decades of kicking the can down the road.

Digging out of our accumulated fiscal problems also requires changes in awareness and expectations. Being saddled with paying off IOUs for past years' bills means that Illinois' citizens must reduce their expectations for the services that they can expect from government and be prepared to pay more for government now and in the future. Decision makers need to understand—and act on—the fact that pay-later financing hurts the state's residents and businesses in future years. •

APPENDIX A

Estimating Crowding Out Effects Not Included in the Fiscal Futures Model

SIMULATION 1: EXISTING LIABILITIES WITHOUT PAYMENT SCHEDULES

Some of the legacy costs detailed above have pay-off schedules and are included in the deficit projections, but others do not. The lack of a pay-off schedule can conceal but does not change the fact that legacy liabilities will crowd out other spending. In order to illustrate the magnitude of those “hidden” effects of past deficits, we use the *Fiscal Futures Model* to simulate effects of specified pay-off schedules for the “hidden” liabilities. The liabilities and the assumed pay-off schedules are:

- **Unfunded liabilities for pensions.** The statutory pension payment schedule is calculated to achieve only 90 percent funding by 2045—not the 100 percent that would eliminate all unfunded liabilities. We calculate that to reduce unfunded pension liability to zero by the end of FY 2045 would require additional payments of \$309 million per year from FY 2016 to FY 2045.¹
- **Unfunded liabilities for retiree health costs.** To amortize this \$34.5 billion liability over the next 30 years at a 4.5 percent discount rate² would require payments of \$2.6 billion per year from FY 2016 to FY 2045.
- **Unpaid bills.** To eliminate the state’s \$6.5 billion in unpaid bills over the next five years would require payments of \$1.5 billion per year from FY 2016 to FY 2020.

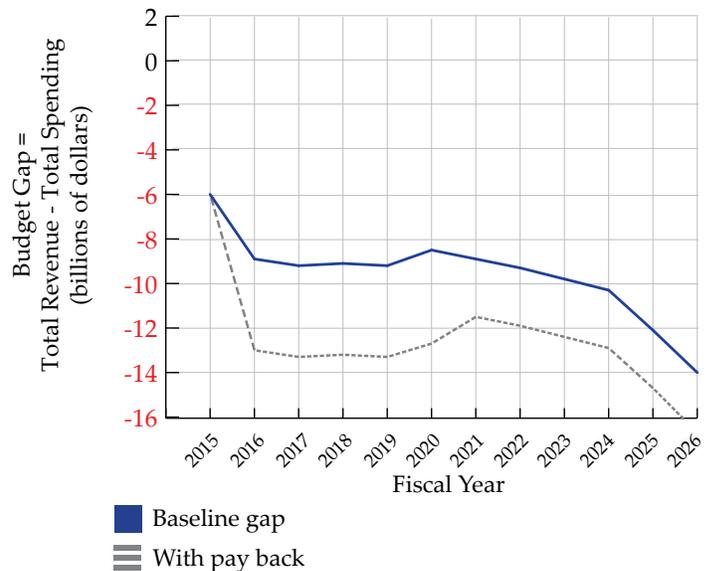
Figure A1 shows the result of adding these three payment schedules to the *Fiscal Futures Model*. The solid line represents the same “baseline” deficit shown in Figure 2. The dashed line shows with the larger deficit “with pay back” of the liabilities listed above.

The problems of dealing with a deficit of roughly \$9 billion per year over the next few years are enormous. How much more spending in the near-term would be crowded out by a \$13 billion per year deficit? Remember that while the timing and amount of the extra payments in this illustration are hypothetical, the liabilities they represent are not.

¹Separate calculations for each of the state’s five retirement systems start with the unfunded liability remaining in 2045 with the existing payment schedule, use the system’s own assumed rate of return as a discount rate, with level payments amortized over 30 years.

²The State of Illinois uses 4.5 percent rate of return as the discount rate to calculate OPEB liabilities. State of Illinois Comptroller (February 28, 2014). *Comprehensive Annual Financial Report: Fiscal Year Ended June 30, 2013*. Table 17-5, p. 144. Retrieved January 8, 2015, from <http://www.ioc.state.il.us/index.cfm/resources/reports/cafr/fy-2013/>.

Figure A1: Illinois All-Funds Budget Gap Projections for FY 2015-2026 With Extra Payments to Amortize Unfunded Retirement Liabilities and Unpaid Bills Included



Source: IGPA’s *Fiscal Futures Model*, January 2015.
 Notes: See text for assumed amortization schedules. Also see notes 1-3 to Figure 2.

SIMULATION 2: BORROWING TO PAY FOR FUTURE DEFICITS

This example is constructed to illustrate the consequences of continually avoiding the tough policy choices necessary to eliminate the mismatch between spending and revenue; and to quantify the amount of crowding out that would result from borrowing to cover deficits. Suppose that the state experiences the deficits projected by the model for FY 2016 and beyond. Noting that this example is meant to be hypothetical, assume:

- The state is able to issue new bonds to cover each year’s deficit plus debt service costs without enacting revenue increases or cutting overall spending.
- New bonds have an interest rate of 5 percent; cost of issuance of \$5 per \$1,000 is included in the amount borrowed; bonds have level principal payments and a 25 year maturity.³

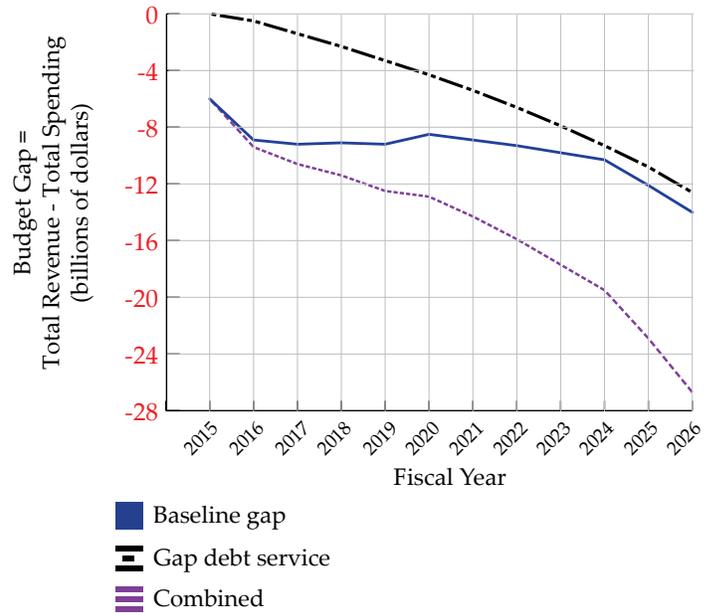
³The interest rate is slightly higher, but the other terms are very similar what is shown in bond sale disclosures for recent issues: <https://www2.illinois.gov/gov/budget/Pages/BondSaleDisclosures.aspx>.

- Neither laws nor lenders limit the total amount of debt and the interest rate does not go up as the state borrows more and more.

Figure A2 shows the result of this “borrow to eliminate the deficit” scenario. The solid line is the same baseline deficit projected by the *Fiscal Future Model* shown in Figures 1-3. The dot-dashed line represents the compounding debt service costs: in 2016 the state pays \$0.5 billion to service bonds from the 2015 deficit; in each successive year, service costs increase to cover the deficit and service costs from an additional year. The dashed line shows the baseline deficit plus the debt service in each year.

Because of the “without reducing overall spending” assumption, the debt service obligation (dot-dashed black line) also represents the amount of other (non-debt service) spending that must be crowded out of the same overall total. For example, in FY 2024 the debt service costs reach \$9 billion, so other spending must be reduced by that amount. •

Figure A2: Illinois All-Funds Budget Gap Projections for FY 2015-2026 With Debt-Service Costs for “Borrow the Gap” Bonds Included



Source: IGPA’s *Fiscal Futures Model*, January 2015.
 Notes: See text for assumptions for this scenario. Also see notes 1-3 to Figure 2.



The Fiscal Futures Project is dedicated to informing the public and policymakers about state budget transparency and long-term budget concerns. Three central elements are:

- The creation and maintenance of a comprehensive and consistently defined measure of the Illinois state budget.
- The capacity to project Illinois state spending and revenue streams into the future under current or alternative policies.
- The comparison of budget transparency issues across states—a search for best practices.

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