Illinois' Fiscal Future

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Illinois' Fiscal Future: Fundamental Issues Facing Illinois

By David F. Merriman

Calling the negotiations over Illinois' fiscal 2008 budget contentious is a bit like saying it is chilly at the Arctic Circle. The legislature went into a record overtime before passing a budget, the governor used his line item veto to negate almost $500 million of spending and many budgetary issues remained unresolved well into the fiscal year. The intense budget battles of 2007 provided some fascinating insights into the tactics, ideology and psychology of major political players, but did not shed much light on the major fiscal challenges facing the state. Let's step back from the political fray and examine some fundamental fiscal issues facing Illinois.

The Fundamental Issues

Any state's fiscal plan must answer two basic questions: What should the state spend? And how should the state raise the revenue necessary to support this spending?

Fundamentally, spending for state services ought to be determined by comparing the benefit from the spending to the cost of raising the necessary revenue. This can be difficult to do because benefits are often difficult to quantify. For example, a program designed to subsidize health insurance for low-income children has direct beneficiaries (the families who receive the insurance subsidies) and indirect beneficiaries (doctors and hospitals) for whom benefits may be relatively easy to quantify. But it also has more remote beneficiaries, such as those who feel more secure because the program exists, or high-income families who feel comforted by knowing that children in poor families get necessary care. Because the goods and services derived from government programs often are not available in private markets, these benefits can be difficult to value. Also, people who benefit from government spending are rarely the same people who bear the revenue-raising burden. It would serve little purpose to force the most direct beneficiaries (e.g., the families of poor children) to pay because it would solve one problem (no health insurance) by creating another (even less money available to buy basic necessities). Political rhetoric aside, it is rarely true that "everyone will benefit." In particular, any government program that subsidizes the purchases of some must fund the subsidies with higher taxes or reduced spending elsewhere. While analyses can help to quantify the trade-off, decision makers must weigh the costs to some individuals against the benefits to others.

On the spending side, states ought to use whatever revenue-raising vehicle imposes the least burden on taxpayers. Economic principles argue for taxes that are neutral, horizontally and vertically equitable, and easy to administer.

Neutrality means that a tax should not distort incentives and favor certain types of economic activities. An exception to the principle of neutrality occurs when there are particular types of behaviors we wish to discourage (such as driving gas-guzzling cars) or encourage (such as charitable contributions). In these cases, we may want to design non-neutral taxes to promote socially responsible behavior.

Horizontal equity means that similar individuals should be treated similarly while vertical equity means that taxes should promote an equitable income distribution. Administrative ease is clearly desirable and should be considered from both tax collectors' and taxpayers' points of view. These general principles favor taxes with a broad base and a relatively low rate.

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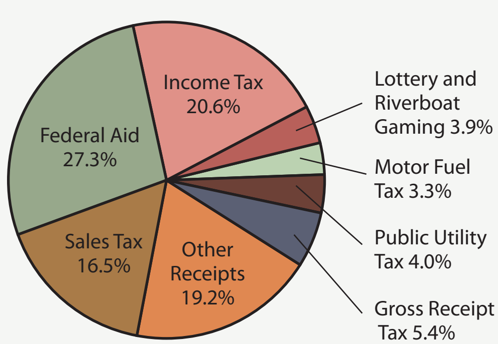
Sometimes, general principles of taxation conflict with each other and the final burden of a tax may be difficult to assess. For instance, some would argue that a neutral tax, such as a sales tax on all consumption including food, is vertically inequitable because poor households spend more of their income on food and therefore pay a higher average rate. Ultimately though, all increases in tax – individual or business – will reduce economic well-being of some households.

The 2007 Budget Debate

The governor proposed two large new spending programs – a program called Illinois Covered that aimed to ensure affordable health insurance for all Illinoisans and a four-year, $10 billion increase in spending for preschool to high school education. The governor also proposed a massive infusion of money into the state's pension systems. This would not have been new spending because it would have changed the timing of an existing obligation rather than the state's long-term command of resources.

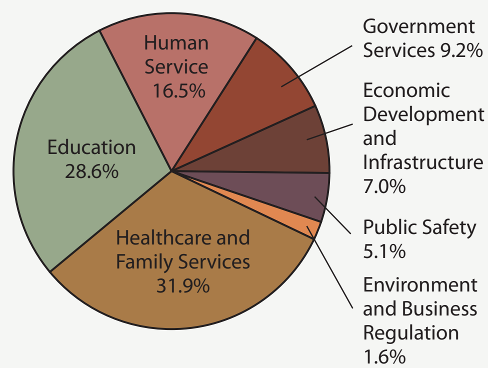
The governor proposed to do all three major programs without increasing sales or income taxes. Instead, he proposed three new sources of funds: $16 billion of Pension Obligation Bonds, $10 billion from lease of the state lottery, and a new gross receipts tax (GRT) that he estimated would eventually raise $6 billion annually. Because the sale of pension obligation bonds would require repayment out of future revenues and leasing the lottery would require foregoing current (and future) lottery revenues, these proposals primarily would have changed the timing rather than the amount of state revenues.

Figure 1
Fiscal Year 2008 Revenues by Source Percentage of Total
All Appropriate Funds - $49 Billion



Source: Blagojevich, Rod R. March 2007. *Illinois State Budget Fiscal Year 2008*. Springfield, Illinois: State of Illinois. Available at http://www.state.il.us/budget/ (accessed October 24, 2007.)

Figure 2
Fiscal Year 2008 Appropriations by Major Purpose - Percentage of Total
All Funds - $49.06 Billion



Source: Blagojevich, Rod R. March 2007. Illinois State Budget Fiscal Year 2008. Springfield, Illinois: State of Illinois. Available at http://www.state.il.us/budget/ (accessed October 24, 2007.)

As of November 2007, the GRT has not been enacted, the lottery has not been leased, and there has been no new issuance of pension obligation bonds. Squabbling over health-care expansion continues, but it is clear that nothing on the scale envisioned in the governor's original budget will be enacted in fiscal 2008.

However, it is important to understand the major changes in spending, business taxes and one-time revenue that were included in the administration's proposals. We analyze them below.

Health Insurance: The argument that health insurance subsidies for low-income house-

holds are appropriate seems to be built upon two beliefs. First, that quality health care is a basic public amenity that, like quality public schools, ought to be assured by the public sector. Second, that subsidized health insurance is a cost-effective method of providing quality health care. The legislative and policy debate ought to explicitly focus on these two beliefs. The first rests on the assertion that quality health care provides public, as well as private, benefits and contributes to a stronger, happier society. The second belief rests on the assertion that without health insurance, some people will either be denied or forego necessary treatment, and that with health insurance people who need treatment will seek and receive it. Debate about the first belief should include an explicit enumeration and discussion of the public benefits and costs. Debate about the second should make use of empirical studies of alternative methods of promoting access to health care including subsidized health insurance.

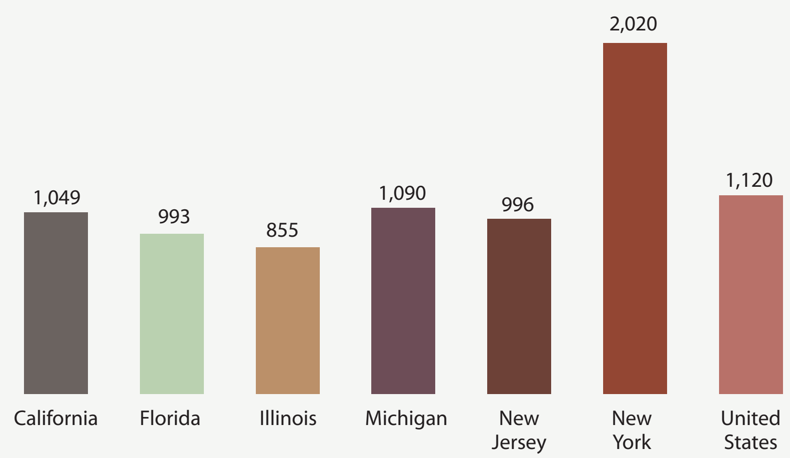
Figure 3 shows that in 2004, the latest year for which nationally comparable data are available, Illinois spent less per capita on health care than a number of other large states and the nation as a whole. While comparisons with other states are interesting, Illinois' relatively low spending in 2004 does not necessarily mean that it is spending too little. There may be other factors at play, such as 2004 may not be a representative year, Illinoisans may have less need for government-sponsored health care, or other levels of government may provide more health care in Illinois. Other states may spend too much or Illinois may be more efficient at delivering services than other states.

Education: There is a long history of public education funding and a widespread consensus that funding of elementary and secondary education is a public responsibility. Current debates about Illinois education funding relate to three main questions:

- What is the appropriate level of state (as opposed to local) funding?
- What is the appropriate overall level of funding?
- What is the appropriate level of public investment in pre-kindergarten education?

State funding is inextricably tied to beliefs about the minimum level of spending necessary to assure an adequate education. A major difficulty is that, even if we can agree on what makes for an adequate education, the cost of educating students may vary enormously with their backgrounds, home environment and innate abilities. Pre-kindergarten education of children, especially those with deprived backgrounds and/or learning disabilities may be the most cost-effective method of ensuring an adequate education. The budgetary debate would be enhanced if these issues were explicitly discussed.

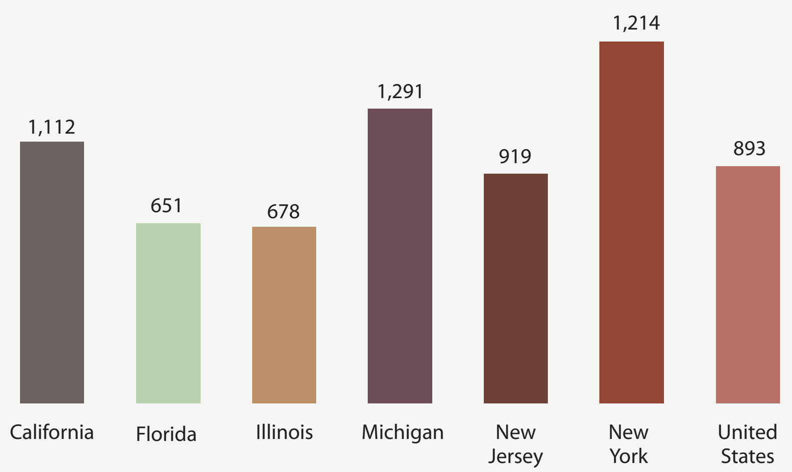
Figure 3
2004 Health Spending (per capita, 2004$)



Source: Annual State and Local Government Finance Data. Pivot tables produced by the Public Policy Institute of California. Available at http://www.ppic.org/main/datadepot.asp. Data from U.S. Bureau of the Census, Annual Survey of State and Local Government Finances, multiple years. (Last accessed October 24, 2007.)

Figure 4 (pg. 12) shows that in 2004 Illinois spent less per capita on K-12 education than a number of other large states and the nation as a whole. Again, this does not necessarily mean that Illinois is spending too little. Local government has greater than average responsibility for funding education in

Figure 4
2004 Education Spending (K-12, per capita, 2004$)



Source: Annual State and Local Government Finance Data. Pivot tables produced by the Public Policy Institute of California. Available at http://www.ppic.org/main/datadepot.asp. Data from U.S. Bureau of the Census, Annual Survey of State and Local Government Finances, multiple years. (Last accessed October 24, 2007.)

Illinois. Other states may spend too much or Illinois may be able to deliver education at lower cost than other states.

Business Taxes: The economic burden of a tax may be different from the impact of the tax because taxes alter prices and behavior. Ultimately, all taxes, including taxes on business, must be paid by individuals. Economic analysis suggests that, in most cases, increased taxes will force firms to raise prices or lower wages. Economic analysis also implies that business taxes will promote efficiency if they reflect the cost of providing public services to businesses. In general, business taxes are a poor mechanism for redistribution because it is not possible to target them to particular income groups.

While economic analysis does not reach definitive conclusions on the best structure for business taxes, it does suggest that taxes on relatively immobile factors, such as land, are less likely to result in avoidance and may be efficient compared with taxes on more mobile factors, such as labor or capital.
As part of the argument for an increase in Illinois business taxes, Governor Blagojevich pointed out that in the 1970s there was a 4-to-1 ratio of personal to corporate income tax revenues, but in 2004 that ratio was 7.12-to-1.[1] The decline in corporate taxes relative to personal income taxes and other economic aggregates is part of a national trend.[2] However, corporate income taxes are only a small share (about 9 percent nationally) of the taxes paid by business, according to a study by Ernst and Young.[3] That study found that property taxes, payroll taxes and other taxes were far more significant than corporate income taxes.

From the perspective of economic efficiency, it is more appropriate to compare the cost of providing public services to business and the taxes that businesses pay than to the ratio of business to individual taxes. Although it is very difficult to quantify benefits that public services convey to business, a recent study found that Illinois businesses paid more than $4 in taxes for each dollar of benefits received.[4] This ratio puts Illinois in the group of states that had the highest ratio of taxes to benefits. Taken literally, this study suggests that it would be economically efficient for Illinois to enact a drastic *cut* in business taxes.

Table 1
Business Taxes as a Share of Private Sector GSP, FY2006

State	**State and Local (Percent of GPS)**
California	5.2%
Florida	5.4%
Illinois	5.3%
Michigan	4.7%
New Jersey	4.8%
New York	5.9%
United States	5.1%

Source: Cline Robert, Tom Neubig, and Andrew Phillips 2007. "Total State and Local Business Taxes, 50-State Estimates for Fiscal Year 2006", Washington, D.C.: Ernst & Young February. (available at http://www.statetax.org/Template.cfm?Section=Studies,_Articles_and_Special_Reports&template=/ContentManagement/ContentDisplay.cfm&ContentID=7978 (accessed October 18, 2007.)

[1] See http://www.illinois.gov/includes/Investing_in_Families.pdf March 7, 2007. Accessed September 25, 2007.

[2] Fox, Luna and Murray April 4, 2007, http://www.chicagofed. org/news_and_ conferences/conferences_and_events/files/2007_business_taxation_luna.pdf. Accessed September 25, 2007.

[3] Feb. 27, 2007, http://www.ey.com/global/Content.nsf/US/Media_-_Release_-_02-27-07BDC. Accessed September 25, 2007.

[4] September 17, 2007, http://www.chicagofed.org/news_and_conferences/conferences_and_events/files/2007_tax_mattoon_testa.pdf. Accessed September 25, 2007.

Table 1 shows business taxes as a share of output in Illinois and selected states as well as the nation as a whole. According to these calculations, Illinois business taxes are not very different from other similar states. Of course, this does not mean that the level of business taxes is appropriate, but it does suggest that, relative to its most prominent competitors, the level of business taxes in Illinois is neither a big advantage nor disadvantage.

So, is it better to tax corporate income or the gross receipts of business? Business taxes should be based upon (1) the extent to which they are economically neutral, (2) their degree of equity, and (3) their administrative ease.

To avoid or reduce their corporate income tax, firms generally make accounting changes so they do not have to make changes in business practice that might be inefficient. However, some companies may have more ability to avoid the corporate income tax than others – for example, large firms with branches in many states may be able to use transfer pricing practices to reduce total tax. Thus, the corporate income tax may inefficiently favor certain types of businesses that have a greater ability to avoid.

Because the GRT is based on sales, we should expect that companies would minimize the amount of sales needed to generate each dollar of profit. Also, because the GRT levies a tax on each sale, industries that can artificially reduce sales would have an advantage over industries that cannot. Thus, like the corporate income tax, the GRT is likely to inefficiently favor firms or industries that have a greater ability to avoid.

In the long run, business taxes usually are shifted forward to consumers, so consumers ultimately pay either the corporate income tax or the GRT. As noted, the GRT is heavier in industries with multiple layers of business-to-business sales compared to those that are vertically integrated. Consumers who make a disproportionate share of their purchases in relatively lightly taxed industries benefit relative to those who make a disproportionate share of their purchases in heavily taxed industries. However, it is difficult to tell without detailed studies which industries are which and, in any case, it is very unlikely that the pattern of taxation across industries serves any identifiable public purpose.

A 1996 study estimated that in the mid 1990s it cost about $2 billion annually for businesses to comply with federal and sub-federal corporation income taxes. Compliance costs are a significant share of the total burden of business taxes. However, there is no clear evidence about the relative cost to comply with a GRT versus a corporate income tax. It is likely that initially a GRT would require additional procedures and record keeping. After a transition period, the cost of compliance might be the same or less than the corporate income tax.

Around the nation, corporate tax receipts have declined as a share of output. Economists attribute the decline to increased corporate tax avoidance and to changes in state and federal policy that sometimes have eroded the base. States have responded by changing laws, by allowing tax amnesties that include incentives for paying back taxes, decoupling from the federal tax base and by adopting alternative business tax bases. In recent years, states including Ohio, New Jersey, and Texas have adopted some form of a GRT. New Jersey used this tax temporarily to help it weather the dramatic decline in other tax revenues following the 2001 recession and has since repealed it.

One-Time Revenue: There are two types of one-time (or non-recurring) revenue: windfall revenue is money the state obtains on a one-time basis without giving up future claims on an asset; and liquefied assets are revenues the state obtains by converting an existing asset to current revenue or by borrowing.

In recent years, Illinois, along with other states, has made increased use of both types of

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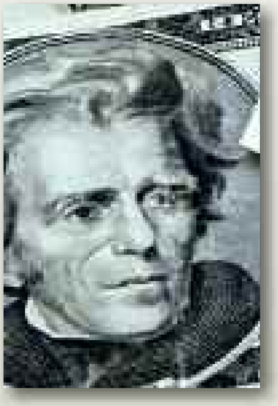

one-time revenue. In FY2003 and 2004, the state was recovering from the collapse that followed the 2001 recession and made extensive use of one-time revenue. In addition to the $770 million windfall from a one-time infusion of federal funds, Illinois used $2.2 billion obtained by borrowing to replace general revenue funds that otherwise would have been required to cover the state's pension obligation. The state also liquefied some assets through the sale and leaseback of several government buildings, by "sweeping" (seizing) some fund balances, and from a tax amnesty.[5]

In subsequent budget years, the state has continued to make use of one-time revenue. During the fiscal 2008 budget debate, the governor proposed an enormous amount of one-time revenue in the form of $16 billion in pension obligation bonds and $10 billion in lottery leases.

The appropriate use of windfall revenue and liquefied assets may differ. Using windfalls to support continuing government expenses is clearly a dangerous budgetary practice because it virtually assures a fiscal crisis when the windfall is exhausted. However, it may be appropriate to use some or all such windfalls to cover continuing expenditures if they happen to coincide with *temporary* shortfalls. Use of such a windfall may avert the need for temporary revenue increases or severe spending cuts.

Liquefied assets are simply a form of borrowing. An asset, whether it is a building or a lottery, provides a flow of services (or revenue) to the state. Sale of the asset either diverts the flow of revenue or requires the state to make payments to retain it. If the private sector can do a better job than the public sector of managing the asset, then liquefying, or selling, the asset is an appropriate public policy. However, liquefying assets to obtain one-time revenue during a fiscal crisis has no inherent advantage over other types of borrowing and is not normally an appropriate policy response to a fiscal imbalance.

Borrowing: The Blagojevich administration proposed issuing $16 billion in pension obligation bonds to make payments to the pension fund. The idea is that the state could borrow at a relatively low rate (about 6 percent) and then the money would be invested and earn a higher rate of return. Because the amount to be borrowed was very large, the return to the state also would be potentially very large.

But this borrowing plan requires that taxpayers assume some risk. There is no guarantee down the road that investment return will exceed the interest obligation on the bonds. Smart investors think in terms of "risk-adjusted rates of return" and the state should, too.

Regardless of whether it is good state policy to invest borrowed money through pension funds, sound fiscal management dictates that borrowed money should not be used to pay operating expenses. While Governor Blagojevich's public statements suggested that *all* the borrowed money would be used to pay down the state's very significant pension debt, the precedent set in 2003 and 2004, when more than $2 billion from pension obligation bonds went to the general fund, suggests that Illinois might be cautious in pursuing this strategy.

Leasing the Lottery: Governor Blagojevich also proposed leasing the Illinois State Lottery. Under this plan, a private firm would run the lottery and would retain the profits for a number of years (probably 50). In exchange for this right, the private firm would pay the state an up-front licensing fee estimated at $10 billion. In essence, the state would have traded an annual stream of revenue estimated at $622 million for a one-time payment of $10 billion.[6] The revenue from leasing the lottery would have been invested in the pension fund and would therefore have decreased the need for future payments to the fund.

There is some reason to believe that private firms would out-perform the state if profit

[5] Merriman, David. "A summary of Illinois' recent fiscal history" Illinois Tax Facts Taxpayers' Federation of Illinois. 56(6): September 2003 (also available at http://www.igpa.uillinois.edu/).

[6] Schwartz, Nelson D. and Ron Nixon. October 14, 2007. "Privatizing the Prize," *New York Times* Sunday Business Section p1. and 10.

were the only objective in running the lottery. But we as a state want to ensure that the lottery does not prey on people with a gambling addiction, desperate households, people with intellectual disabilities, etc. Therefore, even if a private firm leased the lottery it would probably be necessary for the state to regulate it, a prospect that might cause private firms to reduce their bidding price.

Even if leasing of the lottery generated a bid equal to or greater than the value of the stream of revenue the state would have generated from the lottery, it would create a temporary cash-flow problem under Governor Blagojevich's plan because the leasing payment would be deposited into the pension fund. Some new revenue source would be required to offset the loss to the general fund because even without the sale of the lottery planned spending exceeds expected income.

Options for Illinois' Fiscal Future

Even without extensive new programs, over the long term Illinois will have to make hard choices in order to pay for its normal operating expenses, pension obligations and Medicaid programs. Minor tinkering with the tax system, user charges and one-time revenue fixes simply will not provide enough money for Illinois to continue business as usual. There is a long list of revenue-raising options, which includes increases in sales, corporate or income tax rates or elimination of exemptions; means testing for tax credits; changing the base of the personal income tax to the federal income tax liability; expanding the sales tax to include consumer services; increasing the gasoline tax; value-added tax; and others.[7]

While many of these ideas may have merit, we will analyze here just two ideas from this list and one additional idea. We evaluate each only in relation to general economic principles of taxation and have not used political viability as a criterion for selecting the options we examine. Our discussion is intended to illustrate the types of issues that policymakers should consider and is not a complete analysis.

Change the personal income tax base to federal income tax liability: This option would convert Illinois' personal income tax to a surcharge on the federal income tax, and each Illinoisan's personal income tax liability would simply be a share of their federal income tax liability. Rhode Island currently has a state income tax of this variety. Unlike most large tax policy changes, this would be relatively simple to manage. The burden of complying with the state income tax would be reduced because virtually all state income tax filers also are required to file a federal income tax form.

While there is nothing about altering the tax base that inherently requires increasing tax revenue, it would be relatively simple for the state to adjust the tax rate (i.e. the share of federal tax liability due to the state) to obtain the desired revenue. Because the federal tax code is progressive (rates rise with taxable incomes), Illinois' tax would become more progressive. If the share of income going to high-income households continues to increase, the new tax system would generate more rapid increases in revenue than the current system. It would also add to the state tax base because, in most cases, neither pension nor Social Security income are excluded from the federal income tax base. However, federal tax law allows many deductions, credits and exemptions that are not part of Illinois law. Thus, most high-income households and those who currently receive income that is exempt from Illinois taxes would pay higher state income taxes, while most low-income households and those who have large federal credits that they cannot claim under state law would pay less.

Linking Illinois state tax payments to federal tax payments also would mean that changes in the federal tax base or rates would cause changes in Illinois' tax receipts, unless Illinois made legislative changes of its own

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[7] This list was compiled from a number of sources including Gardner et.al. (2002), Center for Tax and Budget Accountability (no date), Voices for Illinois Children 2006 and Skosey (2007).

to its tax rate or base. Under this system, the Illinois Legislature might be more insulated from lobbying about the state's income tax code because the base would be determined by federal tax policy.

Expand the sales tax to cover consumer services: This change would broaden the sales tax to include an important and growing segment of purchases. It was included in HB/SB 750 during the 2007 legislative session, and it was estimated that it would raise $2.2 billion even after accounting for the cost of a tax credit to reduce the burden on low- and middle-income families.

The sales tax is often believed to be vertically inequitable because low-income households spend a greater share of their income on taxable goods than high-income households. But extending the sales tax to services could make it less regressive because high-income households spend a disproportionate share of their income on consumer services. Extending the sales tax to services would impose modest compliance costs on many businesses that provide services but do not currently sell taxable items.

Enact a statewide property tax on businesses: Economic reasoning suggests that taxes are most economically efficient when tax payments closely correspond to benefits received. From this perspective, neither the corporate income tax nor a gross receipts tax is an efficient way to tax business activity. The corporate income tax base is profit and profits may be small even when a firm is a high consumer of state services, or businesses can avoid the corporate income tax simply by reorganizing their structure. Similarly, the base for gross receipts tax – sales – generally does not correspond to the benefits a company receives. Sales can be manipulated by vertical integration or creative accounting.

On the other hand, companies with large operations in high-value areas, such as downtown Chicago, generally pick those locations because they gain access to markets, suppliers, natural amenities and public services that would not be as readily available elsewhere. Thus, the amount that a firm spends to buy or rent real property may be a reasonable measure of the benefit it receives by locating in the state.

If decision makers wish to increase state revenue by levying additional taxes on business, they could adopt a uniform statewide property tax on business real estate. Such a tax could supplement or replace existing state business taxes. Currently, virtually all property taxes in Illinois are levied and administered at the local level. However, there is precedent and some experience in other states with uniform statewide property taxes. Because much of the existing administrative apparatus used to collect local property taxes could be adapted for collection of state property taxes, such a tax might have a modest administrative burden.

Of course, should the state adopt a statewide business property tax, we might expect that businesses would try to avoid it. If the services government could provide with the additional revenue were less valuable to them than the additional taxes, the demand for business property in Illinois would fall. This would have two effects. Business property values would fall so that current owners would experience a capital loss (compared to a situation without the business property tax). Also, non-business uses of real estate (e.g., residential uses) would become relatively more attractive and some business real estate might be converted to other uses.

The best choice? While enacting a property tax on business may be a relatively efficient way to tax business, there is no clear efficiency or equity reason to increase Illinois business taxes and some might argue that a state property tax would compete with local property taxes. There are good reasons to recommend broadening the sales tax to consumer services. It would increase economic efficiency and modernize the sales tax system so that revenues would grow more rap-

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idly as the economy expands. However, even with this change the sales tax would remain vertically inequitable. Furthermore, the growth of Internet purchasing continues to erode the sales tax base and may make it difficult to sustain in the long run.

Of the three options we've considered here, changing Illinois' personal income tax base to the federal income tax liability (Option 1) may be the most attractive, even though it would involve a radical change in Illinois tax policy. Option 1 would introduce significant progressivity into an income tax system that is now nearly proportional. The fairness of this change should be debated but if there is public support for more progressivity, Option 1 would introduce it while minimizing administrative burdens. This alternative also would change Illinois' income tax base by taxing pension and Social Security income. This would be economically efficient because it would remove the advantage retirees have over other income earners. Perhaps most importantly, Option 1 would allow Illinois' revenue to grow more rapidly in the future if the current trend toward disproportionate growth of high incomes continues. This change could help stabilize Illinois' fiscal climate for many years into the future.

Summary and Conclusion

In this chapter, we have used fundamental economic reasoning to examine Illinois' fiscal situation. We argued that the debate about health insurance should focus on the degree to which legislators believe guarantees of health care are a public responsibility and an examination of the degree to which health insurance results in better health outcomes. The debate about state spending for education ought to begin with an agreement about the minimum level of education the state is committed to providing. Our discussion of business taxation pointed out that these taxes are a poor vehicle for income redistribution and should be designed to charge business for the benefits they receive by locating in the state. We find little reason to believe that the gross receipts tax is superior to the current system as a means to tax business. We also examined a number of strategies Illinois has explored for increasing its one-time revenue. The trend toward increased use of one-time revenue is disturbing because it could result in only short-term solutions for long-term problems.

We do not believe that Illinois can attain sustained, stable fiscal balance unless it changes its fiscal system to obtain more revenue and we've discussed three options for doing so. While these and other options deserve more complete study, our preliminary investigation supports an option that would convert Illinois' personal income tax to a surcharge on federal income tax liability. This change would be administratively simple, would introduce progressivity into the state tax system and would probably generate future revenue increases that would make it easier for the state to meet its future spending obligations.

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