The Illinois Budget Policy
TOOLBOX

Toolbox Fundamentals

Overview of the Economic and Fiscal Situation in Illinois

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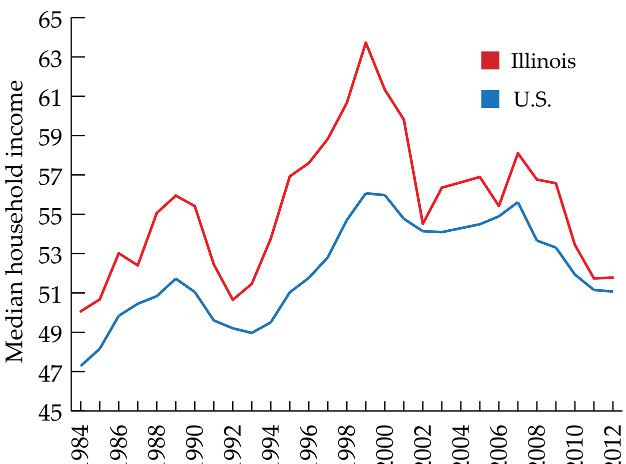
Despite enormous recent challenges, Illinois' economy remains relatively healthy compared to other states. As shown in Figure 1, median family income in Illinois has remained above the national average since at least 1984. After a relatively prosperous period in the late 1990s when median family income in Illinois exceeded the national average by more than $7,000, the most recent data indicate that Illinois is now only about $700 above the national average.

While Illinois has been shrinking as a share of the nation's population—from 4.8 percent in 1984 to 4.1 percent in 2012—Illinois' recent economic slide may or may not be a precursor to long-term economic decline.

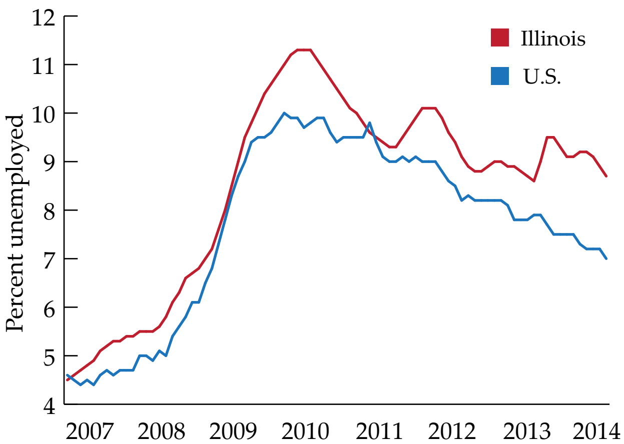
In recent recessions, Illinois has a pattern of doing worse than the national average and has stumbled to slow recoveries. Nonetheless, following the recessions that ended in March 1991 and November 2001, Illinois eventually regained firm economic footing. Unfortunately, the recession that began in December 2007 and ended in June 2009 has hit both the nation and Illinois exceptionally hard, and Illinois' recovery has lagged the nation's recovery in profound and disturbing ways. Figure 2 (on page 2) shows that Illinois' unemployment rate—a major indicator of economic distress—soared far above the national

Figure 1: U.S. and Illinois median household income (thousands of 2012 dollars)



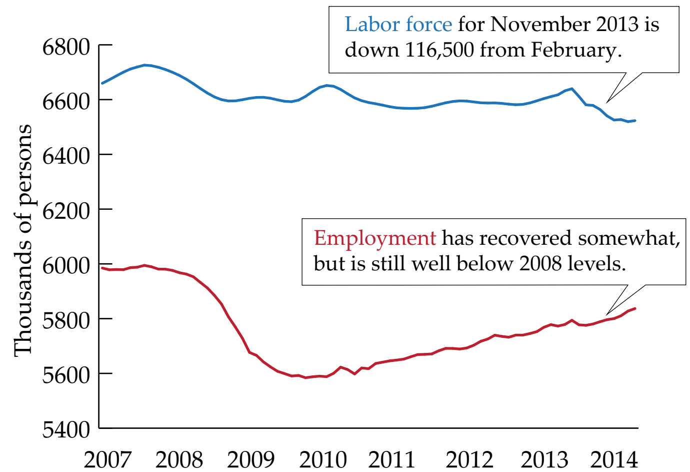
Source: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements (http://www.census.gov/hhes/www/income/data/statemedian/). Note that because the original source contains no data for 2004, it is interpolated based on data from 2003 and 2005.

Figure 2: U.S. and Illinois Civilian Unemployment Rate, 2007-2014



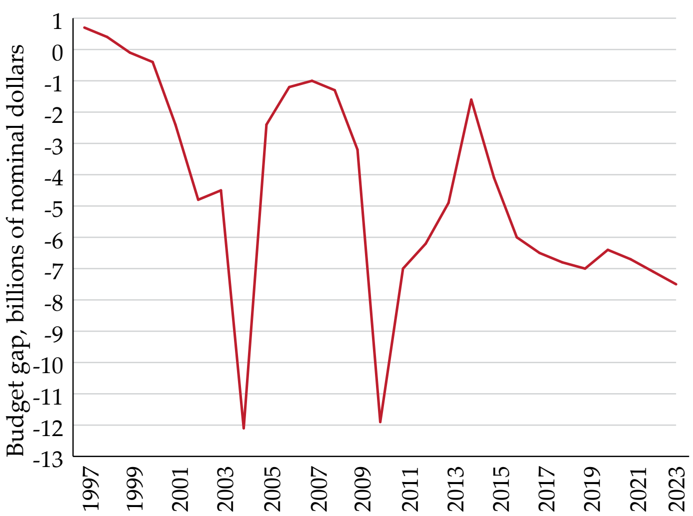
Source: research.stlouisfed.org

Figure 3: Illinois Civilian Labor Force and Employee Nonfarm Payrolls, 2007-2014



Source: research.stlouisfed.org

Figure 4: Illinois Consolidated Funds Expenditures Minus Receipts, FY 1997-2023



Source: IGPA Fiscal Futures Model. Note: Borrowing and fund balance transfers not counted as receipts. FY 1997 to 2011 are based on historical data; FY 2012 data is preliminary; FY 2013 is estimated based on appropriations and other information; FY 2014 to 2023 are projected by the Fiscal Futures Model.

average following this recession and has remained disturbingly high. It is far above the national average more than three years after the recession ended. The unemployment rate in Illinois is now (November 2013) about the same as in Michigan (which has suffered severe disruption due to the decline of the auto industry). Both Illinois and Michigan are much higher than our neighboring states of Indiana and Wisconsin.

Of perhaps equal concern is that employment is still far below its pre-recession level (as shown in Figure 3). The labor force, essentially the number of people working or looking for work, has shown no growth since the start of the recession and has shrunk in recent months. These trends do not bode well for economic growth in Illinois.

Recent economic woes in Illinois have intensified, but did not cause, its fiscal difficulties. Illinois' fiscal woes go back to at least the early 1990s. During the period from 2001 to 2006—a period when the Illinois economy was doing relatively well—the state ran significant budget deficits[1] before coming close to a balanced budget beginning in 2006. The federal stimulus that followed the great recession staved off immediate fiscal disaster in Illinois, but deficits began to emerge again. By late 2010, Illinois was far behind on paying its bills. At that point, budgetary balance was no longer possible even with significant increases in economic growth, drastic spending cuts, or large tax increases.[2] In January of 2011, the Illinois legislature reacted by approving significant temporary increases in the personal and corporate income tax rates and by endorsing caps on spending from the state's general funds.

[1]For more detail about Illinois' fiscal situation in this period. ee Merriman, David. (September 2003). A summary of Illinois' recent fiscal history. *Illinois Tax Facts*. Taxpayers' Federation of Illinois. 56(6). Available at http://igpa.uillinois.edu/system/files/Illinois_Summary_r11.pdf.

[2]See Dye, Richard, Hudspeth, Nancy and Merriman, David. (2011). Titanic and sinking. *The Illinois Report 2011*. Institute of Government and Public Affairs, University of Illinois. Available at http://igpa.uillinois.edu/IR11/Report/

Figure 5: Major Categories of Illinois State Spending, 1997-2014

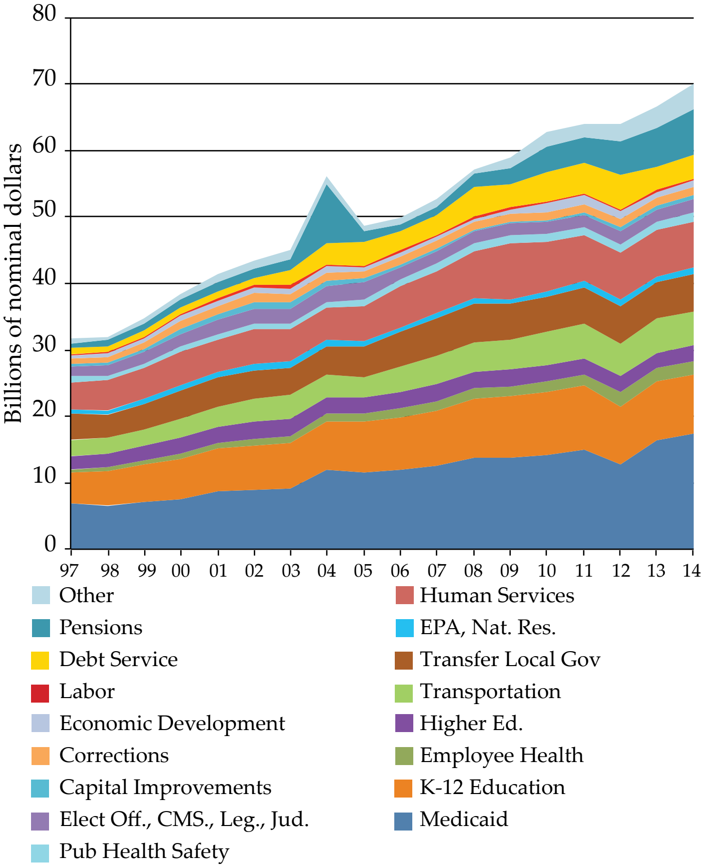
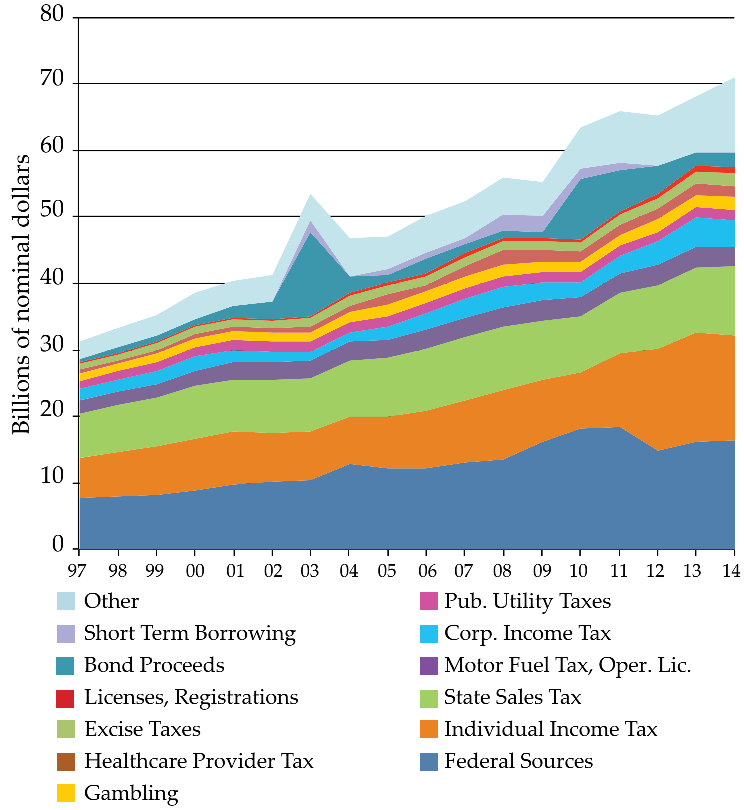


Figure 6: Major Categories of Illinois State Revenue Sources, 1997-2014



Source for Figures 5 and 6: IGPA's Fiscal Futures Project; Illinois Comptroller's data

Despite these significant steps by the legislature, analysis by The Fiscal Futures Project shows a continued significant structural fiscal imbalance. Figure 4 (on page 2) uses the Fiscal Futures model to show fiscal imbalances, both historical (1997-2012) and projected (2013-2023). The model projections are based on historical patterns of growth and forecasts of key variables that drive individual categories of spending and revenue. While this analysis from early 2013 incorporates neither the major pension changes of November 2013 nor other most recent data, the fundamental pattern is unchanged: the 2011 tax increase and spending caps reduced but did not eliminate the budget gap. The phase-out of the tax increase scheduled to begin January 1, 2015 will leave Illinois with a major structural budget gap that will be painful to eliminate.

Figure 5 shows historical data regarding major categories of state spending in Illinois over the last 17 years. These data were prepared using a comprehensive framework that encompasses all relevant categories of spending and revenue. It uses a consistent methodology so that categories are comparable over time.[3]

Overall, total state spending was close to $70 billion in 2014 and has grown at a rate of about 4.76 percent per year. The most rapidly rising categories of spending have been pensions (14.2 percent), other (9.4 percent), state employee health care (8.8 percent), debt service (8.4 percent) and Medicaid (5.6 percent). Pensions (9.8 percent of spending in 2014) and Medicaid (24.7 percent of spending in 2014) are both large and growing rapidly. Medicaid's growth has slowed in recent years, partly as a result of policy changes, so its share of the state budget has been virtually unchanged since 2006. Furthermore, the federal government matches half or more of Illinois' Medicaid expenses on a dollar-for-dollar basis, so any cuts in state Medicaid spending will reduce federal revenues simultaneously.

[3]For more detail on our methods and sources, see Dye, Richard, Nancy Hudspeth and David Merriman 2013 Fiscal Futures Project Documentation. Available at http://igpa.uillinois.edu/system/files/fiscal_futures_documentation_12oct13.pdf.

Figure 7: Illinois G.O. Bond Ratings, 1998-2013

Year	S&P	Moody's	Fitch
1998	AA	Aa2	AA
1999	AA	Aa2	AA
2000	AA	Aa2	AA+
2001	AA	Aa2	AA+
2002	AA	Aa2	AA+
2003	AA	Aa3	AA
2004	AA	Aa3	AA
2005	AA	Aa3	AA
2006	AA	Aa3	AA-
2007	AA	Aa3	AA
2008	AA	Aa3	AA-
2009	A+	A2	A
2010	A+	A2	A
2011	A+	A1	A
2012	A	A2	A
2013	A- (developing)	A3 (neg.)	A- (neg.)

As detailed in an Illinois Budget Policy Toolbox paper by Richard F. Dye, in December 2013, the state enacted major changes in Illinois' public pension programs, but these changes are expected to have only a modest impact on pension spending.

Other categories of spending also will not be easy to cut. Note that much transportation spending is paid for with earmarked taxes and fees. This money is often used to provide the state or local share necessary to obtain federal matching funds that are available solely for transportation-related expenditures. Thus, cuts in state transportation spending could reduce federal transfers to Illinois, and might have a relatively small impact on Illinois' fiscal gap.

Figure 6 (on page 3) shows historical data on major categories of state revenue in Illinois over the last 17 years. Only four categories of revenue were larger than 6 percent in 2014. These were federal sources (23.1 percent), individual income taxes (22.3 percent), state sales taxes (14.6 percent) and other revenue (9.5 percent). Of these large revenue categories, those growing more rapidly than spending are only the individual income tax (growing at 5.8 percent per year) and other revenue (growing at 9.5 percent per year). Sales tax revenue has been growing only about 2.7 percent per year, so its share has shrunk from 21 percent to about 15 percent of revenue.

Given this set of facts, and projected annual fiscal gaps on the order of $7 billion, no one should expect that balancing Illinois' budget will be easy. Efforts to close the fiscal gap by reducing spending would almost certainly have to look at a variety of expenditure categories – including those with widespread support and those that have already been subjected to very significant constraints. Significant increases in revenues are unlikely to come from smaller revenue categories, and federal revenue sources are largely beyond the control of state legislators. Thus, the personal income tax and the general sales tax are the only existing revenue sources that could feasibly provide substantial additional revenue.

Unfortunately, failure to act to reduce the fiscal gap has already had severe negative impacts on Illinois, and further inaction is likely to lead to even more serious consequences. Perhaps, the most tangible negative consequence of Illinois' fiscal troubles—besides painful budgetary cuts and tax increases—has been a large backlog of unpaid bills and a greatly tarnished credit rating.

Unpaid bills were more than $6.4 billion in December of FY2013, an amount that fell by October of FY2014 to $4.4 billion. Even these staggering sums do not completely reflect the magnitude of cash imbalances, however, since these figures exclude money owed to state-affiliated agencies including the University of Illinois. The lack of cash to pay the state's bills has led to substantial delays between the time when a vendor bills the state and when the vendor receives payment. Even though Illinois compensates vendors for late payments in some cases, many vendors probably find that it is not worth the trouble; they may avoid bidding on state jobs or charge a higher fee when they do bid. While the direct cost of this outcome has not been quantified, it certainly has resulted in much negative publicity that has damaged Illinois' reputation as a business partner.[4]

More evidence of Illinois' damaged financial reputation comes in the credit ratings given to Illinois debt issues. Figure 7 shows the rating of Illinois debt by the three major credit rating agencies over the period from 1998 through 2013. Cells in red indicate a credit downgrade, while green cells represent an upgrade, and blue cells

[4] Jones, Tim. (December 18, 2013). Vendors unpaid as pitfalls impede Illinois' path to stability. *Bloomberg News.* Available at http://www.businessweek.com/news/2013-12-18/vendors-unpaid-as-pitfalls-impede-illinois-s-path-to-stability.

represent no change. All three credit rating agencies have downgraded Illinois' debt several times since 2003, and Illinois' bond rating is now among the lowest of any state in the country. While it seems very unlikely that Illinois will default on any of its debt, the lowered credit rating has a tangible cost in the form of increased debt service. This cost is probably small in comparison to the real, but intangible, reputational cost suffered by the state. Illinois' poor credit rating and news of its fiscal problems undercut confidence in Illinois' potential for future economic growth. This lack of confidence could translate into a self-fulfilling prophecy if businesses, citizens, state employees and others decide to locate or invest elsewhere because they worry that Illinois' fiscal troubles could limit their future. A credible and widely supported plan that charts a course to sustainable fiscal balance could do much to reduce the damage from Illinois' fiscal woes and could lead to a brighter economic future. •

Further Reading

Dye, Richard, Merriman, David and Hudspeth, Nancy. (2014). Peering over Illinois' fiscal cliff: New projections from IGPA's Fiscal Futures Model. *The Illinois Report 2014.* The University of Illinois Institute of Government and Public Affairs. Available at http://igpa.uillinois.edu/IR14

State Budget Crisis Task Force. (October 2012). *Report of the State Budget Crisis Task Force: Illinois.* Available http://www.statebudgetcrisis.org/wpcms/wp-content/images/2012-10-12-Illinois-Report-Final-2.pdf

Merriman, David. (September 2003). A summary of Illinois' recent fiscal history. Illinois Tax Facts. Taxpayers' Federation of Illinois. 56(6). Available at http://igpa.uillinois.edu/system/files/Illinois_Summary_r11.pdf.

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