THE FISCAL FUTURES PROJECT

igpa.uillinois.edu/fiscalfutures

TOOLS TO ASSESS BUDGETARY CONCERNS: THE U OF ILLINOIS FISCAL FUTURES PROJECT PRESENTED AT

URBANA-CHAMPAIGN KIWANIS

February 2, 2017

HAWTHORN SUITES

101 TRADE CENTER DRIVE

CHAMPAIGN, IL, 61820

BY DAVID MERRIMAN

(DMERRIM@UIC.EDU)

INSTITUTE OF GOVERNMENT & PUBLIC AFFAIRS

UNIVERSITY OF ILLINOIS

URBANA-CHAMPAIGN • CHICAGO • SPRINGFIELD

If we needed any more evidence of what a mess we have

Yesterday February 1, 2017

Fitch Ratings has downgraded the following ratings of the state of Illinois:
–Issuer Default Rating (IDR) to 'BBB' from 'BBB+;
–$25.9 billion in outstanding general obligation (GO) bonds to 'BBB' from 'BBB+';
–$431 million Illinois Sports Facilities Authority sports facilities bonds (state tax supported) to 'BBB-'from 'BBB';
–$2.6 billion Metropolitan Pier and Exposition Authority McCormick Place expansion project bonds to 'BBB-' from 'BBB';
–$267.8 million city of Chicago motor fuel tax revenue bonds to 'BBB-' from 'BBB'.

The Rating Watch Negative is maintained.

No Surprise since
Fitch warned it would downgrade the ratings if the state didn't have a budget by the end of January.

KEY RATING DRIVERS

The downgrade of Illinois's IDR and related ratings reflects the unprecedented failure of the state to enact a full budget for two consecutive years and the financial implications of spending far in excess of available revenues, which has resulted in increased accumulated liabilities and reduced financial flexibility. Even if the current attempts at a resolution to the extended impasse prove successful, Fitch believes that the failure to act to date has fundamentally weakened the state's financial profile.

The Negative Watch reflects Fitch's expectation that the state's implementation of a solution, whether temporary or permanent, will be a challenge in the current political environment and that in the interim the state will continue to delay and defer payments in lieu of balancing the budget. While Fitch acknowledges that there is a plan being developed in the state Senate that contains elements that could ultimately resolve the impasse, its passage is uncertain and the timing of implementing solutions is unknown. Fitch expects to resolve the Rating Watch within the next six months based on an assessment of the state's fiscal trajectory as it starts fiscal 2018. If the state continues on the current path, a further downgrade would be warranted.

Illinois has failed to capitalize on the economic growth of recent years to bolster its financial position. Rather, the decision to allow temporary tax increases to expire and the subsequent failure to develop a budget that aligns revenues with expenditures have resulted in a marked deterioration in the state's finances during this time of recovery. Once again, the state has displayed an unwillingness to utilize its extensive control over revenues and spending to address numerous fiscal challenges.

IGPA's Fiscal Futures Project

- Mission: Conduct and promote objective, broad-based, long-term analysis of Illinois' budget
- Began in 2008 with goal of estimating trajectory of gap in state budget
- Recognized need for broad-based budget data consistently defined & categorized over time
- Developed model for budget projection

Institute of Government & Public Affairs
University of Illinois
Urbana-Champaign • Chicago • Springfield

Fiscal Futures Model

- **Forward-looking**: projects out 10+ years
- **Broad-based**: "All Funds" budget measure, avoids distortions from General Funds alone
- Focus on ***Budget Gap***

  = Total Revenue – Total Spending

  Sustainable Total Revenue *excludes* new borrowing, decreased fund balances, or other one-time sources
- Will show example of model projections later in talk

BACKGROUND: TIME-SHIFT BUDGETING

For decades, Illinois has used a variety of buy-now pay-later devices

- Explicit borrowing (e.g. pension bonds ‘03, ‘10, ‘11)
- Sale of long-term assets or income streams
- Increase in backlog of unpaid bills
- Pay current workers with unfunded promises of
  - Future pensions (now totaling $130 billion)
  - Future payments for retiree health care ($33 billion)

INSTITUTE OF GOVERNMENT & PUBLIC AFFAIRS
UNIVERSITY OF ILLINOIS
URBANA-CHAMPAIGN • CHICAGO • SPRINGFIELD

OVERVIEW

- **Fiscal Conditions in Illinois**
  1. Large structural imbalance, i.e.,
     spending > sustainable revenue
  2. Deficit projected to grow even larger
  3. No full budget for FY2016 and FY2017
  4. Large accumulation IOUs from past deficits
  5. Worst-among-states credit rating & borrowing costs

COMPOUNDING FACTORS

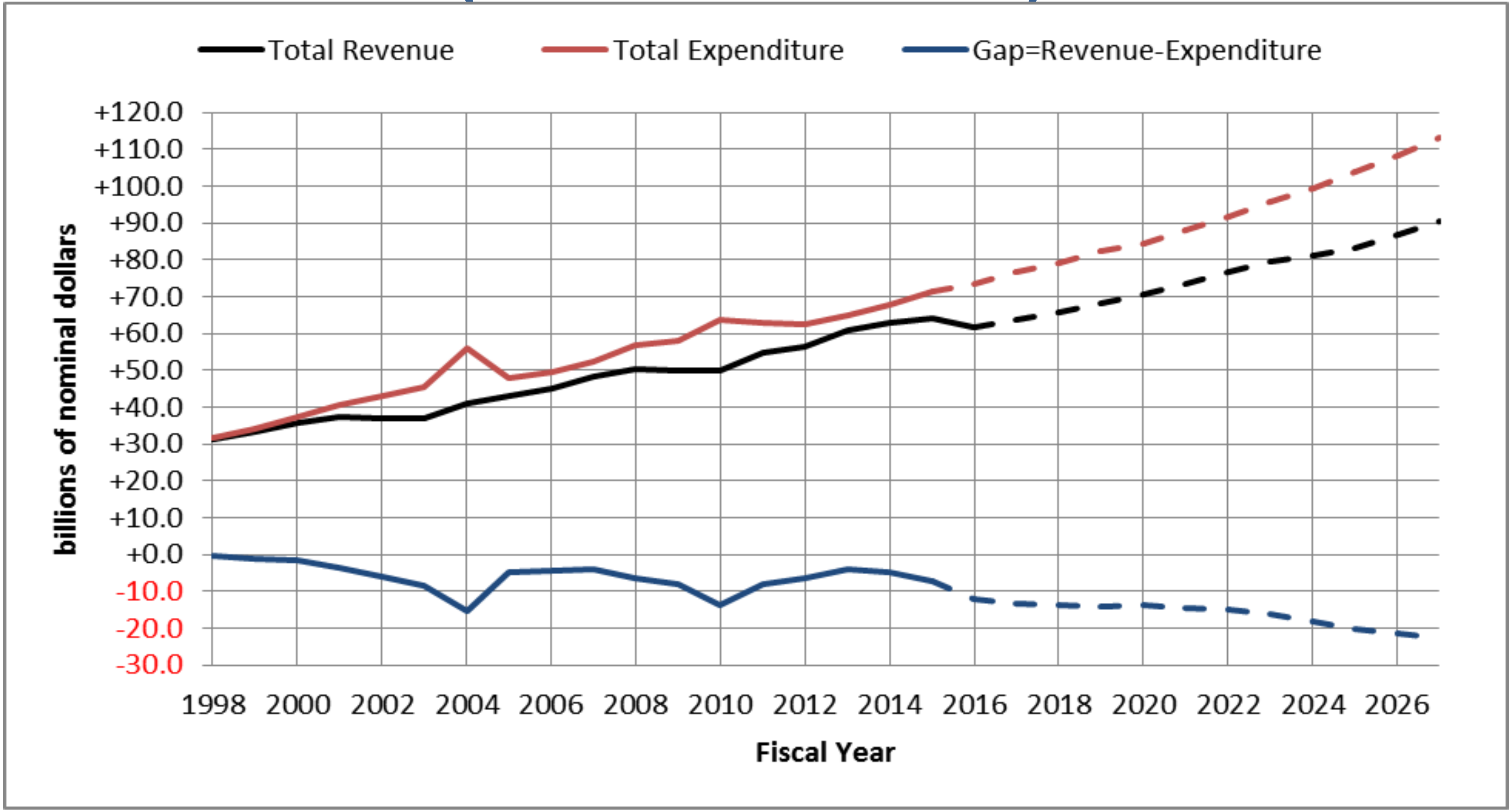
- Three temporary revenue surges in a row
  - Revenue collections bubble 2007-08
  - Federal stimulus funds 2009-11
  - Income tax rate increase 2011-14
- Supreme Court struck down attempts to cut legacy costs (health care 2014, pensions 2015)
- Political impasse on business cost reforms
  - No budget in FY 2016
  - Half-year budget in FY 2017
- Solutions are painful (big ↑tax or ↓spending)

It's bad & inaction has made it worse

Measure	As of Jan. 2015	As of Nov. 2016
Current All-Funds Deficit	$6 billion (FY15)	$13 billion (FY17)
Near Term All-Funds Deficit	$9 billion (FY16-22)	$14 billion (FY18-21)
10-year All-Funds Deficit	$14 billion (FY26)	$23 billion (FY27)
Retiree Legacy Costs	$152 billion	$174 billion
Unpaid Bills	$6.5 billion	$10 billion

See: IGPA, Fiscal Futures, "First you stop digging" (November 2016) for sources.

FIGURE 1: ILLINOIS ALL-FUNDS REVENUE, SPENDING, AND BUDGET GAP (= REVENUE – SPENDING) PROJECTIONS



Source: IGPA Fiscal Futures Model, November 2016. Note: Revenue excludes new borrowing.

INSTITUTE OF GOVERNMENT & PUBLIC AFFAIRS
UNIVERSITY OF ILLINOIS
URBANA-CHAMPAIGN • CHICAGO • SPRINGFIELD

CONSEQUENCES OF DEFICITS

- Diminished fund balances and other assets
- Increased liabilities

Both of which affect future budget years

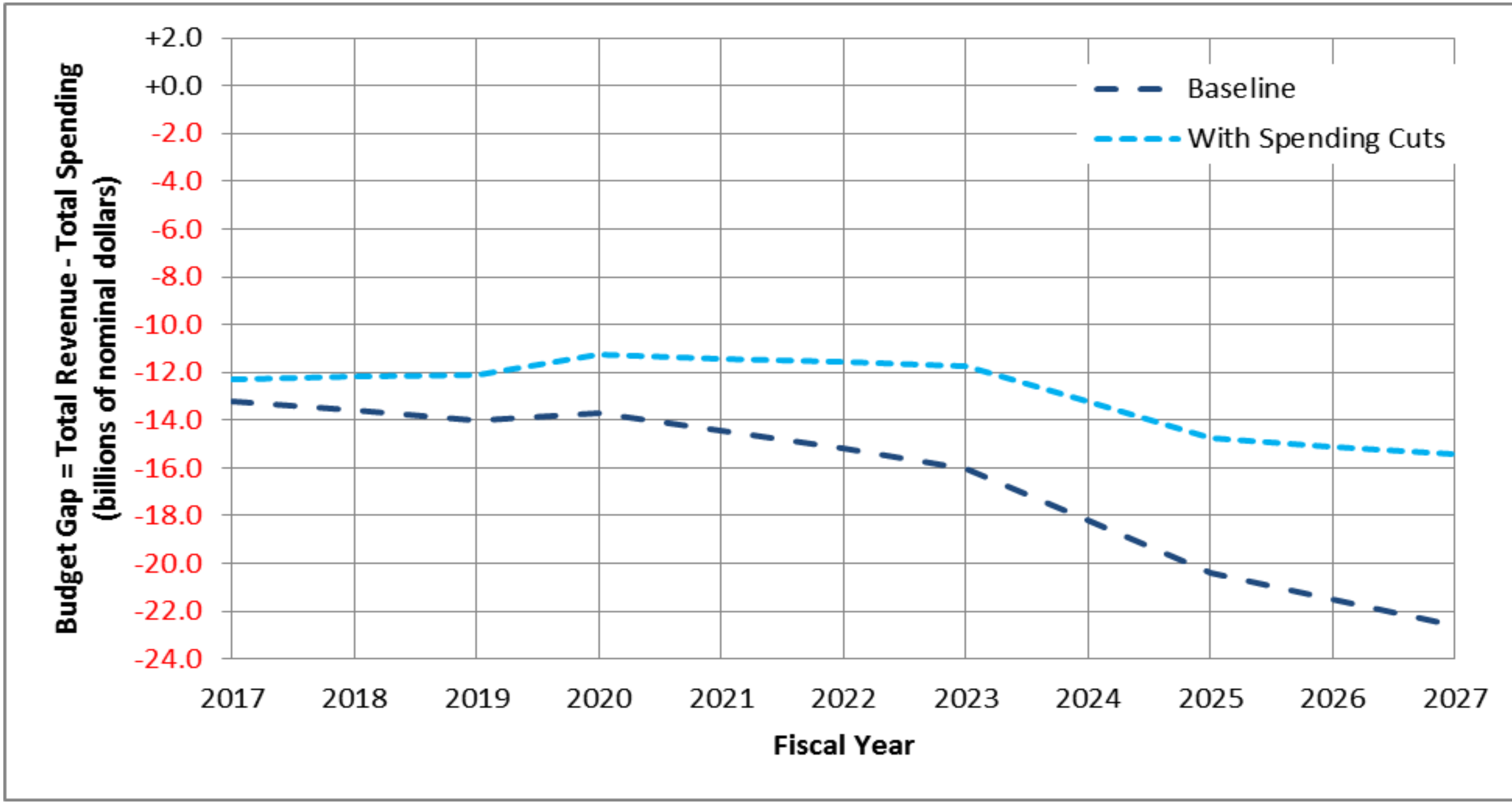
- Liabilities are claim on future revenues, which **crowds out future spending** on state services
- Credit ratings affected negatively

What would it take to close the gap?

Look at five ambitious policies—none do it alone

- Cut spending in "discretionary" categories 2% below projected each year
- Increase personal income tax rate from 3.75% to 4.75%, corporate rate from 5.25% to 6.65%
- Increase income tax base by 10%
- Increase sales tax base by 15%
- Assume income growth +0.5% each year

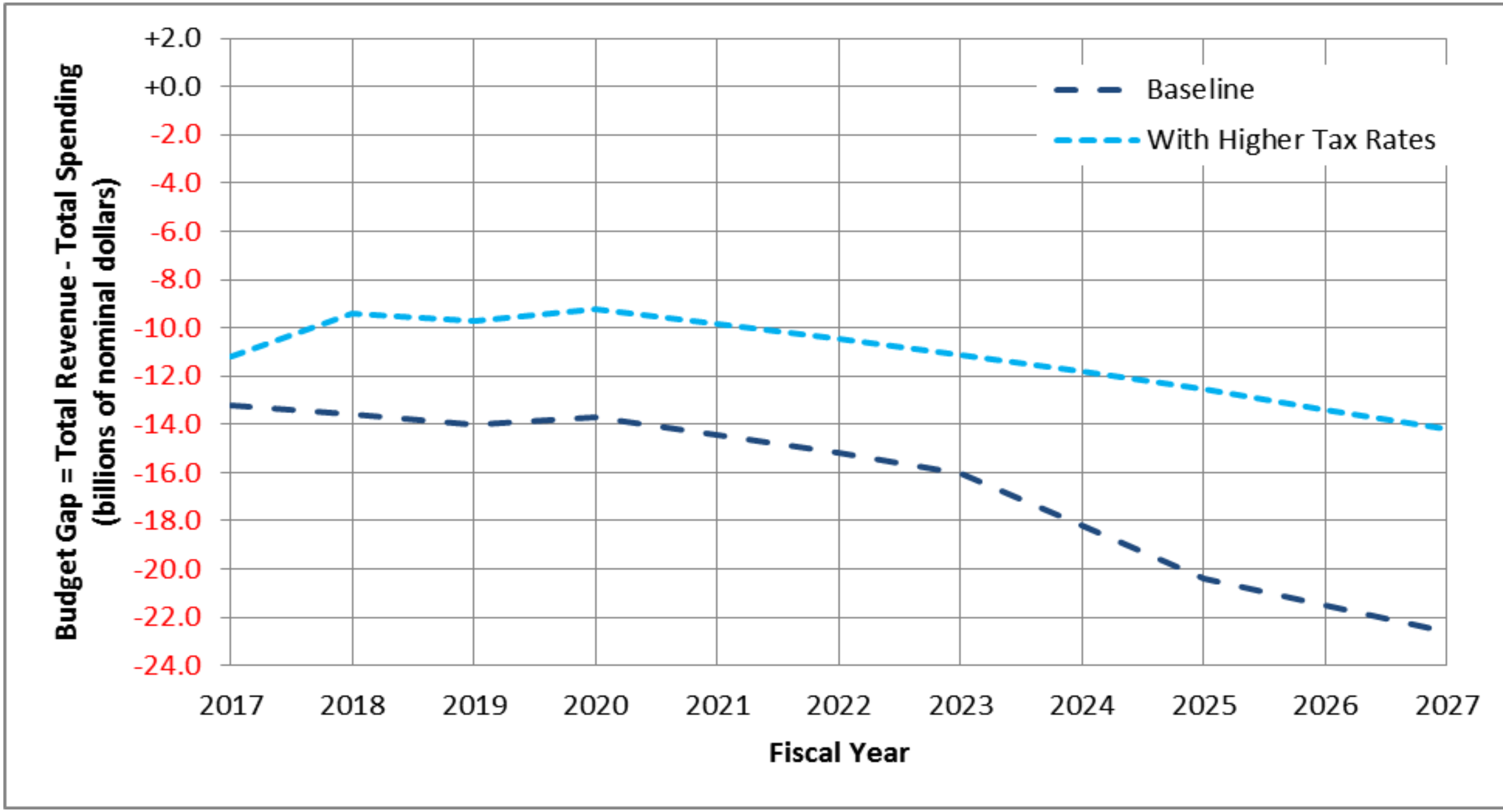
FIGURE 2: PROJECTED BUDGET GAPS WITH AND WITHOUT SPENDING CUTS



IGPA Fiscal Futures Model, November 2016

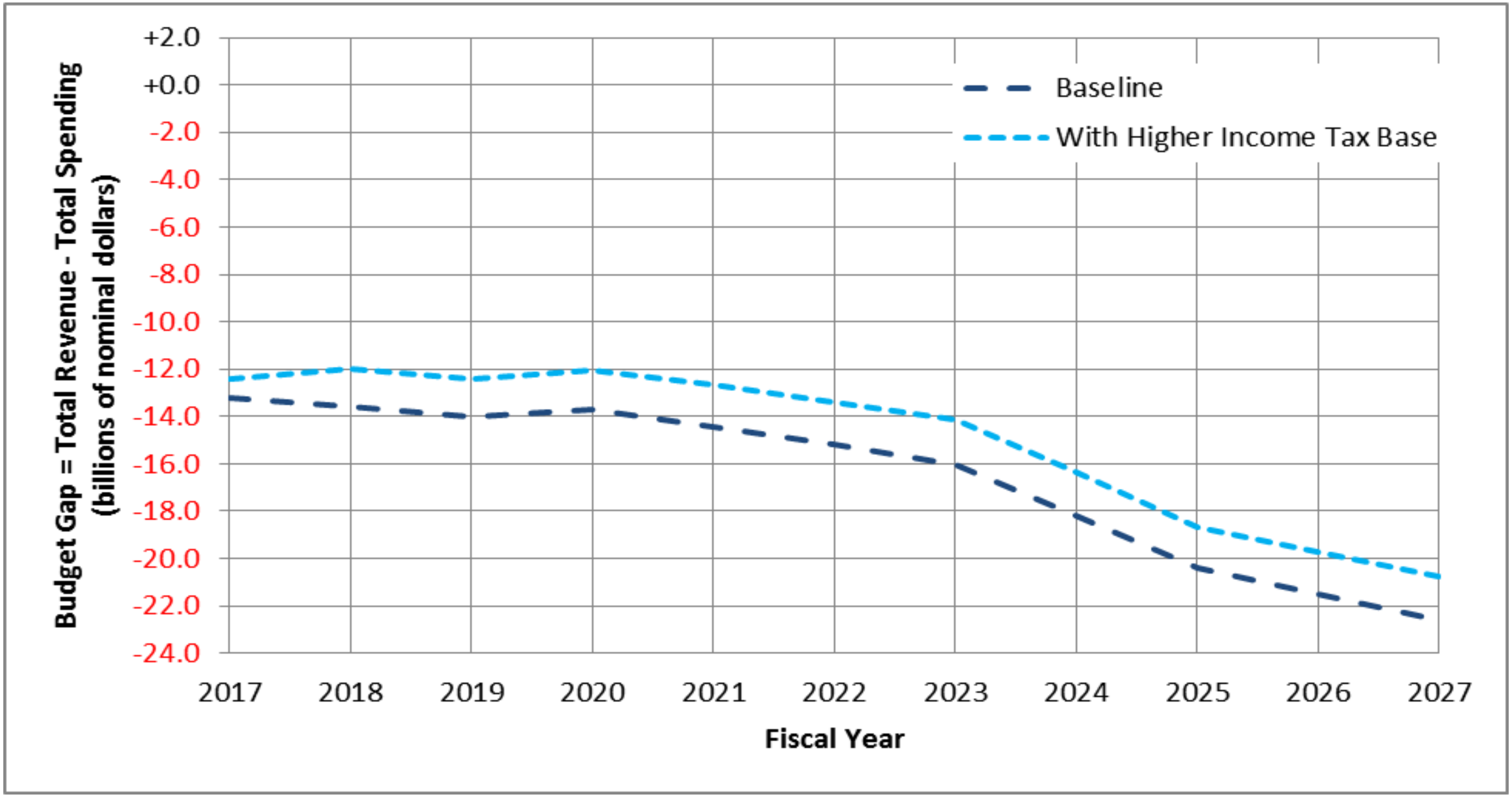
INSTITUTE OF GOVERNMENT & PUBLIC AFFAIRS
UNIVERSITY OF ILLINOIS
URBANA-CHAMPAIGN • CHICAGO • SPRINGFIELD

FIGURE 3: PROJECTED BUDGET GAPS WITH AND WITHOUT INCREASE INDIVIDUAL RATE TO 4.75%, CORPORATE TO 6.65%



IGPA Fiscal Futures Model, November 2016

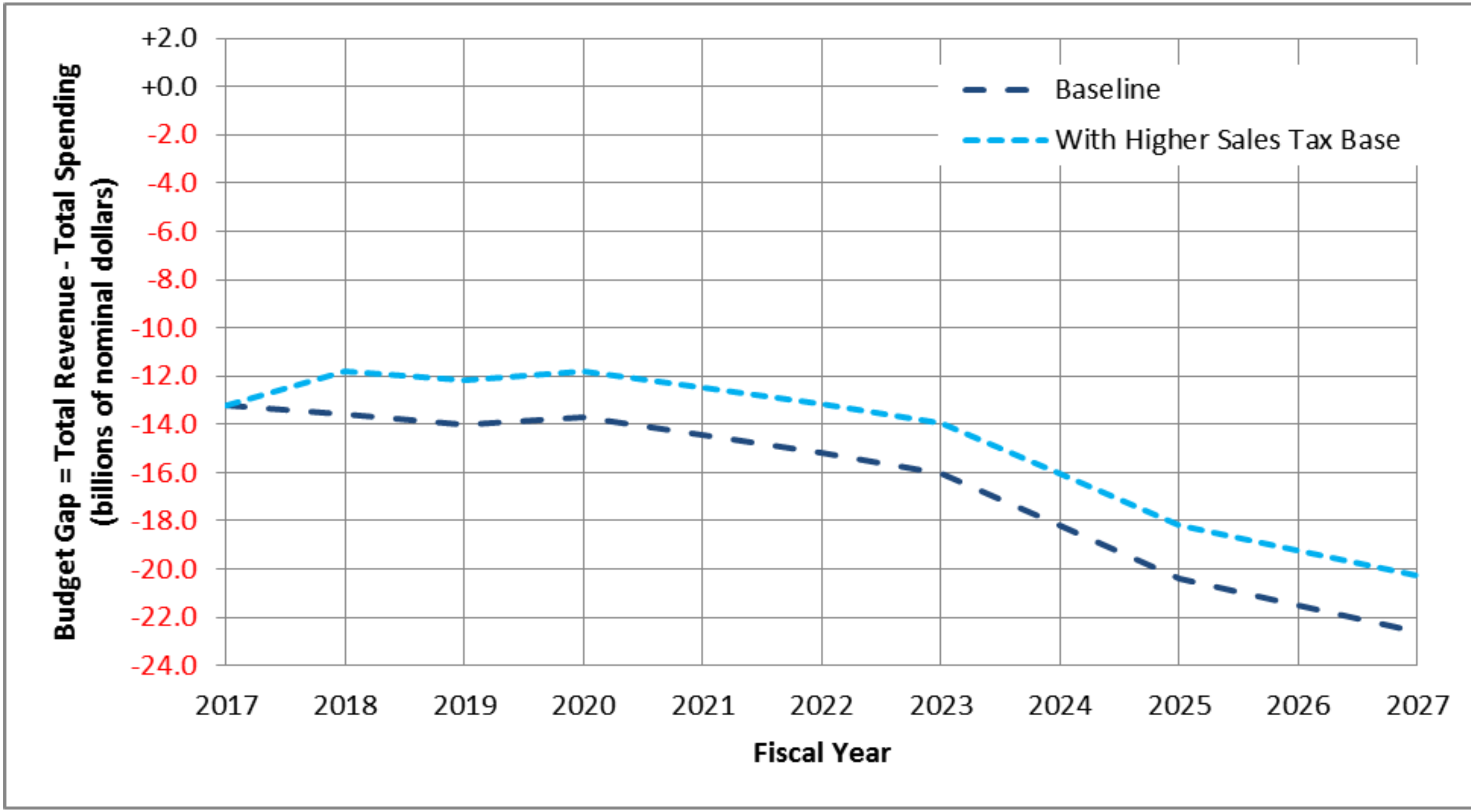
FIGURE 4: PROJECTED BUDGET GAPS WITH AND WITHOUT INCOME TAX BASE EXPANSION BY TEN PERCENT



IGPA Fiscal Futures Model, November 2016

INSTITUTE OF GOVERNMENT & PUBLIC AFFAIRS
UNIVERSITY OF ILLINOIS
URBANA-CHAMPAIGN • CHICAGO • SPRINGFIELD

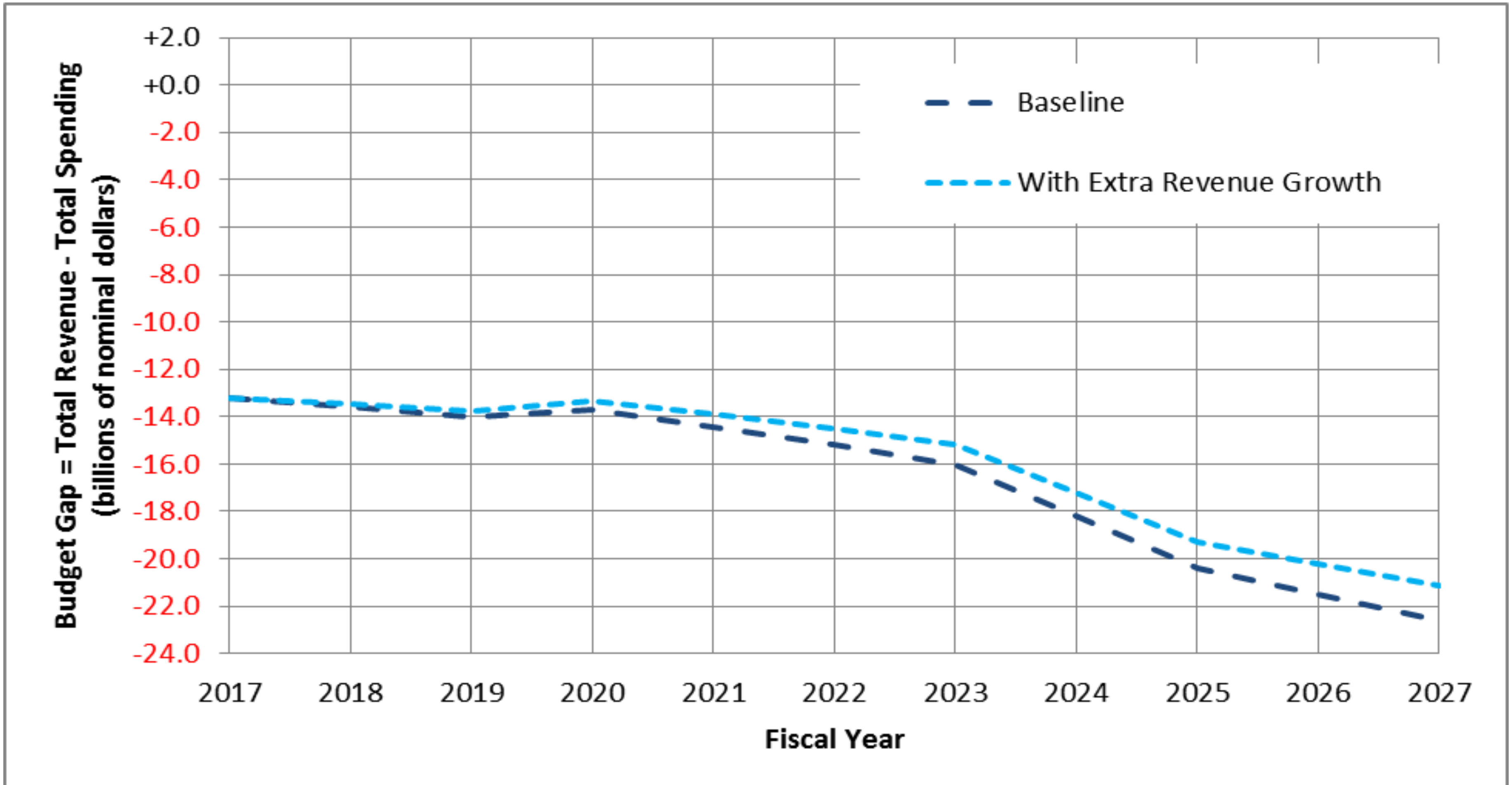
FIGURE 5: PROJECTED BUDGET GAPS WITH AND WITHOUT SALES TAX BASE EXPANSION BY 15%



IGPA Fiscal Futures Model, November 2016

INSTITUTE OF GOVERNMENT & PUBLIC AFFAIRS
UNIVERSITY OF ILLINOIS
URBANA-CHAMPAIGN • CHICAGO • SPRINGFIELD

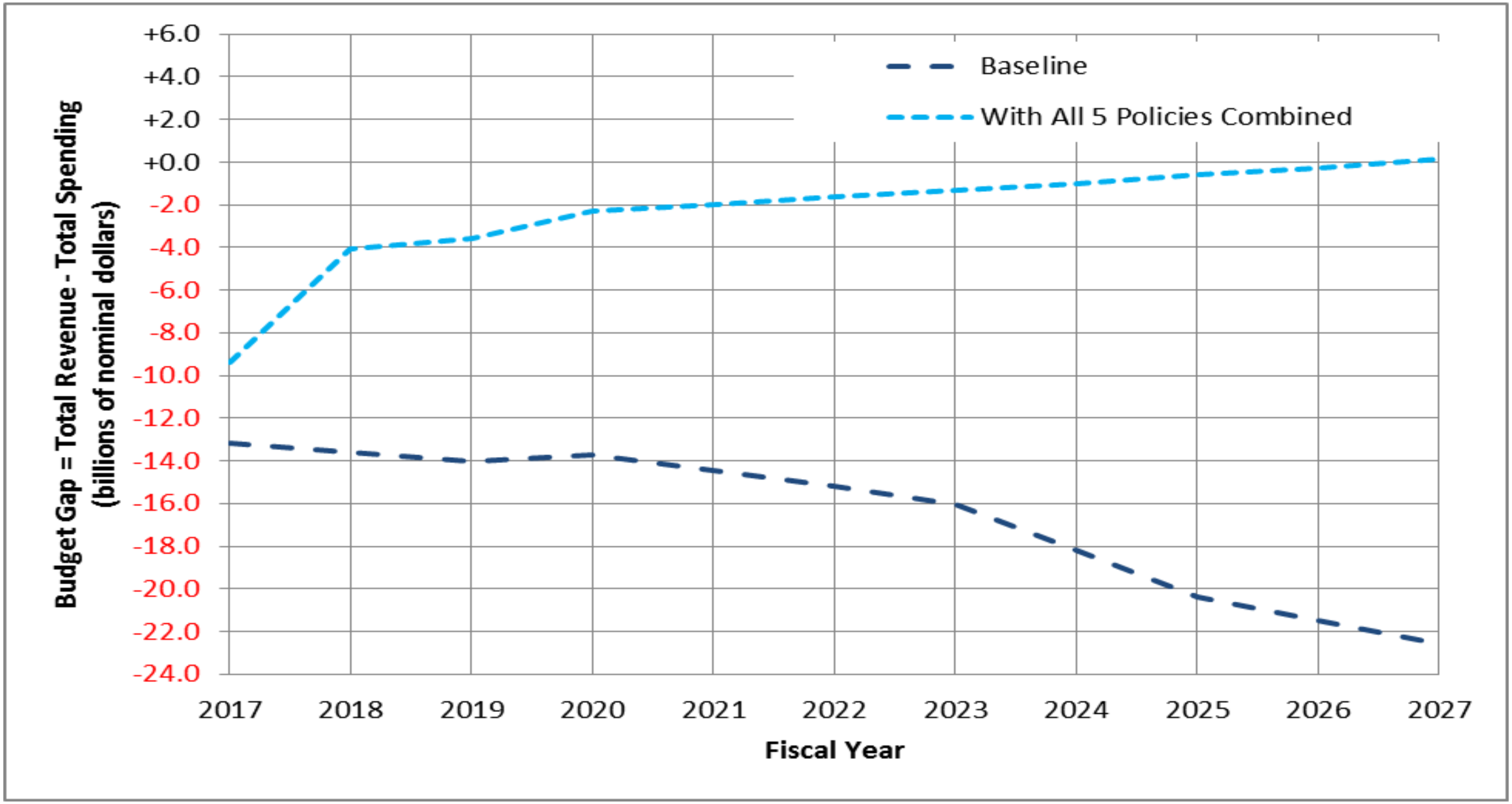
FIGURE 6: PROJECTED BUDGET GAPS WITH AND WITHOUT HIGHER PERSONAL INCOME GROWTH OF 0.5% EACH YEAR



IGPA Fiscal Futures Model, November 2016

INSTITUTE OF GOVERNMENT & PUBLIC AFFAIRS
UNIVERSITY OF ILLINOIS
URBANA-CHAMPAIGN • CHICAGO • SPRINGFIELD

FIGURE 7: PROJECTED BUDGET GAPS WITH ALL FIVE POLICIES IMPLEMENTED (FIGURES 2-6 COMBINED)



IGPA Fiscal Futures Model, November 2016

ILLINOIS HAS LARGE, CHRONIC, STRUCTURAL FISCAL PROBLEMS AND THERE IS NO SINGLE SOLUTION

- Additional borrowing, increased unfunded liabilities, or decreased asset balances will only make things worse
- Increases in economic growth—alone—are insufficient
- Increases in taxes—alone—are insufficient
- Cuts in spending—alone—are insufficient
- Aggressive pension changes—alone—are insufficient

DEALING WITH DEFICITS (SPENDING > REVENUE)

- To <u>avoid</u> a deficit, must either
  - Decrease Spending
  - Increase Revenue
- To <u>fund</u> a deficit, must either
  - Decrease Assets
    - Deplete existing fund balances
    - Sell other assets
  - Increase Liabilities
    - Take on more debt
    - Delay paying bills
    - Promise to pay benefits later (e.g., pensions)

INSTITUTE OF GOVERNMENT & PUBLIC AFFAIRS
UNIVERSITY OF ILLINOIS
URBANA-CHAMPAIGN • CHICAGO • SPRINGFIELD