Illinois' Fiscal Future and the State's Economy

Structural deficit remains—Can Illinois get its fiscal situation turned around?

Illinois' Fiscal Future and the State's Economy

By Richard F. Dye and Daniel P. McMillen

The first two editions of *The Illinois Report* made a number of points about the Illinois state budget and about the Illinois economy. Giertz (2007) documented recent budgetary shortfalls and argued that the state faces even more serious problems in the future, looking in particular at unfunded obligations for state employee pensions. Giertz and Hewings (2007) looked at the state's economy and found that the state had recovered from recession at the beginning of the decade, but was not doing as well in comparison to other states. Merriman (2008) looked at the state's continuing budget crisis from two perspectives: stepping back from the political fray to review first principles of fiscal analysis and then wading in to describe and analyze the current budget debate. Hewings (2008) documented the continuation of slow recovery and underperformance of the state's economy.

In this chapter, we take another look at the continuing and projected fiscal problems of Illinois and draw some links between the state's budget and the state's economy. We outline many of the ways the state's budget affects the economy and, in the opposite direction, ways the state's economy affects the budget. One such link, the role of public infrastructure and the transportation sector in particular, is examined in more depth.

As bad as the fiscal situation looks, there is good reason to believe that things will be even worse if we project out several decades.

The State Budget

The state of Illinois has, for several years, faced a severe structural deficit—an underlying mismatch between revenue and government service costs, currently and projected into the future. This mismatch means that sooner or later some very unpleasant political choices must be made—which programs to cut or which taxes or other revenue to raise. The harshness of those choices has contributed to a contentious, even hostile, political climate for budget negotiations over the past several years. The 2009 budget process was no exception.

Ominously, at the same time in February 2008 that the governor proposed his budget for the 2009 fiscal year, he identified a $750 million shortfall in the well-underway fiscal 2008 budget. The shortfall was addressed with special fund transfers to the general fund and elimination of certain so-called "loopholes" in business taxation. The 2009 budget proposed by the governor in February 2008 included both an operating budget and a capital budget. The battle over the operating budget continued past the June deadline to a special session. Following the special session, the version finally passed by the House of Representatives did not include sufficient revenue, causing the governor to use his amendatory veto power to cut $1.4 billion in spending. The 2009 capital plan was not adopted, due to failure to agree on appropriate revenue sources.

In his February 2008 report on the "Fiscal State of the State" over the prior five years, the Illinois state comptroller said that "since the low point in fiscal year 2003 … the state's economic revenues have enjoyed an impressive resurgence in tandem with the performance of the U.S. economy," but that while most other states used their additional revenue to stabilize their fiscal condition, Illinois did not and still has a significant Generally Accepted Accounting Principles (GAAP) deficit.[1] The fiscal condition of the state can be summarized in several different measures of the deficit or surplus. Figure 1 presents for recent years two cash flow measures of budget balance—operating balance, budgetary balance—and the GAAP balance, a modified accrual accounting measure. Only by rolling spending into next

[1] http://www.apps.ioc.state.il.us/ioc-pdf/2007FiscalStateOfState.pdf.

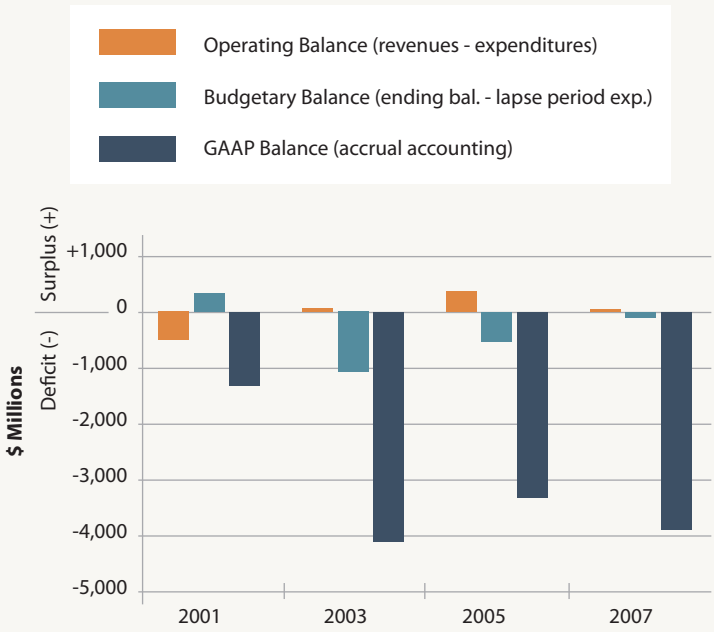
year is the cash budget balanced. Including currently accrued liabilities, most importantly pension liabilities, the deficit situation looks much, much worse.

The state's current budgetary situation is severe, but there are three very different forces that may make it even worse in the future. First, state revenue is linked to the economy, so revenue will fall off as the economy enters a down cycle. Second, state revenue and obligations may grow at different rates relative to the underlying economy and, if expenditures grow faster than revenue, the structural deficit will grow over time. Third, there are demographic forces that affect revenue and spending over the longer haul that are of concern.

Cyclical Deficits

The U.S. economy turned down slightly in the third quarter of 2008[2] and showed little signs of improvement heading into 2009. Painful experience tells us that revenue will be adversely affected when the economy enters a period of decline or even slow growth. In its September 2008 monthly briefing, the Illinois Commission on Government Forecasting and Accountability reported some growth in key revenue sources but expressed concern that "worsening economic conditions suggest that even these modest rates of growth will struggle to be maintained over the remainder of the fiscal year."[3] This cautionary note was issued even before the depth of the global financial crisis was fully realized and before the consensus of economic forecasters predicted a significant recession in economic activity over the next year or more. By the time of its November 2008 briefing, the Commission of Government Forecasting and Accountability was estimating a $1.3 billion revenue shortfall for fiscal year 2009, compared to the assumptions made to balance the budget months earlier. The commission further cautioned that "the effect of this recession will be felt for some time, with the worst perhaps to come in FY2010."[4] Compounding this concern, the financial crisis makes the state's underlying deficit even worse by sharply eroding the value of financial assets held to support future pension obligations.

Figure 1
Illinois State General Fund Balance on a Cash Basis and on a Generally Accepted Accounting Principles (GAAP) Basis (in Millions of Dollars)



Source: Illinois Office of the Comptroller, http://www.wh1.ioc.state.il.us/FiscalCondition/index.htm.

Structural deficits

In his contribution to *The Illinois Report 2007*, J. Fred Giertz presented estimates of a structural deficit growing year after year because state revenue is projected to grow at a slower rate than expenditures. He concluded that, "[s]oon, the state must face the prospect of either making large and painful cuts in major programs or finding additional permanent sources of revenue." The state has taken no such action and may have made things worse by funding additional expenditures with the recent cyclical surge in revenue and by relying on other one-time revenue sources.

[2] http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm.

[3] http://www.ilga.gov/commission/cgfa2006/Upload/0908revenue.pdf.

[4] http://www.ilga.gov/commission.cgfa2006/upload/1108revenue.pdf.

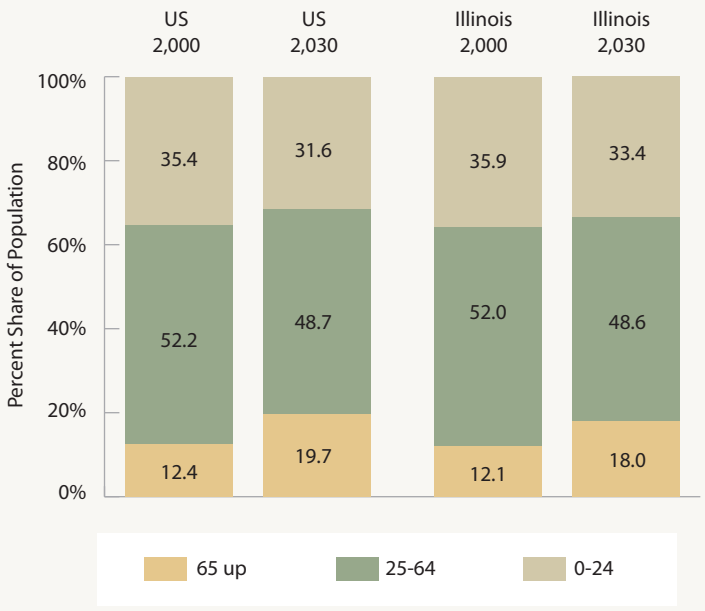
While all studies agree that public investment provides jobs and increases productivity in the private sector, they are far from unanimous in concluding that the benefits warrant the costs.

The Fiscal Effect of an Aging Economy

As bad as the fiscal situation looks, there is good reason to believe that things will be even worse if we project out several decades. A recent conference hosted by the Institute of Government and Public Affairs and an IGPA publication highlight the potential impact of the changing age distribution of the American population on state budgets.[5] Figure 2 shows the age distribution of the population in the 2000 census alongside projections for the year 2030. The projections are for a dramatic increase in the share of the population that is of retirement age over the next 20 years.

Tax collections will be affected by this shift. As the working-age population declines, state tax collections from labor income can be expected to fall. There will be no offsetting increase in income tax collections from retirees, because Illinois is one of only three states with an individual income tax that fully exempts income from pensions and Social Security. Sales tax collections will be affected in complicated ways, but the net effect probably will be a decline. Incomes go down in retirement and consumption can be expected to decline as well. Consumption patterns change in retirement, possibly with a shift toward goods and services not included in the sales tax base. Business tax collections may go down if the decline in the size of the labor force leads predictably to a decline in total state production. The expenditure side of the state budget will be affected as well. Most significant will be an increase in state payments for medical costs and for long-term care.

Figure 2
Age Distribution of Population in 2000 and Projected for 2030 (Percent Share of Population)



Source: U.S. Census, "State Interim Population Projections," 2005.

The Budget and the Economy Are Linked

We've already noted links by which changes in the economy lead to changes in the budget—a cyclical slowdown in the national and state economy that leads to a decline in or differential responsiveness of revenue versus expenditures to underlying trends in the economy. The causation can go the other way, too. Better budgetary choices can lead to a stronger state economy. The impact of the budget on the economy can be either on the demand side or the supply side. Demand side macro-simulative effects are, however, much more important at the national level than the state level. Because additional state spending and its multiplier effects can easily flow across state borders, there is little one state can do to pump up its own economy. To look for beneficial or

[5] Richard F. Dye. "The effect of demographic change on state and local government budgets," in *IGPA Policy Forum*, 20(1), (2007); "The Fiscal Future of State and Local Governments: Effects of the Coming Demographic Transition," in *IGPA Conference Highlights* from Feb. 22, 2008. http://www.igpa.uillinois.edu/ library/effect-demographic-change-state-and-local-government-budgets; and http://www.igpa.uillinois.edu/library/conference-highlights-fiscal-future-state-and-local-governments.

detrimental effects of the state budget on the state economy, attention must be given to the supply side—to things like infrastructure and education that increase the quantity, quality and flexibility of capital and labor. The rules as to what is taxed and at what rate can have important incentive effects on work, savings, investment, and business activity. In the next chapter of this report, Anderson and Miller look at an important subset of these issues, the incentive and disincentive effects of taxes on business. We devote the next section of this chapter to another important category, the impact that public spending for infrastructure has on state economic activity.

The Role of Public Infrastructure

The state budget plays a critical role in building and maintaining public infrastructure. Roads and highways, public transit, airports, canals, ports, and railways require regular state funding to maintain high levels of service. Academic researchers treat public infrastructure as a critical input to the production process of businesses. An early influential study by David Aschauer found that public investment in "core" infrastructure—streets and highways, airports, electrical and gas facilities, mass transit, water systems, and sewers—leads to significant increases in the productivity of firms, with a 1 percent increase in core infrastructure leading to a 0.24 percent increase in private sector output.[6] Though Aschauer's research focused on federal expenditures, subsequent research suggests that state and local investments in core infrastructure can have large effects on output and employment in the private sector. By directly increasing employment in the construction industry and indirectly making other firms more productive, highway expenditures in particular may prove to be a good investment on the part of state governments.

Empirical studies are not conclusive regarding the merits of public infrastructure. While all studies agree that public investment provides jobs and increases productivity in the private sector, they are far from unanimous in concluding that the benefits warrant the costs. The jobs "created" by public investment are generally considered by economists to simply be a transfer of people from one activity to another. The literature on tax competition suggests that states may sometimes allocate too much money toward relatively unproductive investments in an attempt to lure firms away from other locations. However, the most important source of inconclusiveness is simply the differences in the approaches taken and data sets used by different

[6] David Alan Aschauer. "Is Public Expenditure Productive?" *Journal of Monetary Economics* 23 (1989): 177-200.

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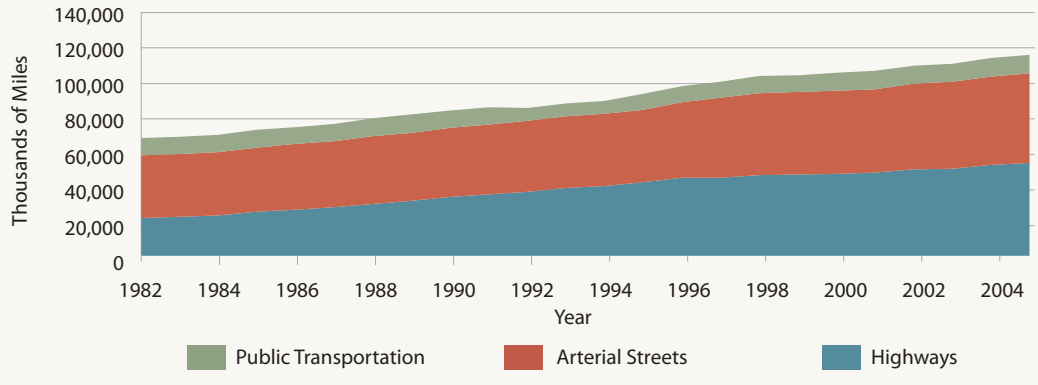
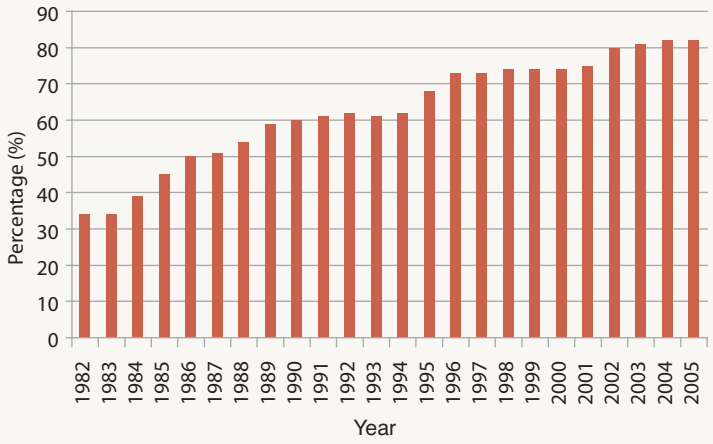
Figure 3
Daily Miles Traveled



authors. Infrastructure is not a simple, uniform, easily-measured good. Different studies have focused on federal, state, and local expenditures. Older urban areas with high levels of infrastructure in place often have antiquated, inefficient public goods that are hard to distinguish empirically from newer, more modern investments.

Figure 4
Travel Time Spent in Congestion



The most important form of public infrastructure investment is roads and highways. Illinois has more than 140,000 miles of state and local roads and the third largest interstate highway system in the country.[7] Highway construction spending totaled $1.8 billion in fiscal year 2006, with the bulk of it devoted to maintenance of existing infrastructure, along with occasional building of new lanes along existing highways to reduce congestion.[8] Businesses consistently rank highways as one of the most important factors in choosing where to locate, and commuting costs are an important determinant of residential locations decisions.

Partly because highway funds are devoted primarily to maintenance and repair instead of new construction, congestion continues to worsen in the Chicago area. The Texas Transportation Institute's (TTI) *Urban Mobility Report* offers a fascinating view of traffic conditions in the Chicago area. Figure 3 (pg. 17) shows the growth in daily miles traveled in the Chicago area for 1982-2005. Despite the presence of a large-scale system of commuter rail and rapid transit lines, highways continue to account for an increasing proportion of travel in the Chicago area.

The result is a large increase in congestion. Figure 4 shows TTI's estimates of the proportion of travel time spent in congested conditions in the Chicago metropolitan area. More than 80 percent of all travel time is now spent in congested conditions, up from only one-third in the early 1980s. New growth and continued decentralization only make congestion worse.

Figure 5 presents TTI's estimates of the number of new lanes that would have to be added to the system *annually* just to maintain congestion at current levels in the Chicago area. About 300 new miles of highway would need to be added each year just to keep congestion from getting worse.

Congested highways make an urban area less attractive as a place to live and as a place to locate a business. Even before the recent run-up in gas prices, enormous amounts of energy were being wasted in crowded Chicago traffic. Figure 6 shows an estimate of excess gasoline consumption caused by congestion in the Chicago area. About 140 *million* gallons of gasoline are burned annually as a result of congestion.

Ironically, one benefit of the high gas consumption is the amount of revenue raised by the state in gas taxes. According to data from the Tax Foundation, Illinois raised about $1.45 billion in revenue from motor fuel taxes in 2006, or about $113 per capita.[9] Motor fuel taxes accounted for 5.1 percent of total state taxes in 2006, placing Illinois right at the median among the 50 states. However, Illinois' per-capita fuel

[7] See the article by Drake Warren in IGPA's *The Illinois Report 2008* for an inventory of the condition of the state's bridges.

[8] http://www.ioc.state.il.us/FiscalFocus/article.cfm?ID=210.

[9] http://www.taxfoundation.org/taxdata/show/241.html.

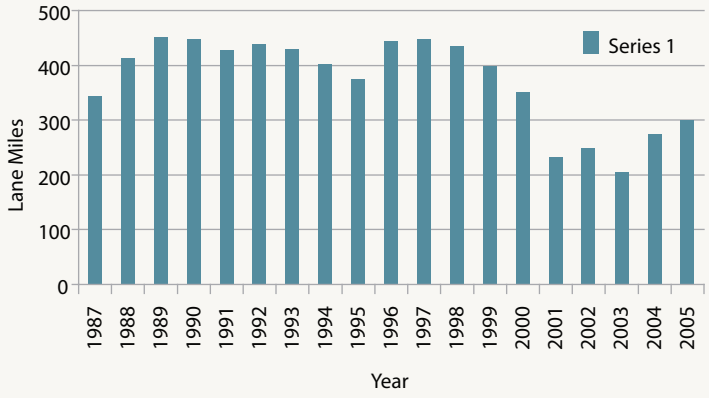
tax revenue is relatively small by national standards: the average is $119, placing Illinois 40th among the states.

Most states tax gasoline consumption on a per-gallon basis. As of January 1, 2008, Illinois' tax was $0.395 per gallon. An obvious but often neglected feature of a unit tax is that revenue does not automatically increases as prices rise: a gallon of gasoline yields $0.395 whether the price is $2 or $4 per gallon. However, Illinois is somewhat unusual in that it also subjects gasoline to the regular state sales tax of 6.2 percent. As a result, when the price of gasoline doubles, the sales tax portion of the motor fuel tax also doubles. A basic rule of economics is that consumption falls when prices rise. Nevertheless, total expenditure may still rise if consumption does not fall proportionately, which is clearly the case with gas consumption. If the state relied solely on the unit motor fuel tax, revenue would fall when prices rise. However, because the demand for gasoline is inelastic, the sales tax portion of the motor fuel will rise even as the number of gallons consumed declines.

Increased gasoline prices help spur ridership on public transportation. Unfortunately, increased fuel costs produce higher losses among public transit systems even as revenues rise. A recent *Chicago Tribune* article summarized the results of a survey by the American Public Transit Association.[10] Among the findings are that recent increases in fuel prices are leading 61 percent of transit systems to consider a fare increase, while 35 percent are considering service cuts. Chicago's situation is worsened by the recent loss of revenue resulting from the state requiring free transit passes for senior citizens. The Chicago Transit Authority estimates that the free passes are leading to a loss of $92,000 per day in revenue.

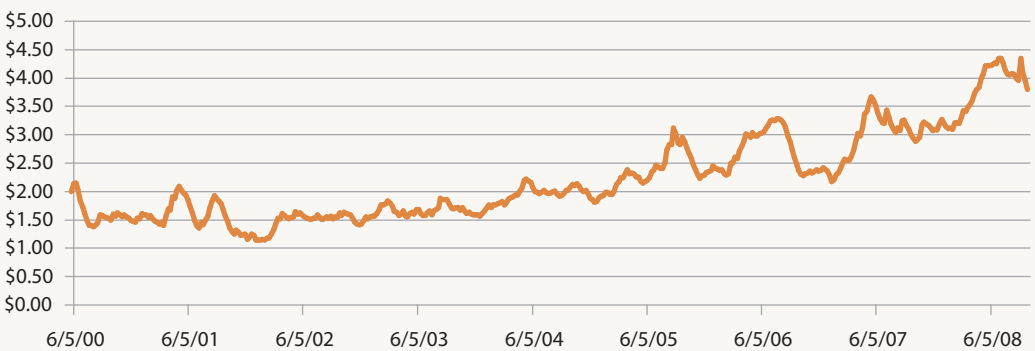
Chicago remains the nation's transportation hub. O'Hare Airport, which is consistently among the world's busiest airports, is the focal point for a massive agglomeration of commercial and industrial industry in the northwest suburbs. As economist Jan Brueckner argues in an article focusing on

Figure 5
Annual Increase in Lane Miles Needed for Constant Congestion Level



[10] "Chicago Area is Not Alone in Transit Woes," *Chicago Tribune*, Oct. 8, 2008.

Figure 6
Retail Price of Gasoline in Chicago



O'Hare, "Frequent service to a variety of destinations, reflected in a high level of passenger enplanements, facilitates easy face-to-face contact with businesses in other cities, attracting new firms to the metro area and stimulating employment at established enterprises."[11] His empirical results suggest that "a 10 percent increase in passenger enplanements in a metro area leads approximately to a 1 percent increase in employment in service-related industries."

Chicago is the freight rail center of the United States. According to data presented in the Chicago Metropolis 2020 paper, "The Metropolis Freight Plan: Delivering the Goods," 20 North American railroads annually transport $350 billion goods "to, from, or through" the metropolitan area, employing 37,000 workers in the process. Trucking companies employ another 50,000 workers to ship an additional $572 billion in goods through the region. Together, "in 2000, the region's top 40 freight centers, where concentrations of manufacturing, warehousing, shipping and related firms have ready access to rail and truck services, accounted for 553,000 jobs and $131 billion in annual sales." However, both rail and highway systems are highly congested. Freight trains can take a week just to travel across the Chicago metropolitan area. Intermodal containerized shipping significantly increases the number of trucks on Chicago's expressways.

One thing the Illinois legislature and governor did achieve in the last session was enactment of the *Mass Transit Funding and Reform Bill*.[12] The act will raise $280 million from an additional 0.25 percent sales tax rate in the six-county region of the Regional Transportation Authority (RTA), $100 million from an additional 0.3 percent real estate transfer tax in the City of Chicago, and commit the state to additional matching funds. The additional revenues will, however, be used almost entirely for operations, not infrastructure improvement.

[11] Jan K. Brueckner. "Airline Traffic and Urban Economic Development," *Urban Studies* 40 (2003): 1455-1469.

[12] Julie Hamos. "Mass Transit Funding and Reform P.A. 95-708 (HB656)," [summary of 2008 Illinois transit funding act], Jan. 23, 2008, http://www.juliehamos.org/pdfs/HB656FACTSHEET_01-23-08.pdf.

Illinois' fiscal future looks very bleak.

Policy Options

Illinois' fiscal future looks very bleak. The governor and legislature have temporized, denied, and pointed fingers. They have spent a cyclical surge in regular revenue and other one-time revenue sources on current operations. They have met the technical requirements of a balanced budget only by repeatedly delaying large amounts of spending until the next budget year. Binding promises for government retiree pensions and medical care are not fully funded. From this starting point, the state budget now faces in the near future a probable significant cyclical downturn in revenue associated with the looming recession. From this starting point, state budget policy makers must look ahead 20 years or so to significant additional fiscal challenges from an aging population—declining taxes on labor source and business incomes and increased obligations for medical services and long-term care for the elderly.

The budget and the state's economy are linked. For example, government investment in transportation infrastructure is very important to the state's economic activity. An aging infrastructure means that more public funds must be spent for repair and maintenance leaving less for growth-inducing investment. The existing and soon-to-be worse fiscal challenges facing the state will make it even harder to fund repair and maintenance, much less net new investment.

We conclude by mentioning examples of three very different types of policy options. There are ways to encourage more efficient use of transportation infrastructure. New revenue sources may have to be considered. Better information may improve decision making.

More efficient use of transportation infrastructure. The Chicago metropolitan area has far too many bottlenecks in its expressway system. Moreover, gaps between state-

designated truck routes lead to inefficient, circuitous routes for freight transportation, particularly in the suburbs. Eliminating bottlenecks requires large investments from both the federal and state governments. Coordination of truck routes can easily be accomplished with regional transportation planning. Traffic flow could be improved greatly by adopting variable, time-of-day congestion pricing on toll roads. While the current fixed-rate tolls help cover some of the costs of highway maintenance, they do little to discourage congestion. Higher tolls during peak times would encourage non-commuters to delay trips until rush hour periods are over while providing significant time savings to regular commuters. Tolls can be made revenue neutral by lowering or eliminating charges during off-peak times, or they can be used to raise money for highway maintenance and improvements.

Consider taxing retirement source income: Illinois is one of only three of the 41 states with an individual income tax that fully exempt private pension income and one of only eight that fully exempt public employee pension income.[13] This tax preference for retirement-source income will adversely affect state income tax collections as the population ages. It might be appropriate to reconsider this preference in anticipation of the impact of an aging population on the state budget. Two other key features of the Illinois personal income tax are relevant to any such re-examination. With a flat rate of only 3 percent, Illinois has the lowest top tax bracket of any income-tax state.[14] This low rate would soften the impact of expanding the tax base to include more retirement income. On the other hand, with a personal exemption of only $2,000 per person and no standard deduction, Illinois has among the very lowest "tax thresholds"—the level of income at which an individual or couple starts paying taxes—of any state.[15] Only if this tax threshold level were raised substantially would it be reasonable to tax retirement source income. With the tax threshold amount of income set at a reasonable level, there should be no reason to favor one source of income over another in defining the tax base.

Provide better estimates of the fiscal future: Illinois is afflicted by "budget blindness" and does not know where it is going. With the exception of pension liabilities and bonded indebtedness, there is no requirement and no systematic effort to project the consequences of present actions and obligation into future years. There is no mechanism for calculating the impact of major demographic changes like the aging of America on the state budget in future years. There is a bias in the budget process that concentrates almost entirely on current-year or next-year amounts. Short-term political expediency often leads to making choices that move costs into the future. In recent years, future revenue streams like the tobacco settlement have been sold or borrowed against to pay current bills. Sale or long-term lease of the state lottery has been proposed. Little attempt has been made to calculate the long-term impact of these short-term choices, so the budget future keeps getting worse.

In the belief that better information may lead to better choices, the Institute of Government and Public Affairs has initiated the *Fiscal Futures Project* with the support of a number of civic and interest groups:

- The Taxpayers' Federation of Illinois;
- The Civic Committee of The Commercial Club of Chicago;
- Illinois Farm Bureau;
- AFSCME Council 31;
- The Illinois Education Association;
- Chicago Metropolis 2020; and
- The Metropolitan Planning Council.

The goal of the project is to develop a long-term budget model for Illinois. The model will: project current budget choices out five, 10, or 15 years; incorporate projections of

[13] Richard F. Dye and Therese J. McGuire. "Illinois' Individual Income Tax and General Sales Tax: Options for Reform," *State Tax Notes*, Oct. 24, 2005: 371-387, Table 6.

[14] Ibid, Table 9.

[15] Ibid, Figure 3 and Table 8.

Illinois is afflicted by "budget blindness" and does not know where it is going.

demographic and economic variables for future years; and project the impact of proposed changes in tax and spending programs on out-year budgets. Eventually, we plan to integrate the budget model to the University of Illinois' Regional Economic Applications Laboratory (REAL) model of the Illinois economy to explore the links between the budget and the economy.

Having a long-term budget model will change neither the harsh constraints on budgetary choices in the state, nor the unfortunate consequences of past choices, but it may lead to a greater appreciation of the long-term fiscal situation, the links between current choices and future budgets, and the links between the budget and the state's economy.

Richard F. Dye has been on the IGPA faculty since 1990. He is co-director of IGPA's *Fiscal Futures Project*. His other research and public outreach activities focus on state and local government finance and include studies of: the impact of property tax limitations; the effects of tax increment financing on local economic development; residential housing teardowns and land values; the growth and stability of different state revenue sources; property tax responses to state aid cuts; the impact of property tax classification on business activity; voter preferences for the equalization of school property taxes; and earmarking revenues for specific public expenditures. He has published in the *National Tax Journal, Journal of Urban Economics, Journal of Public Economics, Journal of Regional Science, Growth and Change, Economic Development Quarterly, State Tax Notes*, and elsewhere. Professor Dye retired from Lake Forest College in 2007 after 24 years on the school's Department of Economics. He received his A.B. from Kenyon College and a M.B.A. and a PH.D. in economics form the University of Michigan.

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