

# TAX FACTS



Taxpayers' Federation of Illinois

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## First You Stop Digging: Projections of Illinois' Fiscal Imbalance and Paths to Remedy It

**"If you find yourself in a hole, stop digging." (Will Rogers)**

By Richard Dye and David Merriman

*Richard Dye and David Merriman are co-directors of the Fiscal Futures Project at the Institute of Government and Public Affairs at the University of Illinois. This excerpt of their recent report is printed with permission. The full report, with additional detail and complete citations, can be found at <http://igpa.uillinois.edu/report/first-you-stop-digging>.*

### Introduction

The state of Illinois has operated for many years with a structurally unbalanced budget in the sense that, under the policies in place at the time, government revenue generated by the tax system was insufficient to pay for government spending under current law. In order to understand and quantify Illinois' structural imbalance better, in 2008 we launched the *Fiscal Futures Project*, which developed a computer model of the Illinois state budget.

In January 2015, a report from Fiscal Futures using a previous, but quite similar, version of our model, summarized Illinois' precarious fiscal situation as follows:

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## NOTES FROM THE INSIDE. . .

By Carol S. Portman

This issue of *Tax Facts* presents a sobering update on the severity of Illinois' fiscal situation from the Institute of Government and Public Affairs' (IGPA's) Fiscal Futures Project. In a nutshell, authors David Merriman and Richard Dye illustrate why the ultimate solution to Illinois' fiscal situation will almost certainly include painful budget cuts, painful tax increases, **and** an unprecedented willingness to sustain both over a decade. As their title implies, the first step is to stop digging Illinois deeper into the hole.

As a bonus, former TFI President Jim Nowlan places the Merriman-Dye findings in historical context while highlighting the state's underlying problem, our inability to align desire for services with the willingness to pay taxes to support them.

Merriman and Dye do not present their model as a forecast, but rather as a "rough measure of the magnitude of the fiscal challenge Illinois faces." The report focuses on the "budget gap," the difference between revenues and spending in all funds, not just the general funds; the model produces a baseline estimate of a budget gap in 2027 in excess of \$20 billion using current revenue and spending trends.

Against that baseline they introduce five options into the model: (1) cutting spending, (2) raising income tax rates, (3) broadening the income tax base, (4) broadening the sales tax base, and (5) stimulating the economy. None of the options as presented is sufficient to eliminate the budget gap on its own. Based on their model, it will require all five actions—and ten years—to eliminate the budget deficit.

It is human nature to second-guess someone else's assumptions, and of course reasonable minds may quibble over some of the details in this report, but the overall conclusion is unavoidable: the solution to Illinois' dire fiscal condition is not going to be simple or easy. A few specific points worth noting:

- The model shows no budget gap in 1998. By then, Illinois had already been hiding its overspending for years by underfunding pensions and other fiscal gimmicks; 1998 is simply a starting point for the model.
- "Spending cuts" for this purpose is a slowing of spending growth below the model's projected baseline, rather than a year-over-year spending reduction. Larger cuts in spending would achieve fiscal equilibrium sooner or allow for smaller tax increases.
- Many believe it is unlikely that extending sales tax to services would yield \$2 billion annually, particularly in the projected time frame.

Those and other questions aside, the Fiscal Futures model provides a clear illustration of Illinois' situation: spending is increasing faster than revenues and will continue to do so, absent significant change. It is equally clear that the road to fiscal health will require difficult decisions by Illinois policymakers. Unfortunately, these decisions will only become even more painful if they are delayed.

The Taxpayers' Federation has a long history of support and collaboration with the IGPA and the Fiscal Futures model. Their latest report should be mandatory reading.

- A deficit of \$6 billion on "all funds" spending of roughly \$72 billion during fiscal year 2015;
- A projected gap of around \$9 billion per year for the next five years;
- "Legacy costs" or unfunded liabilities for retiree pensions and health care of \$152 billion;
- Unpaid bills for services already provided to the state of \$6.5 billion.<sup>1</sup>

It is something of an understatement to say that Illinois has not made substantial fiscal progress following that discouraging report. Republican Governor Bruce Rauner and the Democrat-controlled General Assembly were unable to agree on a comprehensive budget for FY2016. The Illinois personal income tax rate fell from 5 percent to 3.75 percent and the corporate income tax rate fell from 7 percent to 5.25 percent in accordance with legislation that had been enacted in late 2011. Only a few spending items were both approved by the General Assembly and signed into law by the governor. Despite this, as we detailed in a report in February 2016, spending continued in many categories as a result of continuing appropriations, consent decrees, and court orders.<sup>2</sup>

Illinois legislators and the governor also were unable to agree on a comprehensive FY2017 budget, although a few categories of spending—most notably K-12 education—were funded for the entire year and most other spending categories received a six-month appropriation. No significant changes in tax or revenue policy were enacted.<sup>3</sup>

We combined the most recent data available (as of the end of October 2016) from the Comptroller with our model to calculate the same four measures of Illinois' fiscal condition reported above. Under current (baseline) policies we find:

- A deficit of around \$13 billion for the current year (FY2017)
- A projected gap of around \$14 billion per year for the next five years
- "Legacy costs" for unfunded liabilities for retiree pensions and health care of \$174 billion<sup>4</sup>
- Unpaid bills for services already provided to the state of \$10 billion<sup>5</sup>

As our analysis will demonstrate, it is almost certainly not feasible to remedy imbalances of this magnitude by policy changes in a single year. Rather, climbing out of the hole that Illinois is in likely will require hard choices, fiscal discipline and sustained attention over a long period of time. Because of this, our analyses put particular emphasis on projecting the implications of sustained multi-year policy changes that move Illinois toward fiscal balance.

### **New Projections from the Fiscal Futures Model**

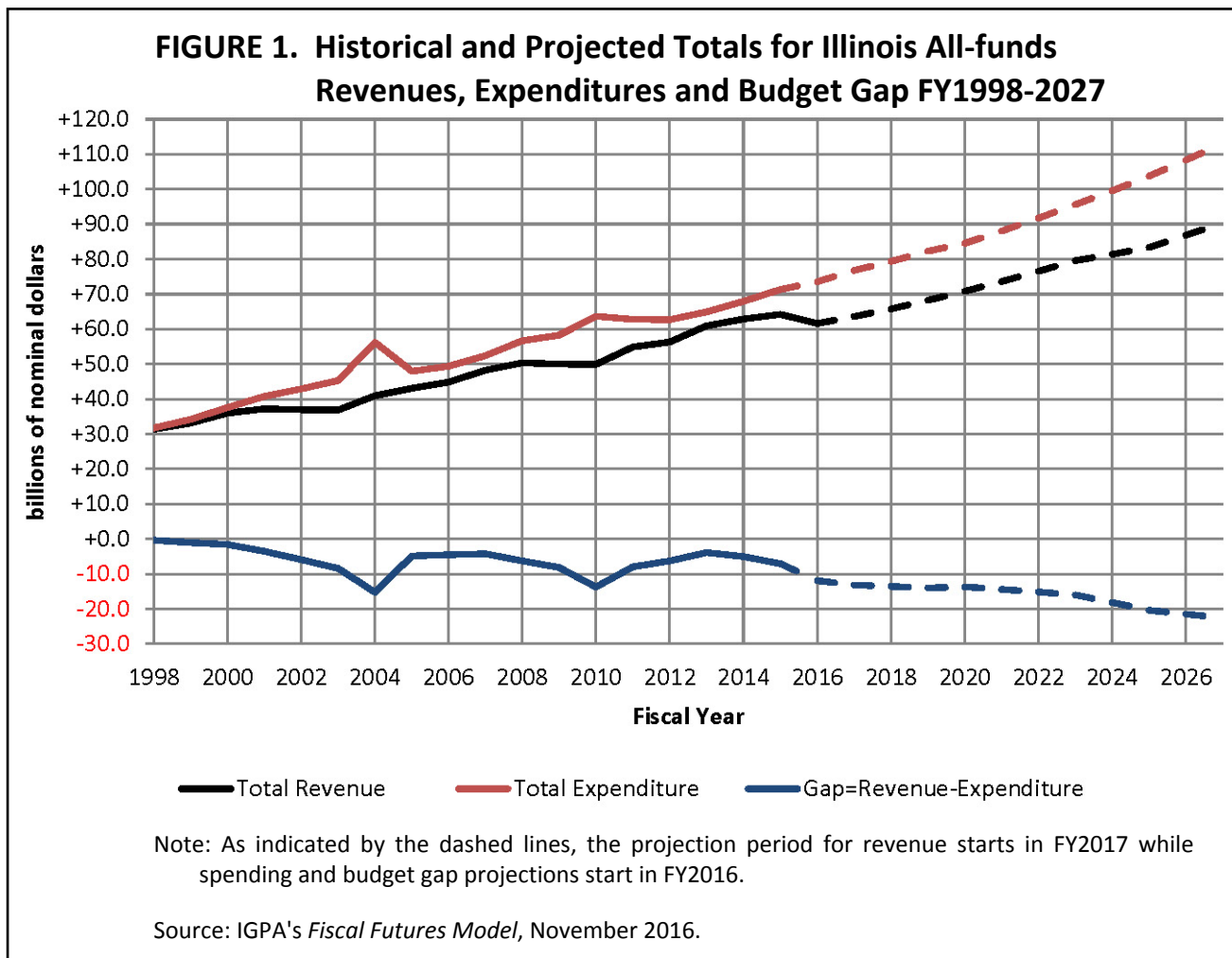
**Figure 1 on page 4** shows observed total all-funds revenue (from FY1998-2016) and expenditures (from FY1998-2015) and projections through FY2027 for each by the Fiscal Futures Model reflecting current policy and past trends. Figure 1 also shows the "budget gap," that is, the difference between sustainable total

revenue and total expenditure for each year. A negative budget gap is called a "deficit."

Readers of our past work will not be surprised by the historical data. We show all-funds revenue and expenditures roughly twice as large as their more commonly discussed general funds counterparts. Historical deficits (negative budget gaps) emerged as early as 2001 and were over \$10 billion in 2004 when Illinois issued a very large set of pension obligation bonds. Large gaps also emerged after the recession of 2008 but deficits, while still quite large, narrowed a bit between 2011 and 2014 when the temporary personal income tax increase was in place. The future trend is ominous, however, with large and

growing deficits in each year. Projected annual deficits grow to more than \$20 billion by 2027.

But these projections actually *understate* the severity of Illinois' fiscal problems for several reasons. The annual budget gap is an "income statement" concept that does not include the "balance sheet" dimensions of the state's problems. Annual budget gap projections do not take into account changes in unfunded pension liabilities, which are projected to grow by another \$15 billion between FY2017 and FY2027, even though, as assumed here, Illinois makes currently scheduled pension payments. Also not included in these projections are increases in unpaid bills or the cost of servicing state debt should budget gaps of the projected magnitude arise. Because of



these and other issues, our projections should not be taken as forecasts of Illinois' future fiscal position. Rather they should be thought of as rough measures of the magnitude of the fiscal challenge Illinois faces.

## **Projections of Alternative Policies: Paths to Reform**

The baseline scenario shown in Figure 1 is probably not sustainable as it would require extreme forbearance from Illinois' suppliers and creditors. Even if such budget deficits were financially and politically sustainable, executing them would result in large stocks of government debt that would eventually have to be repaid and would probably hamper economic activity in Illinois.

**What are the alternatives to maintaining current revenue and expenditure policies? Alternatives to the baseline scenario come in essentially three flavors: reduce spending; increase tax rates or expand tax bases; or generate more economic growth, which would in turn make it possible to generate more tax revenue at current tax rates. Our simulations examine each of these possibilities and show that none by itself is likely to be sufficient to close the budget gap and that, even if we model all of these potential policies and scenarios together, closing the budget gap is likely to be challenging and to take many years.**

We examine a number of scenarios that together encompass all three flavors. Of course, there are many additional scenarios that we do not examine here, and our projections are based on

relatively simple models and assumptions. We do not necessarily advocate or oppose any of the scenarios we examine, but rather offer them as illustrative of the general order of magnitude of actions that would be required to close the budget gap.

### **(a) Spending Cuts**

We begin with reducing government spending. In this scenario, we assume that all discretionary spending is reduced by two percentage points below the model-projected growth rate each year after 2015. We exclude from these cuts the following categories of expenditure because we view them as operationally, even if not legally, non-discretionary.

- Scheduled payments to state pension funds (otherwise unfunded liabilities would increase);
- Scheduled payments to service state debt in the form of bonds (a contractual obligation);
- Transfers of revenue to local governments (linked to various revenue sources);
- State grants to K-12 education (because in 2016 and 2017 school aid was fully funded, not because such a large category of spending should necessarily be off limits);
- Transportation spending, including the Tollway Authority (because the November 2016 amendment to the state constitution protects these);
- Medicaid spending, because many of the programs protected from spending

cuts in FY2016 were Medicaid-related and because of partially offsetting cuts in matching federal revenue.

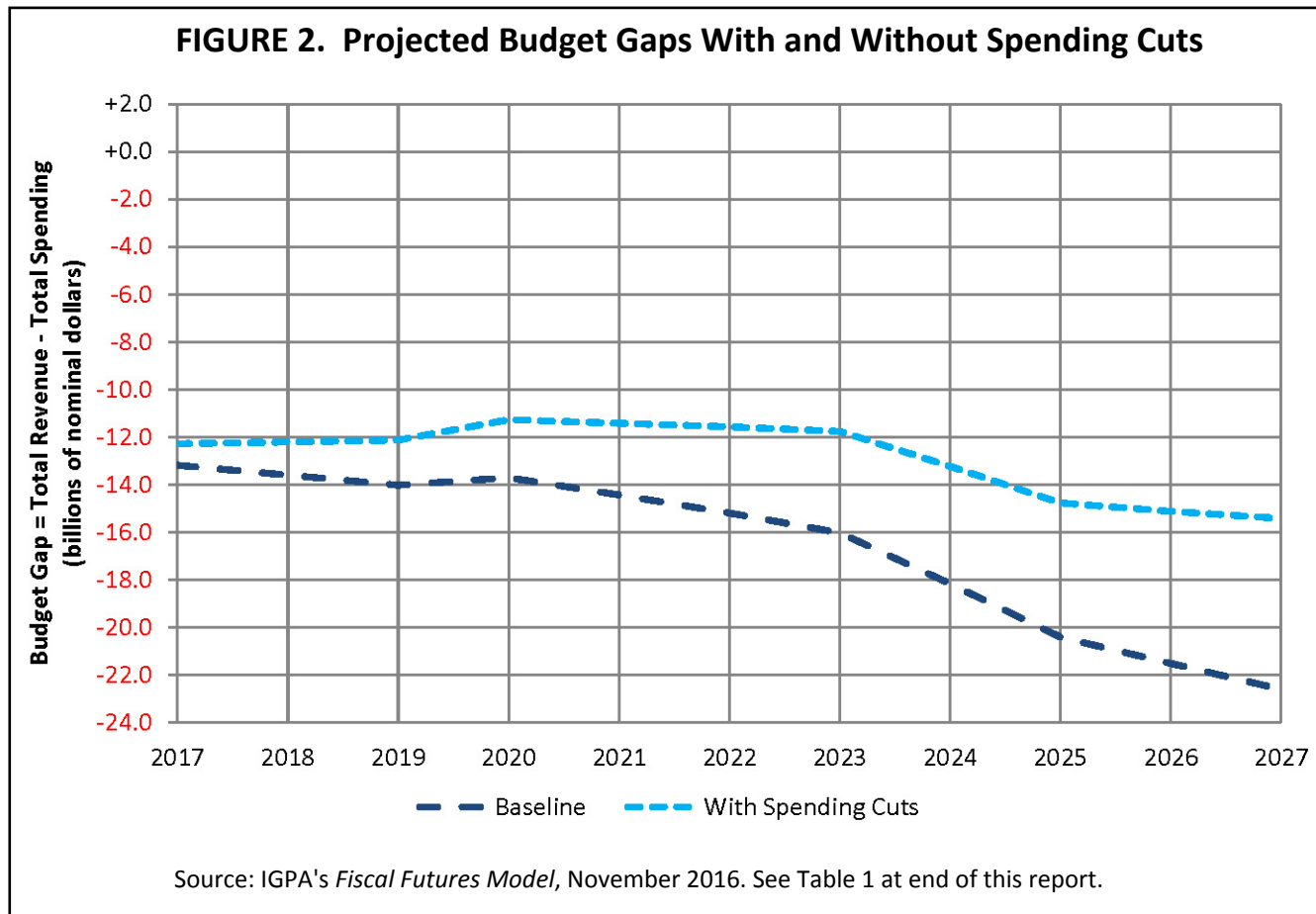
Together these excluded expenditures constituted over two-thirds of total expenditures in FY2015. Cuts of this magnitude on the remaining "discretionary" spending categories would undoubtedly result in substantial hardship to vulnerable populations if they were introduced on an across-the-board basis as we simulate here. Of course, the same total cut in expenditures could be introduced in a more targeted basis with the same net effect on the budget gap.

**Figure 2** shows model projections of two percent per year cuts in "discretionary" spending. (See

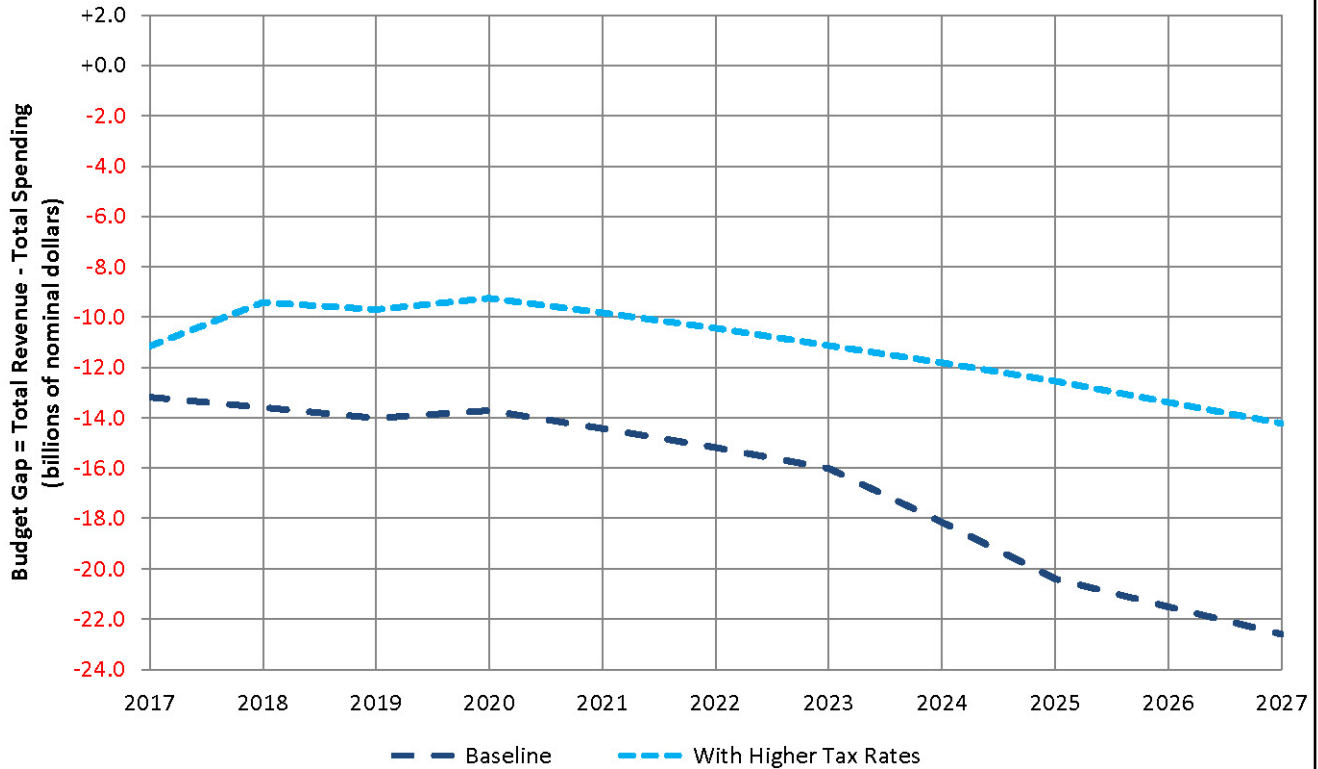
Table 1 at the end of this report for numerical values.) The spending-cut policy that we simulate would have a modest initial effect causing the budget gap to fall (relative to projections) by \$900 million in FY2017. However, the impact of this policy would grow over time and by 2027 we project that the policy would cut the budget gap by roughly \$7.2 billion. However, as drastic as these cuts would be, we project that this would leave a substantial and probably unsustainable annual budget gap of more than \$15 billion in FY2027.

**(b) Income Tax Rate Increase**

We also simulate a variety of policies to enhance revenue. The most straight-forward revenue policy that we examine is one that has been widely discussed—increases in the personal and



**FIGURE 3. Projected Budget Gaps With and Without Income Tax Rate Increases to Individual Rate of 4.75% and Corporate Rate of 6.65%**



Source: IGPA's *Fiscal Futures Model*, November 2016. See Table 1 at end of this report.

corporate income tax rates. The personal income tax in particular is a major source of revenue, providing approximately \$12 billion annually. We simulate an increase in the personal income tax rate to 4.75 percent from the current 3.75 percent effective January 1, 2017. At the same time, we increase the corporate tax rate to 6.65 percent (from the current 5.25 percent, preserving the 1.4-to-1 ratio with the individual rate) with the same effective date. The higher rates are assumed to continue past January 1, 2025 when, in the current-law baseline, they are scheduled to fall to 3.25 percent for individuals and 4.8 percent for corporations.

a substantial fall in the projected deficit. The reduction in the budget gap compared to the baseline would be large: \$2 billion in FY2017, when the higher rates apply for half the year; and \$4.2 billion in FY2018, with the higher rates effective for the full year. However, the increase in the tax rate does nothing to change either the underlying rate of *growth* of revenue in the model, so expenditures would still grow faster and the deficit would eventually grow. By FY2027, the annual deficit in this scenario would be more than \$14 billion or more than 60 percent as large as it would have been with the original tax rates.

As **Figure 3** shows, increasing income tax rates would substantially increase tax revenue, causing

### (c) Income Tax Base Increase

An alternative to increasing income tax rates is to broaden the income tax base by taxing some sources of income that are now excluded. Since the personal income tax is expected to generate about \$12 billion of revenue in FY2017, expanding the tax base by 10 percent would draw approximately \$1.2 billion dollars in additional revenue. A 2016 analysis by the Illinois Comptroller identified three types of credits or subtractions in the Illinois personal income tax that lowered revenue by a combined amount of almost \$3 billion in FY2015.<sup>6</sup> These are the exemption of retirement and social security income that is taxed by the federal government (\$2.3 billion), the tax credit for residential real estate taxes (\$0.6 billion) and the K-12 education expense credit (\$0.08 billion). Eliminating roughly 40 percent of these exemptions would be essentially equivalent to broadening the personal income tax base by 10 percent.

The same 2016 Illinois Comptroller study identified more than \$300 million of tax expenditures that applied to the corporate income tax. Since the corporate income tax is expected to raise about \$1.9 billion in FY2017, eliminating \$190 million of tax expenditures is essentially equivalent to expanding the corporate income tax base by 10 percent. Our projections assume that tax policy changes are enacted to broaden both the personal and corporate income tax bases by 10 percent effective January 1, 2017. We do not specify the mechanisms that would be used to do this, but as explained above, such a tax base expansion could be engineered by reducing

or eliminating some currently allowed tax expenditures.

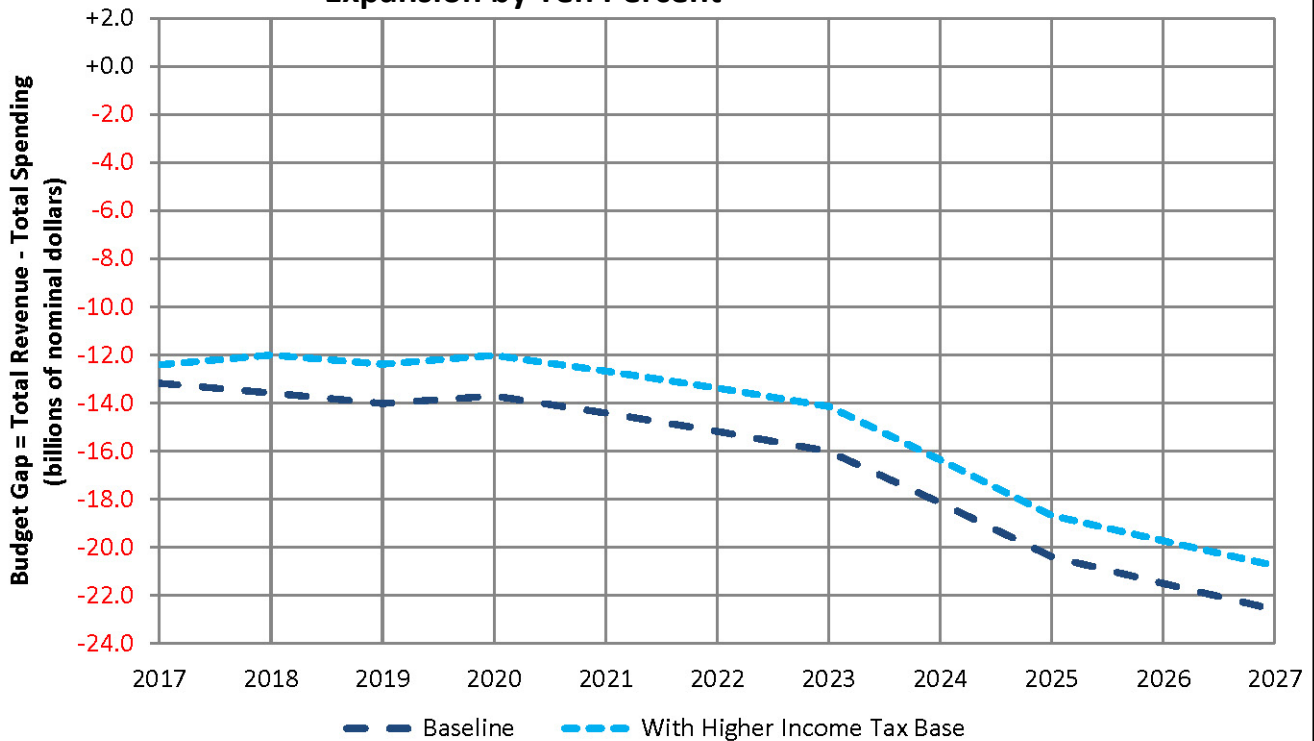
**Figure 4 on page 9** shows our projections of budget gaps with and without the 10 percent expansions of the personal and corporate tax bases. In FY2017, with the tax base expansion assumed to be in effect for half the year, we project that the deficit would fall by about \$770 million. In FY2018, with the policy in effect for the full year, the projected deficit is reduced by \$1.6 billion or 12 percent. The amount of the reduction in the deficit would grow slightly over time—to about \$1.8 billion by 2027.

### (d) Sales Tax Base Increase

In addition to the income tax, Illinois' other main source of tax revenue is the sales tax, raising roughly \$11 billion in FY2016. A 2011 report by Illinois' Commission on Governmental Forecasting and Accountability (COGFA) found that, compared to other states, Illinois' sales tax covered a relatively narrow range of services.<sup>7</sup> The report found that the service sector's share of the Illinois economy had grown from 32 percent in 1977 to 48.5 percent in 2009. The report estimated that the sales tax could raise \$8.5 billion in additional tax revenue if the base was broadened to include a wide range of services including business-to-business transactions. If a narrower base that excluded business-to-business transactions was used, the report found that potential additional revenue was \$4 billion. A \$4 billion increase in sales tax revenue would have been approximately equivalent to broadening the sales tax base by 36 percent in FY2016. However, there are a number



**FIGURE 4. Projected Budget Gaps With and Without Income Tax Base Expansion by Ten Percent**



Source: IGPA's *Fiscal Futures Model*, November 2016. See Table 1 at end of this report.

of reasons to believe that base broadening of this magnitude through the taxation of services would be administratively and politically challenging.<sup>8</sup> Because of this, we project the revenue impact of a 15 percent increase in the base of the general sales tax. This is done to approximate the order of magnitude of adding a number of services to the sales tax base, which currently taxes mostly just goods. The effective date of this change is assumed to be July 1, 2017, the beginning of fiscal year 2018.

**Figure 5 on page 10** indicates our projections of an increase in the sales tax base by 15 percent. This, taken alone, would lower the gap by about \$2 billion per year. However, sales tax base expansion would do nothing to change the rate of growth of expenditures and only slightly

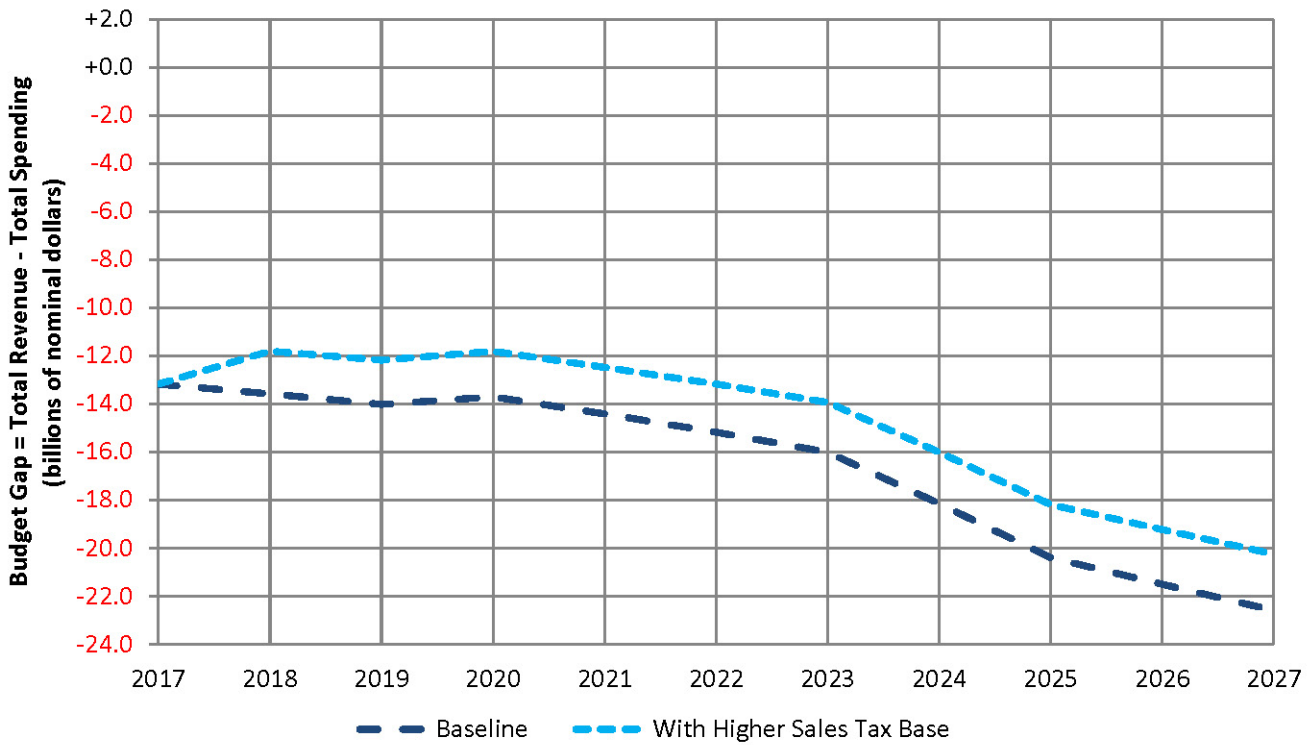
change the rate of growth of revenue (since service consumption grows faster than goods consumption),<sup>9</sup> so we project that the budget gap would continue to grow.

(e) Increasing Illinois's Underlying Economic Growth Rate

In previous reports, we analyzed the potential of economic growth to raise more revenue and found that it was unlikely that economic growth alone could eliminate the structural budget deficit.<sup>10</sup> That said, if the state gets its fiscal house in order and enacts other policies to encourage economic activity, revenue growth could contribute to fiscal balance in the longer term.

Our next projection assumes that, through some combination of policies and improved business

**FIGURE 5. Projected Budget Gaps With and Without Sales Tax Base Expansion by 15%**



Source: IGPA's *Fiscal Futures Model*, November 2016. See Table 1 at end of this report.

and consumer confidence, Illinois is able to achieve an extra one-half of 1 percent growth in personal income each year starting in FY2018. Achieving sustained additional growth of this magnitude would be quite different from past history and likely extraordinarily challenging. Further, the scenario assumes—contrary to the specification of the Fiscal Futures Model—that higher income affects revenue but not spending.<sup>11</sup> The major revenue categories assumed to be affected by higher growth are personal income taxes, corporate income taxes, and sales taxes.

**Figure 6 on page 11** illustrates the fiscal impact of the assumed increase in the economic growth rate and shows a very modest projected fiscal impact from increased growth in personal income. The budget gap would fall by just \$0.1

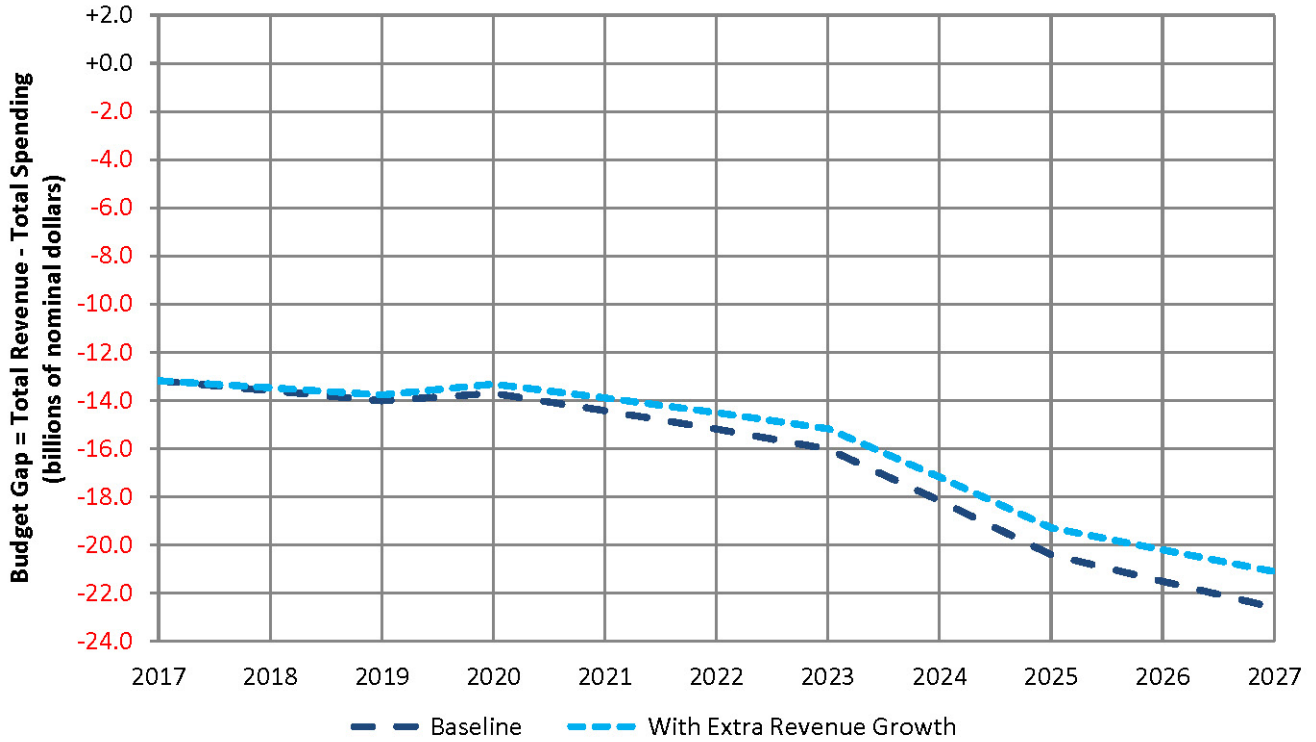
billion compared to the baseline in 2018, and by the end of the decade it would lower the budget gap just \$1.5 billion.

(f) Combined effect of multiple policies

As the above analyses demonstrate, none of the individual policies we have examined would, by themselves, be sufficient to close the budget gap within the next decade. In fact, none of the policies would change the structural deficit caused by spending growing more rapidly than revenue. What if we enacted several of the proposed changes simultaneously? Could this close the budget gap?

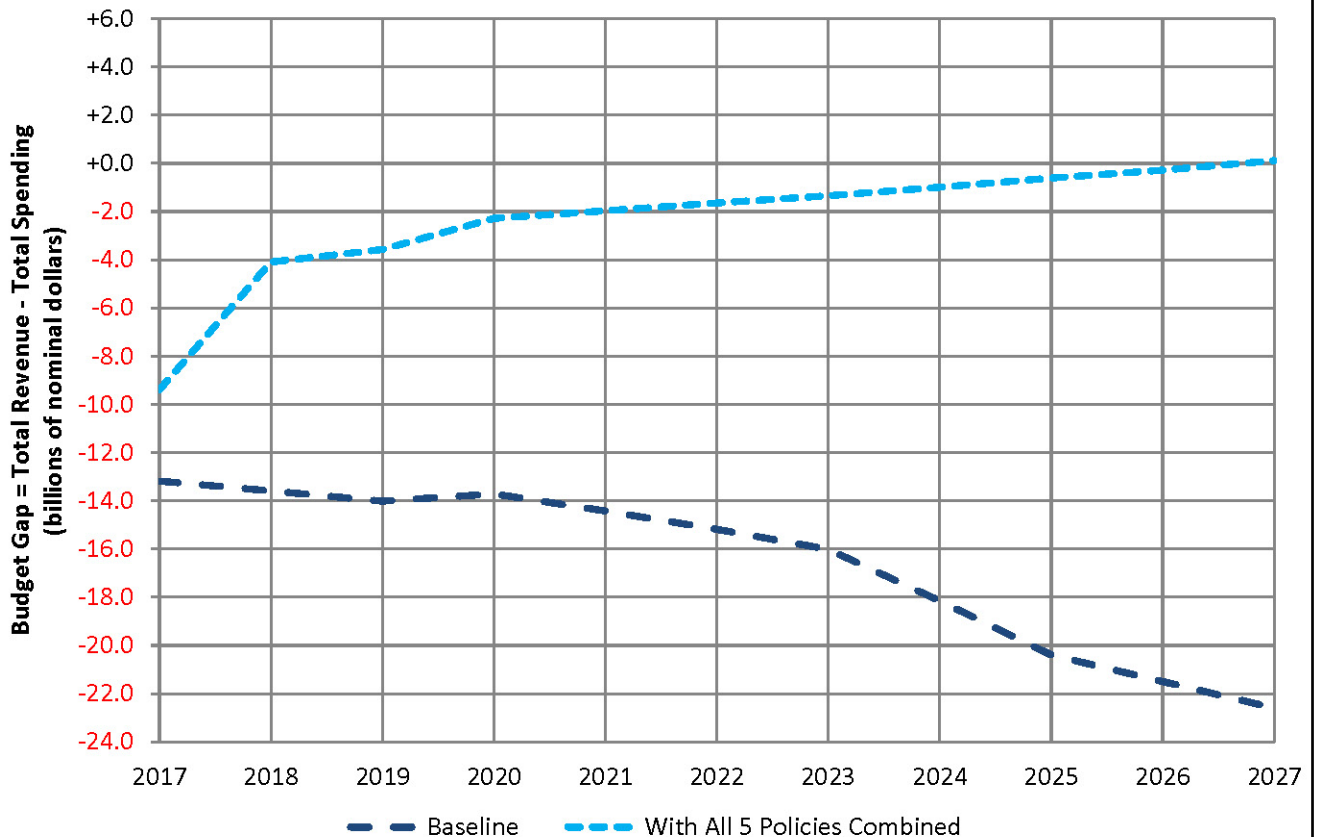
As shown in **Figure 7 on page 11**, our model projects that the combined effect of all of the policy changes we have discussed—substantially reducing spending growth, increasing income tax

**FIGURE 6. Projected Budget Gaps With and Without Higher Personal Income Growth of One-half of 1 Percent Each Year**



Source: IGPA's *Fiscal Futures Model*, November 2016. See Table 1 at end of this report.

**FIGURE 7. Projected budget gaps with all discussed policies implemented (i.e., all of the policies shown separately in Figures 2-6)**



Source: IGPA's *Fiscal Futures Model*, November 2016. See Table 1 at end of this report.

rates, broadening both the sales and income tax bases, and increasing the economic growth rate—would be just sufficient to close the budget gap if we can implement these policies soon and maintain them over the next decade.

Notice from Figure 7 that our projections of these combined policies suggest that, compared to the baseline, most of the budget gap would be eliminated within a few years. We project the budget gap would fall from \$9.4 billion in 2017 to \$2 billion in 2021. Despite this rapid improvement, continued vigilance would be necessary because the reversal of these policies could easily create a situation where revenue once again would grow more slowly than expenditures resulting in a new and widening budget imbalance.

Figure 7 is somewhat encouraging in that it shows a plausible, if challenging, path to fiscal sustainability. But we caution that even this set of policies and circumstances might not be enough. Our arithmetic simulations of what it would take to eliminate Illinois' annual deficit in 10 years do not take into account several important dimensions of Illinois' fiscal situation.

First, to eliminate the \$10 billion backlog of unpaid bills due to past deficits would require even larger tax increases and spending cuts.

Second, all of the policies we project result in deficits continuing for a number of years. This means that Illinois would have to pay for the deficits on its balance sheet with either decreased assets

or increased liabilities. Increased liabilities could take the form of either explicit loans or bonded debt or implicitly borrowing in the form of a higher stack of unpaid bills. Even if Illinois adopted the policies envisioned in Figure 7, we project that it would accumulate more than \$25 billion of additional deficits by 2027. Financing these deficits involves a claim against state resources in future years and would require even larger tax increases or spending cuts, or some form of borrowing that must eventually be paid off by future taxpayers.

Third, recent estimates put Illinois' unfunded pension liability at \$129.8 billion with pension fund assets covering only 37.2 percent of total liabilities.<sup>12</sup> The payment schedule for state contributions to the pension plans incorporated in the model's spending projections is based on actuarial calculations designed to achieve a funded ratio (assets/liabilities) of 90 percent by 2045. To achieve 100 percent funding or to achieve it sooner than 2045 would require an even greater diversion of state resources to pension contributions over the next 10 years.

### **Conclusion: Fiscal balance will require sacrifice, diligence, cooperation and persistence**

We remind readers that, while our analyses are based on the best and most recently available data, our model makes a number of simplifying assumptions to turn past trends into projections of future spending and revenue. As such, our analyses should be thought of not as precise forecasts, but as rough but unbiased measures of the order of magnitude of Illinois' fiscal

challenges. Ultimately, the challenges may be smaller, but they may also be larger. What is clear from our analyses is that, even in the best case, Illinois will face a sustained period of extremely difficult fiscal conditions. It is also clear that without significant policy actions Illinois' current fiscal path is unsustainable. Unless new policies are adopted, spending will grow faster than revenue and Illinois will face large budgetary deficits and will be unable to clear away past liabilities.

We see no plausible path to sustained fiscal stability without sacrifice—Illinois will need to simultaneously increase revenue and cut spending. But fiscal austerity alone will not guarantee success. Increasing revenue, especially through taxation, could discourage economic activity and be counter-productive in the long run. Any revenue enhancement policy should be carefully thought through and be consistent with continued vibrant economic activity. Similarly, budget cuts could be counter-productive if they neglect festering social problems that end up costing even more to deal with in the long run. Furthermore, budget cuts that reduce services essential to the smooth operation of the economy could reduce economic activity and ultimately lead to even larger budget gaps.

What is needed is a "grand plan" that includes multiple spending cuts, multiple new sources of revenue, and spreads these adjustments over multiple years in the form of even more borrowing. Finding the right mix of policies—sharing the pain of digging out of the hole that we are in—will require cooperation among a broad spectrum of groups in this policy arena. Groups will not only have to compromise among themselves but will have to engender confidence that they are committed to sustained action to fill in the budget hole. In the absence of a clear signal of a long term commitment to this goal, neither workers nor business owners can be expected to make the necessary investments to build Illinois' fiscal future.

Credible long-term commitments to fiscal solvency may require a new level of budget transparency and new budgetary mechanisms that can be used to enforce budgetary discipline. We have in the past written extensively about potential mechanisms to improve Illinois' budgetary transparency.<sup>13</sup> Simultaneously with this report, we are releasing a second paper that describes research about budget enforcement mechanisms—ways of constraining the actions of multiple constituencies in multiple years.<sup>14</sup>

## Illinois Tax Facts

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We hope these papers will be a useful resource for policymakers and all Illinoisans as the state tries to address its unprecedented budget problems, because we believe that adoption of additional measures to ensure transparency and mechanisms to encourage sustained

enforcement of agreements about budget discipline could do much to inspire public confidence in Illinois' commitment to fiscal stability. Ultimately these measures may be an important tool to encourage citizens' and businesses' investment in Illinois' future.

**TABLE 1. Illinois All-Funds Total Expenditure, Total Revenue and Budget Gap Projections FY 2015-2027. For Current Policy Baseline and Five Alternative Policy Scenarios (\$ millions)**

Policy Option	Current Policy Baseline			Spending Growth Cut	Increase Income Tax Rates	Increase Income Tax Base	Increase Sales Tax Base	Increase Income Growth	Implement All Five
Figure	1			2	3	4	5	6	7
Fiscal Year	Total Expenditure	Total Revenue	Budget Gap	Budget Gap	Budget Gap	Budget Gap	Budget Gap	Budget Gap	Budget Gap
2015	71,299	64,211	-7,088	-7,088	-7,088	-7,088	-7,088	-7,088	-7,088
2016	73,533	61,581	-11,952	-11,508	-11,952	-11,952	-11,952	-11,952	-11,508
2017	76,765	63,581	-13,184	-12,277	-11,164	-12,417	-13,184	-13,184	-9,389
2018	79,344	65,751	-13,593	-12,200	-9,415	-12,012	-11,812	-13,474	-4,094
2019	82,256	68,234	-14,022	-12,118	-9,703	-12,386	-12,188	-13,775	-3,579
2020	84,513	70,802	-13,711	-11,266	-9,252	-12,020	-11,821	-13,329	-2,284
2021	88,008	73,580	-14,428	-11,412	-9,830	-12,682	-12,480	-13,902	-1,971
2022	91,715	76,528	-15,187	-11,567	-10,445	-13,384	-13,176	-14,505	-1,644
2023	95,580	79,564	-16,016	-11,760	-11,128	-14,155	-13,942	-15,170	-1,338
2024	99,524	81,368	-18,156	-13,230	-11,821	-16,369	-16,020	-17,175	-995
2025	103,736	83,330	-20,406	-14,771	-12,543	-18,695	-18,203	-19,292	-614
2026	108,312	86,806	-21,507	-15,118	-13,389	-19,738	-19,233	-20,209	-289
2027	113,031	90,428	-22,602	-15,416	-14,222	-20,775	-20,257	-21,110	114

**Notes:** Total Expenditure in FY2016 is projected, not actual.  
 Budget Gap = Total Sustainable Revenue – Total Expenditure.  
 Spending Growth Cut simulates spending 2 percent below baseline-projected levels each year for all categories except pensions, debt service, K-12 education, Medicaid, revenue transfers to local government, transportation and tollway.  
 Increase Income Tax Rates simulates personal income tax rate rise to 4.75 percent and corporate income tax rate rise to 6.65 percent effective January 1, 2017.  
 Increase Income Tax Base simulates expansion of the personal and corporate tax bases by 10 percent effective January 1, 2017.  
 Increase Sales Tax Base simulates expansion of general sales tax base by 15 percent effective July 1, 2017.  
 Increase Income Growth simulates 0.5 percent increase in growth rate of personal income each year starting in FY2018.

Source: IGPA's Fiscal Futures Model, November 2016.

## ENDNOTES

- <sup>1</sup> "Apocalypse now? The consequences of pay-later budgeting in Illinois," Richard Dye, Nancy Hudspeth, Andrew Crosby, Institute of Government and Public Affairs, University of Illinois, January 19, 2015, [https://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/reports/FF\\_Apocalypse\\_Now\\_Jan\\_2015.pdf](https://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/reports/FF_Apocalypse_Now_Jan_2015.pdf).
- <sup>2</sup> "Consequences of Inaction: The Effects of the Budget Stalemate on Revenue and Spending at the Midpoint of Fiscal Year 2016," Richard Dye, David Merriman and Andrew Crosby, Institute of Government and Public Affairs, University of Illinois, February 15, 2016, <https://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/reports/Consequences-of-Inaction.pdf>.
- <sup>3</sup> See Jamey Dunn, "The Budget that Wasn't," *Illinois Issues*, July 28, 2016, <http://nprillinois.org/post/illinois-issues-budget-wasnt#stream/0>.
- <sup>4</sup> This is the sum of three things. Pension obligation bond principal at the end of FY2016 was \$12.0 billion (Illinois Commission on Governmental Forecasting and Accountability, *State of Illinois Budget Summary Fiscal Year 2017*, August 10, 2016, p. 206, <http://cgfa.ilga.gov/Upload/FY2017BudgetSummary.pdf>). Unfunded pension liability at the end of FY2016 was \$129.8 billion (Illinois Commission on Government Forecasting and Accountability. *Special Pension Briefing November 2016*, p. 2, <http://cgfa.ilga.gov/Upload/1116%20SPECIAL%20PENSION%20BRIEFING.pdf>). Unfunded liability for retiree health care costs at the end of FY2014 was \$33.1 billion (Illinois Comptroller, *Comprehensive Annual Financial Report Fiscal Year 2015*, p.174, [http://illinoiscomptroller.gov/ioc-pdf/CAFR\\_2015.pdf](http://illinoiscomptroller.gov/ioc-pdf/CAFR_2015.pdf)).
- <sup>5</sup> Illinois Comptroller, *Comptroller's Quarterly*, August 2016, p. 1, <https://ledger.illinoiscomptroller.com/ledger/assets/File/CQ/CQ-fy2016-q4.pdf>.
- <sup>6</sup> See Illinois State Comptroller, *Tax expenditure report fiscal year 2015*, <https://ledger.illinoiscomptroller.com/ledger/assets/File/TaxExpend/2015%20Tax%20Expenditure%20Report.pdf>.
- <sup>7</sup> See Illinois Commission on Government Forecasting and Accountability. *Service Taxes—2011 Update*, <http://cgfa.ilga.gov/upload/servicetaxes2011update.pdf>.
- <sup>8</sup> See Hamer, Brian, "Taxing Services Is No Panacea," *State Tax Notes*, November 16, 2015, [http://ctbaonline.org/sites/default/files/public/2015\\_State%20Tax%20Notes\\_Taxing%20Services%20Is%20No%20Panacea.pdf](http://ctbaonline.org/sites/default/files/public/2015_State%20Tax%20Notes_Taxing%20Services%20Is%20No%20Panacea.pdf).
- <sup>9</sup> The simple way we modeled this policy did not include extra growth from the service portion of the tax base.
- <sup>10</sup> See for example "Apocalypse now? The consequences of pay-later budgeting in Illinois," January 19, 2015.
- <sup>11</sup> "[B]ased on historical data incorporated in our model, higher economic growth raises both revenue and spending by roughly the same amount, so the net impact on the projected budget gap is negligible." Dye, Hudspeth and Merriman, "Peering Over the Fiscal Cliff," *Illinois Issues*, January 2014, <http://illinoisissues.uis.edu>.
- <sup>12</sup> See Illinois Commission on Government Forecasting and Accountability. (November 2016) *Special Pension Briefing*. See <http://cgfa.ilga.gov/Upload/1116%20SPECIAL%20PENSION%20BRIEFING.pdf>
- <sup>13</sup> See for example Richard F. Dye, David Merriman and Andrew Crosby. "Improving Budgetary Practices in Illinois" December 7, 2015 Institute of Government and Public Affairs, University of Illinois. <https://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/reports/Improving-budgetary-practices-in-Illinois.pdf>
- <sup>14</sup> Guo, Chuanyi and David Merriman, "Research about Budget Enforcement Mechanisms," November 2016, Institute of Government and Public Affairs, University of Illinois, [http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/reports/Budget-Enforcement-Mechanisms\\_113016.pdf](http://igpa.uillinois.edu/sites/igpa.uillinois.edu/files/reports/Budget-Enforcement-Mechanisms_113016.pdf)

## About the Fiscal Futures Project Model

The model begins with highly detailed data on state expenditures and revenues supplied by the Illinois Comptroller's office. In order to facilitate cross-year comparisons, the information is grouped into consistently measured and comprehensive categories. To be comprehensive and avoid distortions from cross-year accounting changes, the model covers virtually all state spending, including appropriated and non-appropriated funds and both general and special funds. We have dubbed the budget we analyze the "all-funds" budget to distinguish it from the "general funds" budget that is typically the focus of media and public policy attention. On the revenue side, the model concentrates on sustainable (on-going) as opposed to transitory (one-time) sources.

With solid data on Illinois' historical patterns of consistently categorized spending and revenue, we are able to trace Illinois' fiscal history and to use these data to estimate economic determinants of spending and revenue. The model combines this information about historical patterns with independent projections about future economic activity, population change, and other factors to make projections about future spending and revenue under current law. We can also simulate future sustainable revenue and spending under several alternative policy choices.

Since its formation in 2008, the Fiscal Futures Project has attempted continually to improve and refine our data gathering and analysis procedures while simultaneously maintaining relevance and compatibility with previous reports. The current version of the model incorporates a number of important innovations. Most importantly, we now directly incorporate detailed electronic data supplied by the Illinois Comptroller's office. We detail other less significant changes in our model and procedures in our on-line documentation. We emphasize however that the basic logic and findings of our projection model are very similar to those of earlier models.

One additional note: as a result of Illinois' virtually unprecedented budgeting arrangements since July of 2015, there is an unusual amount of uncertainty about the state's current spending. The very slow payment of invoices, that much FY2016 spending occurred without explicit legislative approval, and the half-year budget for FY2017 all make it difficult to establish the baseline level of spending that we use in our projections. In the end, we decided to use FY2015 spending as the benchmark for projecting spending in subsequent years.



# Rome is Burning

By Jim Nowlan

*A former Illinois House member and state agency director, Nowlan has worked for three unindicted Illinois governors. He was president of TFI in the early 1990s.*

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I have been participating in or observing Illinois politics and government for over half a century, yet I have never seen our state in such a dire fiscal and political plight. Bitter medicine, probably undrinkable to most, is required to rescue the state.

In the accompanying article, University of Illinois state budget experts David Merriman and Richard Dye illustrate how with \$7.6 billion more in annual revenue *and* draconian cuts in state spending, it would still take 10 long years to bring the state back from its national basket-case reputation for unpaid bills, huge pension obligations and budget uncertainty.

Lawmakers have never contemplated actions anywhere close to the magnitude Merriman and Dye have identified.

All this in an environment in which many, maybe most, in the public still think our problems can be solved by cutting out “waste and corruption.”

The situation is probably even worse than the economists suggest. Their model does not

include a plan to pay off \$12 billion in unpaid bills, and they project optimistic future state economic growth.

A respected state legislator told me recently, with a note of satisfaction, that a back-room, bipartisan group of lawmakers reached tentative agreement this past spring on some tax increases. They even broached the idea of taxing retirement income, which the governor’s office immediately shot down.

Either way, their efforts would not have come close to the \$7.6 billion revenue number.

History suggests Illinois elected officials can resolve big fiscal problems—if everyone works together.

During the Great Depression of the 1930s, the legislature met almost continuously. A bipartisan, two-thirds majority of legislators ultimately responded to Gov. Henry Horner’s plea to enact, and shortly thereafter increase, a new sales tax (while scotching the statewide property tax) to meet a relief crisis facing more than a million unemployed.

In 1969, political adversaries Gov. Richard Ogilvie and Chicago Mayor Richard Daley worked behind the scenes throughout a six-month legislative session to fashion a bi-partisan majority for a new income tax.

(By the way, a green-as-grass new legislator that year, I voted for the income tax and was re-elected—without opposition—a year later. In today’s brutal, name-calling political environment, no lawmaker who supported tax increases could expect anything other than to be skewered by the opposition in a re-election bid, which is part of the present problem.)

The present political environment is more much divisive, “toxic” is a word I see used often, than it was in those earlier days, when each side’s political top dogs actually talked to one another.

If lawmakers cannot stomach more than \$4 to \$5 billion in tax increases, then spending cuts will have to be even more severe than Merriman and Dye propose, if the fiscal situation is ever to be stabilized.

The economists dismiss cuts for most of the state budget, to include pensions, Medicaid, distributions to local governments and K-12 education, on the understandable premise these programs are protected, respectively, by the courts, the federal government and political popularity.

I think, however, each of these “protected” areas has to be cut, at least somewhat.

Lawmakers will almost certainly look at no-cost-to-them savings to the state budget that would result from reducing distributions of state tax dollars that now go automatically to local governments.

This might include shifting the “normal cost” for teachers’ pensions down to the local school districts (“save” close to \$2 billion) and reducing distributions of shares of the income and sales taxes to municipalities and counties (pick a number from the \$3.5 billion total).

But then how could lawmakers justify a property tax freeze on those governments, something the governor insists upon?

And even though state funding for higher education has been cut in recent years, the sector still stands out there, as a target atop a fence post, subject to more cuts.

Unfortunately, public colleges and universities will have to restructure to live with less. To save the diamonds, many programs, maybe even institutions, will have to be down-sized, even shuttered.

University of Illinois president Timothy Killeen has cried from the heart, “Rome is burning.”

Yet the University of Illinois can be anything—but not everything—it wants to be.

And state employees will have to accept freezes on their pay and at the same time kick in more to their health care coverage.

Even if all the above, excruciating cuts are made, I don't see the total adding up to anything close to the \$8 billion or so needed (a \$13 billion gap at present between spending and revenue, minus say \$5 billion in new revenues) to stabilize the fiscal situation.

There are recent reports that Democrat and Republican leaders in the state Senate have sketched a proposal that would indeed generate about \$5 billion annually from income tax increases and a new sugary drinks tax.

The senators are simply going around the deadlocked, intransigent governor and House speaker.

The bottom line is, painful for me to write, that Illinois will have to adjust, for some years anyway, our once-towering aspirations for greatness to the humble mediocrity of our circumstances.

## **TFI's 2017 Calendar of Events**

(more to come)

### **January**

30 Income Tax Committee

### **February**

21 Board of Trustees

### **March**

20 Property Tax Committee

### **April**

5 Spring Legislative Conference  
Legislative Reception & Dinner  
Springfield Illinois  
6 Legislative Update Seminar  
Springfield Illinois  
6 Board of Trustees  
21 Income Tax Committee

### **June**

TBD 76th Annual Meeting  
Chicago Illinois  
TBD Board of Trustees

### **July**

18 Income Tax Committee

### **August**

17 Executive Committee

### **September**

TBD 18th Annual Illinois SALT Conference  
Rolling Meadows Illinois  
12 Property Tax Committee

### **October**

5 Income Tax Committee  
19 Board of Trustees

### **December**

7 Executive Committee

**Taxpayers' Federation of Illinois**

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