

TAX FACTS



Taxpayers' Federation of Illinois

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Illinois' Fiscal Future Is Bleak

By Richard F. Dye

Institute of Government and Public Affairs, University of Illinois

The following is an excerpt from the chapter "Fiscal Condition Critical: the Budget Crisis in Illinois," by Richard F. Dye, Nancy Hudspeth, and Daniel P. McMillen, in The Illinois Report 2010, Institute of Government and Public Affairs, University of Illinois. It has been updated to include more recent material contained in "The Fiscal Futures Project: Progress Report and Initial Results," by Richard F. Dye and Nancy Hudspeth, Institute of Government and Public Affairs, University of Illinois, February 2010. Printed here with permission. For more on the Fiscal Futures Project and links to both documents, go to: <http://igpa.uillinois.edu/content/fiscal-futures-project>. The Taxpayers' Federation of Illinois has been a supporter of the Fiscal Futures Project since its inception.

Two clear implications from our examination of fiscal years 2009 and 2010 [in the part of the Chapter not reprinted here] are that cyclical revenue problems will persist for at least another year and that the hangover from some of the temporizing choices—like the five-year repayment of the borrowing that papered over part of the 2010 deficit—will persist for a number of years. The near-term fiscal future of the state of Illinois is bleak. There is also overwhelming evidence of a structural deficit from which we conclude that, absent some major changes, the long-term fiscal future of the state is similarly bleak.

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CONTACT US:

430 East Vine Street, Suite A
Springfield, IL 62703
V. 217.522.6818
F. 217.522.6823
www.taxpayfedil.org
tfi@iltaxwath.org

THE FISCAL FUTURES PROJECT

The Fiscal Futures Project was started in 2008 out of concern that the state of Illinois lacks the capacity to project its fiscal demands and revenue streams into the future. Being able to generate long term projections of anticipated expenditures and revenues can help foster more fiscally responsible long term solutions by state lawmakers. There are a number of elements of the project.

Illinois budget data for prior years. In order to know where you are going, you first need to understand where you have been, so considerable effort has gone into gathering, studying and reconciling 13 years of Illinois state budget data and grouping it into major revenue and expenditure categories. We use a broad concept of the Illinois budget, which we call the *Consolidated Funds Budget*. For fiscal year 2009, our consolidated budget for the State of Illinois is \$61.1 billion, while the less inclusive but more commonly reported *General Funds* budget totals only \$35.2 billion. **Figure 1 and Figure 2** show FY2009 shares for the 16 expenditure categories

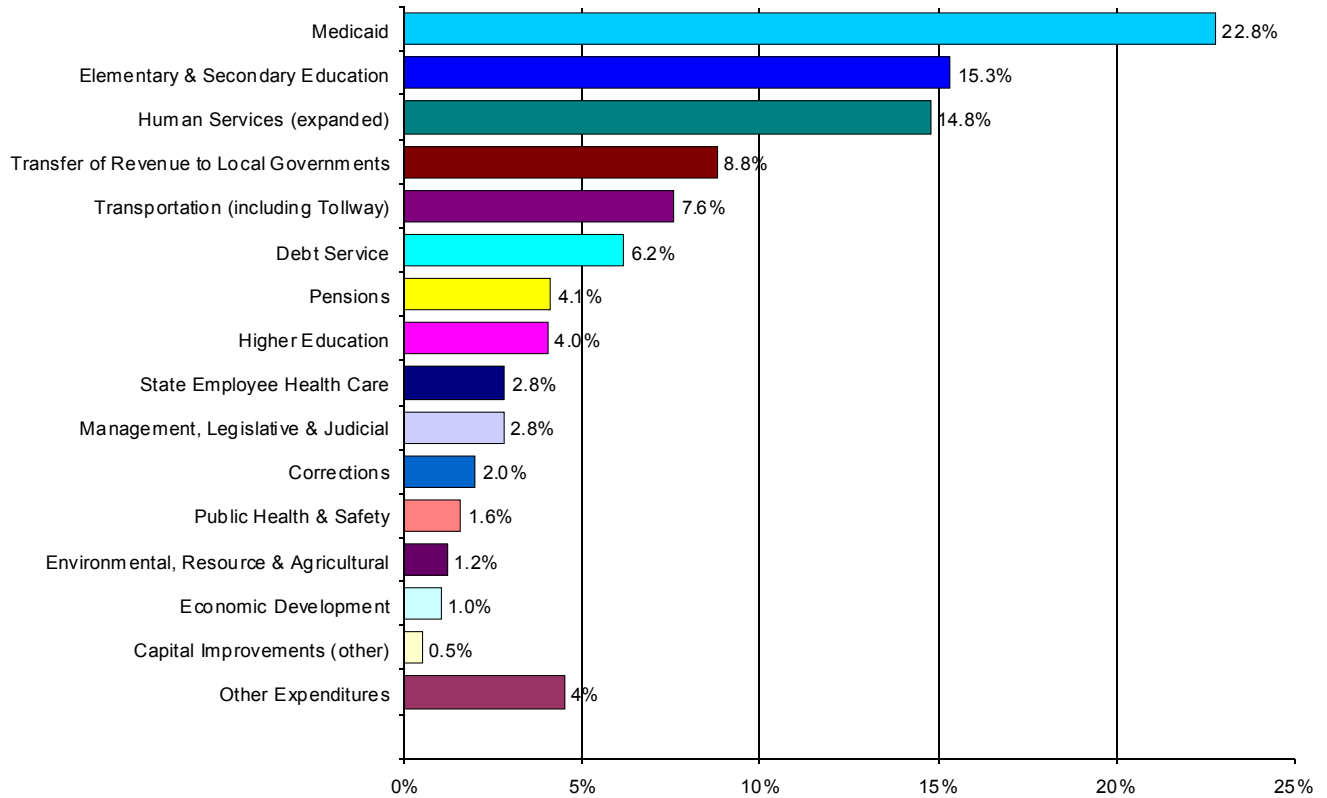
THE GENERAL FUNDS REPRESENT ONLY PART OF THE STATE BUDGET

In most reporting and discussion of the Illinois state budget, the concept of *General Funds* is used. We use a more inclusive concept, which we call *Consolidated Funds*, because we believe that it better represents the total burdens and benefits of state government to taxpayers and residents. If analysis was limited to the four General Funds, it would largely exclude several important categories of revenue and expenditures:

- Only a small amount of the *transportation budget* comes from the General Funds, because motor fuel taxes are deposited in the special road fund. We include transportation revenue and expenditures, including the Illinois State Tollway Authority, in the consolidated budget.
- *Debt service* expenditures do not come directly from the General Fund, but rather from special funds. Debt service is incorporated in the consolidated budget in a way that avoids double counting.
- Most *transfers of revenue back to local governments* do not come from the General Funds but are in our consolidated budget. These include: the Personal Property Replacement Tax levied on businesses and utilities; the 1.25 percent of the general sales tax that is passed back to local governments (out of the 6.25 percent total); the one-tenth of the state income tax that is transferred to local governments; and the portion of motor-fuel taxes that goes to local governments. The consolidated budget includes these taxes, because they are levied statewide at a common rate and with a burden on taxpayers throughout the state. Also, the distribution to local governments is by statutory formula, which could be changed. (Note that purely local-option taxes levied by specific local governments with the state just acting as collection agent are not included in our consolidated budget.)
- *Health care providers' taxes and fees* are a key component of the total Medicaid budget, but they are typically deposited into specially designated funds, not the General Funds. With care to avoid double counting, this revenue source and associated expenditures are included in our consolidated budget.
- Many *federal grants* for a designated purpose go into specially designated non-general funds. These are important sources of revenue for transportation, Medicaid, education, and human services, and are accordingly included in our consolidated budget.

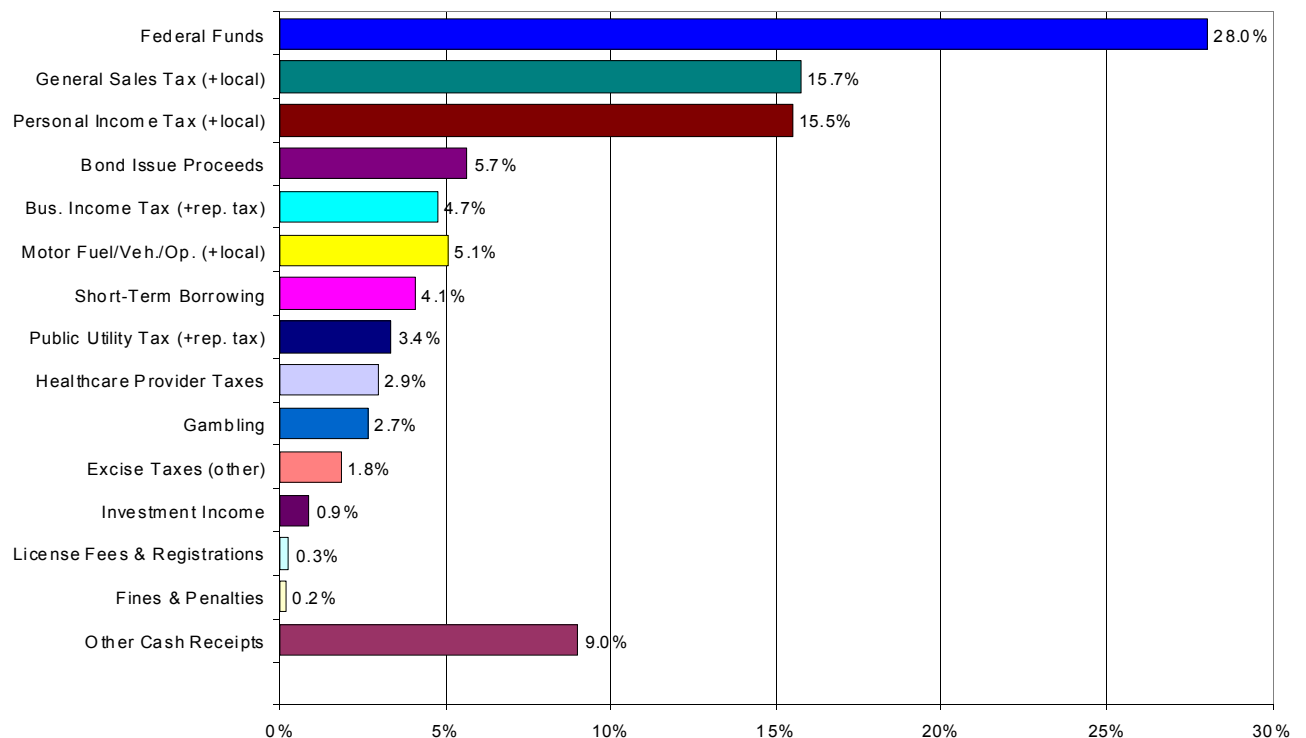
Adding those and smaller adjustments increases the total state budget by over two-thirds in fiscal year 2009—from \$35 billion for the 4 general funds alone to \$61 billion for the 380 funds in our consolidation. In addition to being more inclusive, the consolidated funds budget is also more transparent, because neither inter-fund transfers or reassigning items from general to non-general funds will obscure the analysis.

**Figure 1: Spending Components of Consolidated Budget in FY 2009
(as percent of total)**



Source: IGPA Fiscal Futures Model, 15 February 2010.

**Figure 2: Revenue Components of Consolidated Budget in FY 2009
(as percent of total)**



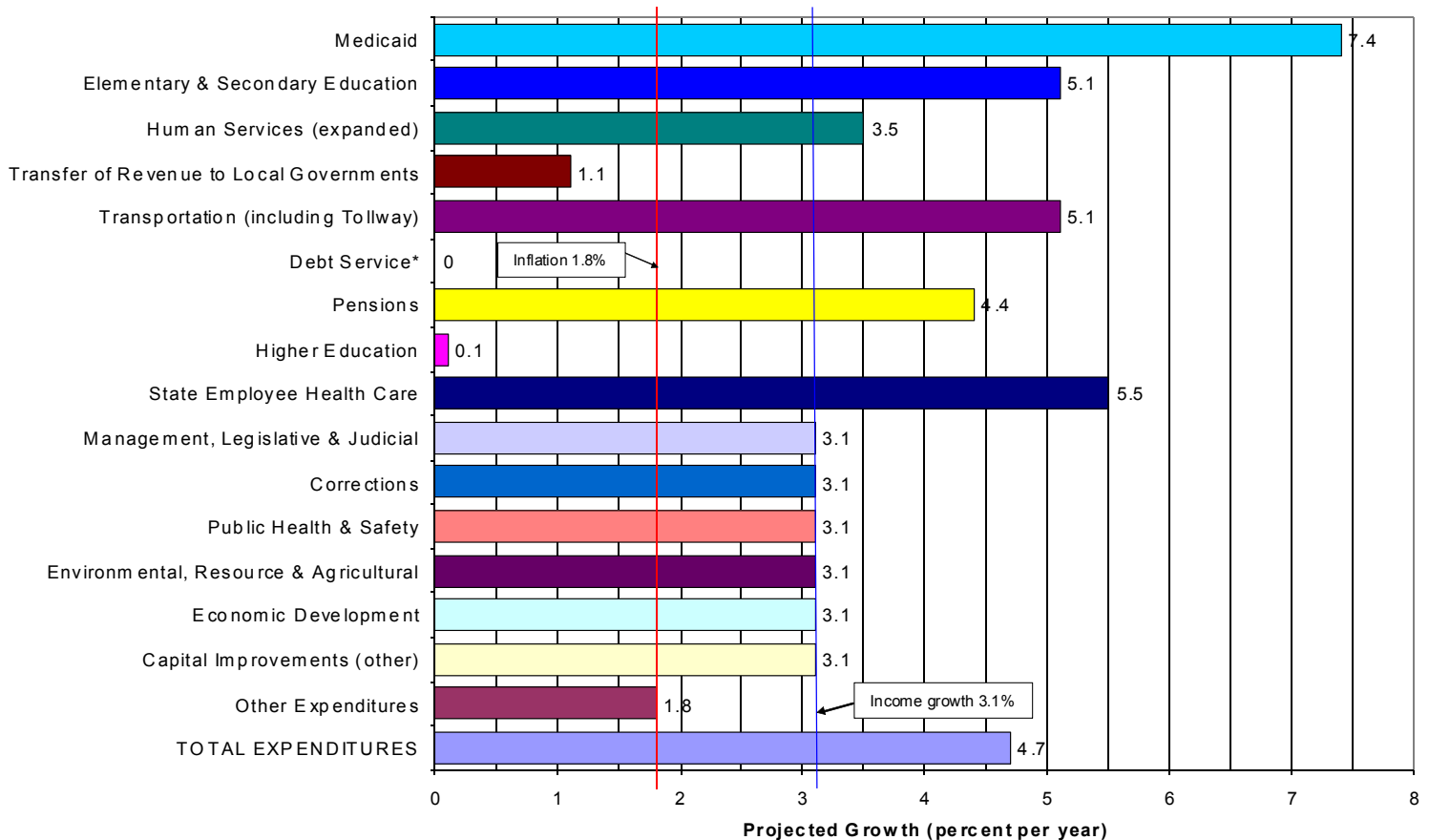
Source: IGPA Fiscal Futures Model, 15 February 2010.

and 15 cash receipts categories in the consolidated fiscal futures budget.

Economic and demographic data: actual for prior years, forecasts for future. The Regional Economics Applications Laboratory (REAL) at the University of Illinois supplied detailed historical and forecast data from its model of the Illinois economy. Additional economic, fiscal, and demographic data for both the state and the nation has also been obtained. In particular, the model described below makes use of past and forecast data for Illinois personal income, consumption, consumption of services, total population, and population in various age groups as “drivers” of different budget categories.

Demonstration model. We have completed a preliminary version of the fiscal futures model. For some of the budget components—pensions and debt service—official schedules of future payments are used. For each of the other designated revenue and expenditure categories we have created a “projection module.” The modules estimate the historical relationship between the budget variable and one or more “driver” variables, such as total income or population, and use forecasts of the driver variables to create projections for the budget component. Most of the attention to date has been given to the largest revenue and spending categories: personal income and general sales taxes, Medicaid, and K-12 education spending.

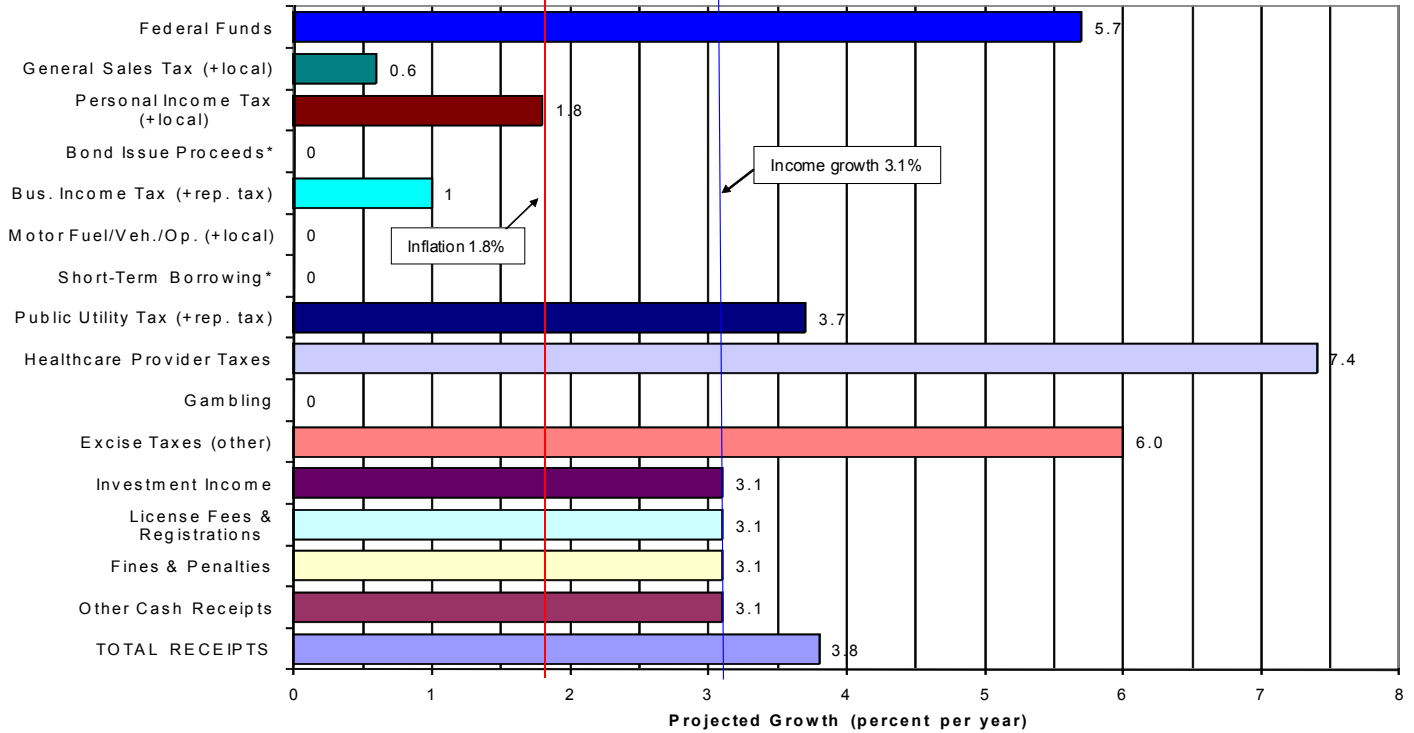
**Figure 3: Projected Growth Rates for Expenditure Categories
(annual average for 2014 to 2024)**



Source: IGPA Fiscal Futures Model, 15 February 2010.

* Model assumes no new debt and only debt service currently obligated.

**Figure 4: Projected Growth Rates for Receipts Categories
(annual average for 2014 to 2024)**



Source: IGPA Fiscal Futures Model, 15 February 2010.

* Model assumes no new debt and only debt service currently obligated.

The default module simply relates past growth in the budget measure to past growth in state personal income; for some components, additional drivers are used, such as growth in: population, school-age population, college-age population, or health-sector output. Two revenue sources, gambling and motor fuel, showed zero growth in recent years so we assumed zero growth in the future. Several smaller categories had very uneven historical patterns that showed no relationship to driver variables, so they were simply assumed to grow at the same rate as personal income.

Figures 3 and 4 show the growth rates for each of the revenue and expenditure components generated from this data and the estimates that lead to the assumed relationships with the driver variables. The growth rates predicted by the model fluctuate somewhat in the initial years, and then converge on a fairly constant rate, so

the figures show the annual average for the 2020 to 2030 time period. The vertical lines in both figures give, for reference, the rate of growth for personal income and the rate of inflation in the Consumer Price Index.

The growth rate projections for the spending categories are shown in Figure 3. Recall from Figure 1 that the largest spending components are elementary and secondary education and Medicaid, both of which have high projected growth rates, 5.1 and 7.4 percent, respectively. Transportation spending also has a high projected growth rate, as does the payment schedule for state contributions to state and local public employee pensions. The growth projections for all types of spending total 4.7 percent per year.

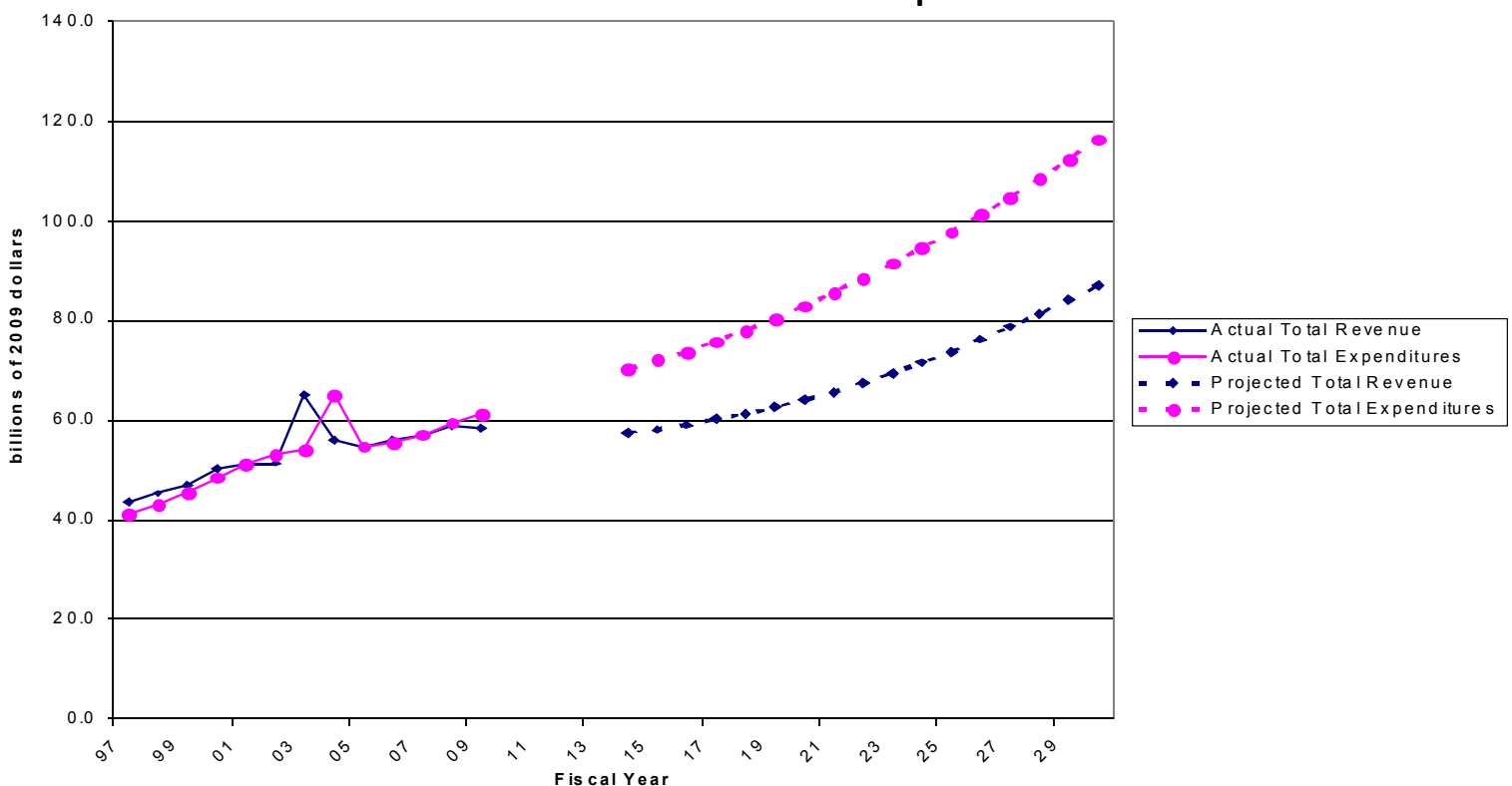
The growth rates in revenue components are shown in Figure 4. In Figure 2, we saw that the three largest revenue sources are the personal income tax, the general sales tax, and federal funds. The growth rate in personal income tax collections is projected to be only 1.8 percent per year, which happens to be the same as the inflation rate. The general sales tax is projected to grow at only 0.6 percent per year, which is far less than the rate of inflation. Projected growth in federal aid is 5.8 percent per year, which is a statistically educated guess based on the growth rate between 1997 and 2009. Whether or not this actually happens depends upon the future actions of Congress. The projections for all types of revenue indicate total growth of 3.8 percent per year.

The projected difference between expenditure growth (4.7 percent) and revenue growth (3.8 percent) is slightly less than one percent per

year. This may not seem like much, but compounded over a number of years it will lead to a large and growing budget gap—a structural deficit.

The demonstration model has two basic purposes. First, the model can be used to project a “baseline” into future years of revenue and spending under current law and current projections of economic and demographic trends. The difference between total would-be spending and total would-be revenue in a future year can be called an estimate of the budget gap—a deficit if negative and a surplus if positive. Second, with the right data, the model can also simulate budgets under alternative policy scenarios or using different economic and demographic variables. These “what if” estimates, or out-year projections of policy alternatives, might be called the “scorekeeping” function of the model. For example, the personal

Figure 5: Actual (FY 1997-2009) and Projected (FY 2014-2030) Illinois Consolidated Total Revenues and Expenditures



Source: IGPA Fiscal Futures Project 12 March 2010.

Note: Actual receipts includes new borrowing, but no new borrowing is assumed in projections.

income tax module has been constructed in a way that allows for changes in policy parameters like the tax rate or the amount of the personal exemption.

Total budget estimates. **Figure 5** shows the actual and projected paths for total state expenditures and total state revenue over time in real (inflation-adjusted) dollars. The first part of the figure shows actual values for the consolidated budget for the historical 1997 to 2009 period. The amount by which spending exceeds revenue is called a deficit, and the amount by which revenue exceeds spending is called a surplus. The surge in revenue in fiscal year 2003 is a cash surplus resulting from a new issue of pension obligation bonds and a related jump in pension spending shows up in the next year. The projected values for 2014 to 2030 come from the model described above. As noted, the model compounds any differences between spending growth rates and revenue growth rates over the years, so the higher growth for spending leads to an ever larger deficit projection. The model projects that the deficit will grow to the order of \$13 billion (in real 2009 dollars) by 2014 and to \$29 billion by 2030. This underlying mismatch between the level of revenue that existing rules can sustain and the level of

spending that caseload drivers project is sometimes called a structural deficit.

Policy simulations. The model can also be used to make hypothetical projections of future budgets with alternative policies. For example, we have used the model to compute projected revenue of several of the revenue-raising proposals discussed in recent months. We will not present those results here, but the important qualitative result from our tax simulations is that there is no perceptible impact on the *growth rate* of revenue in future years. Except possibly for the expansion of the sales tax base to include services, none of the proposed changes will increase the *growth rate* of revenue, only the baseline amount. So even if a policy is successful in closing the gap in one year, it will do little or nothing to change the fact that spending will grow faster than revenue, so the structural deficit will soon re-emerge.

Notes on interpreting the model. This is being written in budget year 2010, but the model is based on available data that stops in fiscal year 2009. Even though we know that, due to the severity of the recession, budget year 2010 is much worse than the model projects, we base our later-year projections on the 2009 baseline. This is why we choose not even to show the near-term projections of the model.

Data lags are not the only thing to note about the model. The fiscal futures model measures underlying, long-run tendencies and makes projections, not predictions or forecasts, so the model is not a substitute for existing short-term budget forecasting techniques. Future policy makers will be forced by balanced-budget requirements or cash-flow constraints to raise revenue, cut spending, or increase the amount of explicit or implicit debt to avoid the would-be

Illinois Tax Facts

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J. Thomas Johnson President
 Scott Selinger Legislative Director
 Kellie R. Cookson Office Manager
 Courtney Flanders Office Assistant

deficits. Or, in the words of economist and sage Herb Stein, “If something cannot go on forever, it will stop.” We are continuing to refine our model and are seeking support to expand its capabilities.

Using the consolidated data to compare and analyze past budget years. There is an additional application of the model that was not anticipated when we started the project, but we now recognize as important. As already noted, the consolidated funds measure presents a better picture of the state’s fiscal situation than the General Funds, because:

- it uses a consistent definition over time, thus a better measure of changes over time;
- is a broader measure that incorporates several important categories of receipts and expenditures;
- inter-fund transfers are not confused with changes in total state receipts or expenditures;
- changes in assignment of an item from one fund to another from one year to the next are not confused with changes in total state receipts or expenditures.

So with consolidated data, we can make better comparisons of the fiscal situation across years. As an example of this type of application, **Figure 6** shows three different definitions of the budget gap for past years.

Existing practice in Illinois allows borrowing to be treated as a cash receipt in calculating whether the budget is balanced or not. The first bar (A) in the figure for each year shows how the past years in the dataset compare by that measure. Counting borrowing as a receipt, the state’s consolidated fund budget is close to being balanced in every year except 2003 that was

distorted by pension bond receipts and 2004 that was distorted by the corresponding surge in pension spending.

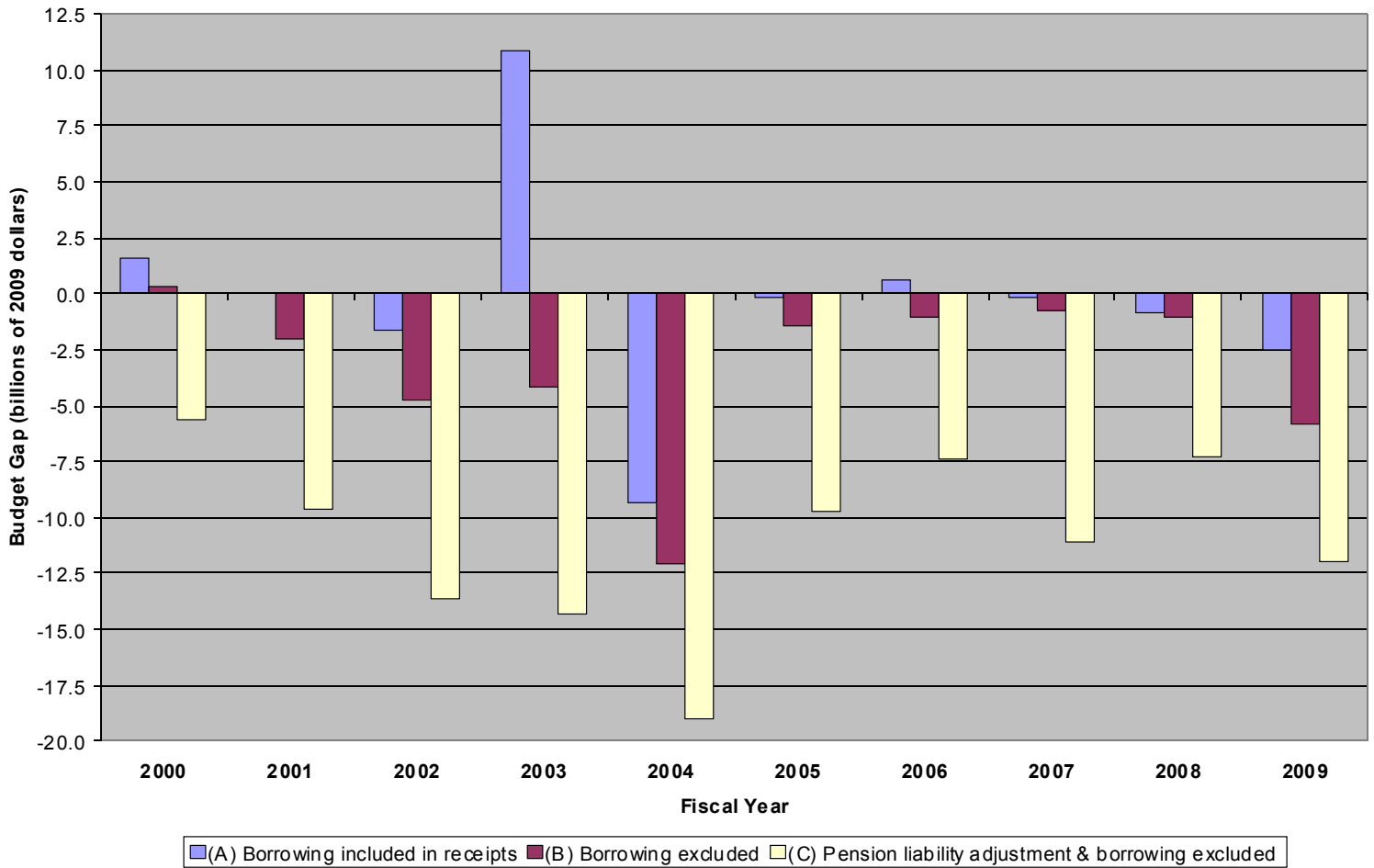
Taking on additional debt shifts obligations into the future and is not a sustainable source of revenue, so budget gap definition (B) removes new long-term debt and short-term borrowing from receipts and the payout of the principal amount of short-term borrowing from expenditures. Since the state borrowed in every year, it is no surprise that when new debt is not counted as a receipt the budget gap looks worse. The second bar in Figure 6 shows that using the without-borrowing measure (B) deficits were above \$4 billion in four of the last ten years.

Another way of shifting obligations into the future is to not put aside sufficient funds in the current year to cover the present value of the increase in future pensions that workers earn during the year. When the increase in unfunded pension liability is treated as an implicit expenditure—bar (C) in Figure 6—the state’s consolidated budget gap situation is much worse. The state of Illinois has run deficits in the consolidated budget ranging from 5 to 19 billion dollars per year for all of the last ten years.

REGRETTABLE CHOICES IN THE PAST, TOUGH CHOICES IN THE FUTURE

Illinois has both a cyclical and structural deficit. The current recession has contributed significantly to the state’s problems, but if the recession went away tomorrow the state’s budget problems would not. The current problem and its projection into the future have been exacerbated by the avoidance of tough choices in the past. The most significant choice made repeatedly was to not make current contributions to cover the cost of future pension obligations. Other avoidance mechanisms in the

Figure 6: Surplus (+) or Deficit (-) in Consolidated Illinois Budget Under Alternative Definitions



Source: IGPA Fiscal Futures Model, 15 February 2010. See *Fiscal Futures Project: Progress Report* (February 2010), Appendix 4. See text for budget gap definitions.

past include: borrowing against or selling future revenue streams and spending the proceeds on current operations; rolling unpaid bills into the next budget year; and committing temporary, cyclical surges in revenue to new or expanded programs. All this temporizing has put Illinois in a very deep hole. Worse, the differential growth rates driving existing revenue streams and program caseloads make for a structural deficit. Even if we restored balance next year, the state would face deficits several years down the road.

It is inescapable that Illinois faces very, very tough choices. There almost certainly will have to be both major cuts in spending programs and major increases in revenue.

Governor Quinn's 2011 Fiscal Plan

By J. Thomas Johnson, President, Taxpayers' Federation of Illinois

Governor Pat Quinn presented his fiscal plan for 2011 (beginning July 1, 2010) in his annual budget message presented to a Joint Session of the General Assembly on Wednesday March 10th. Although he called for total appropriations for operations of \$51.7 billion for all funds, the focus of greatest attention is always the spending proposals from the General Funds.

The Governor's planned spending from General Funds total \$32.1 billion down \$500 million from 2010 levels (after adjusting for the pension payments in 2010 from the issuance of Pension notes.) Total general fund resources are expected to be \$27.4 billion resulting in a budget deficit of \$4.7 billion requiring the issuance of "voucher payment notes" in that amount. Increased spending primarily for pensions, debt service and healthcare is offset by spending reductions for various programs of \$2 billion.

Revenues are expected to be down by \$500 million due primarily to the expiration of the federal stimulus program (\$ 1 Billion decline between the two fiscal years) offset by increases in state own source revenues (Income and sales taxes, etc.)

There is no planned reduction in the accumulated deficit which is projected by the Governor to be close to \$6 billion at the end of fiscal year 2010 and will remain at that level through the 2011 fiscal year exclusive of the new borrowings.

The Governor proposed major General Fund spending reductions (including % change from current levels) in the following areas.

Elementary and Secondary Education	\$ 1.2 Billion	(-14%)
Higher Education	.1 Billion	(-5%)
Local Government Revenue Sharing	.3 Billion	(-30%)
Human Services	.1 Billion	(-2%)
Employee/Retiree Healthcare	.3 Billion	(-30%)

No new revenues were proposed by the Governor in the formal budget documents, other than the normal growth from the existing tax base. The Governor did however, state in his message that a 1% increase in the state income tax could be used to forego the impact his budget would have in education funding cuts and could also pay down some of the backlog of bills that are owed to the state's vendors, state universities and local governments. This increase would generate approximately \$3 billion but it is not completely understood how much would be used for increased spending for education versus offsetting the structural deficit that requires the \$4.7 billion of new borrowing for operations.

GENERAL FUNDS - BUDGET RESULTS & BUDGET PLANS FY2009-FY2011

3/6/2010

	Fiscal Year 2009 Actual	Fiscal Year 2010 Revised Budget	Fiscal Year 2011 Introduced Budget
OPERATING REVENUES PLUS TRANSFERS IN			
REVENUES			
State Sources	\$ 20,984	\$ 19,085	\$ 19,884
Federal Sources	\$ 6,567	\$ 6,743	\$ 6,032
TOTAL REVENUES	\$ 27,551	\$ 25,828	\$ 25,716
STATUTORY TRANSFERS IN			
Statutory Transfers In	\$ 1,593	\$ 2,167	\$ 1,728
TOTAL TRANSFERS	\$ 1,593	\$ 2,167	\$ 1,728
TOTAL OPERATING REVENUES PLUS TRANSFERS IN	\$ 29,144	\$ 27,995	\$ 27,444
OPERATING EXPENDITURES AND TRANSFERS OUT			
CURRENT YEAR EXPENDITURES			
APPROPRIATIONS (Total Budget) ¹	\$ 27,796	\$ 26,309 ¹	\$ 24,777
Less: Unspent Appropriations (Unspent Budget plus Uncashed Checks)	(\$322)	(\$400)	(\$496)
NET APPROPRIATIONS BEFORE PENSION CONTRIBUTIONS	\$ 27,474	\$ 25,909	\$ 24,281
PENSION CONTRIBUTIONS			
Less: Savings from Pension Stabilization	\$ 2,486	\$ - ¹	\$ 4,157
Equals: CURRENT YEAR EXPENDITURES (Net Appropriations Spent)	\$ -	\$ -	(\$287)
STATUTORY TRANSFERS OUT	\$ 29,960	\$ 25,909	\$ 28,171
Legislatively Required Transfers (Diversions to Other Funds)	\$1,897	2,002	\$ 2,004
Pension Obligation Bond Debt Service (includes FY10 Pension Funding Bonds)	\$466	\$564	\$ 1,611
Debt Service Transfers for Capital Projects	\$636	\$670	\$ 638
Less: Reduced Transfer to Local Government Distributive Fund	\$0	\$ -	(\$308)
TOTAL TRANSFERS OUT	\$ 2,999	\$ 3,236	\$ 3,946
TOTAL OPERATING EXPENDITURES AND TRANSFERS OUT	\$ 32,959	\$ 29,145	\$ 32,117
BUDGET BASIS FINANCIAL RESULTS AND BALANCE			
BUDGET BASIS OPERATING SURPLUS (DEFICIT) [Receipts less Payments]	(\$3,815)	(\$1,150)	(\$4,672)
OTHER FINANCIAL SOURCES (USES)			
Short-Term Borrowing Proceeds	\$2,400	\$1,250	\$0
Repay Short-Term Borrowing (including interest)	(\$1,424)	(\$2,295)	\$0
Voucher payment notes ²	\$0	\$0	\$4,672
TOTAL OTHER FINANCIAL SOURCES (USES)	\$976	(\$1,045)	\$4,672
BUDGET BASIS SURPLUS (DEFICIT) FOR FISCAL YEAR	(\$2,839)	(\$2,195)	\$0
Plus: Budget Basis Fund Balance at Beginning of the Fiscal Year	(\$834)	(\$3,673)	(\$5,868)
BUDGET BASIS FUND BALANCE (DEFICIT) AT END OF FISCAL YEAR	(\$3,673)	(\$5,868)	(\$5,868)
CASH BASIS FINANCIAL RESULTS			
BUDGET BASIS SURPLUS (DEFICIT) FOR FISCAL YEAR	(\$2,839)	(\$2,195)	\$0
Change in Accounts Payable (Change in Lapse Period Amounts)			
Accounts Payable at End of Prior Fiscal Year	\$975	\$3,953	\$6,148
Less: Accounts Payable at End of Current Fiscal Year	(\$3,953)	(\$6,148)	(\$6,148)
Equals: Increase/(Paydown) of Accounts Payable During Fiscal Year	\$2,978	\$2,195	\$0
CASH BASIS SURPLUS (DEFICIT) FOR FISCAL YEAR ³	\$139	\$0	\$0
CASH POSITION			
CASH BASIS SURPLUS (DEFICIT) FOR FISCAL YEAR	\$139	\$0	\$0
Plus: Cash Balance in General Funds at Beginning of Fiscal Year	\$ 141	\$ 280	\$ 280
Equals: Cash Balance in General Funds at End of Fiscal Year	\$ 280	\$280	\$280
Plus: Cash Balance in Budget Stabilization Fund at End of Fiscal Year	\$ 276	\$ 276	\$ 276
Equals: Total Cash at End of Fiscal Year	\$ 556	\$ 556	\$ 556

¹ FY2010 appropriations do not reflect the FY2010 statutory pension contribution for the General Funds. That amount will be financed and paid through issuance of approximately \$3,466 million in General Obligation Pension Funding Bonds during the fiscal year.

² A series of notes to pay specific vouchers during the fiscal year.

³ Cash Basis Surplus (Deficit) equals Budget Basis Surplus (Deficit) minus (plus) Other Cash Uses (Sources) relating to changes in Accounts Payable during the fiscal year.

NOTES FROM THE INSIDE....

By J. Thomas Johnson

This issue of Tax Facts includes two articles on the fiscal challenges facing our state. Dick Dye, Nancy Hudspeth and Dan McMillen from the Institute of Government and Public Affairs of the University of Illinois provide a progress report on the Fiscal Futures Project. The Illinois Tax Foundation provided some of the seed money to get this program jump started. We are hopeful that the University will be able to find the resource support to take this project to the next step and we will work with them to reach this result. We think this project will produce an invaluable tool to help us with the fiscal challenges facing our state government into the future and will create a map on determining what government programs are affordable and doable over the long term and which need to be modified so that Illinois can afford the government we want and yet stay competitive with neighboring states for job creation and investment. The other article (authored by me) is a short synopsis of Governor Quinn's fiscal 2011 budget plan. Another year of borrowing for operations, something the bond rating agencies will frown on and we won't be allowed to continue. We would call on our governmental leaders to put together the "five year fiscal plan" so we can see into the future what our governmental programs will look like and the resources proposed to support them.

Taxpayers' Federation of Illinois

430 East Vine Street, Suite A
Springfield, IL 62703
V. 217.522.6818
F. 217.522.6823

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