

Chicago Fed Letter

Charting Illinois's fiscal future

by Richard Mattoon, senior economist and economic advisor

The state of Illinois has been facing a precarious fiscal situation for the past several years. According to the Civic Committee of the Commercial Club, Illinois has accumulated over \$120 billion in total indebtedness. This works out to nearly \$25,000 per household. Even in the short run, Illinois faces a budget deficit in excess of \$11 billion in the next budget year.

On June 17 and 18, 2010, the Federal Reserve Bank of Chicago and the Institute of Government and Public Affairs at the University of Illinois convened a group of academics, policymakers, business leaders, and policy analysts to discuss the scope of Illinois's fiscal problems and what measures might be taken to restore the state's fiscal stability.

Measuring debt

Rick Mattoon (Chicago Fed) presented joint work with Daniel McMillen and William Testa on how to measure total state indebtedness. Mattoon noted that in international studies, debt is often reported as a percentage of gross domestic product. In the case of state debt, Mattoon suggested that a more appropriate measure would relate the level of debt to the state's own source revenues (taxes and state-generated revenues), because this would reflect the state's ability to pay off the debt. Under this measure, Illinois had a state and local debt level of over 210% of total taxable resources in 2007, which compares to a level for all U.S. states of roughly 180% during the same year. In addition, a key consideration in constructing a measure of state indebtedness is what *types* of debt to include. Options include state short-term and long-term debt, combined state and local debt, and state and local debt plus unfunded pension and other post-employment (OPEB) liabilities. When

unfunded and OPEB liabilities are included in the debt measure for 2007, Illinois's total liability is nearly 35% of gross state product (GSP), compared with 20% in Indiana, 19% in Wisconsin, and 13% in Iowa.

Leslie McGranahan (Chicago Fed) analyzed the history of government debt in the United States and identified three eras of debt issuance. In the first era, roughly from 1800 to 1850, states issued far more debt than municipalities or the federal government. Much of the state debt was related to public-private partnerships intended to support economic development by building canals and infrastructure. This era ended abruptly with a series of state debt defaults beginning in the 1840s. In all, nine states defaulted on their debt and several barely escaped default, leading to a wave of debt limitation regulations. The second era, post-1850 to the 1920s, saw municipalities as the major issuers of debt. In the third era, from the 1920s to the present, the federal government became the dominant debt player. McGranahan noted that debt limitation measures tended to become less binding over time; and debt issuance showed a sharp increase after 2000.

Lessons from New York City

Allen Proctor (Proctor Consulting) served as deputy budget director for New York City and executive director

More information on the conference is available at www.chicagofed.org/webpages/events/2010/charting_illinois_fiscal_future.cfm.

of the New York State Financial Control Board during a period of significant fiscal stress. In the wake of New York City's fiscal crisis in the mid-1970s, Proctor explained, the city was essentially placed into receivership. In response, the city had to begin producing four-year rolling budgets that would be monitored and revised on a quarterly basis. This longer horizon introduced more disciplined planning into the budgeting process. Moreover, the city was required to balance its budget on a GAAP (generally accepted accounting principles)

The model significantly expands the number and types of state funds included from the traditional four funds in the general fund budget (\$35 billion in FY09) to 380 funds (\$61 billion), providing a far more comprehensive picture of how the state spends its resources.

The model produces three different measures of the state's budget gap based on whether borrowing is included as a receipt (measure A), excluded as a receipt (measure B), or reflects the cost of new unfunded pension liabilities (measure C).

Illinois's unfunded pension liability is roughly \$80 billion, giving the state a funded pension ratio (assets minus liabilities) of 38.5%.

basis to allow comparison of the budget's performance against the annual audited financial statements. Finally, a two-tiered oversight system was created. In the first tier, a control board was established to run city finances; and in the second, an ongoing monitor was set up to ensure that fiscal discipline continued. Proctor argued that support from the business community was a key component in the city's financial turnaround. Business leaders recognized that the fiscal health of the city would have a direct influence on their firms and the city's ability to retain its position as a vibrant economic hub.

Proctor also discussed the strong position of New York City's pension funds. The city uses its own actuary, who updates funding projections every three months. Because there is a 100% funding requirement, a shortfall in the pension fund requires that employers adjust their funding levels immediately to close the gap. Finally, Proctor noted that the city has developed other institutions to strengthen financial oversight, such as an independent budget office and a Citizen's Budget Commission.

Improving fiscal transparency in Illinois

Richard Dye (IGPA) presented joint work with Nancy Hudspeth and David Merriman on a fiscal model designed to allow multiyear budgeting for Illinois.

In examining the period from 2000 to 2009, measure A shows modest deficits or surpluses, while measure B shows a worsening condition with larger deficits and only one small surplus. Measure C shows large deficits over each of the past nine years.

According to the model, total expenditures are projected to grow at 4.6% per year, while total receipts will grow at 3.5% per year. Without policy changes, this 1% growth gap will lead to significantly larger deficits in the future, Dye said. Finally, he noted, the model can also be used to test how different policy interventions and economic scenarios might affect future budgets.

The problem with pensions

Lance Weiss (Gabriel, Roeder & Smith), J. Fred Giertz (University of Illinois), and James Spiotto (Chapman and Cutler) discussed the impact that Illinois's large unfunded pension liability is having on state finances. Weiss noted that as of June 30, 2009, Illinois's unfunded actuarial accrued liability was roughly \$80 billion, giving the state a funded pension ratio (assets minus liabilities) of 38.5%. This is due to a combination of historically underfunded pension contributions and poor investment returns over the past several years. In particular, the lack of any binding funding requirement has allowed the state to avoid making necessary

pension contributions. To bring the system back into line, costs must be reduced by reducing basic or ancillary plan benefits for current and/or new employees, increasing investment returns, or reducing administrative costs. It might also be possible to identify new funding sources to reduce the size of the gap.

Fred Giertz added overly generous actuarial assumptions to the list of reasons for pension underfunding. He discussed Illinois's recently passed pension reform (HB 1946), which creates a two-tier pension system with significantly less generous benefits for new employees. Giertz noted that this reform does little to reduce the existing liability for pensions in the state, but it will significantly reduce pension costs for new hires. However, he pointed out, these less generous benefits will make hiring more difficult. For example, state university pension benefits may not be competitive with those offered by universities elsewhere. In order to attract faculty, universities may have to offer higher wages to offset the reductions in benefits. Giertz mentioned a couple of potential solutions. One would be to deal with the long-term structural deficit, thereby allowing appropriate pension contributions to be made in the future. However, Giertz said that this solution might not be politically viable in Illinois. A second option would focus on pension-specific reforms, including moving from a defined contribution to a defined benefit program, moving to a pay-as-you-go system, and making a series of pension-related changes designed to enhance revenues and reduce benefits without violating the state's pension non-impairment clause.

James Spiotto described a proposal to create a Public Pension Funding Authority in an effort to prevent a municipal bankruptcy filing related to pension debt. This new institution would have the power to resolve past underfunding levels by increasing taxes or requiring a referendum on tax increases, intercepting state taxes in order to pay necessary pension contributions, approving the local government budget, and requiring arbitration to determine if the level of benefits is sustainable. In addition, the authority would be able to suspend tax limitations,

increase pension contributions from both government and employees, and issue bonds in certain cases. In the case of local pension fund insolvency, the authority would be permitted to transfer the local fund to an established statewide plan and ultimately authorize the local government to file for Chapter 9 bankruptcy. Spiotto argued that establishing this type of authority is critical to providing options prior to a Chapter 9 filing, which can have punitive effects on a local government.

Business climate

Fred Montgomery (Sara Lee) provided a business perspective on factors that influence location and capital investment. Potential investment decisions are split between increasing capacity or lowering costs at an existing location and opening a new plant. The impact of public policy on business costs plays an important role in determining the outcome. Particularly beneficial are incentives related to reduced property taxes and payroll taxes.

Montgomery drew a distinction between business taxes and business climate. Taxes and incentives do play a role in business location decisions, but a poor business climate has a greater impact on discouraging existing investment in any given state. In particular, the future tax environment becomes uncertain when a state is in fiscal distress, and this uncertainty is disruptive to the business planning structure. New forms of taxes, such as service taxes and gross receipts taxes, can be difficult for firms to administer and collect and involve additional administrative costs. Changes to existing tax provisions, such as a single weighted sales factor for apportioning income or repeal of the sales tax exemption on machinery and equipment, can also be quite costly to firms, Montgomery said. He argued that raising the rate on the corporate income tax would be less detrimental than other actions, particularly if it were coupled with a doubling of the section 199 deduction (which allows firms with qualified domestic production activities to take a 3% tax deduction from net income) and a permanent and (possibly enhanced) research and development credit. A final improvement, he said, would be changing

the EDGE tax credit to allow it to be a credit against payroll taxes.¹

Filling the gap

Matt Murray (University of Tennessee) observed that Illinois is facing a structural deficit because its expenditures are outpacing growth in the existing revenue base. To fill this gap, Murray suggested that a starting point might be to consider whether the state has unused tax capacity. Unused tax capacity would be a measure of the comparative burden of taxes in Illinois versus other states. Before exploiting this unused capacity, Illinois should target revenue enhancements with limited economic distortions. In the short run, the yield must be sufficient to bridge existing gaps; and in the long run, the enhancements must have the revenue elasticity to promote future budget balance, minimize additional tax increases, and allow for supporting a rainy day budget reserve fund.

Murray presented a list of potential options from traditional “sin” taxes (on alcohol and tobacco) and newer ideas like taxing soda and salt (which would not have a large revenue yield even though these ideas might be politically popular) to a state property tax (unlikely given that the local burden is already considered relatively high). Raising corporate taxes is not that appealing, Murray said, because the revenue yield is limited and it encourages corporate tax planning to avoid the tax. Alternatives to standard corporate taxes such as gross receipts taxes and value-added taxes could work, he added, but only if they improve the corporate tax system rather than being used simply to raise new revenues. Given these considerations, he argued that the most reasonable options would be to raise the personal income tax rate (given that the 3% flat tax rate in Illinois is lower than in neighboring states) and to consider extending the sales tax to a larger group of personal services. Illinois only taxes 17 services, he pointed out, while Iowa taxes 94. Finally, targeted tax relief should be offered to low-income households that would be adversely affected by these changes.

Creating a new structure for improving budget decision-making was the focus

of a presentation by Stan Marshburn, (Washington State Office of Financial Management). In 2002, the state of Washington adopted the Priorities of Government (POG) system to drive budgeting. The system identifies core services in government and aims to provide these services through an enterprise-wide perspective rather than focusing on individual agencies. Ten key functions of state government were identified, ranging from improving student achievement to improving recreational opportunities. The goal is to build an evidence-based budgeting system, with key indicators to allow decision-makers and the public to understand how key government activities directly relate to statewide policy objectives.

For example, a high-level strategy for the state is to increase healthy behaviors. The strategies identified to promote this goal include reducing tobacco usage and substance abuse, protecting against injury and accidents, reducing obesity, promoting safe sexual behaviors, and encouraging healthy eating and exercise. The POG system establishes a series of metrics to measure trends in each of these categories. The state agencies then have to demonstrate how their activities would improve one or more of these metrics in order to obtain full funding, Marshburn

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concluded that while the POG system has been highly successful in Washington, it does have a few challenges. First, performance management is still imperfect, so budgeting decisions are not 100% objective. The POG system also introduces a parallel budgeting process, so it stretches already thin budgeting staff resources even further.

The role of tax limitations, specifically California's Proposition 13, on state fiscal conditions was the focus of a presentation by Tracy Gordon (University of Maryland). Prop 13 was adopted in 1978 and capped property tax rates at 1% of assessed value, while limiting increases in assessed value to 2% per year unless the property was sold (at which point it would be assessed at market value). In addition, the act mandated that any new taxes would require a two-thirds majority of the state legislature. The state also became responsible for allocating property taxes among local governments within a county.

In the near term, Prop 13 cut property taxes in half and increased local reliance on user charges and developer fees. It also increased reliance on state aid, particularly to support education. In the

longer term, this led to the centralization of education finance in the state. These changes produced mixed results. While California's school expenditures per pupil are about average for the nation, the state has a significantly higher than average student-teacher ratio. California public schools lag the nation in student achievement; as a result, students have fled to private schools. These problems have led to dozens of ballot box initiatives designed to change budgeting dynamics in the state, often with unintended and conflicting consequences. Finally, Gordon suggested that state-local fiscal relationships have been made more difficult. Tensions between governments run high, she added, and accountability is unclear.

Laurence Msall (Civic Federation) outlined a fiscal plan for Illinois that the Civic Federation proposed this spring. The plan takes a comprehensive approach to state finances and includes pension reforms; a rollback of FY11 state spending by \$2.5 billion (exempting Medicaid and most education spending); and tax reforms, such as increases in the personal and corporate income tax rates, an end to the tax exemption on retirement

income, and an increase in the cigarette tax. To date, Msall reported that the FY11 budget, while adopting some improvements for future pension funding, has done nothing to reduce the \$6 billion in backlogged bills owed by the state and will likely lead to an even larger deficit in FY12. Of particular concern is the impact fiscal instability is having on the state's debt rating, which is increasing the cost of borrowing.

Conclusion

Solving Illinois's fiscal problems is likely to require extensive action across many policy areas. New structures will be needed to improve budget decision-making and transparency. Eliminating the state's structural deficit will require a multiyear strategy that is likely to include both revenue enhancements and program reductions.

¹ The Economic Development for a Growing Economy Tax Credit Program (EDGE) is an Illinois program that provides tax credits to qualifying companies, equal to the amount of state income taxes withheld from the salaries of employees in the newly created jobs. The nonrefundable credits can be used against corporate income taxes to be paid over a period not to exceed ten years.