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SPECIAL REPORT:

FLAWED TAX POLICY IS THE PRIMARY DRIVER OF ILLINOIS' RECURRING GENERAL FUND DEFICITS

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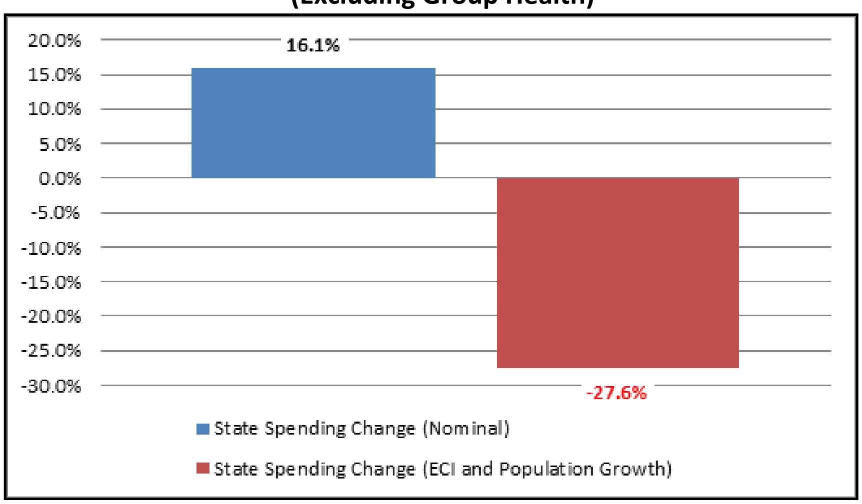
1. Overspending on Services is Not the Driver of the State's Ongoing Deficit Woes

The General Fund deficit for FY2013 will be approximately $8.3 billion, which would be 33.55 percent of total scheduled spending on current services for the year. It is also nothing new. According to the Illinois Comptroller's Office, Illinois has had a deficit in its General Fund every fiscal year since at least 1991 (the records do not cover years prior to that date).[1] This ongoing deficit problem is a legitimate cause for concern, since over $9 out of every $10 spent on services through the General Fund goes to the four core services of education, healthcare, human services and public safety.

Given that General Fund Deficits have been incurred over such an extended period of time, many have naturally concluded that overspending on services must be a major contributing factor. The data, however, clearly indicate that Illinois' persistent General Fund deficits are primarily caused by its tax policy, not its service spending. As shown in Figure 1, after adjusting for inflation and population growth, real General Fund spending on services in FY2013 will be 27.6 percent *less* than in FY2000.

Figure 1
FY2013 General Fund Services Appropriations Relative to FY2000
In Nominal Dollars and Adjusted for Inflation and Population Growth
(Excluding Group Health)



Sources: FY2000 unadjusted appropriations from Governor's final budget summary for FY2000; and FY2013CTBA analysis of GOMB, FY2014 Operating Budget Detail (March 6, 2013), http://www2.illinois.gov/gov/budget/Pages/BudgetBooks.aspx and House Bills 206 and 207 of the 98th General Assembly. Inflation for healthcare inflated by Midwest Medical Care CPI; all other appropriations adjusted using ECI-C and Midwest CPI from the BLS as of January 2013, and population growth from the Census Bureau as of January 2013.

2. Illinois' Fundamentally Flawed Fiscal System Drives Deficit Growth

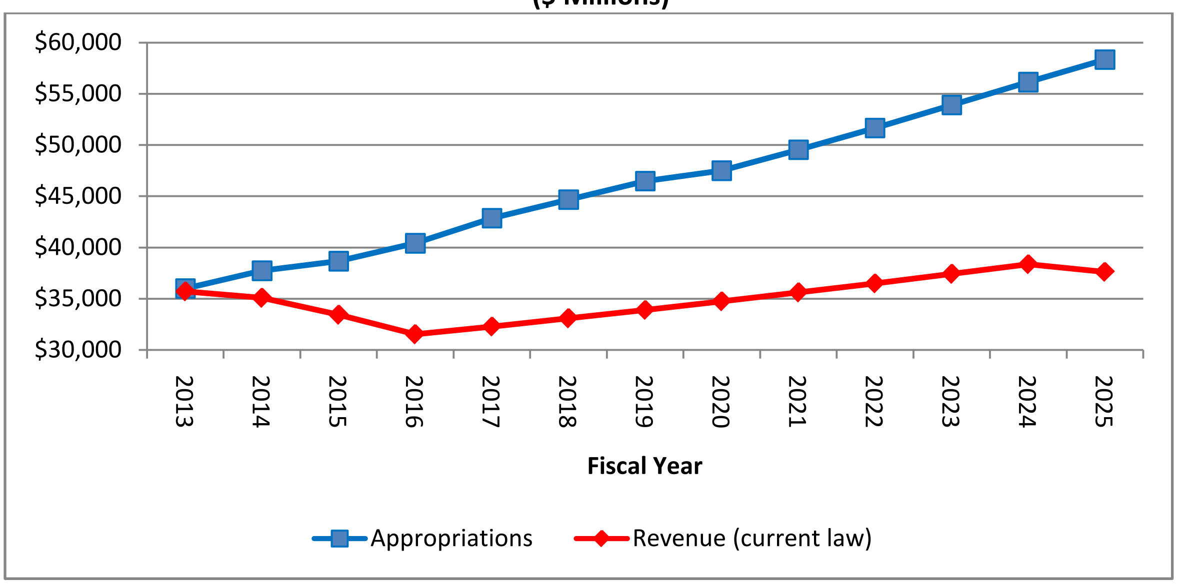
So, how does the state's tax policy drive General Fund Deficit growth? Well, to create a sound tax system that will sustainably fund services in a modern economy, that system must satisfy the following four principles:[2]

- First, it must be **FAIR** to taxpayers, by assessing tax burden in a manner that corresponds to ability to pay;
- Second, it must be **RESPONSIVE** to growth in the private sector economy;
- Third, it must be **STABLE,** by continuing to generate adequate revenue even during poor economic cycles; and
- Fourth, it must be **EFFICIENT**, by minimizing the impact it has on important, private sector economic decisions.

Illinois' tax system fails to satisfy any of these principles. As CTBA has pointed out for over a decade, Illinois' flawed tax policy causes the state's General Fund budget to generate deficits consistently, even when spending on services is held constant from one fiscal year to the next in real, inflation adjusted terms. This happens because revenue does not grow with the modern economy over time, whereas the cost of providing public services—even when service levels are not increased—at a minimum do.

The ongoing mismatch in the state's General Fund between the lower rates of growth for revenue than for the cost of maintaining service levels from one fiscal year to the next is commonly called a "**structural deficit**." Figure 2 is a graphic depiction of the structural deficit in the Illinois General Fund.

Figure 2
Illinois State General Fund Structural Deficit
($ Millions)



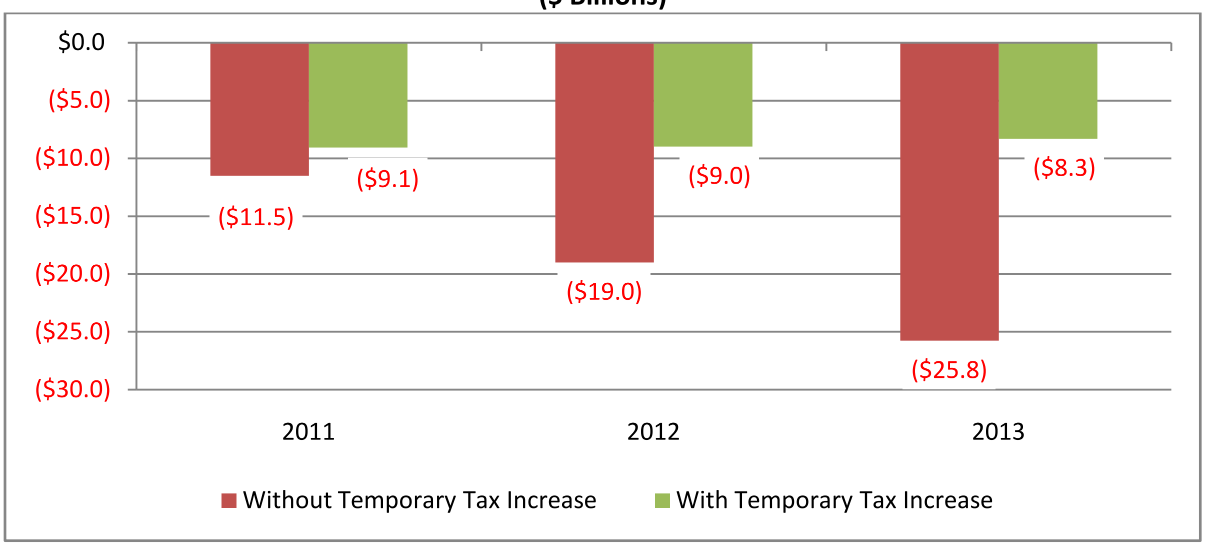
The structural deficit depicted in Figure 2: (i) assumes that enacted appropriations, including supplemental appropriations, for FY2013 will be fully realized; (ii) uses the Commission on Government Forecasting and Accountability's (**COGFA**) FY2013 revenue estimates, but with revised personal income tax, corporate income tax and federal sources that take into account the April 2013 revenue spike; and (iii) revenue for FY2014, FY2015 and FY2016 is based on COGFA's estimates.[3] Figure 2 also assumes that the state maintains constant spending on services in real terms through FY2025, meaning that no programs are expanded or added, and that revenue will continue to grow at historic rates.[4] It should also be noted that the revenue declines that occur in FY2015 and FY2025 are due to the expiration of the temporary income tax rate increases under the 2011 Taxpayer Accountability and Budget Stabilization Act, which is analyzed in Section 3 below.

3. The 2011 Temporary Tax Increase has Prevented Billions in Service Cuts

While the deficit projected for FY2013 of $8.3 billion is certainly large, without the Taxpayer Accountability and Budget Stabilization Act (**TABSA**) which passed in January of 2011,[5] the situation would be much worse. TABSA had two major components. First, it instituted hard spending caps on General Fund expenditures for fiscal years 2012, 2013, 2014 and 2015, something never done before in Illinois. Note that including non-discretionary spending (debt service on bonds, pension payments and statutory transfers) and repayment of past due bills from prior fiscal years, aggregate General Fund expenditures for FY2013 are scheduled to be $35.8 billion. Under TABSA, however, the cap for FY2013 was set at $37.55 billion. Hence, total FY2013 General Fund expenditures will be $1.72 billion *less* than permitted despite the fact that expenditures for hard costs, like debt owed to the pension systems, are increasing significantly over time. Indeed, combined appropriations for all nondiscretionary payments, like debt service owed to the pension systems for instance, will be some $7.25 billion more in FY2013 than they were just four years ago in FY2009.[6] The full increase in total General Fund spending over the last four years is in fact attributable to these nondiscretionary hard costs, further demonstrating that spending on core services is not driving the state's deficits.

Second, TABSA raised revenue by temporarily increasing the personal and corporate income tax rates from 3 percent to 5 percent and 4.8 percent to 7 percent, respectively. While the temporary tax increases did not completely resolve the state's financial problems, they effectively stabilized the state's overall fiscal condition. Figure 3 compares the state's actual General Fund budget deficits for the FY2011-FY2013 sequence to what those annual deficits would have been without the revenue from the temporary tax increases under TABSA, but including all spending cuts made to services.

Figure 3
Comparison of Accumulated Deficits With and Without Temporary Tax Increase
($ Billions)

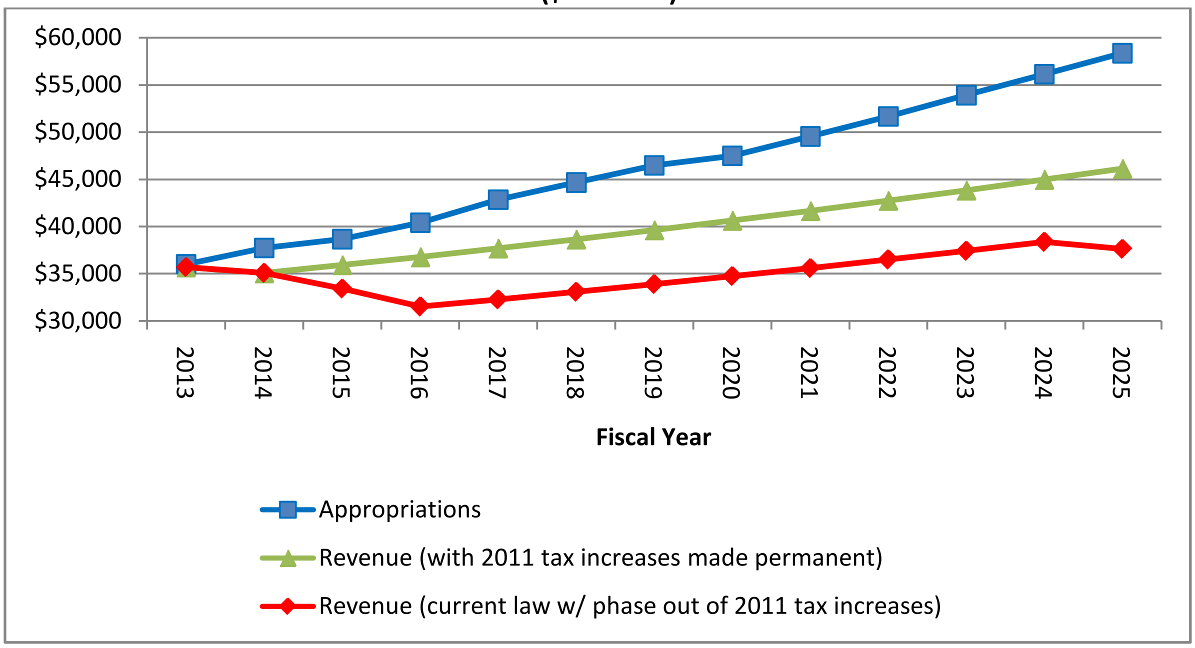


Sources: CTBA calculations using total spending figures for FY2011 and FY2012 as reported in GOMB, *FY2013 Budget Book* (Springfield, IL: February 2012 2013), Ch. 2-18; total spending for FY2013 as reported in GOMB, *FY2014 Budget Book* (Springfield, IL: March 2013), Ch. 2-16 and House Bills 206 and 207 of the 98th General Assembly; actual revenue for FY2011-FY2012 and estimated revenue for FY2013 as reported and estimated by COGFA in *FY2014 Economic Forecast and Revenue Estimate and FY2013 Revenue Update (*Springfield, IL: March 12, 2013), but adjusted to account for the April 2013 revenue spike.

Figure 3 demonstrates how crucial the revenue increases under TABSA were to ensuring the state had the fiscal capacity to provide core services. Consider that after adjusting for all supplemental appropriations, total spending on services in FY2013 is scheduled to be $24.74 billion. With the temporary revenue generated under TABSA, of that total FY2013 spending amount, $8.3 billion or nearly 34 percent is deficit spending. *Without the revenue generated by TABSA, the deficit would have been $25.8 billion in FY2013, which is over $1 billion more than the entire amount scheduled to be* *spent on services.* This dramatically shows how much of the deficit problem is driven by inadequate revenue, rather than spending.

While the revenue from the temporary tax increases under TABSA has been crucial to maintaining the state's fiscal capacity to fund services, those increases alone—even if made permanent—would not eliminate the state's structural deficit, as shown in Figure 4. The reason for this is simple. While increasing income tax rates of course results in increased revenue, the overall structural design flaws in the state's tax policy are left unresolved—meaning over time, revenue growth will not keep pace with the modern economy.

Figure 4
Illinois State General Fund Structural Deficit with Tax Increases Kept
($ Millions)



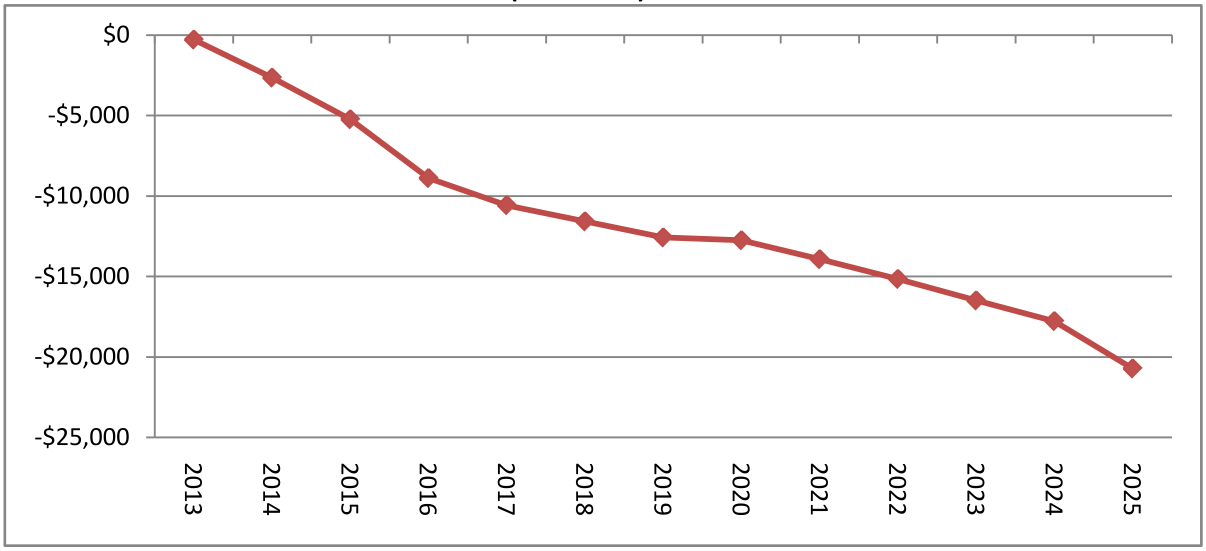
Note, this structural deficit model uses the same assumptions and sources as Figure 2.

4. Without Comprehensive Tax Reform, the State's Fiscal Future is Dim

The state's structural deficit, together with the Governor's three-year spending projections which call for General Fund service spending cuts through FY2016,[7] raise a number of concerns about the state's capacity to continue funding core services into the future. Figure 5 below assumes that the state maintains constant spending on services in real terms through FY2025, meaning that no new programs are added and no existing programs are expanded. Instead, public spending on core services is adjusted over this period solely to account for historic rates of inflation and population growth. On the revenue side, Figure 5 assumes: (i) the currently legislated phase-out (beginning in 2015 and occurring again in 2025) of the temporary increases in the individual and corporate income tax rates under TABSA will occur; (ii) state-own source revenue will grow in-line with historic rates; and (iii) federal revenue will be flat (which is optimistic, given that federal transfers to Illinois have been cut by more than $500 million over the last four years, according to the Congressional Budget Office).

As shown in Figure 5, despite the significant cuts in state spending that have occurred over the last several years, and assuming no real increases in spending on any core service, the state's estimated General Fund operating deficit will have grown by over $20 billion through FY2025.

Figure 5
Projected Growth in Illinois State General Fund Annual Operating Budget Caused by the Structural Deficit
($ Millions)



Note that Figure 5 only shows the estimated growth in the state's annual operating deficit in its General Fund, assuming a balanced budget in FY2013. Given that Figure 5 does not take into account the accumulated General Fund deficit that will exist by the end of FY2013, estimated at $8.3 billion, the state's accumulated General Fund deficit in FY2025 will likely be in the $28 billion range.

5. Tax Reforms Needed to Move Illinois Forward

To modernize its tax system, Illinois at a minimum must revise existing policy in two key ways. First, to both stabilize revenue generation during poor economic cycles and respond better to how growth is occurring in the modern economy, Illinois must expand its state sales tax base to include consumer services. Although Illinois is one of 46 states with a sales tax, it is an outlier in that it excludes most services from being subject to the state sales tax. That means Illinois has the fourth most narrow sales tax base in the nation.[8] It is also a losing proposition, as the sale of services, what Illinois for the most part does not tax, now accounts for over 60 percent of the state's economy, while the sale of goods, what Illinois primarily does tax, accounts for less than 12 percent.[9] For more information on the importance of expanding the state sales tax base to include services, please see *"Funding Our Future,"* available online at www.ctbaonline.org.

Second, to both tax people more fairly and to respond better to how income growth is distributed in the modern economy, Illinois should pass a constitutional amendment to permit using a graduated rate structure for its personal income tax. Illinois is one of 41 states that imposes an income tax, but is again an outlier because it is one of just seven that utilizes one, flat income tax rate that applies to all levels of income. This flat rate approach—required by the state constitution—[10] prohibits the state from designing its income tax in a manner that is fair to people and responsive to income growth over time, by corresponding to ability to pay. For more information on why Illinois should amend its constitution to permit using a graduated income tax rate structure, please see *"The Case for Creating a Graduated Income Tax in Illinois,"* also available online at www.ctbaonline.org.

ENDNOTES

[1] State of Illinois Comptroller, GAAP Fund Balance, http://www.ioc.state.il.us/index.cfm/fiscal-condition/gaap-fund-balance.

[2]Hugh Stretton, Economics: a New Introduction (London: Pluto Press, 1999), 623.

[3] FY2013 and FY2014 from COGFA, *FY201 Economic Forecast and Revenue Estimate and FY2013 Revenue Update* (Springfield, IL: March 2013); and FY2015 and FY2016 from COGFA, *3-Year Budget Forecast FY2014-FY2016* (Springfield, IL: April 2013). Revenue estimates beyond FY2016 assume; (i) state source growth will be in-line with historic rates; and (ii) federal funding will be flat.

[4]Public spending on the core services is based on these assumptions: (i) projecting spending on core services using the Congressional Budget Office's projection on employment growth and population growth using the Illinois Department of Commerce and Economic Opportunity's population projections; (ii) pension contributions based on the funding plan put in place by Public Act 88-593; (iii) statutory transfers are projected based on historic CPI-U growth and population growth using the Illinois Department of Commerce and Economic Opportunity's population projections; and (iv) bond debt service is the General Revenue Fund schedule reported by the Comptroller in FY2011 Bond Indebtedness and Long Term Obligations.

[5] PA 96-1496.

[6] FY2009 hard costs were $3.04 billion, as reported in GOMB, *FY2010 Proposed Operating Budget* (Springfield, IL: March 2009), Ch. 2-12.

[7] See GOMB, 2013 Three Year Projection, (Springfield, IL: January 11, 2013), http://www.state.il.us/budget/Financial%20Reports/3%20Year%202013%20FINAL.pdf.

[8]CTBA analysis of Federation of Tax Administrators, *State and local tax collection by source FY 2010* (Washington, DC: FTA, May 2013).

[9]CTBA Analysis of BEA Data, IL GDP by Industry, (Washington, DC: 2008) http://www.bea.gov/regional/gsp.

[10]Article IX, Section 3 of the Illinois Constitution.