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The Impact of Flawed Tax Policy & Pension Debt Repayment Plans on Illinois' Structural Deficit

October 21, 2019

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The Impact of Flawed Tax Policy & Pension Debt Repayment Plans on Illinois' Structural Deficit

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1. Introduction

One thing is abundantly clear: Illinois state spending on services is now—and historically has been—in excess of its means. When Fiscal Year **("FY")** 2020 ends in June of 2021, Illinois is projected to have an accumulated General Fund deficit of $7.5 billion. That's significant, given it represents 28 percent of total FY2020 appropriations for current services.[1] It's also nothing new. According to the Comptroller's Office, Illinois has run a deficit in its General Fund every year for the last seventeen consecutive years.[2] These ongoing deficits are a cause for concern, since over $9 out of every $10 of General Fund spending on services goes to the four, core areas of education, healthcare, human services, and public safety.

What isn't so clear is the cause of these deficits. Many erroneously believe over-spending on services is primarily to blame. The data, however, is completely at odds with that belief. Indeed, Illinois has cut real General Fund spending on nearly every service area since FY2000. As it turns out, gross real General Fund appropriations, after adjusting for inflation, for current services in FY2020 are projected to be 11.41 percent less than they were two decades ago in FY2000.[3]

So how is it possible that the state is still running such a huge General Fund deficit, given its long-term, real disinvestment in core services? Well, the data make the answer clear: Illinois' persistent General Fund deficits are primarily caused by two items:

> **First is the State's historically flawed tax policy, which for decades and adjusting solely for inflation has failed to generate adequate revenue growth to cover the cost of providing the same level of services from one fiscal year into the next.**
>
> **Second is the 1995 plan devised for repaying the pension debt Illinois incurred to cover part of the historic mismatch between revenue and service cost growth.**

Indeed, Illinois' tax policy is so poorly designed that in inflation adjusted terms, state revenue from all sources in FY2020 is projected to be roughly equivalent to what the Illinois' tax system generated two decades ago in FY2000.[4] In other words, Illinois has a textbook "structural deficit."

The problem is, a structural deficit can't be eliminated without raising taxes. And raising taxes is politically difficult at best – especially if the myth of "over-spending" continues to muddy the waters. So, before tackling how to reform tax policy in the manner needed to raise adequate revenue to fund services sustainably, it's time to put the whole "over-spending" myth to bed.

2. Illinois is a low-spending state

To start with, Illinois is very low in spending when compared to the other 49 states. Despite having the sixth largest population[5] and the fifth largest Gross Domestic Product (**"GDP"**) of any state,[6] Illinois ranked 26th in General Fund spending on services per capita in 2017, the last year for which there's comprehensive data available.[7] Illinois also ranked 39th in spending as a share of GDP in the last year for which there's a national comparison.[8] Hence, no matter the metric, Illinois is relatively low spending on current services.

Moreover, aggregate General Fund spending on the four, core services of education, healthcare, social services, and public safety declined by 11.41 percent after inflation over the FY2000-FY2020 sequence. Indeed, net General Fund spending on current services is projected to increase by only $9.1 billion or about 2.5 percent in nominal, non-inflation adjusted terms, since FY2000.[9] Bottom line: the evidence compellingly demonstrates that Illinois spending on services doesn't drive the structural deficit.

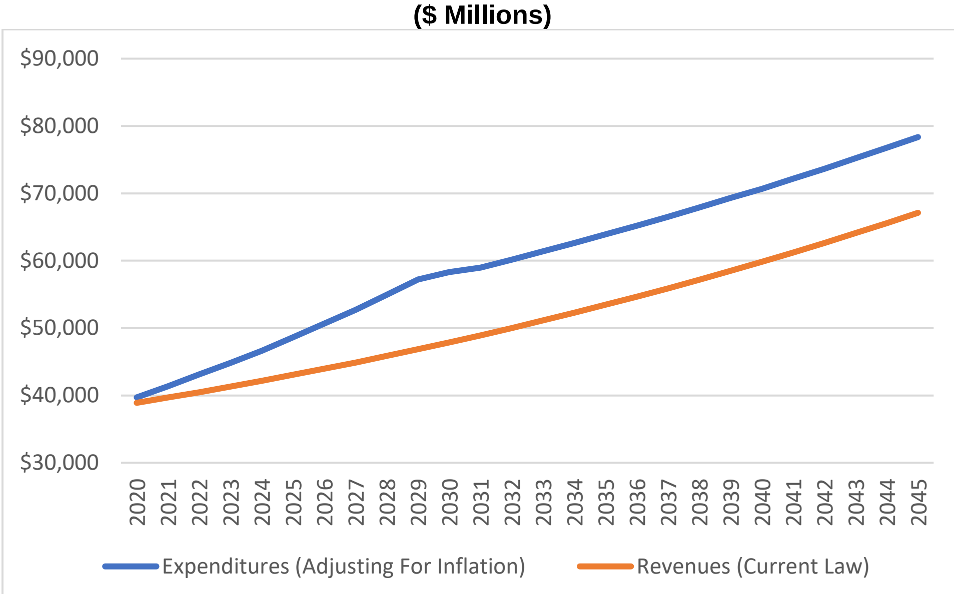
3. Flawed tax policy significantly contributes to the structural deficit

On the other hand, all the data show that flawed tax policy very much drives the state's structural deficit. Here's why: to fund services sustainably over time in a modern economy, tax policy must satisfy three economic principles.[10] It must be:

- **FAIR** to taxpayers;
- **RESPONSIVE** to growth in the modern economy; and
- **STABLE** during poor economic cycles.

Illinois' tax policy doesn't satisfy any of these principles, which not only doesn't work – it causes the ongoing mismatch between revenue growth and service cost growth from one fiscal year to the next as depicted in Figure 1.

Figure 1
Illinois State General Fund Structural Deficit
($ Millions)



Source: CTBA analysis of Illinois General Fund budgets, COGFA pension reports

In essence, Illinois' tax policy is so flawed, the state lacks the fiscal capacity to maintain its current—and relative to other states, low—investment levels in the four, core services over time. **The only sustainable path available to eliminating Illinois' structural deficit—that doesn't require material, harmful service cuts—involves two key steps:**

- **modernizing Illinois tax policy to generate adequate, recurring tax revenue over time; and**
- **re-amortizing the debt Illinois owes to its five pension systems.**

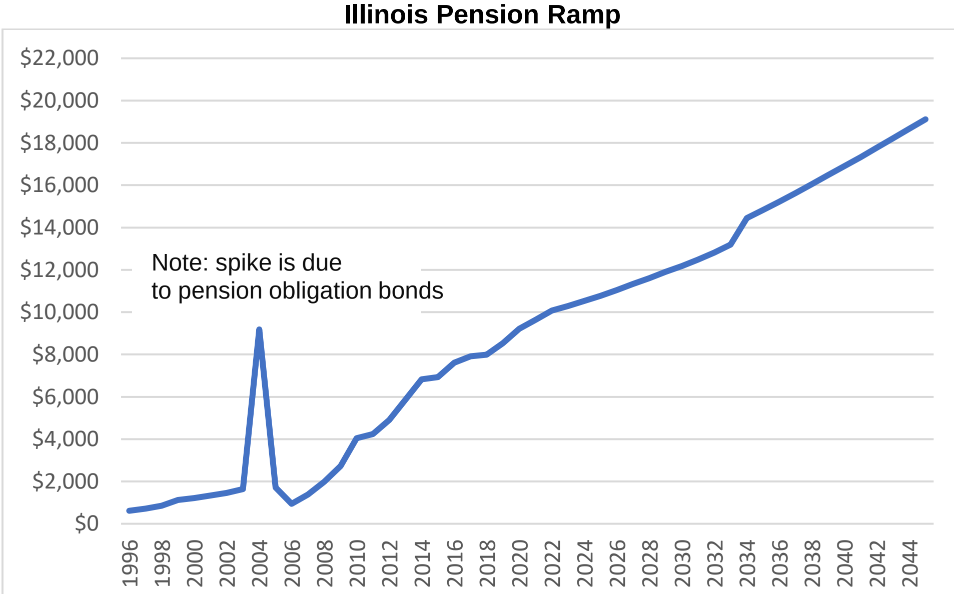
Indeed, at this point in time, tax reform and pension-debt reamortization are inexorably entwined.

4. The current pension debt repayment schedule exacerbates the structural deficit

The reason for this is clear: for generations, Illinois' structural deficit meant revenue growth was insufficient to maintain service levels from year-to-year. But honestly fixing that problem would have required elected officials to raise taxes. And that is so divisive politicians in both parties wanted to avoid it. So they did. Rather than raise taxes, they chose to paper over the imbalance between revenue and service cost growth, by borrowing against what was owed to the pension systems and using that revenue that should have funded pensions to instead subsidize the cost of providing current services. Sure, this temporarily hid the structural deficit from taxpayers, but over time, it became the primary reason the state developed such a significant—as in $133 billion—unfunded liability today.[11]

Unfortunately, the irresponsible practice of borrowing against the pensions became such standard operating procedure that it was codified into law as part of the "Pension Ramp" that passed in 1995.[12] Under the Pension Ramp, the state—now by statute—continued the practice of borrowing against the contributions owed to pension systems to subsidize the cost of delivering current services, for the first 15 years following its enactment. Then in out-years, the Pension Ramp created an incredibly back-loaded repayment schedule, which grows in unattainable, unaffordable annual increments, as shown in Figure 2.

Figure 2
Illinois Pension Ramp



Source: COGFA, *Illinois State Retirement Systems: Financial Condition as of June 30, 2018* (Springfield, IL: April 2019). Note: contributions for 1996-2019 are actual appropriations and 2020-2045 are projections.

The Pension Ramp creates such an unrealistic repayment schedule that it would continue to strain Illinois' fiscal capacity even after modernizing tax policy. Hence, resolving Illinois' structural deficit requires that, in addition to implementing the tax reforms identified below, Illinois must also re-amortize its extant pension debt to create a realistic repayment structure that:

- increases the funded ratios of the five systems annually, until they become healthy;

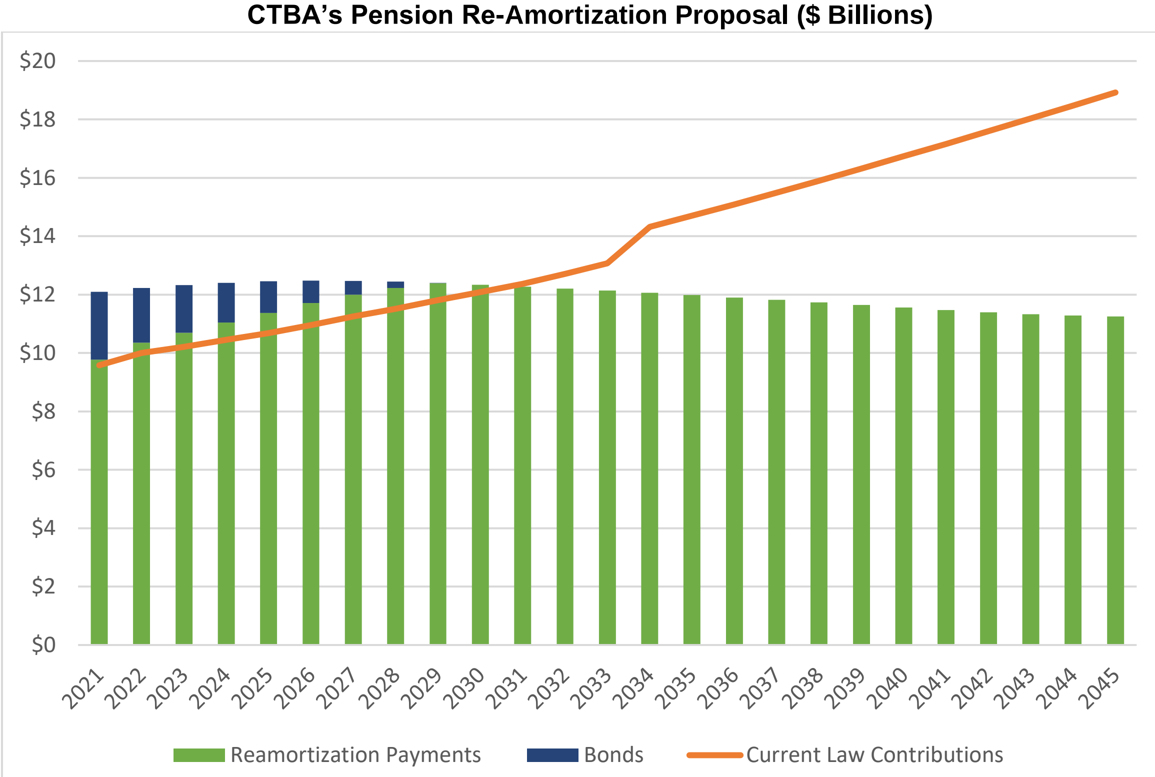
- accomplishes that growth in funded ratio after accounting for all cash flow obligations to pay benefits to current and future retirees; and
- is affordable, given the other demands on current tax revenue to fund core services.

5. Level-dollar pension debt reamortization is critical

The most effective way to re-amortize the pension debt is to ditch the politically devised backloading of the repayment, and instead smooth the obligation out into annual payments that are level, akin to a traditional, fixed rate mortgage.

This level dollar approach to paying off unfunded liabilities is advantageous because the state's repayment obligation stays the same from year-to-year in nominal dollars. Hence in real, inflation adjusted terms, the annual contribution actually becomes a declining financial obligation over time. CTBA has run the numbers, and Illinois can resolve its unfunded liability, grow its funded ratio, and meet all system cash flow obligations to pay retirement benefits, by covering the annual normal cost of benefits being earned, each year, plus utilizing a level dollar annual repayment of its pension debt set at approximately $9.6 billion. This reamortization plan is shown in Figure 3. Note that, for each of the first nine years following the implementation of this plan, it is contemplated that Illinois would issue relatively small pension obligation bonds, to cover the difference between the pension contribution called for under current law and the contribution called for under the reamortization. Repayment of those pension obligation bonds—at a 6.55 percent interest rate over 25 years—is included in Figure 3.

Figure 3
Pension Fund Contributions under Current Law, Compared to CTBA's Pension Re-Amortization Proposal ($ Billions)



Source: CTBA analysis using Illinois state pension fund actuarial valuations.

Under this re-amortization, Illinois' five pension systems would be approximately 72 percent funded by FY2045. This puts them on a sustainable path to full funding given they are only 39 percent funded today. Implementing the reamortization depicted in Figure 3 not only gets the pension systems on a sustainable path to solvency, but also significantly benefits taxpayers, as it saves them $45 billion in debt service payments over the Pension Ramp.

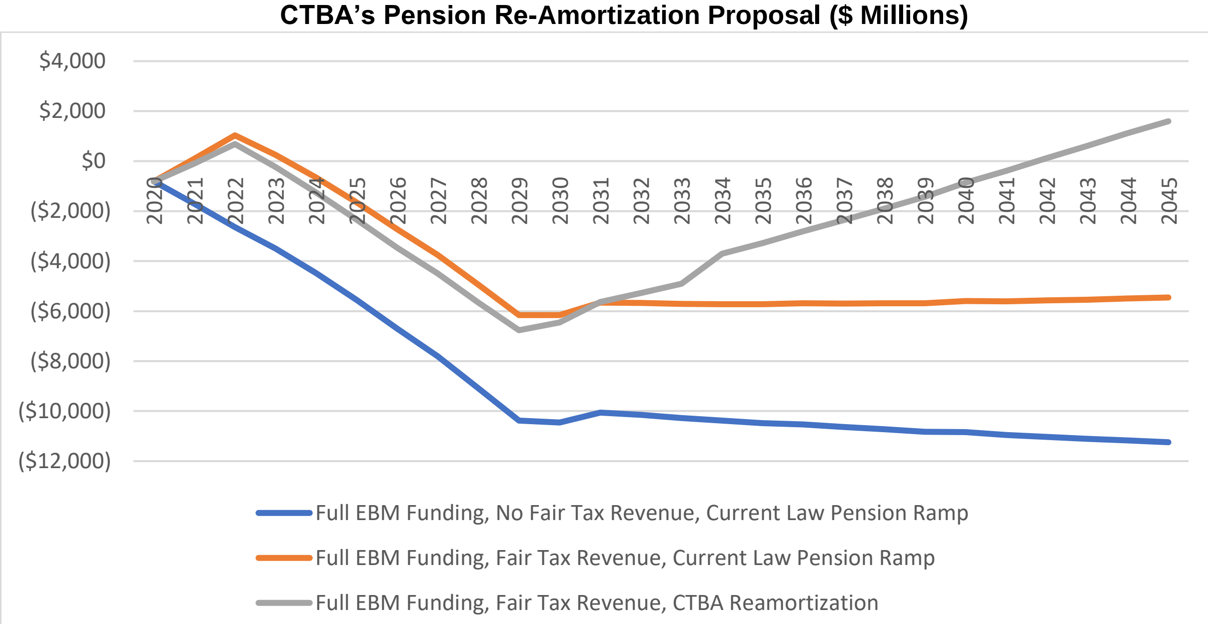
6. Illinois' tax policy must be more reflective of the modern economy

Which brings us to modernizing Illinois tax policy. Sure, the tool kit is limited, but that helps make the solutions obvious. Indeed, by implementing the following tax reforms (in addition to re-amortizing its pension debt as aforesaid), Illinois can completely eliminate its structural deficit by 2042:

> **First, reform state income tax policy by implementing a graduated rate income tax as proposed by Governor Pritzker.**
>
> **Second, reform sales tax policy by expanding the base of the sales tax to include most consumer services.**

In May of 2019, the General Assembly passed a resolution to amend the State's constitution to implement Gov. Pritzker's graduated income tax proposal—known as the "Fair Tax." If this resolution is ratified by voters, this Fair Tax is projected to raise $3.6 billion in new, annual revenue from the wealthiest three percent of tax payers in Illinois, while cutting the income tax liability of the bottom 97 percent of state filers.[13] For the projections set forth in Figure 4, CTBA used the estimated $3.6 billion in new revenue from the Fair Tax, with implementation in the second half of FY2021, and the first full year of revenue in FY2022.

Figure 4
Projected Structural Deficit Under Current Law, Compared to CTBA's Pension Re-Amortization Proposal ($ Millions)



Source: CTBA analysis using Governor's Office of Management and Budget, *State of Illinois General Funds Financial Walk Down, 5 Year Projection*, Springfield, IL.

Finally, Illinois has to expand its sales tax base to include most consumer services. The "base" of a sales tax is simply the basket of items and services that the tax applies to when sold. In general, Illinois' sales tax applies primarily to goods (like clothing and furniture) and not services (like lawn care and haircuts). In fact, Illinois' general sales tax applies to only five of the 168 service industry categories identified by the Federation of Tax Administrators.[14] That's a loser proposition, given that over 72 percent of Illinois' economy is the sale of services.[15]

By excluding most services from the sales tax base, Illinois has created a mismatch between the state's economy and the portion of that economy taxed to fund public services. Expanding the sales tax base to include consumer services (but not professional or business-to-business services) fixes this problem and generates $2.0 billion more in revenue annually.[16]

7. Conclusion

Despite being one of the wealthiest states in America, Illinois has struggled to fund core services like education and the social safety net for generations. This negatively impacts vulnerable people, such as individuals suffering from mental illness and those with disabilities, while denying most children the educational opportunity they need to build a successful future.

Given the decades of evidence, there's no question that the root cause of Illinois' fiscal struggles is poorly designed tax policy and an unaffordable, back-loaded pension debt service repayment plan, which collectively have generated structural deficits for years. The simple reforms outlined in this Issue Brief effectively eliminate the structural deficit, generate the fiscal capacity Illinois needs to satisfy the state's demographically-driven demand for core services, and all for a total cost in new tax revenue that's under one percent of the state's $865 billion-plus economy, which is quite affordable. The only thing standing in the way of moving forward is politics – and that we can't truly afford.

Endnotes

[1] CTBA analysis using Governor's Office of Management and Budget, *Illinois State Budget Fiscal Year 2020*, Springfield, IL, February 2019, https://www2.illinois.gov/sites/budget/Documents/Budget%20Book/FY2020-Budget-Book/Fiscal-Year-2020-Operating-Budget-Book.pdf (accessed October 16, 2019).

[2] Illinois Comptroller's Office, *Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2018*, Springfield, IL, August 2019, https://illinoiscomptroller.gov/financial-data/find-a-report/comprehensive-reporting/comprehensive-annual-financial-report-cafr/fiscal-year-2018/ (accessed October 16, 2019): 33.

[3] CTBA analysis using Commission on Government Forecasting & Accountability, *State of Illinois Budget Summary Fiscal Year 2020*, Springfield, IL, August 2019, http://cgfa.ilga.gov/Upload/FY2020BudgetSummary.pdf (accessed October 16, 2019).

[4] CTBA analysis using Commission on Government Forecasting & Accountability, *State of Illinois Budget Summary Fiscal Year 2020*, Springfield, IL, August 2019, http://cgfa.ilga.gov/Upload/FY2020BudgetSummary.pdf (accessed October 16, 2019).

[5] US Census Bureau, *Table 1. Annual Estimates of the Resident Population for the Unites States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2018*, Last updated December 2018, https://www2.census.gov/programs-surveys/popest/tables/2010-2018/state/totals/nst-est2018-01.xlsx (accessed October 16, 2019).

[6] Bureau of Economic Analysis, *Annual Gross Domestic Product (GDP) By State in Current Dollars (SAGDP2)*, Last updated July 2019, https://www.bea.gov/data/gdp/gdp-state, (accessed October 16, 2019).

[7] CTBA analysis using (i) US Census Bureau, *Table 1. Annual Estimates of the Resident Population for the Unites States, Regions, States, and Puerto Rico: April 1, 2010 to July 1, 2018*, Last updated December 2018, https://www2.census.gov/programs-surveys/popest/tables/2010-2018/state/totals/nst-est2018-01.xlsx (accessed October 16, 2019) and (ii) National Association of State Budget Officers, *2018 State Expenditure Report – Fiscal Years 2016-2018*, Washington, DC, 2018, 15.

[8] CTBA analysis using (i) National Association of State Budget Officers, *2018 State Expenditure Report – Fiscal Years 2016-2018*, Washington, DC, 2018, 15; and (ii) Bureau of Economic Analysis, *Annual Gross Domestic Product (GDP) By State in Current Dollars (SAGDP2)*, Last updated July 2019, https://www.bea.gov/data/gdp/gdp-state, (accessed October 16, 2019)

[9] CTBA analysis using Commission on Government Forecasting & Accountability, *State of Illinois Budget Summary Fiscal Year 2020*, Springfield, IL, August 2019, http://cgfa.ilga.gov/Upload/FY2020BudgetSummary.pdf (accessed October 16, 2019).

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

[11] Karen Pierog, "Illinois' unfunded pension liability climbs to $133.5 billion," *Reuters*, December 7, 2018, https://www.reuters.com/article/us-illinois-pensions/illinois-unfunded-pension-liability-climbs-to-1335-billion-idUSKBN1O62KC (accessed October 16, 2019).

[12] Public Act 88-593 (1995)

[13] Paris Schutz. "Millionaires Would Pay 3 Percent More Under Pritzker Tax Plan." *WTTW Chicago Tonight*, March 7, 2019. https://news.wttw.com/2019/03/07/millionaires-would-pay-3-percent-more-under-pritzker-tax-plan (accessed October 16, 2019).

[14] Note this comparison is only for industries taxed under states' general sales taxes. Analysis of Federation of Tax Administrators, *Survey of Services Taxation*, Washington, DC, July 2008, http://www.taxadmin.org/fta/pub/services/btn/0708.html (accessed October 16, 2019).

[15] CTBA analysis using Bureau of Economic Analysis, *Annual Gross Domestic Product (GDP) By State in Current Dollars (SAGDP2)*, Last updated July 2019, https://www.bea.gov/data/gdp/gdp-state, (accessed October 16, 2019)

[16] Benjamin L Varner, Commission on Government Forecasting & Accountability, *Service Taxes 2017 Update*, Springfield, IL, January 2017 http://cgfa.ilga.gov/Upload/ServiceTaxes2017update.pdf (accessed October 16, 2019), 11.