

Issue Brief

THE ILLINOIS STRUCTURAL DEFICIT

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Fundamentally Flawed Fiscal System.

Illinois state government just struggled through its longest overtime legislative session in history. Predictably, the session was dominated by political bickering. Yet, through it all, there was unanimity of opinion expressed over only one, key aspect of government—the state was broke. While the reasons for this vary, including items such as escalating healthcare costs, unfunded pension liabilities and other cost factors, it is clear that the main problem lies in the design of the fiscal system itself.

Economists have identified five principles to use for creating a sound fiscal system¹—it should: (i) be **fair** in assessing tax burden among taxpayers; (ii) be **responsive** to growth in the private sector economy; (iii) generate **stable** revenue, even during poor economic cycles; (iv) be **efficient**, by minimizing the impact it has on important, private sector economic decisions; and (v) be **simple, transparent and accountable**, to reduce taxpayer error and instill taxpayer confidence. The Illinois tax system fails to satisfy any of these principles, with predictably negative consequences.

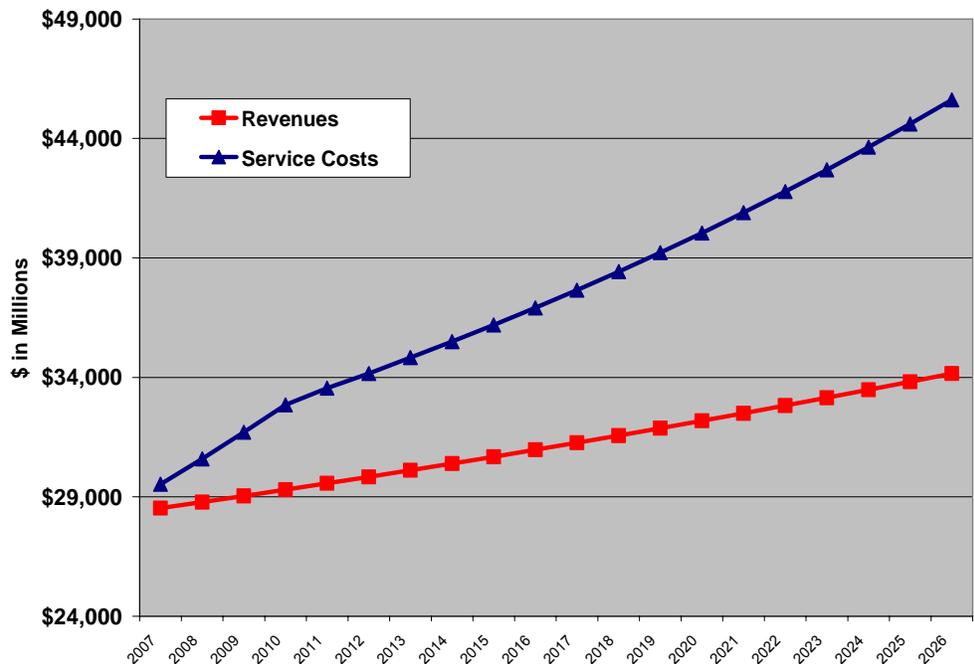
According to the Illinois Comptroller's Office, the state ran a \$3.1 billion GAAP² deficit in Fiscal Year 2005,³ the largest such deficit of any state in the nation.⁴ Conservative projections are that Illinois will have a budget deficit in Fiscal Year 2008 of over \$3 billion.⁵ This is a significant amount, representing more than 10 percent of the state's projected FY2008 General Revenue Fund—the fund that covers core public services like education, healthcare, public safety, environmental protection and human services.

Illinois' inability to balance its budget is not the result of a one-time aberration caused by unforeseen economic conditions, or the actions of any one administration or legislature. Instead, they are the natural product of a revenue system that has not grown with the economy for decades,⁶ even though the cost of providing services has. This fiscal mismatch is called a "structural deficit", and is illustrated in Figure 1.⁷

What precisely is a "structural deficit"? The term simply means that Illinois' fiscal system will not generate enough tax and fee revenue to continue funding current service levels from one year to the next, adjusting solely for inflation and population growth. Put another way, even if the current budget were balanced (it is not), the economy bounces back robustly (dubious, at best) and Illinois does not expand, enhance or increase any existing services or provide any new services, the fiscal system would *still* generate a deficit over time. Even the conservative Civic Committee of the Commercial Club of Chicago, an organization of 300 business leaders, recently acknowledged the structural nature of the ongoing "gap between current state revenues and total state expenses."⁸

Figure 1 illustrates how the state's structural deficit grows over time. To begin with, the projection ignores the state's accumulated deficit to date, and instead assumes Illinois actually had recurring revenues equivalent to its budgeted expenditures for Fiscal Year 2007.⁹

Figure 1
The Illinois Structural Deficit
(How Revenue Growth will not
Keep Pace with the Cost of Current Services)



The projection then follows a conservative model to forecast service cost and revenue growth over time, similar to the methodology, used by the nonpartisan Congressional Budget Office, which makes similar projections for the federal government. For Illinois, our projection assumes: (i) the economy will grow by four percent per year through 2026; and (ii) no new programs and no program expansions are passed, only current services under existing laws are maintained. The graph then compares the projected costs of maintaining current services over time against projected state revenue growth, adjusting solely for inflation based on the historic performance of Bureau of Labor Statistics' Consumer Price Index,¹⁰ and population growth.

As the graph illustrates, even if Illinois started with a balanced budget and had an economy that grew at four percent annually,¹¹ the state's deficit would still increase by more than \$3 billion dollars over the next five years, without adding or expanding.

Poor Fiscal Practices Worsen the Problem.

How is it that Illinois can deficit spend, given the state constitutional requirement that Illinois produce a balanced budget annually? The answer is simple. There are numerous legal stratagems available that enable the state to deficit spend, while still technically complying with the balanced budget requirement.¹² The most significant budget stratagems include: (i) deferring from one fiscal year to the next, Medicaid payment obligations owed to private providers of health services to low-income patients (for instance, the state deferred into FY 2007, over \$2.3 billion in such Medicaid payments it owed to providers for services rendered in FY 2006)¹³; (ii) underfunding the employer contribution the state owes its five public employee pension systems; and (iii) transferring revenue from special use state funds to the General Fund.

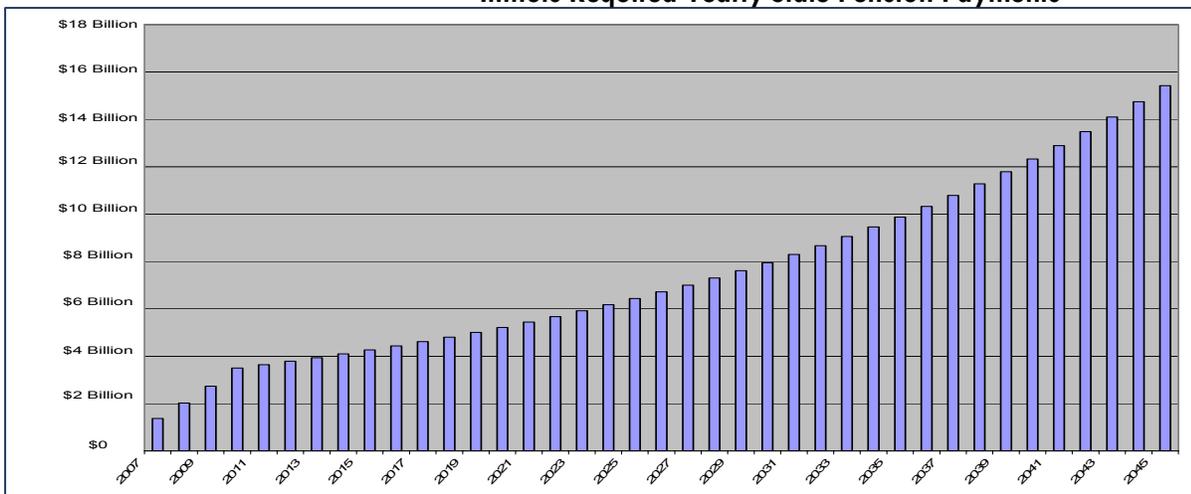
Utilized by state government to varying degrees for decades, these budgetary loopholes have culminated in the accumulated deficit that exists today, and contribute to the structural deficit that threatens tomorrow. They also allow the state to maintain public service levels that it does not have the fiscal capacity to afford. In Fiscal Year 2008, it is projected that Illinois will spend at least \$3 billion more on services than it will have the revenue to cover, accounting for fully 10 percent of total FY 2008 General Fund appropriations for all public services.¹⁴

Ironically, while a lack of revenue causes the state to use

these stratagems to make the budget appear balanced, in the long run they actually contribute to the worsening of the state's ongoing deficit problems. In no case is that more clear than the state's now decades long practice of failing to make its full employer contribution annually to the five public employee retirement systems.¹⁵ Over time, the frequent underfunding of the required employer contribution ultimately created a total, unfunded liability of \$44.2 billion, worst in the nation. To address that

huge unfunded liability, current law requires ever increasing, annual catch-up payments, frequently call the "Pension Ramp."¹⁶ As Figure 2 illustrates, the Pension Ramp has become a material contributing factor in the state's structural deficit.

Figure 2¹⁷
Illinois Required Yearly State Pension Payments



Illinois' Fiscal Problems Hinder the State's Ability to Meet Demand for Public Services.

If state government does not have the fiscal capacity to provide the current level of public services it delivers without deficit spending, it cannot be expected to satisfy growing demand for public services that can be anticipated to develop from declining wage and benefit trends. *The State of Working Illinois*, a series of annual reports that detail the state's industry, job, wage and benefit changes over time produced by Northern Illinois University and the Center for Tax and Budget Accountability, document a number of challenges for policy-makers based on changes in the Illinois economy. Among other things, these reports show that:¹⁸

- Median income in Illinois declined by 12.2% since 2000, the second worst decline in the nation;
- Since 1980, the percentage of Illinois workers with employer provided health insurance declined from over 75 percent to 59.2 percent, with Latinos being particularly hard hit, as over 57% of Latino workers do not have employer-provided insurance—Latinos also happen to be the fastest growing segment of Illinois' workforce;
- Less than half of Illinois workers currently have any private, employer-provided retirement benefits;



- Illinois lost 239,000 high paying manufacturing jobs since 1990—this loss of 26 percent of in-state manufacturing jobs over 17 years was worse than the rate of loss for the Midwest (20.8 percent) and the nation (20.9 percent);
- Most job growth in Illinois since 1980 has occurred in the lower paying, reduced benefit, service sectors; and
- Almost 60 percent of all new jobs created in the state over the next 10 years are projected to pay less than the current average of occupational wages, indicating median income will continue to decline.

Certainly, the Illinois economy is experiencing a transition that has major policy implications. From a demand for public services standpoint, the evolving wage and benefit trends are crucially important. To the extent that workers are realizing a decline in income over time, or a loss of health and/or retirement benefits, the corresponding demand for the public sector to fill benefit gaps, provide access to healthcare, childcare, housing assistance or even income supports grows. This in turn presents the fundamental question—can Illinois' current fiscal system be expected to generate enough revenue to meet this growing demand for services? The answer is no—unless the state modernizes its fiscal system by enacting tax reform (not just an increase—but a true reform) that eliminates the structural deficit and comports with the principles of sound, fair, sustainable tax policy.

References

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2. Generally Accepted Accounting Principles. A standard established by the Accounting Practices Board of the American Institute of Certified Public Accountants. These rules, conventions, and procedures define accepted accounting practices.
3. State of Illinois, Office of the Comptroller, *Hynes Calls for Reforms to Address Medicaid Liabilities and Resulting Structural Deficit Problems*, 7/7/2006.
4. A comparison of Comprehensive Annual Financial Reports for each state is available from the National Association of State Auditors, Comptrollers and Treasurers.
5. See Mancini, Chrissy and Martire, Ralph, *Private Sector Job Trends and the Illinois Structural Deficit*. January 2007. Available at www.ctbaonline.org
6. Giertz, J Fred., Therese J. McGuire, and James D. Nowlan. 1995. "The Illinois Structural Deficit Dilemma: The Growing Gap Between State Expectations and Revenue Realities." *State Tax Notes*. March 4, pp. 727-737.
7. Ibid.
8. The Civic Committee of the Commercial Club of Chicago, *Facing Facts*, December, 2006.
9. Based on the modeling designed for CTBA by J. Fred Giertz, Professor of Economics, University of Illinois and faculty at the Institute of Government and Public Affairs.
10. United States Department of Labor, Bureau of Labor Statistics, Consumer Price Index, CPI-U.
11. IL Const. art. VIII, § 2. Note: 49 of the 50 states have balanced budget requirements.
12. E.g., the state is able to defer Medicaid payments to health care providers from one fiscal year to the next under 30 ILCS. 105/25.
13. Illinois State Comptroller's Office, Comprehensive Annual Financial Report, Fiscal Year 2006.
14. State of Illinois Fiscal Year 2008 Budget Book. The Fiscal Year 2008 General Revenue Fund budget is projected \$27.9 billion.
15. "Report on the Financial Condition of the Illinois Public Employee Retirement Systems" Illinois Commission on Government Forecasting and Accountability, July 2007.
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17. "Report on the Financial Condition of the Illinois Public Employee Retirement Systems" Illinois Commission on Government Forecasting and Accountability, Appendix B, p 54, July 2007.
18. Center for Tax and Budget Accountability and Northern Illinois University. *The State of Working Illinois, 2005, 2006 and 2007*.

ABOUT CTBA

Founded in 2000, the Center for Tax and Budget Accountability is a non-profit, bi-partisan research and advocacy think tank committed to ensuring that tax, spending and economic policies are fair and just, and promote opportunities for everyone, regardless of economic or social status.

CTBA uses a data-focused, bipartisan approach to work in partnership with legislators, community groups and other organizations to help change both public policy and perceptions.

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