Illinois Fiscal Position:

Should we be worried or is there a path to solvency?

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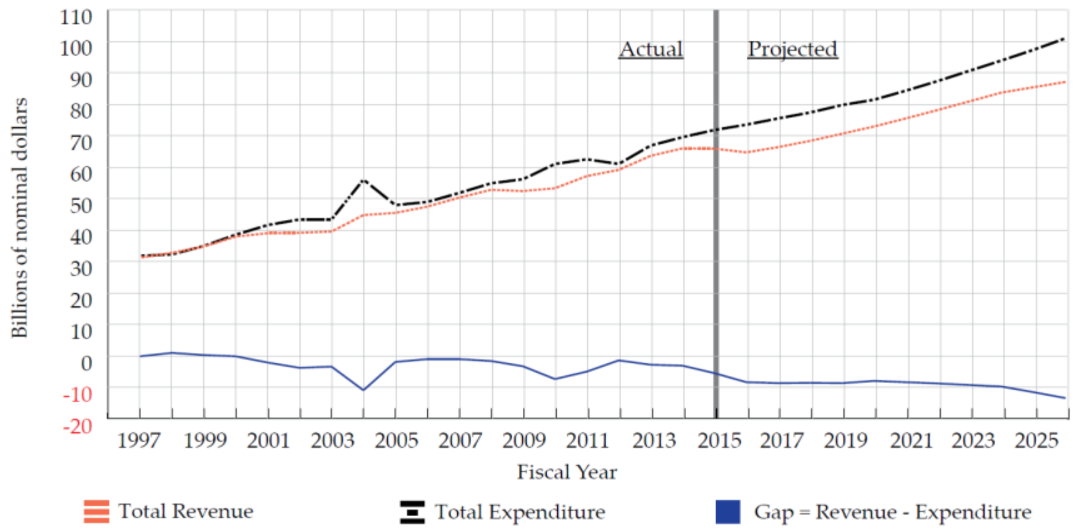
Where are we and how did we get here?

Figure 1: Historical and Projected Totals for Illinois All-Funds Budget



Source: *IGPA's Fiscal Futures Model*, January 2015.
Notes: 1. Historical values for FY 1997 to 2014; estimates for FY 2015; projections for FY 2016 to 2026. 2. Total Revenue includes sustainable sources, and excludes borrowing or other one-time sources. 3. Budget Gap is defined as: Total Sustainable Revenue minus Total Spending.

How did we get here?

- Shoot the accountants. Illinois public accounting structure failed to identify what the **true tax price** was of providing government services.
- We didn't know it but we were consuming more public services than we actually were paying for.
- How did we do this? We didn't pay our bills and we underfunded pensions and delayed infrastructure.
- However, with a new governor came many new proposals…

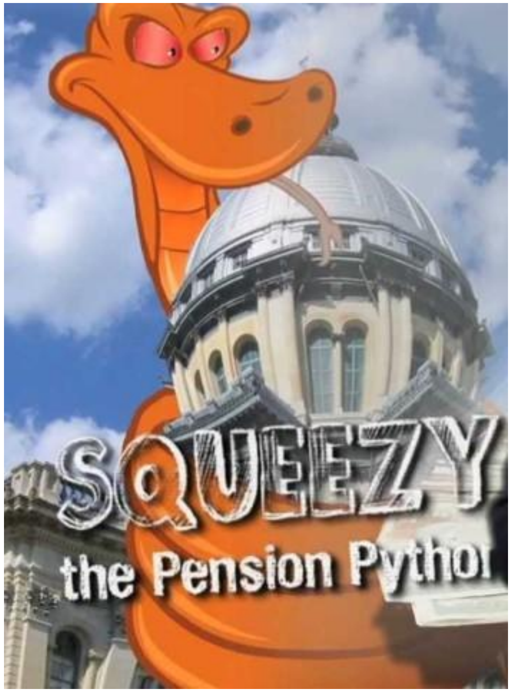
The good news?

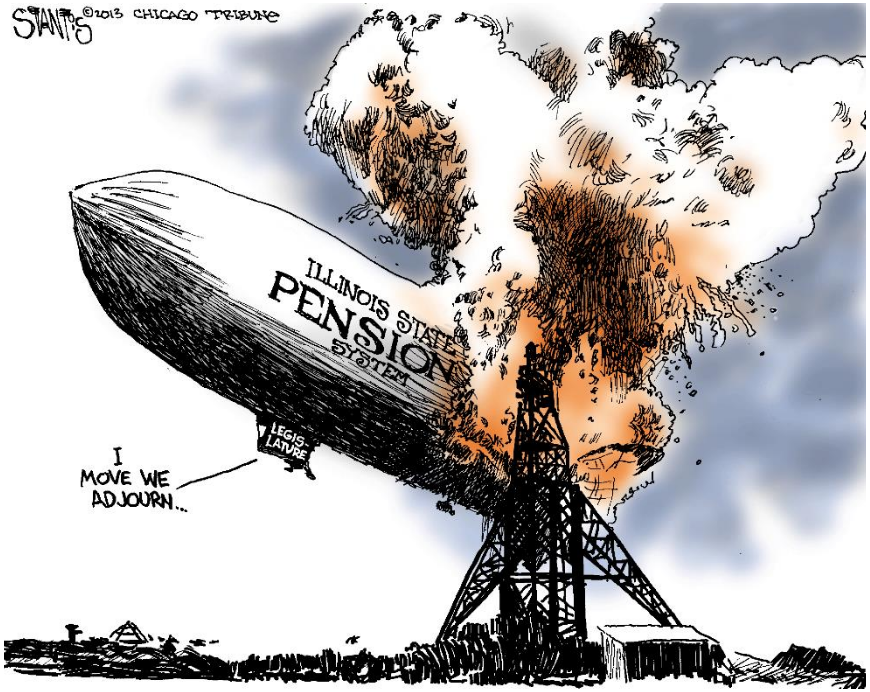
- The FY20 budget was passed on time and with bipartisan support. This means the state has a spending plan.
- A capital plan (funded in part by a 19 cent per gallon increase in gasoline taxes) was approved. Most importantly it establishes a sustainable stream of revenues to keep funding needed infrastructure work.
- Maybe good news? Cannabis sales will become legal in 2020. Will provide a revenue boost. Also permitting sports betting. Increasing the use of sin taxes?

The less good news…

- The approved budget isn't really balanced. The state still has $6.5 billion in unpaid bills even after issuing bonds last year to reduce the total.
- The capital plan is well structured on the revenue side, but could use some work on creating more transparency on what projects get funded and what the value is of specific projects. (see Virginia Smart Scale)
- Nothing really changed on reducing or addressing the unfunded pension liability. In fact, absent an April tax revenue surprise, the plan had been to extend the amortization period in order to limit the state's annual contribution.

The 800 pound gorilla...pensions

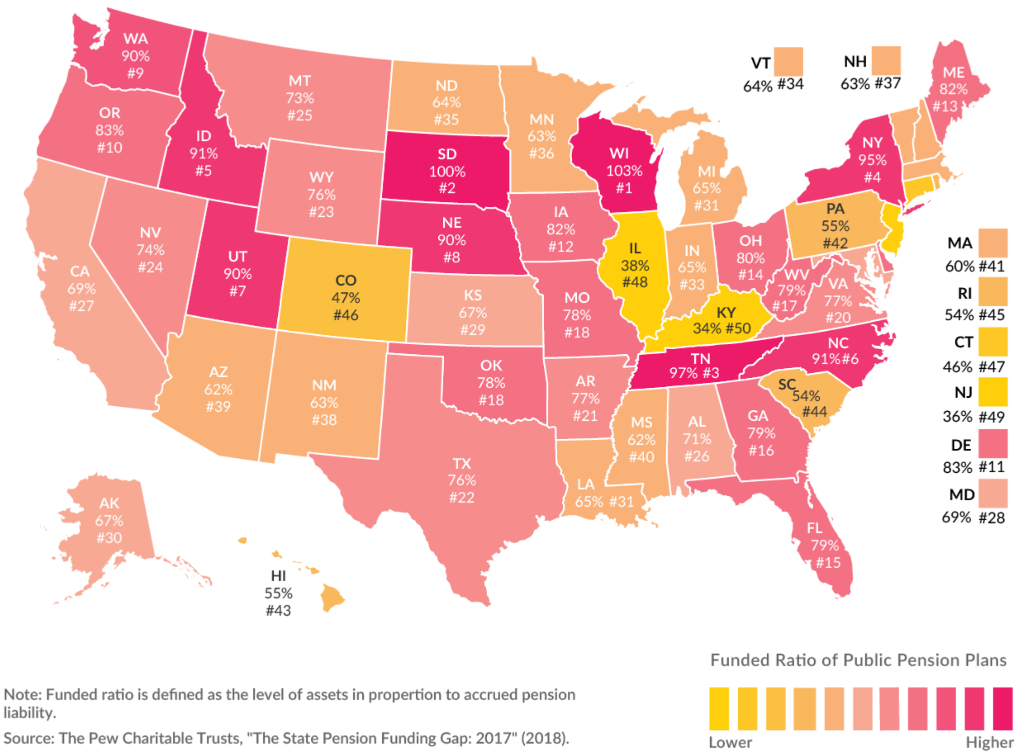




It’s not like we are alone…but we are near the bottom

How Well-Funded Are Pension Plans in Your State?

Funded Ratio of Public Pension Plans, Fiscal Year 2017



Note: Funded ratio is defined as the level of assets in propertion to accrued pension liability.

Source: The Pew Charitable Trusts, "The State Pension Funding Gap: 2017" (2018).

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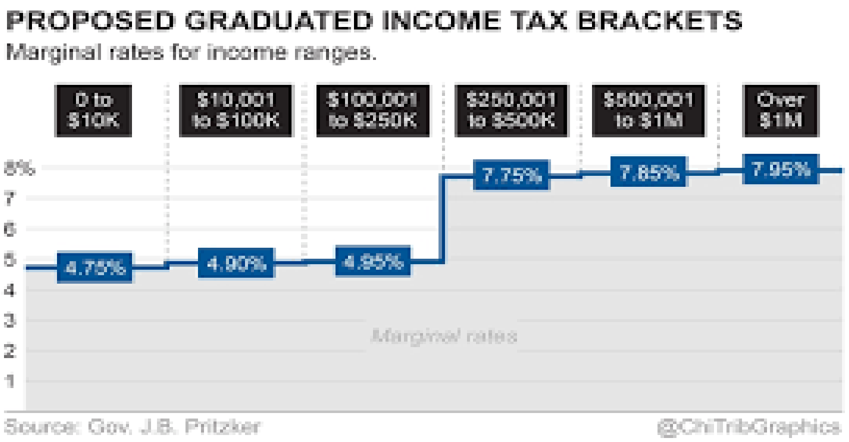
Pensions…its not like we haven't been creative

- The first effort…the pension ramp under Governor Edgar.
- Issuing $10 billion in pension obligation bonds under Gov. Blagojevich (2003).
- Creating a less generous Tier 2 pension for employees hired after January 1, 2011.
- Legislative action to restructure pensions in 2013 which was struck down by the state Supreme Court.
- Changing the tax system…increasing then rolling back and then increasing the flat rate income tax rate.
- Creating penalties for governments that fail to make a proper pension contribution. Allowing the state to intercept state revenues to local governments.
- <u>The newest option…adopt a graduated rate income tax</u> that boosts state revenues by $3.6 billion and channel some of the proceeds to paying down the pension debt.

Other strategies

- Consolidate downstate police and fire pensions into 2 funds (2019). Reduce administrative costs and increase investment returns.
- Constitutional amendment to restructure pension payouts?

A Word About the Graduated Income Tax Option



- Estimated to raise $3.6 billion (however, this isn’t a dynamic estimate)
- Designed to raise money for both general government programs and increased pension payments
- A graduated structure up until you go over $1 million

Current Personal Income Tax Rate Comparisons

	Tax rate	Bracket-- lowest	Bracket— highest	Exemption -- single	Exemption -- married	Exemption -- dependents
Illinois	4.95	Flat	Flat	2,000	4,000	2,000
Indiana	3.23	Flat	Flat	1,000	2,000	2,500
Iowa*	0.36 to 8.98	1,598	71,910	40	80	40
Michigan	4.25	Flat	Flat	4,000	8,000	4,000
Wisconsin	4.0 to 7.65	11,450	252,150	700	1,400	700

Source: Federation of Tax Administrators as of 7/1/2018. Iowa allows Federal income tax deductibility

Other (outside the box) ideas?

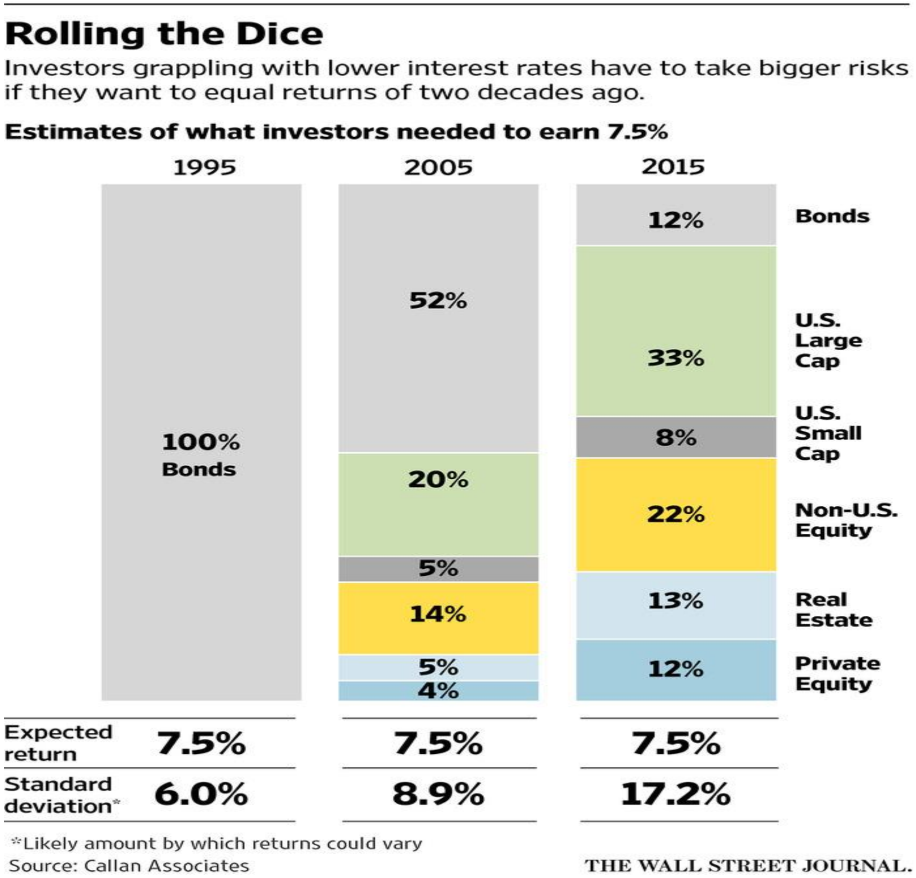
Maybe we don't have to fully fund our pensions?

- Lenney, Lutz and Sheiner, "The Sustainability of State and Local Pensions: A Public Finance Approach" (2019).
  - "Under-funded may not mean a plan isn't sustainable. In a low interest environment, pension debt may have low or no fiscal costs…you can roll over the debt indefinitely and not have to make tax or expenditure adjustments. The goal may be to stabilize the debt with modest fiscal adjustments rather than to fully fund the pension. Part of why this works is that while pension obligations will be high over the next 2 decades, policy and demographic changes insure that they decline in the future."

What if you think full funding is the best policy?

- Since without a Constitutional amendment, payments appear fixed, your only options are on the revenue side. These include:
  - Increase the government contribution—build a ramp.
  - Dedicate a significant portion of a tax base increase to increasing pension payments. (N.J. 15% rule?)
  - Issue pension obligation bonds…U of I professors proposal to issue $100 billion.
  - Hope for unexpectedly high investment returns. However this requires a shift to riskier assets.

Changing risk profile to get a 7.5% return



Taxes, efficiency and growth or should a statewide property tax be used to payoff the pension liability?

- A case study—(or as a commentator in Crain's Chicago Business called it, "the dumbest idea I had ever heard of") what tax base should be used to payoff the unfunded pension liability?
  - Start with economic considerations, not just how much money can be raised from existing sources.

The Defense for a Statewide Property Tax

- How you raise the revenue for paying off the liability matters…need to consider the economic feedback of taxes into the economy.
- Start with where is a large liability likely to be capitalized.
  - Not likely in income if wages are paid on a national level. In fact higher income tax rates might cause employers to have to pay higher wages.
  - Not likely on retail sales. Hikes in sales taxes could be regressive and also encourage avoidance.
  - That leaves property—has the greatest chance of efficiently capitalizing the liability into prices.

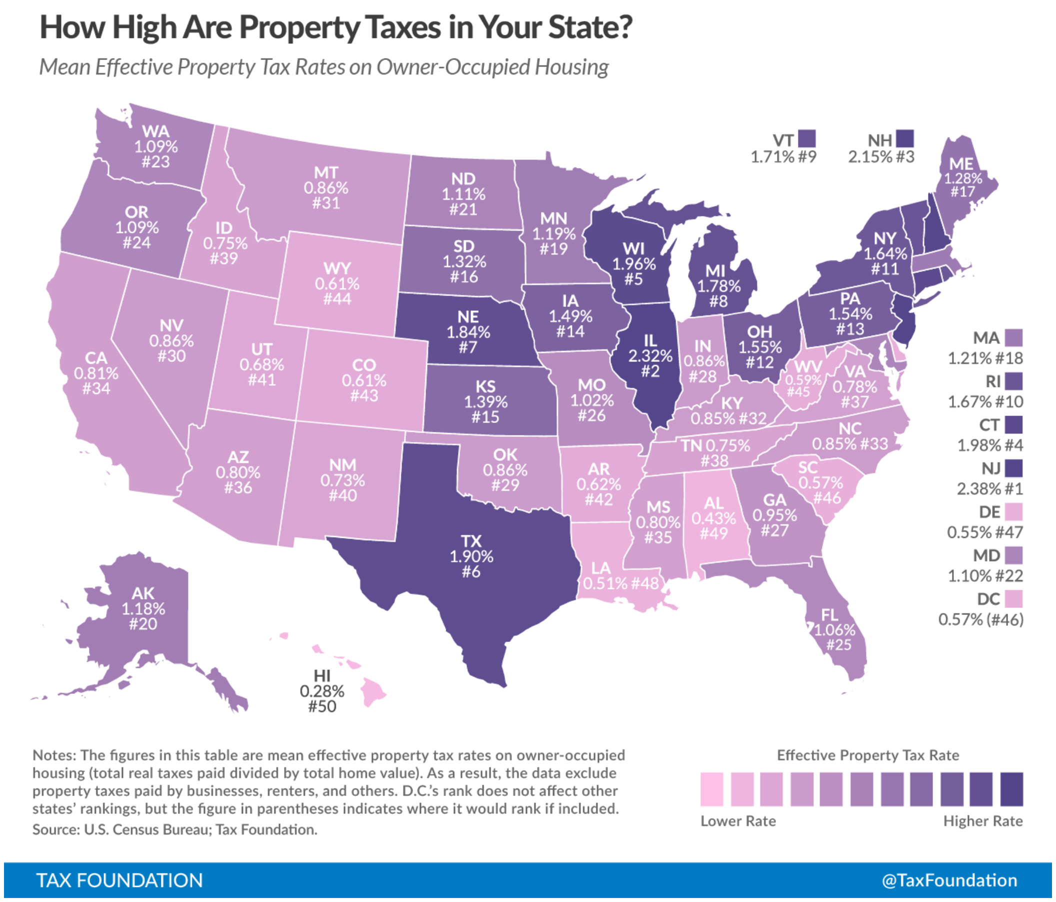
Why the Property Tax?

- It is potentially more efficient—the tax can be calibrated to fund the ARC and pay down the balance over a longer-time horizon.
- Its transparent. The payments would be known as well as the duration. The tax would be capitalized into real estate values which would prevent people leaving the state to avoid paying for the liability. Similarly new entrants would be able to purchase real estate at a discount.
- It's generationally fair. The liability reflects services already consumed that weren't paid for by previous taxpayers. Other tax bases would not recover taxes from beneficiaries of an era where government services were not fully paid for.

Why the Property Tax?

- It creates certainty. A dedicated property tax would only be used to pay off the pension liability. Once this occurs, the tax expires.
- It avoids squeezing out other government services by making them compete for the same tax base. Paying for the liability out of the general fund requires reducing expenditures for other necessary state services. This allows government services to be fully funded using the existing tax base. However, its competition with the existing property tax could be very difficult for localities.
- The plan can be modified to reflect equity concerns. Communities with high effective property tax rates could be exempted since the additional property tax burden might have serious development consequences.
- However, our estimate suggests that this would be a 30 year tax at 1% of house value.

Is there a fly in the ointment?



Could a Hybrid Solution Work?

- State’s over-reliance on the property tax to fund schools already makes it difficult to increase existing levies, let alone create a new levy.
- This suggests that a tax swap might be an option—raise income and sales taxes through base broadening and use the revenue gained to reduce local property taxes (most likely by increasing state funding for local education). This would mute the impact of the pension related property tax.
- Also possible to use a more limited form of a pension bond sale to reduce the amount of property tax revenue would be needed to fund the pensions.

Part of the long-term answer

- Accounting to the rescue!
  - Create a state all funds balance sheet that recognizes long-term liabilities. Example proposal by Haughwout and Inman (2019).

Balance sheet account structure

- Cash account—cash and security holdings plus short-term liabilities
- Pension account—ex. Underfunded if present value of benefits exceeds present value of assets
- Capital account—government assets, particularly land, structures and durable equipment

If you aren’t depressed yet…

- When Warren Buffet was asked about Illinois he responded—
- "In the public sector, you know, it's a disaster. ... If I were relocating into some state that had a huge unfunded pension plan, I'm walking into liabilities," "And those are big numbers, really big numbers. ... And when you see what they would have to do — I say to myself, 'Why do I want to build a plant there that has to sit there for 30 or 40 years?'"

Happy Holidays!!!