

# Illinois Fiscal Condition: How bad is it and what can be done about it

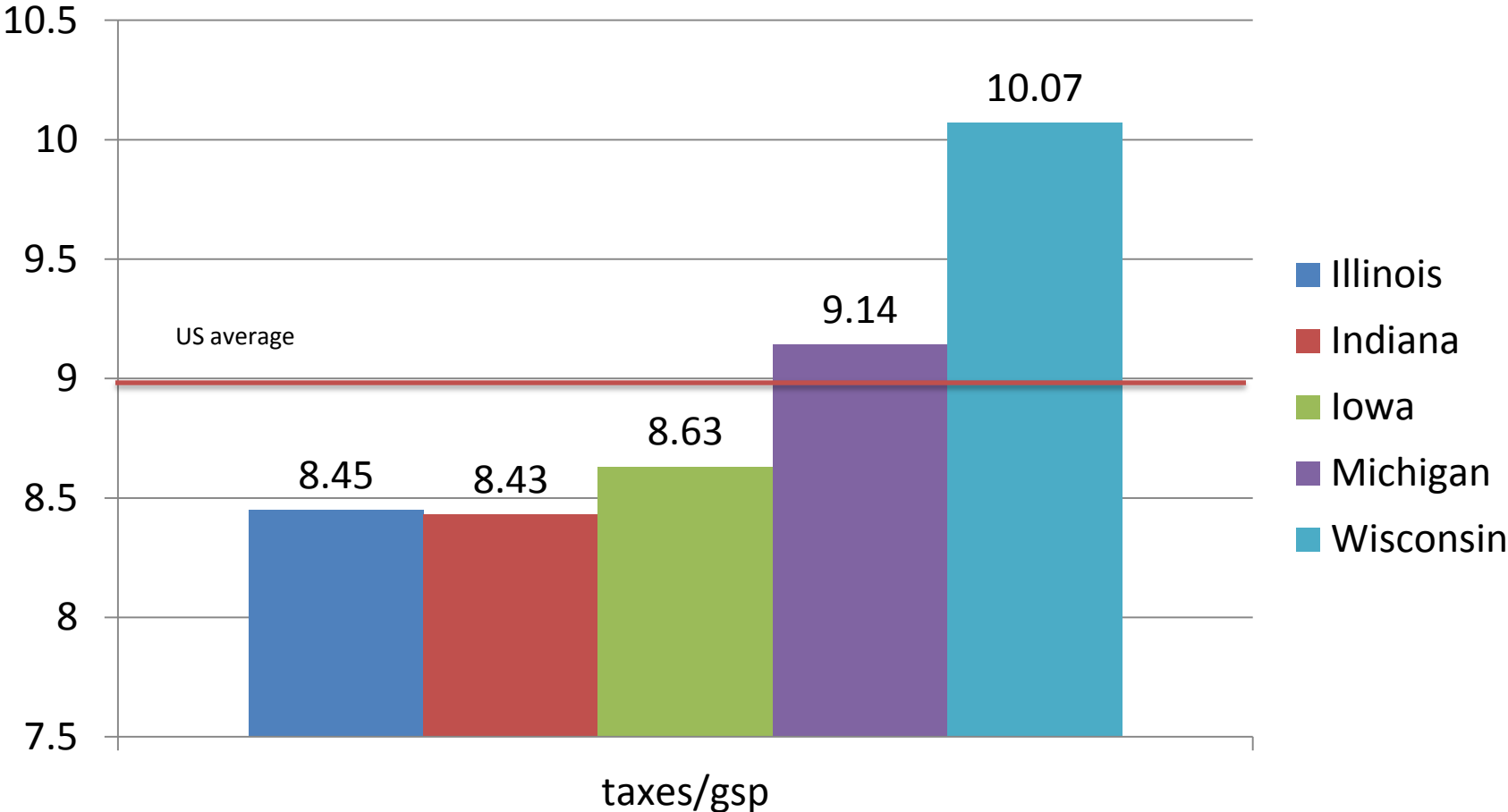
Rick Mattoon  
Senior Economist and Economic Advisor  
Federal Reserve Bank of Chicago  
Economic Outlook Symposium  
December 1, 2017

# Illinois fiscal climate in context

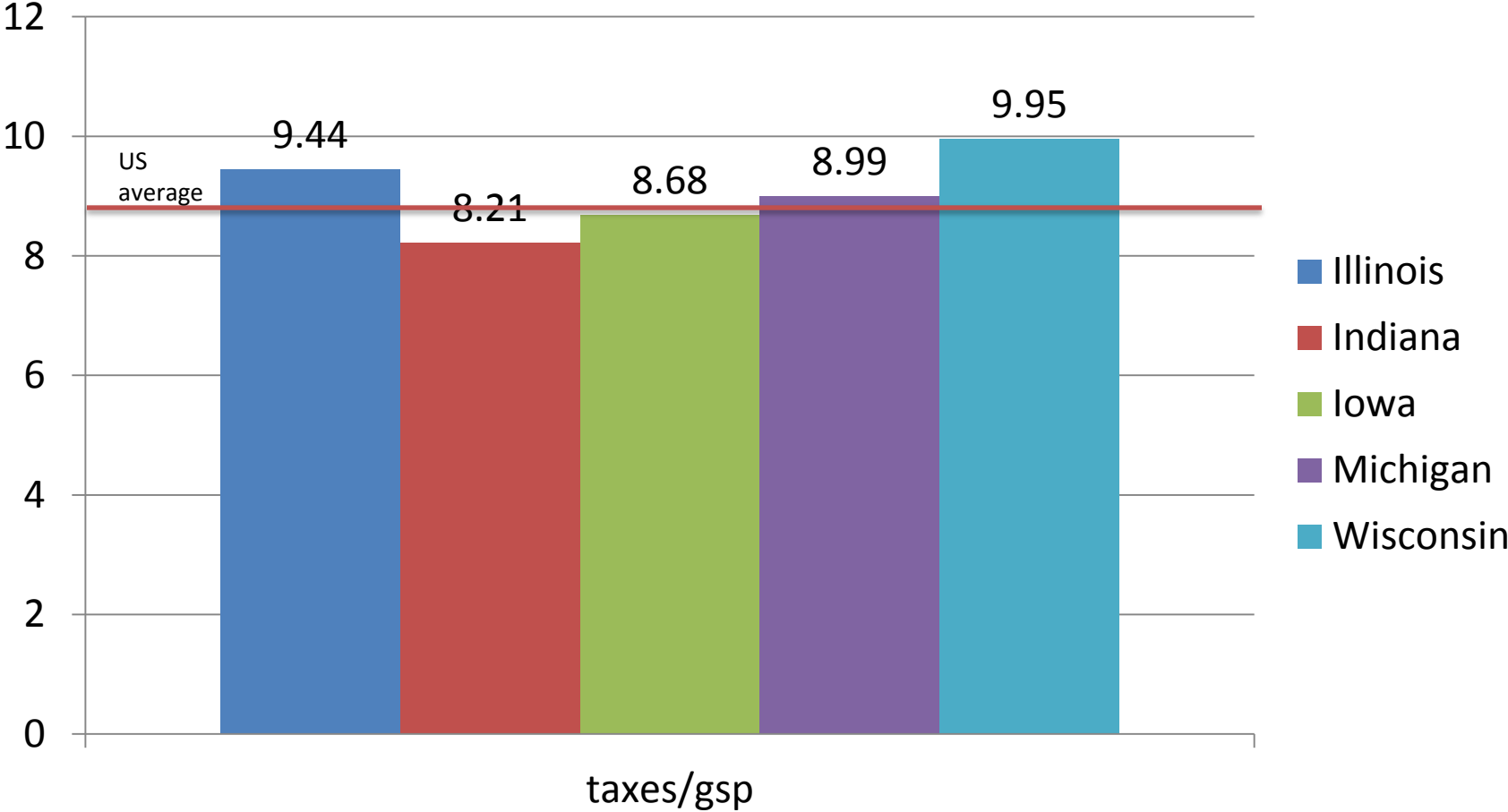
- On paper, Illinois has historically not been a particularly high tax state.
- However, Illinois borrows from the future to keep rates low and services available.
- Illinois faces two big issues—uncertainty and paying for services already consumed.
- Issue for all municipalities is contagion – shifting state costs to local governments or reducing aid/tax sharing.

Dimensions of the problem...

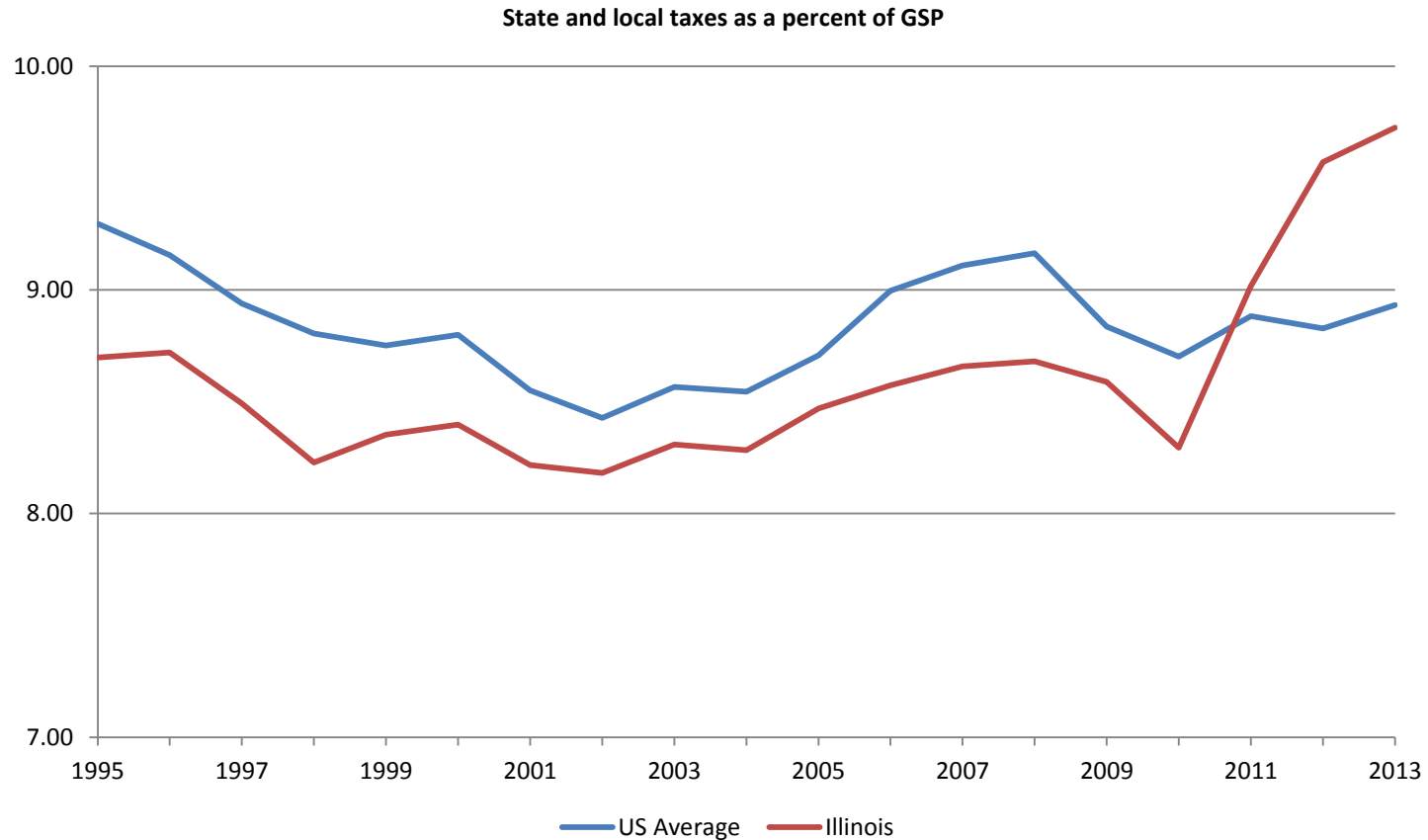
# State and Local Taxes as a % of Gross State Product (average from 1995 to 2010)



# State and Local Taxes as a % of Gross State Product (average 2011-2013)



# Trend in Illinois State and Local Taxes



# Why Illinois isn't a cyclical story

(or why we can't just blame this on the Great Recession)

- In one word—**DEBT**—Illinois has legacy costs for Pensions, OPEB that dwarf other states.
- **Structural deficit** that shows up in an estimated backlog of \$15 billion in unpaid bills.
- **A history of political dysfunction.** Went 2 full years without a full-year budget. Premium on issuing debt soared to 350bp over triple A and backlog of existing bills are subject to 9% to 12% interest rate penalties.
- Hasn't gone unnoticed...**State bond rating hovers near junk status...**

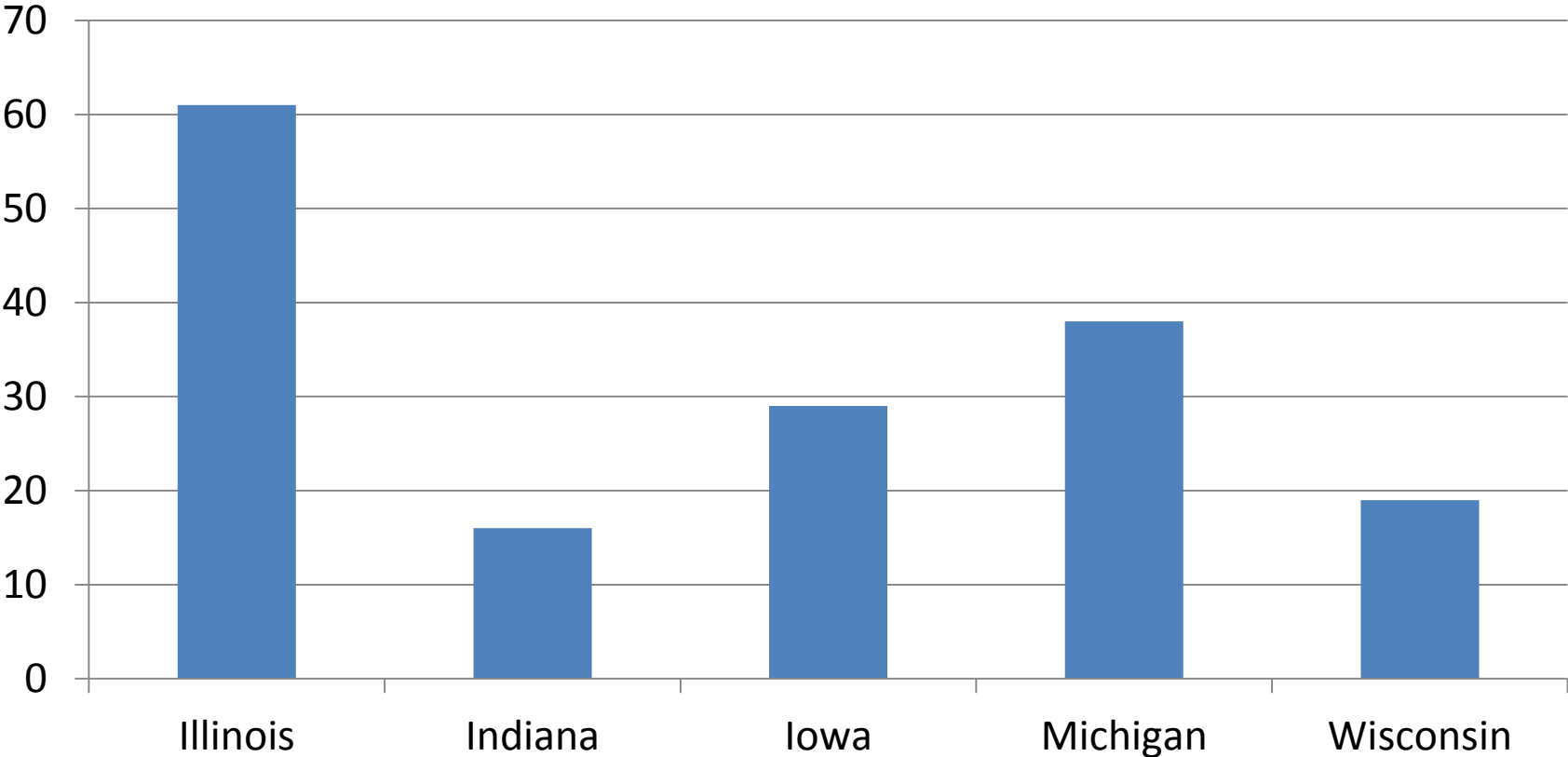
# Which one doesn't belong?

S&P Global GO credit ratings for 7-G states

Illinois	BBB- stable (7/12/2017)
Indiana	AAA stable (7/18/2008)
Iowa	AAA stable (9/11/2008)
Michigan	AA- stable (3/17/2016)
Wisconsin	AA stable (8/15/2008)

# How big is the liability? Total Outstanding Debt as a Percentage of Total State Personal Income (2014)

**total debt, unfunded pension, OPEB**



Source: Mercatus Center, June, 2016



# How big is the gap?

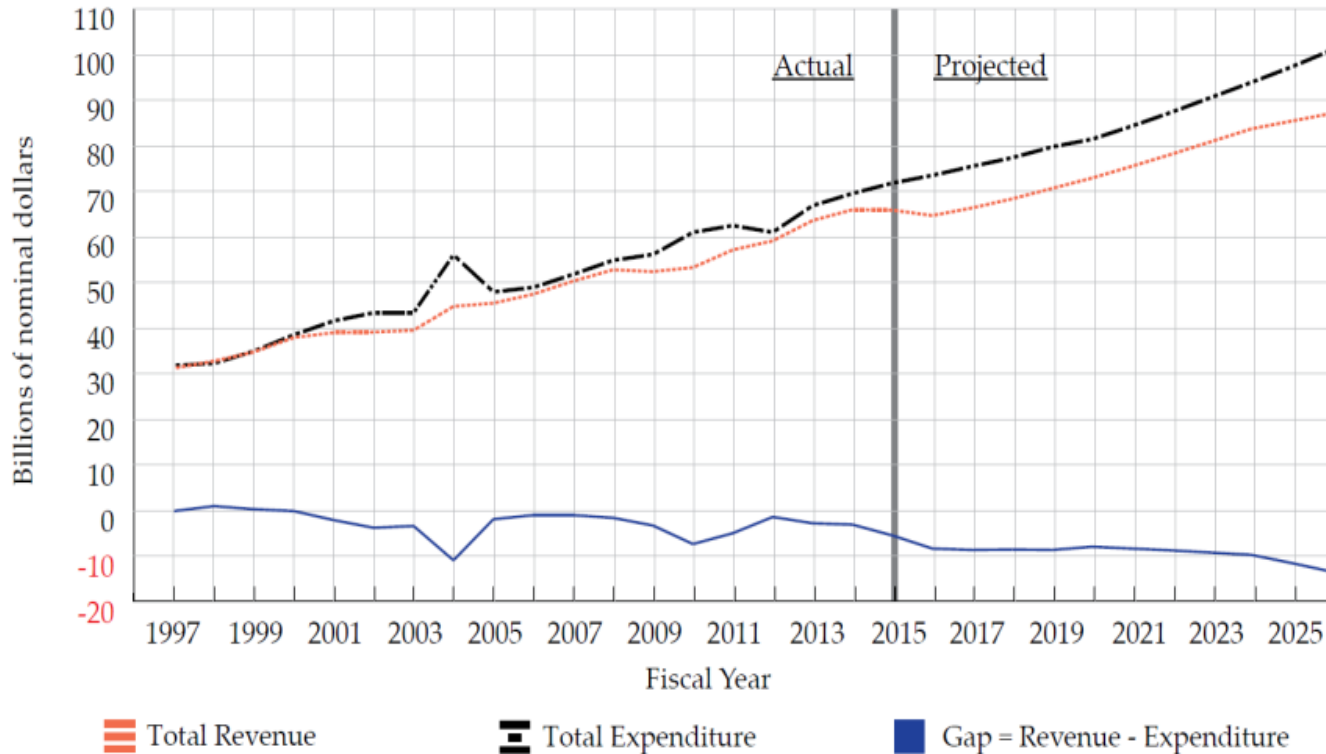
## U of I Fiscal Futures project

- Estimates all funds spending and revenues
- Forecasts future absent any policy changes

# Illinois ran deficits since 2000

“Legacy Costs” in their projections: Liability = \$159 billion

**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.

# But wait...it gets worse

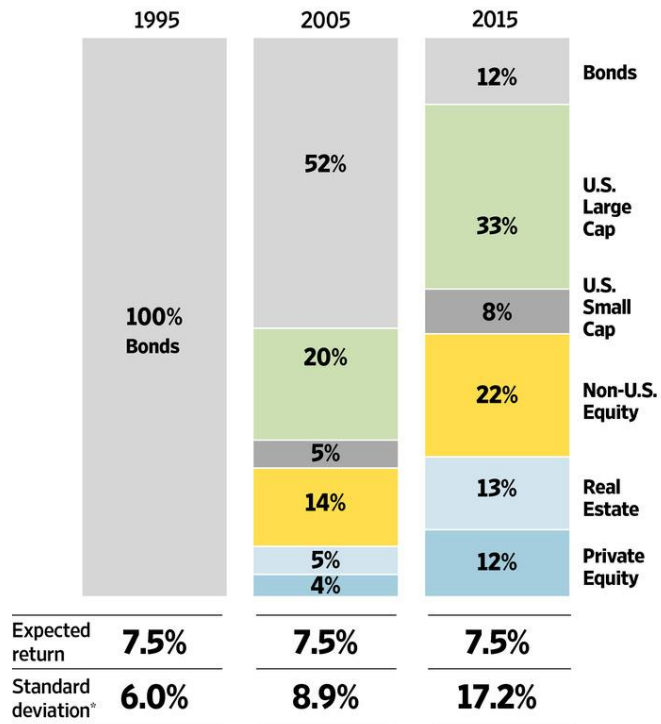
- The liabilities for pensions are probably understated.
- Current basis uses optimistic investment return assumption of 7-8%.
- What happens when you use a more “risk-free” rate of return

# Changing risk profile to get a 7.5% return

## Rolling the Dice

Investors grappling with lower interest rates have to take bigger risks if they want to equal returns of two decades ago.

### Estimates of what investors needed to earn 7.5%



\*Likely amount by which returns could vary  
Source: Callan Associates

THE WALL STREET JOURNAL.

Pensions are the most visible problem, but even this may be understated...actuarial reported versus market

Illinois 2014	All State and Local Systems	All State Systems	Local Systems
Pension debt (thousands)	\$140,261,234	\$99,978,217	\$40,283,017
Funded ratio	44.5%	44.5%	44.5%
Assumed rate of return	7.89%	7.89%	7.89%
Debt per household	\$29,390	\$20,949	\$8,441
Debt as a share of total (S +L) general fund revenues	3.81%	2.72%	1.10%

# But if you change a few assumptions, things look much worse

Illinois 2014 Market	All State and Local Systems	All State Systems	Local Systems
Pension debt--market (thousands)	\$371,398,779	\$264,733,075	\$106,665,704
Funded ratio	23.3%	23.3%	23.3%
Assumed rate of return	3.0%	3.0%	3.0%
Debt per household	\$77,822	\$55,471	\$22,350
Debt as a share of total (S +L) general fund revenues	10.10%	9.33%	3.76%

# But, we did get a budget for FY 18!

## (Details of FY18 Budget)

- **Expenditures.** The state adopted a \$36.1 billion spending plan for FY18. This reduces spending over current levels by \$2.5 billion and includes a 5% across the board reduction to state agencies and a 10% cut to higher education. The budget also assumes \$500 million in pension savings through the creation of a 401K plan for newly hired workers to compete with the defined benefit plan.
- **Revenues.** The personal income tax rate is boosted from 3.75% to 4.95% which raises an estimated \$4.5 billion in revenue. The corporate income tax rate is boosted from 5.25% to 7% which would raise roughly \$500 million. (Note: Illinois corporations continue to be subject to a 2.5% personal property replacement tax which boosts the overall rate to 9.5%). Both increases were effective July 6.
- **Borrowing.** The budget generates a revenue surplus by design that could be used to support bonding of up to \$3 billion to help pay off accumulated bills.
- **Questionable items.** The budget reduces state pension contributions from \$7.9 billion to \$6.4 billion by provisions that allow the state to defer contributions while taking savings upfront. The budget assumes \$300 million in one-time revenues from the sale of the Thompson Center. Additional estimated pension savings are based on the assumption that newly hired state employees (including teachers) prefer a 401K pension over a defined benefit pension.

# Can the gap be solved in 10 years?

- IGPA options
  - **Spending cut of 2%** for all discretionary spending (32% reduction in gap)
  - **Income tax rate hike** (4.75% for personal, 6.65% for corporate), (40% reduction in gap)
  - **Expand income tax base** by 10%, (12% reduction)
  - **Increase sales tax base** by 15% (tax more services), \$2 billion revenue gain)
  - **Supply-side**—get  $\frac{1}{2}$  of 1% faster personal income growth, (only produces \$100 million in tax income)



# What if you do everything?

- **Most of the budget gap would be gone in 10 years (2027).** Gap would decline to \$9.4 billion in FY17 to \$2 billion by FY21 and near 0 by 2027.
- **Caveats—**
  - Doesn't address current bill backlog
  - Need to fund the annual deficits by either decreasing assets or increasing liabilities
  - Assumes pension contributions are based on current actuarial projections to have pensions funded to 90% by 2045.
- **What is needed is a “Grand Plan”** (and it needs to be binding).

# What else might help?

- **Pension cuts**—a less generous, “new tier” already exists for new employees but attempts to reduce benefits for existing employees and retirees have been ruled unconstitutional due to the “non-impairment and diminishment” clause of the state constitution. Possibly the only source of relief would be a constitutional convention. Biggest problem may be the 3% compounded COLA.
- **The state gets lucky.** Example of New York City’s fiscal crisis in the 1970s.

# How to Make Sure This Doesn't Happen in the Future

- Wally Oates—"the soft-budget constraint"—incentives to appropriate resources from other levels of government rather than making tough decisions.
- **Lack of penalties for bad fiscal behavior**—bad bond ratings don't seem to have that much bite since they only force higher borrowing costs.
- Is the answer **a binding (structural) budget constraint**?
- Part of this requires **better information** and all funds budget accounting (with accrual—Inman and Haughwout, PWAT—a measure of public wealth).

# A Final Thought

- How we pay off the state's liabilities matters
  - Intergenerational equity?
  - A transparent and predictable payment mechanism
  - A statewide property tax solution?