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ILLINOIS'S FISCAL BREAKING POINTS

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1. Introduction

After more than a decade of failing to balance the state's budget, the Illinois legislature and Governor Pat Quinn presented the FY 2012 budget, "designed to help Illinois return to fiscal stability."[1] The strategy presented includes, Illinois Working, a plan to "provide streamlined, efficient state government, foster economic growth, and develop the jobs of today and tomorrow."[2] Pointing to decades of fiscal mismanagement, compounded by a deep recession, the governor also signed into law Budgeting for Results, a spending reform which mandates that budget decisions be based on performance and impact, not politics. In addition, the legislature instituted a new law which it is claimed, "for the first time in Illinois's history, places limits on state spending."[3] These measures led to an improved bond rating from Fitch Ratings and Standard & Poor's ratings agencies.

While these strategies sound meaningful they are unlikely to work, as they fail to identify the underlying causes for the rapid growth in spending in the state's budget. The legislature and governor continue to focus on revenue enhancements through increased taxation and borrowing, instead of institutional spending reforms, thus making it unlikely that the state will avoid serious fiscal repercussions in the near future, some of which will be triggered by the run-out in pension fund assets projected for 2018.

As Elinor Ostrom writes, "while the existence of grave problems tells us that reform is needed, it does not tell us what kind of reform will lead to the amelioration of problems. Reforms can make things worse as well as making them better." [4] Recent policy recommendations aimed

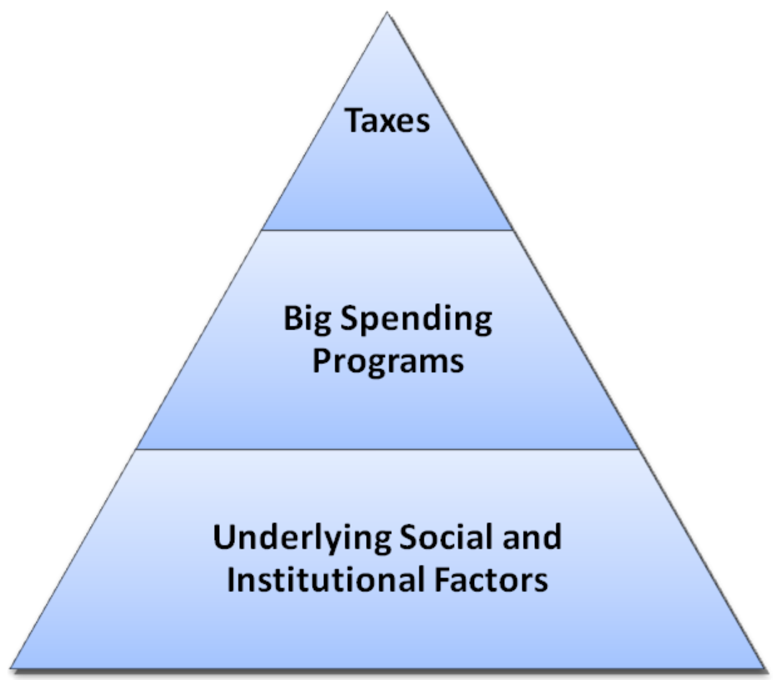
[1] Governor Pat Quinn, "The Governor's Letter of Transmittal," Illinois State Budget, Fiscal Year 2012, February 16, 2011, http://www2.illinois.gov/budget/Documents/FY%202012/FY12_Operating_Budget.pdf.
[2] Ibid.
[3] Ibid.
[4] Elinor Ostrom, "Metropolitan Reform: Propositions Derived from Two Traditions," in *Polycentricity and Local Public Economies*, ed. Michael D. McGinnis (Michigan: The University Michigan Press, 1999), 139.

at addressing the long-running fiscal problems facing Illinois generally tackle obvious symptoms, such as revenue solutions to plug the state's structural deficit via tax hikes, or modifications to future pension costs. Some policy reforms focus on causal factors and modify the budgetary rules of the game—such as the state's new spending limit and the discussion of a structural overhaul of the state's pension system.

It is important to understand that Illinois's current fiscal crisis is not the result of a single critical event but rather a series of events in Illinois's economic and fiscal history.

A review of the fiscal indicators shows that Illinois has rapidly growing budget costs as well as business and resident out-migration. Both parties claim they seek an efficient system of government that is financially stable and fiscally responsible. What policy reforms are likely to achieve this end?

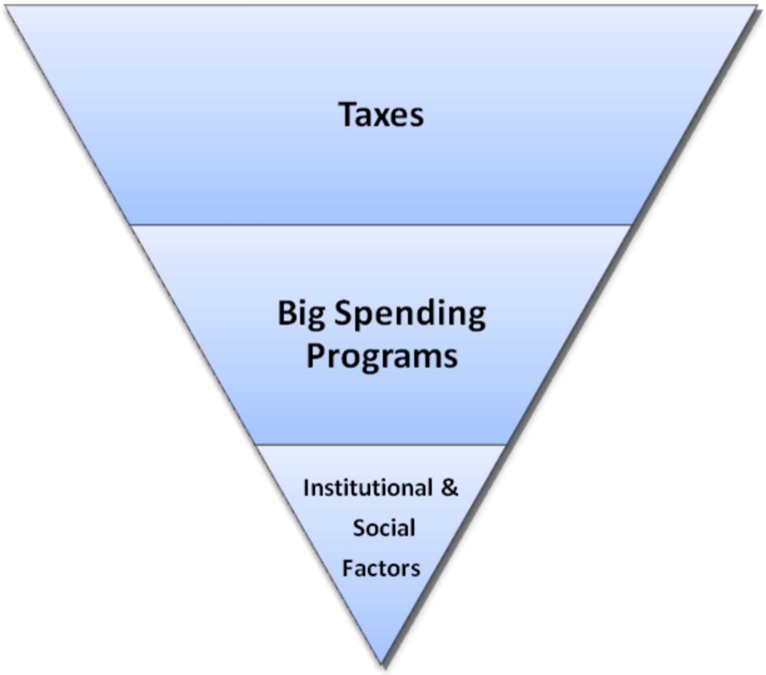
Chart 1: Magnitude of the Impact of Policies on a System



This paper unpacks the crisis by looking at the state's long-running fiscal and economic indicators in the context of the state's budget rules and institutional environment.

Chart 1 depicts three main areas for reform: taxation, cuts to large programs, and changes to underlying social and institutional factors. The pyramid represents the relative impact of each of these reforms on the fiscal health and economy of the system (i.e., tax cuts are likely to have a smaller impact compared to cuts to big-spending programs). Chart 2 depicts changes to institutional factors, or "the rules of the game" that have the largest impact on an economic system, but are often the most politically difficult to achieve.

Chart 2: How the Problem is Approached



Since changing the rules is more difficult, in many cases policymakers tend to pursue less-effective measures—such as focusing on tax reform—while avoiding structural changes to spending or institutional drivers such as budget rules. Long-term institutional changes tend to be avoided until the crisis reaches a breaking point.

This paper begins by examining key fiscal indicators in Illinois and then takes a deeper look at spending drivers within the budget, including Medicaid and the state's pension system. This is followed by a discussion of the budget rules that guide policymakers in determining their effects on Illinois's spending. The paper then discusses Illinois's tax structure and recent reforms intended to stabilize the state's finances and spur economic activity. The paper concludes with a series of recommendations, listed in order of those likely to have the greatest effect in improving both the fiscal and economic outlook of the state.

2. The State of the State

Illinois has run a structural deficit for over a decade. The state's unfunded pension obligations are $173 billion, with the fund projected to run out of assets by 2018. Illinois's Other Post Employment Benefits (OPEB)—largely consisting of health care benefits for public workers—are only 0.1 percent funded, with a liability of $43.9 billion.[5] The state's ongoing budget shortfalls and rising liabilities are compounded by the fiscal distress in Cook County, where the treasurer estimates that the county's municipal governments face a combined debt of

[5] The Pew Center on the States, "The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs," April 2011, 6, http://www.pewcenteronthestates.org/initiatives_detail.aspx?initiativeID=85899358839.

$108 billion.[6] Further compounding the issue is the fact that the City of Chicago's unfunded pension liability is $48.8 billion or $42,000 per capita.

Illinois's FY 2012 budget was balanced with line-item reductions totaling $3 billion and $415.4 million in federal assistance, tax hikes, and borrowing. In 2011, Illinois raised its flat-rate income tax from 3 percent to 5 percent resulting in $7 billion in additional General Fund revenues. Revenue enhancement was also achieved through the authorization of "interfund borrowing" and $1.25 billion from the state's sale of its rights to a portion of its future Tobacco Settlement Fund payments. The state of Illinois claims that Jobs Now!, a $31 billion capital program instituted with American Recovery and Reinvestment Act of 2009 (ARRA) money, has helped bolster Illinois's economic recovery by creating 135,000 jobs supported by state borrowing and federal monies. The state is also claiming a $220 billion savings from pension reform over a 35-year period and $800 million in savings from Medicaid reforms. On deeper examination, none of these reforms tackle the drivers of spending growth, but instead, shift spending into future years. While many point to the Great Recession as a cause of Illinois's recent budget shortfalls, over the course of several gubernatorial administrations Illinois has shown a tendency to support spending growth with increased indebtedness and a variety of other fiscal maneuvers, ultimately contributing to the current crisis.[7] In fact, spending in the FY 2012 budget may be subject to additional increases. The Senate will be called back to session this fall to review Governor Quinn's proposal for an additional $480 million in appropriations.[8] If these appropriations are granted, General Fund spending for FY 2012 would increase by roughly $1 billion over FY 2011.

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[6] Cook County Treasurer's Office, "Pappas Details Impact of Local Government Debt," press release, June 20, 2011,
http://www.cookcountytreasurer.com/newsdetail.aspx?ntopicid=434.

[7] These budgetary behaviors are by no means unique to Illinois. Such techniques constitute forms of "fiscal evasion," defined as, "any means of an accounting tactic, budgeting rule, or intergovernmental arrangement that conceals the full cost of public spending." See, Eileen Norcross, "Fiscal Evasion in State Budgeting" (working paper, Mercatus Center at George Mason University, Arlington, VA, July 2010),
http://mercatus.org/sites/default/files/publication/Norcross.Fiscall%20Evasion.%20State%20Budget%20Gimmicks.%20Updated%208.23.10.pdf.

[8] Collin Hitt, "Budget Fail: Plan Awaiting Gov. Quinn's Signature Grows Spending, Debt," Report, Illinois Policy Institute, June 21, 2011.

2.1 Budget Indicators

The General Fund is Illinois's basic operating fund which finances a portion of the operating budgets of each agency and is a good indicator of the state's overall fiscal health. Currently, Illinois's General Fund is running a budget deficit on both a cash and accrual basis. However, each of these accounting methods tells a different story concerning the magnitude of the deficit. As Figure 1 shows, when using cash-basis accounting, the General Fund balance moves from a surplus of $2.7 billion in 1998 to a deficit of $3.7 billion in 2009. This shows that Illinois's budget deficit predates the recent recession. When accounting for accrued expenditures, the General Fund balance grows in magnitude from a deficit of $271 million in 1998 to a deficit of $7.7 billion in 2009. Over a 12-year period Illinois's General Fund deficit has increased by nearly $7.5 billion in real terms.[9]

Figure 1: IL Real General Funds Balance (2009 Dollars)

Source: State of Illinois Office of the Comptroller Traditional Budgetary Financial Report , various editions; GAAP Fund Balance Data directly linked on Comptroller's website; Bureau of Labor Statistics CPI Adjusted for Chicago-Gary-Kenosha; Authors calc

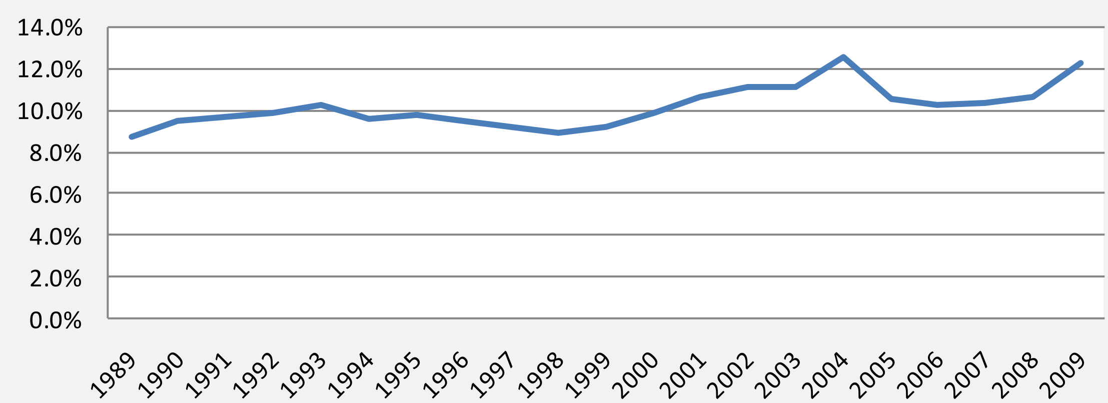
[9] Whether governments should use cash or accrual-basis accounting is an area of debate among economists. A 2007 GAO report (GAO-08-206 Accrual Budgeting) details the use of each method in six countries. In accrual-basis accounting revenue is recognized when it is earned and expenses are recognized when they are incurred. Accrual-basis can be useful for encouraging better management of government assets and liabilities, and also to facilitate comparisons between private and public sector spending. However, accrual-basis accounting also has the potential to be gamed, and it is inherently more complex than cash-basis accounting. In cash-basis accounting, revenue is recognized when it is received and expenses are recognized when they are paid. Cash-basis accounting is easier to calculate with great accuracy and is important for monitoring a country's fiscal position. The GAO concludes that both cash- and accrual-basis measures are important for understanding and monitoring a government's fiscal condition.

Other indicators that are useful in diagnosing a state's fiscal condition include: (1) appropriations as a percent of state Gross Domestic Product (GDP), (2) outstanding debt as a percent of GDP, and (3) the size of federal transfers in the state's budget.[10]

2.2 Appropriations as a Percent of GDP

Illinois's total appropriations as a percent of the state's GDP have increased by 41 percent in real terms, from 8.7 percent to 12.3 percent between 1989 and 2009 (Figure 2).[11]

Figure 2: IL Real Appropriations as Percent of GDP (2009 Dollars)



Source: State of Illinois Office of the Comptroller Traditional Budgetary Financial Report , various editions; Bureau of Economic Analysis GDP by state; Bureau of Labor Statistics CPI Adjusted for Chicago-Gary-Kenosha; Authors calculations.

Over the past several decades, Illinois's income has been consumed by a growing amount of state spending. The negative wealth effects that result from government over-spending are well-documented. Grier and Tullock (1987), Landau (1983), Barth and Bradley (1987), and Barro (1991) have all reached similar empirical conclusions that economic growth is "inversely

[10] Eileen Norcross and Frederic Sautet, "Institutions Matter: Can New Jersey Reverse Course?" (working paper, Mercatus Center at George Mason University, Arlington, VA, 2010).

[11] Illinois's rapid growth in spending can be traced to the 1970s and 1980s. Between 1980 and 1992, state spending increased 137 percent in nominal terms, or 7 percent per year on average. Between 1990 and 1992, spending increased to 12 percent per year. These increases are largely attributed to spending growth in public welfare programs, including Medicaid and Aid to Families with Dependent Children, and the Illinois Department of Children and Family Services. In addition, the Central Department of Management Services, responsible for procurement and management, experienced significant spending growth during this period. See, Michael A. Finch, Joseph L. Bast, and Patrick T. Foys, "How to Win Illinois's Battle of the Budget," Heartland Institute Policy Study no. 63, September 30, 1994, http://www.heartland.org/custom/semod_policybot/pdf/27097.pdf.

related to the share of government consumption of GDP."[12] As the share of government consumption of income in Illinois increases it will continue to negatively affect state economic growth.[13]

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[12] For a discussion, see Andreas Bergh and Magnus Henrekson, *Government Size and Implications for Economic Growth* (Washington, DC: The AEI Press, 2010) and Robert J. Barro, "Government Spending in a Simple Model of Endogenous Growth," *Journal of Political Economy* 98 no. 5, (1990): 103-125, and Robert J. Barro, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics* 106, no. 2 (1991).

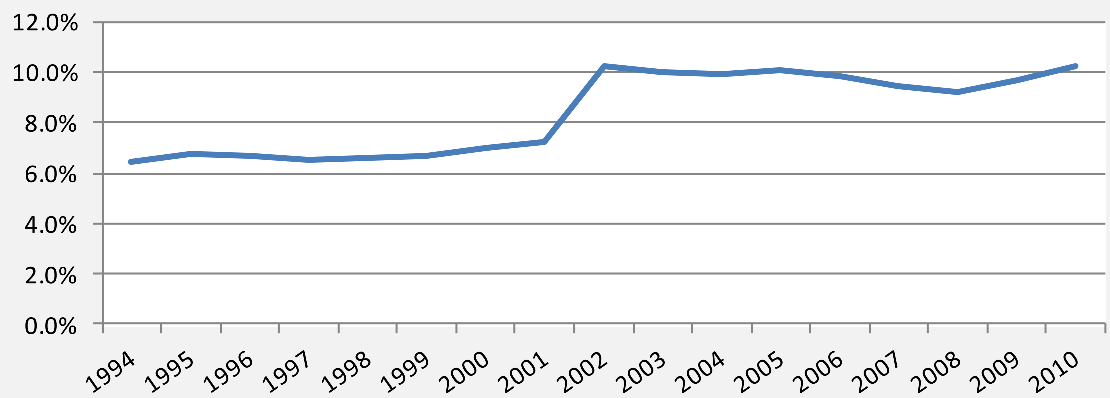
[12] Peter J. Boettke, "Economic Calculation: The Austrian Contribution to Political Economy," *Advances in Austrian Economics* no. 5 (1998): 145.

[13] An additional issue, known as the economic calculation problem, arises as the government's share in the economy expands. The knowledge necessary to make decisions over how to most efficiently allocate resources in society is available only through the market process. Government spending lacks the information provided via the market process and the profit and loss system as government spending occurs in a political-bureaucratic realm. The state cannot engage in rational economic calculation. While a certain level of state spending is a necessary component of any smoothly functioning democracy, rapidly increasing levels of state spending in Illinois are of great concern for the state's economic prospects.

2.3 Illinois's Debt by Percent of GDP

Another concern in Illinois's budget is the way in which the state has financed increased spending: the issuance of debt.[14] Illinois's total outstanding debt as a percent of GDP has increased in real terms from 6.4 percent in 1994 to 10.3 percent in 2010 (Figure 3). The sharp spike during 2002 represents a 43.3 percent increase, which was mainly a result of increases in debt issued by the Illinois Development Finance Authority and the Illinois Health Facilities Authority.[15] Total outstanding debt in 2010 was just over $66.9 billion or $5,206 per capita.[16]

Figure 3: IL Outstanding Bonded Debt as a Percent of GDP (2009 Dollars)



Source: State of Illinois Office of the Comptroller Bond Indebtedness and Long-term Obligations Report, various editions; Bureau of Economic Analysis GDP by state; Bureau of Labor Statistics CPI Adjusted for Chicago-Gary-Kenosha; Authors calculations.

Bonded Debt

Illinois's total bonded indebtedness fits into two categories: Direct Debt and Revenue Bonds. Table 3 outlines both types of debt, including totals for the specific types bonds issued under each category for FY 2010.

[14] Illinois State Comptroller, "Bond Indebtedness and Long-Term Obligations Report," 2002, 2, http://www.apps.ioc.state.il.us/ioc-pdf/FY02_complete_annual_bond_report.pdf.

[15] Ibid.

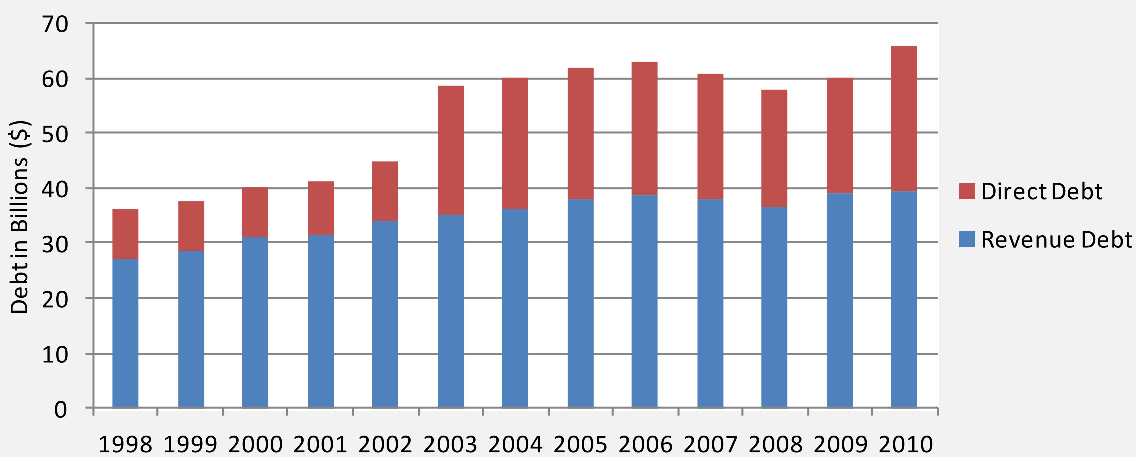
[16] Moody's 2010 State Debt Medians Report ranks Illinois 11th among the 50 states in terms of net tax-supported debt per capita and 14th in net tax-supported debt as a percentage of personal income. See Moody's Investors Service, "2010 State Debt Medians Report," May 2010, 6, http://www.vermonttreasurer.gov/sites/treasurer/files/pdf/bonds/2010StateDebtMediansReportMay2010.pdf.

Table 3: IL Total Bonded Debt Outstanding FY 2010 (in millions)

Bond Type	Total Indebtedness	Percent of Total
Direct Debt	26,792	40.1%
General Obligation Bonds.............	11,140	16.7%
Pension Obligation Bonds.............	13,316	19.9%
Build Illinois Bonds....................	2,336	3.5%
Revenue Bonds	40,000	59.9%
Conduit Debt...........................	31,500	47.2%
Moral Obligation Debt................	5,500	8.2%
Indirect Debt...........................	3,000	4.5%
Total Bonded Debt Outstanding	66,792	100.0%

Unfortunately, Illinois's reliance on debt is not a new phenomenon; in fact, bonding has been habitually employed not only to fund capital projects and meet spending shortfalls but also to fund the state's pension system. Therefore, in order to gain a better understanding of the magnitude of this debt, it is important to also examine exactly how it has grown over time. Figure 4 details how both Direct Debt and debt created via Revenue Bonds have grown since 1998.

Figure 4: IL RealTotal Bonded Debt by Type (2009 Dollars)



Source: State of Illinois Office of the Comptroller Bond Indebtedness and Long Term Obligations Report, various editions; Bureau of Labor Statistics CPI Adjusted for Chicago-Gary-Kenosha; Authors Calculations

Direct Debt

Direct Debt is the first category of Illinois's total bonded indebtedness and consists of General Obligation (GO) Bonds, Pension Obligation Bonds (POB), and Build Illinois (BI) Bonds. This type of debt is often state-supported and plays an integral role in the state's budgeting process. Each component of Illinois's Direct Debt is slightly different in how it is issued and in the purpose for which it is intended to be used.

GO Bonds are the first component of Illinois's Direct Debt, and until recently, were the largest direct borrowing program in Illinois, funding road improvements, environmental and conservation projects, correctional facilities, mass transit, aviation projects, and school construction. These bonds are backed by the full faith and credit of the State of Illinois and the state has pledged to repay GO debt before any other financial commitments.[17] The second component consists of POBs, which were first issued in 2003 via Public Act 93-0002 and are now the largest component of Illinois's Direct Debt.[18] POBs are used to improve the funded ratio of the state's pension system and to provide budgetary relief. BI Bonds make up the final component of Illinois's Direct Debt. These bonds fund the Build Illinois program which focuses on fostering economic development through business development, infrastructure construction, education, and environmental protection.[19]

Revenue Bonds

Revenue Bonds is the other category of Illinois's bonded indebtedness and consists of Indirect Debt Bonds, Conduit Bonds, and Moral Obligation Bonds. Similar to Direct Debt, each component of Revenue Debt is slightly different.

The first component of Revenue Debt, Indirect Debt Bonds, are issued to, and considered property of, local governments. However, a portion of the debt service for these bonds is paid

[17] Illinois State Comptroller, "Illinois's Long-Term Debt," *Fiscal Focus Magazine,* April 2008.
[18] Illinois 93rd General Assembly Public Act 093-000, "The Pension Contribution Fund."
[19] During the 1980s, the state issued short-term debt to cover spending. Between 1985 and 1993 under former Governor Jim Thompson, Illinois issued $1.4 billion in Build Illinois (BI) Bonds, increasing General Obligation debt by 10.7 percent. Finch, Bast, and Foys, 10.

from state resources as these bonds are essentially a partnership between the state and a locality.[20]

The second component of Revenue Debt consists of Conduit Bonds. These bonds are generally issued to industries and local governments and the money used to repay the bonds comes entirely from the industry or local government. Thus, the State of Illinois is not required to assist in repaying the debt service costs for Conduit Bonds.[21] Conduit Bond debt has nearly doubled since 1994, increasing from $16 billion to $31.1 billion in real terms. Some of the larger portions of this increase include $3.4 billion issued to the Illinois Finance Authority and $1.6 billion issued to the Illinois State Toll Highway Authority.

Moral Obligation Bonds make up the remaining component of Revenue Bonds. With Moral Obligation Bonds, instead of being backed by the full faith and credit of the state, the state is morally but not legally obligated to pay the debt in the event of the issuing authority's default.[22] There are currently four moral obligation projects that are in default and receiving financial support from the state, three of which are development projects under the Southwestern Illinois Development Authority and one which is a development project under the Upper Illinois River Valley Development Authority.[23]

Unfunded Pension Obligation

Although Bonded Debt accounts for a large increase in spending, it does not provide a complete picture of the severity of Illinois's current debt load which also includes the state's unfunded pension obligation, guaranteed by the state's constitution.[24]

Illinois's pension system includes the following five state-retirement systems: the State Employees' Retirement System, Teachers' Retirement System, State Universities' Retirement

[20] Illinois State Comptroller, "Bond Indebtedness and Long-Term Obligations Report," 2009.
[21] Illinois State Budget, Fiscal Year 2012, February 16, 2011, http://www2.illinois.gov/budget/Documents/FY%202012/FY12_Operating_Budget.pdf.
[22] Illinois State Comptroller, "Illinois's Long-Term Debt," *Fiscal Focus Magazine*, April 2008.
[23]Illinois State Budget, Fiscal Year 2012.
[24] Illinois's Constitution 1970, Article XIII, Section 5 titled "Pension and Retirement Rights" states the following: Membership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired.

System, Judges' Retirement System, and the General Assembly Retirement System. The Illinois FY 2012 operating budget reports that the state's 2010 total pension assets were $53.2 billion and the total actuarial liabilities were $138.8 billion, putting the funded ratio at 38 percent and the state's total unfunded liabilities at $85.6 billion. However, when using discount rates that reflect the risk of public pension liabilities, Illinois's unfunded pension liabilities amount to $173 billion[25] and the funded ratio across systems drops to 31 percent in FY 2010. [26] Table 4 presents the previous bonded debt figures along with Illinois's unfunded pension liabilities in 2010.

Table 4: IL Total Debt Outstanding FY 2010 (in millions)

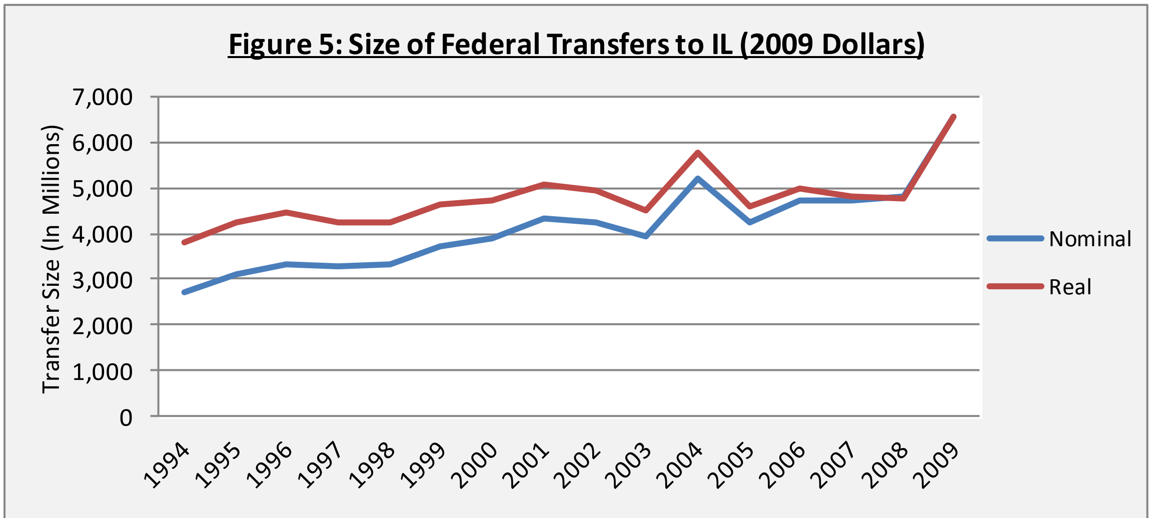
Debt Type	Total Indebtedness	Percent of Total
Direct Debt	26,792	11.2%
General Obligation Bonds..............	11,140	4.6%
Pension Obligation Bonds..............	13,316	5.6%
Build Illinois Bonds......................	2,336	1.0%
Revenue Bonds	40,000	16.7%
Conduit Debt............................	31,500	13.1%
Moral Obligation Debt..................	5,500	2.3%
Indirect Debt............................	3,000	1.3%
Other Obligations	173,020	72.1%
Unfunded Pension Liabilities.........	173,020	72.1%
Total Debt Outstanding	239,812	100.0%

Illinois's bonded debt is nearly $70 billion and when including the state's unfunded pension liabilities, it is clear that the state is on the hook for an amount closer to $239 billion. In addition to the state's total debt, factoring in the unfunded liabilities for the City of Chicago's pension system adds an additional $44.8 billion.[27]

[25] Robert Novy-Marx and Joshua D. Rauh, "Public Pensions Promises: How Big Are They and What Are They Worth?," *Journal of Finance*, forthcoming.
[26] Authors' calculations: The data used here are for June 2010 as reported by the State of Illinois Comptroller, Comprehensive Annual Financial Report, June 30, 2010, 24, http://www.ioc.state.il.us/index.cfm/linkservid/083E57BA-1CC1-DE6E-2F48783E3F984EF7/showMeta/.
[27] Robert Novy-Marx and Joshua Rauh, "The Crisis in Local Government Pensions in the United States," in *Growing Old: Paying for Retirement and Institutional Money Management after the Financial Crisis*, Robert Litan and Richard Herring, eds., (Washington, DC: Brookings Institution, forthcoming).

2.4 The Size of Federal Transfers

A final indicator of Illinois's fiscal health is the size of federal transfers into the General Fund. Between 1994 and 2009, federal transfers have nearly doubled in real terms, from $3.8 billion to $6.6 billion (Figure 5).



Source: State of Illinois Office of the Comptroller Traditional Budgetary Financial Report , various editions; Bureau of Labor Statistics CPI Adjusted for Chicago-Gary-Kenosha; Authors calculations.

Intergovernmental spending, such as grant-in-aid transfers, is money that is not raised through direct taxation and as such creates "fiscal illusion."[28] Fiscal illusion occurs when the perceived cost of spending is diluted since it is spread across all federal taxpayers and into future years as debt. The effect is to make state spending appear less costly than it is. Examples of fiscal illusion include an overly complex tax system, income tax withholding, and intergovernmental aid. Fiscal illusion can lead to higher levels of state and local spending than would have occurred absent the federal transfers.[29]

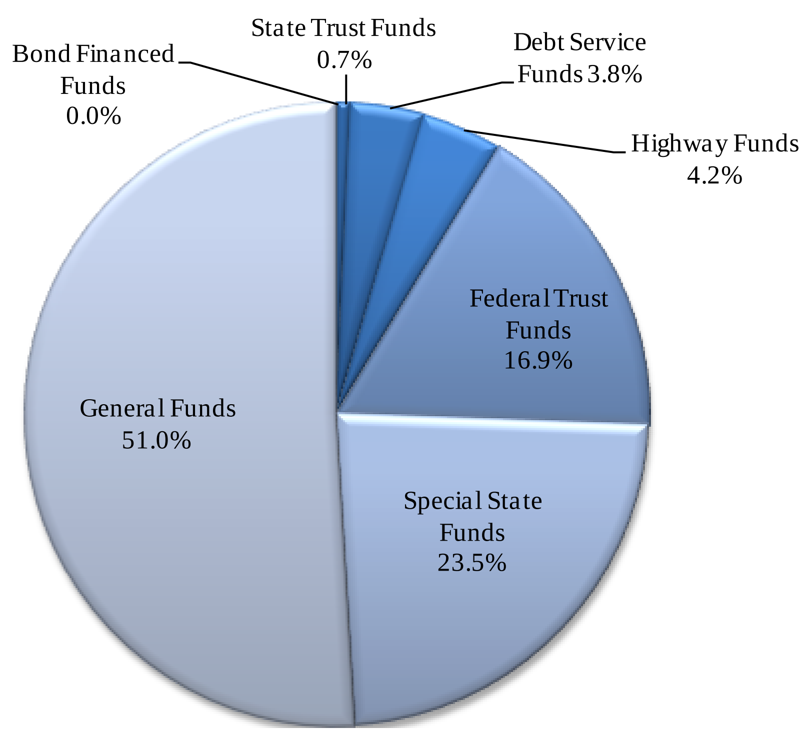
3. Spending Drivers

What is driving increased levels of spending and indebtedness relative to state GDP? Table 5 provides an overview of Illinois's FY 2012 budget, detailing the total operating appropriations

[28] Norcross and Sautet, 10.
[29] Ibid.

separated by fund group.[30] The General Fund, commonly known as the state's Operating Fund, makes up 51 percent of the total appropriations and supports a large portion of the state's programs as well as the executive, legislative, and judicial branches of the state's government. The bond-financed funds, state trust funds, debt service funds, and highway funds collectively make up less than 9 percent of the total appropriations. The remainder of the operating appropriations consists of federal trust funds and special state funds. The federal trust funds support state programs including education, health care, human services, community development, transportation, and energy with federal funds. All other appropriations are lumped into the special funds category which consists of over 300 funds, each tailored to a specific service including, among others, medical assistance, children's services, environmental cleanup, financial regulation, and health insurance.

Table 5: IL Operating Appropriations by Fund Group FY 2010



[30] Illinois's State Budget, Fiscal Year 2012.

There are several programmatic drivers of spending. These include Medicaid and the state's pension system, which will require a doubling of current contributions in order to continue paying retirees. Both of these programmatic areas have long been identified as areas in need of structural reform.

3.1 Spending Drivers: Medicaid

Medicaid currently accounts for over 30 percent of Illinois's General Fund appropriations, making it the largest single expense in Illinois's budget.[31] The program covers 20 percent of Illinois's population.[32] Enrollment growth was especially rapid between 2002 and 2006, growing 26.2 percent. This was due to a combination of factors including increasing enrollment in existing programs, expanding eligibility, and notably increasing the income threshold for the aged, blind and disabled in 2000, from 36 percent of the poverty level to 100 percent of the poverty level.[33]

As with all states, the Medicaid program in Illinois has been an area of rising costs since the 1980s. A growing number of unfunded federal mandates passed in the 1980s and 1990s to broaden eligibility and expand services added to the costs of the program. In addition, Illinois has opted to participate in a growing number of optional coverage areas.[34]

According to Illinois law, the state is allowed to defer Medicaid claims into the next fiscal year to balance the budget.[35] This strategy is known as "the Section 25 loophole" and has been employed several times to balance the state budget.[36] Deferred payments averaged $1.8 billion between FY 2005 and FY 2007.[37] With the passage of the American Recovery and Reinvestment Act of 2009 (ARRA), the federal reimbursement rate increased from 50.32 cents for every Medicaid dollar spent to 60.84 cents on the dollar, temporarily covering part of

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[31] Hitt.
[32] Institute for Illinois' Fiscal Sustainability at the Civic Federation, "The Illinois Medicaid Program" Issue Brief, May 22, 2009, 6, http://civicfed.org/sites/default/files/civicfed_295.pdf.
[33] Ibid., 9.
[34] Finch, Bast, and Foys, 32.
[35] Ibid., 10.
[36] Institute for Illinois' Fiscal Sustainability at the Civic Federation, "House FY2012 Medicaid Budget Cuts Appropriations But May Not Reduce Spending," May 26, 2011, http://www.civicfed.org/iifs/blog/house-fy2012-medicaid-budget-cuts-appropriations-may-not-reduce-spending.
[37] Ibid., 22.

Illinois's Medicaid expenses.[38] The increased federal reimbursement rate was in effect until the end of 2010, leaving Illinois in the position of needing to increase the state's Medicaid contribution to pre-2008 levels. In FY 2011, Illinois was among 24 states that presented balanced budgets on the *expectation* that the federal government would extend the enhanced federal Medicaid match for another year.[39] In FY 2012, Governor Quinn presented a Medicaid reform projected to save $537 million. However, this reduced spending comes in the form of delayed payments to hospitals. This reduction does not lower the cost of the program which can only occur when changes are made to program eligibility, coverage, or reimbursement rates to providers.[40] According to The Civic Federation, Governor Quinn anticipates that reduced appropriations to providers will lead hospitals to accept lower reimbursement rates. However, it is more likely the state will need to once again exercise Section 25 and push the deferred payment into the FY 2013 budget.

According to the 2011 federal Patient Protection and Affordable Care Act (PPACA), states are not permitted to tighten eligibility criteria for the Medicaid program under the Maintenance of Eligibility (MOE) requirements until the health care bill takes effect in 2014. Governor Quinn's proposal to reduce eligibility fraud by requiring Medicaid recipients to present proof of their earnings and residency has been rejected by the Obama Administration.[41]

Reform to Medicaid is essential to the health of state finances. Costs are expected to grow by over $1.2 billion in Illinois with the implementation of the PPACA and the expansion of Medicaid roles.[42] One proposal to contain costs in the program is to grant states more flexibility in the management of their own programs by block-granting the program. The Congressional Budget Office (CBO) estimates that block-granting the long-term care portion of the Medicaid

[38] Ibid.

[39] The Council of State Governments, "Is Medicaid match extension included in States' 2011 Fiscal Year Budgets?," *Capitol Ideas,* July/August 2011, http://www.csg.org/pubs/capitolideas/enews/issue42_2_Chart.aspx.

[40] Institute for Illinois' Fiscal Sustainability at the Civic Federation, "FY2012 State Budget Delays Medicaid Bills, Cuts Union Raises," May 26, 2011, http://www.civicfed.org/iifs/blog/fy2012-state-budget-delays-medicaid-bills-cuts-union-raises.

[41] Benjamin Yount, "Feds halt Illinois Medicaid Reform," *Illinois Statehouse News*, July 18, 2011, http://illinois.statehousenewsonline.com/6610/feds-halt-illinois-medicaid-reform/.

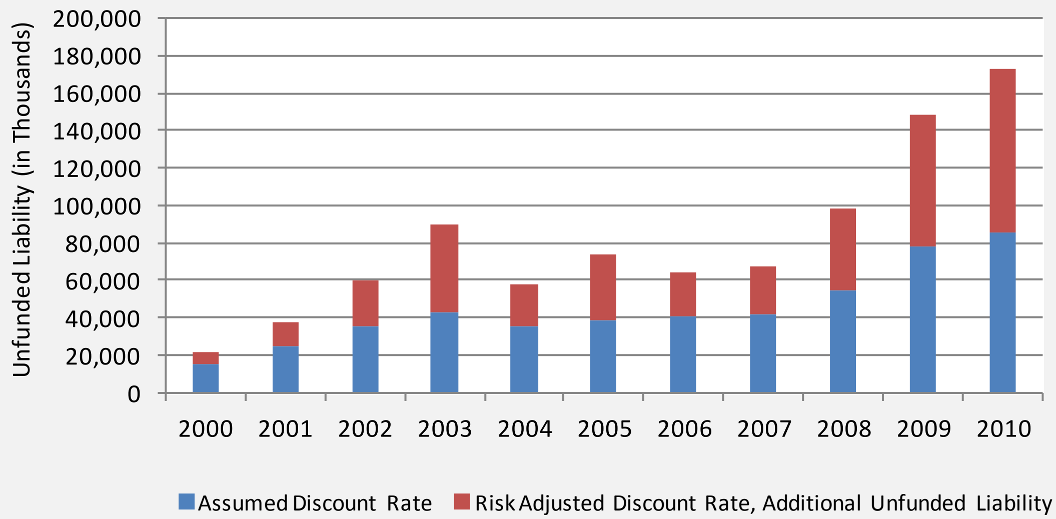
[42] Illinois Policy Institute, "Illinois Legislators Guide to the Issues," 2011, http://illinoispolicy.org/uploads/files/2011-2012ILLegislatorsGuideFINAL.pdf.

program would save the federal government a total of $187 billion.[43] In addition, a block grant would allow states to find cost savings by giving them more flexibility in how dollars are spent. For example, according to the CBO, states could drop optional Medicaid services and ending the federal match for these services would remove the incentive for states to spend more on long-term care in order to maximize the matching payment from the federal government.[44]

3.2 Spending Drivers: Pensions

Another area of fiscal pressure in Illinois is the state's underfunded pension system for public employees. According to the Commission on Government Forecasting and Accountability, between 2000 and 2010 the size of the state's unfunded pension liabilities increased by just over $70 billion, from $15.5 billion to $85.6 billion. As Figure 6 shows, these reported figures understate the true size of the liability due to current accounting standards.

Figure 6: IL Unfunded Pension Liabilities



Source: The Commission of Government Forecasting and Accountability, Financial Conditions of the State of Illinois Retirement Systems As of 2010; U.S. Department of the Treasury, Treasure Yield Rates; Author's Calculations.

The Government Accounting Standards Board (GASB) states that a pension liability may be valued by selecting a discount rate based on what pension assets are expected to return when

[43] Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," (Washington, DC: CBO, 2011): 55.
[44] Ibid., 56.

invested. Illinois has assumed an expected rate of return of between 8 percent and 8.5 percent. However, choosing a discount rate on this basis is flawed. According to financial theory, a liability should be valued using a discount rate that matches the risk (or safety) of the liability and the timing of its payment. Since public pensions are considered as binding as GO debt, and are guaranteed to the recipient, these liabilities should be valued with reference to a low-risk discount rate. Thus, the appropriate rate to use would be the 15-year yield on Treasury Bonds.[45] When applying this lower discount rate, Illinois's pension liabilities increase from $80 billion to $173 billion in FY 2010, resulting in a pension system that is slated to run out of assets in 2018. In addition to the pension liability, Illinois carries $49.9 billion in OPEB liabilities. These benefits are only 0.1 percent funded. OPEB are not considered as legally binding as pension obligations. Nevertheless, this represents a growing fiscal burden to the state and a valuable promise to public workers to fund their health care benefits in retirement, putting more pressure on the state's budget in the near-term.

To date, Illinois has avoided making any meaningful changes to its pension system that would reduce the growing size of this obligation in the near term. Since the 1980s, the state has used its pension fund as a tool to balance its budget. Namely, Illinois has been routinely reducing the minimum payment necessary to fund the pension system since 1987, contributing to the fast-growing unfunded liability.

Between FY 2003 and FY 2008 the state has either relied on bond proceeds or passed a statute to lower its annual contribution.[46] In FY 2004—a year the state made its full contribution—it did so through the issuance of $10 billion in POBs. Illinois's long-term plan to fund its pension system, instituted in 1995 as Public Act 88-0593, is to gradually increase contributions until reaching the full amount necessary to fund the system at 90 percent by FY 2045. As the Civic Foundation notes, "The fact that the…contribution is so large that the state determined it would take decades before it could make that level of contribution is an indication

[45] M. Barton Waring, "Liability-Relative Investing," *Journal of Portfolio Management* 30, no. 4. See also Robert Novy-Marx and Joshua D. Rauh, "The Intergenerational Transfer of Public Pension Promises, *Chicago GSB Research Paper* no. 08-13, September 2008, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1156477.
[46] Beverly Bunch, "Budget Deficits in the States: Illinois," *Public Budgeting & Finance* (Spring 2010): 117.

of how unaffordable the state's pension promises have become."[47] By its own estimate, under the state's funding plan, state pension contributions are projected to increase by an annual average of 12.2 percent from FY 2010 to FY 2045, and the system's accrued liabilities are projected to increase to $536.8 billion by the end of FY 2045.

Without any policy changes, Illinois will have to increase its annual pension contribution from $6 billion to $17.5 billion, representing 21 percent of total tax revenues.[48]

In 2010, Governor Quinn signed Senate Bill 1946 which changed pension benefits by raising the retirement age to 67, limiting the maximum pensionable salary to $106,800, increasing the number of years used to calculate final average salary, and calculating the Cost of Living Adjustment based on simple rather than compounded interest.[49] These reforms will reduce the state's pension liability by $220 billion in the next 35 years. In other words, the reforms do not affect the current liability nor the size of benefits that are yet to be earned by current employees. These provisions only apply to employees hired as of January 1, 2011.

The key obstacles to pension reform in Illinois stem from the interaction of flawed accounting rules, incentives arising from union political influence and the state's constitution, which provides the strongest protection of pension benefits in the nation. Legislators cite the 1970 Illinois state constitution as the reason they cannot reduce or alter the current pension formulas for current employees, including reducing accrual rates going forward. The constitution states, "Membership in any pension or retirement system of the state, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[50] This has been interpreted to mean that pension benefits and formulas may not be changed for current employees, including the benefits that have not yet been earned. Only the pension benefits of future employees may be altered.

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[47] Institute for Illinois' Fiscal Sustainability at the Civic Federation, "The State of Illinois Retirement Systems: Funding History and Reform Proposals," Issue Brief, September 30, 2008, 8, http://civicfed.org/sites/default/files/civicfed_279.pdf.
[48] Robert Novy-Marx and Joshua Rauh, "The Revenue Demands of Public Employee Pension Promises," *Zell Center for Risk Research at the Kellogg School of Management, Northwestern University* (June 2011): 52.
[49] Public Act 096-0889, http://www.ilga.gov/legislation/publicacts/96/096-0889.htm
[50] Illinois Constitution 1970, Article XIII, Section 5.

If this interpretation of the constitution's pension protection clause is correct, the state should consider modifying the constitution by removing this protection of unearned benefits for current employees. Furthermore, the state should also move to cap the massive liability posed by Illinois's pension plan by closing the defined benefit plan and transferring new workers to a defined contribution plan. This option should also be offered to current workers.

Unfortunately, instead of pursuing state constitutional reform to make important and necessary structural changes to the state's pension system, Governor Quinn notes in the FY 2012 budget that additional pension reforms may include, "refinancing the liability and *seeking a federal guarantee of the debt*, or increasing the annual required state contributions."[51]

The constitutional protections afforded to Illinois's pension beneficiaries are among the state's "fiscal rules of the game" and are instrumental to understanding why spending reform has proven difficult over a sustained period in Illinois.

4. Illinois's Budget Rules

Illinois's budget, like all state budgets, is guided by a combination of constitutional and statutory rules which operate in a political realm. The current rules under which Illinois's budget operates provide a key to the state's recurring inability to constrain spending. These rules include the state's balanced budget requirements, the Budget Stabilization Fund (BSF), and a recently adopted spending limit.

4.1 Balanced Budget Requirement

The Illinois Constitution requires the governor to prepare and submit a balanced state budget to the General Assembly for the upcoming fiscal year, so that proposed expenditures do not exceed the funds estimated to be available during that fiscal year.[52, 53] The legislature then votes to pass the bill, requiring a simple majority before May 31, and a two-thirds majority after May 31—leading to a "major effort to pass appropriations before May 31."[54] The appropriations bill is also

[51] Executive Budget for FY 2012, Chapter 2-7.
[52] Illinois Constitution 1970, Article VIII, Section 2a.
[53] Beverly Bunch, "Budget Deficits in the States: Illinois," *Public Budgeting & Finance* (Spring 2010): 108.
[54] Ibid.

subject to a balanced budget rule with appropriations not exceeding estimated funds for that fiscal year.

After the bill is passed, the governor may reduce or veto line items. With a two-thirds majority, vetoed items may be restored by the legislature and reductions may be restored to their original amount with a majority in each house.[55]

The balanced budget rule contains a loophole. Section 25 of the State Finance Act requires that, "expenditures for liabilities incurred within a given fiscal year be paid from that year's appropriations, with certain exceptions."[56] The exceptions include liabilities for Medicaid, state employee and retiree health insurance, and certain spending by the Department of Public Health. These funds, which generally consume a large portion of the budget, are unaffected by legal requirements for proposing a balanced budget. The budget may appear balanced but it is because, by law, the budget need not include a growing portion of state expenditures. This loophole represents a total of $20 billion in deferred payments between 2000 and 2010 (Table 6).

Table 6: IL Section 25 Deferred Liabilities by Category ($ in thousands)

Fiscal Year	Healthcare and Family Services	Human Services	Health Insurance Fund	Total
2000	977,324	3,337	93,872	1,074,533
2001	972,056	12,820	133,497	1,118,373
2002	1,227,913	16,530	191,980	1,436,423
2003	1,722,995	14,250	111,631	1,848,876
2004	1,137,127	52,579	105,031	1,294,737
2005	2,612,910	106,666	164,463	2,884,039
2006	2,166,413	107,367	73,566	2,347,346
2007	3,184,784	89,634	93,203	3,367,621
2008	2,148,749	105,383	113,363	2,367,495
2009	1,045,951	123,943	321,078	1,490,972
2010	929,475	67,756	523,535	1,520,766
Grand Total	**18,125,697**	**700,265**	**1,925,219**	**20,751,181**

Source: Illinois' Office of the Comptroller Section 25 Deferred Liabilities Report

55 Ibid.
56 Illinois State Comptroller, "Section 25 Deferred Liabilities," Illinois State Comptroller website, http://www.ioc.state.il.us/index.cfm/fiscal-condition/section-25.

Additionally, the accounting methods which the state uses in the budget process changed in 1997 via Public Act 90-0479 which requires the state to use revenue and expenditure measurements that are consistent with Generally Accepted Accounting Principles (GAAP). This act applies to six funds: General Revenue Fund, Common School Fund, Educational Assistance Fund, Road Fund, Motor Fuel Fund, and the Agricultural Premium Fund. Of these six funds, the General Revenue Fund is the only one that has expenditures compliant with Section 25 of the State Finance Act.

Although the governor must submit a balanced budget, this is not the equivalent of spending restraint. A balanced budget implies revenues have been found to support a desired level of spending. Illinois has achieved a technically balanced budget by using a series of tactics including Medicaid payment delays, bonding, stimulus dollars, and pension payment deferrals. The state has also shown a willingness to rely on non-recurring revenues such as Tobacco Settlement Fund monies and trust fund sweeps.

4.2 Budget Stabilization Fund

In 2000, Illinois created a BSF. The fund was established to reduce the need for tax increases, maintain a high bond rating, and reduce the need for short-term borrowing in periods where revenues are insufficient to cover current spending. [57]

BSFs are a relatively recent budgetary institution.[58] Depending on their design, they have been shown to decrease borrowing costs for state governments, and to lessen expenditure volatility during cyclical downturns.[59] Design matters in terms of the effectiveness of the BSF, "the more policy maker discretion over the use of BSF monies, the more likely such monies will replace monies that were previously maintained as a General Fund surplus…while policy makers have a strong incentive to save during periods of robust growth, the realization of a budget surplus also carries with it pressures from constituents and interest groups to increase spending

[57] Budget Stabilization Act, 30 ILCS, 122, http://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=2543&ChapterID=7&Print=True.
[58] Gary A. Wagner, "The Bond Market and Fiscal Institutions: Have Budget Stabilization Funds Reduced State Borrowing Costs?" *National Tax Journal* LVII, no. 4 (December 2004): 788.
[59] Ibid.

or reduce taxes. In the short term, policy makers may find it in their best interest to act on these pressures, thereby making previous plans to save time inconsistent."[60]

If Illinois runs a budget surplus, excess from the General Fund is deposited into the BSF by the State Comptroller. Funds may be withdrawn by legislative appropriation. There is no limit on fund size. This makes Illinois's fund "weak" by design since withdrawals are determined by legislative discretion rather than a rule that compels legislators to ensure a predetermined level of funding.[61] States with "strict" BSF rules that force deposits and limit withdrawals tend to realize fiscal benefits.[62] Namely, they experience less expenditure volatility, and are able to improve their creditworthiness. Since 2001, Illinois has replenished the BSF with money transferred from the Tobacco Settlement Fund and has used these funds several times to balance the budget, ultimately zeroing it out in FY 2010. The fund currently has a balance of $276 million. Tightening the depositing and withdrawal requirements around the BSF may have positive benefits for the state's fiscal outlook.

4.3 Spending Limit

In 2011, the Illinois legislature passed a spending limit that caps government spending to 2 percent year-to-year growth in General Expenditures between 2013 and 2017. The Taxpayer Accountability and Budget Stabilization Act of 2011 (P.A. 96-1496) also includes a tax rate increase: the flat-rate income tax is increased from 3 percent to 5 percent and the corporate income tax rate is increased from 7 percent to 9.5 percent. These rates are scheduled to expire, absent legislative action, in 2015 and 2025, respectively. Net Operating Loss (NOL) reductions were also suspended for four years.

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[60] Gary A. Wagner and Erick M. Elder, "The Role of Budget Stabilization Funds in Smoothing Government Expenditures Over the Business Cycle," *Public Finance Review* 33, no. 4 (July 2005): 439-465, http://cba.ualr.edu/emelder/bsf1.pdf.

[61] Wagner, "The Bond Market and Fiscal Institutions: Have Budget Stabilization Funds Reduced State Borrowing Costs?"

[62] Ibid., 803. "If BSF funds are perceived by investors to increase a state's ability to mitigate periods of fiscal stress through increased savings, then the existence of such funds should decrease the probability of default. However, if investors perceive BSFs as having little to no effect on a state's ability to provide future interest payments (perhaps because of substitutability with the General Fund), the likelihood of default may not be affected. In other words, investors do not perceive all budget stabilization funds as equal."

On the surface, capping the annual increase in General Expenditure to 2 percent per year sounds like a strict measure to contain spending. However, the cap only applies to the General Fund which includes pension contributions, debt service, statutory transfers, and the Budget Stabilization Fund.[63]

As Table 7 shows, in the first year of the cap, FY 2012, the legislature has set General Fund spending at $36,818,000,000, an increase of 10 percent from FY 2011. From FY 2013 to FY 2015, spending growth may not exceed 2 percent per year in the General Fund. Special funds are excluded from the cap. Moreover, this spending limit is tied to estimated revenues. If revenues are robust and permit spending beyond the 2 percent cap, a trigger is put into effect and the newly increased flat tax on income drops from 5 percent back to 3 percent and the corporate tax rate drops to 4.8 percent.

It is too early to empirically evaluate the effect of this rule. The biggest weakness is that the rule only constrains one portion of overall spending and therefore there is no guarantee that Illinois's budget will not experience spending growth beyond the 2 percent limit.

Table 7: Illinois's Spending Limit

Fiscal Year	General Fund Expenditures
FY 2011	$33,500,000,000
Two percent annual spending limit enacted	Limit applied to the General Fund
FY 2012	$36,818,000,000
FY 2013	$37,554,000,000
FY 2014	$38,305,000,000
FY 2015	$39,072,000,000

[63] Institute for Illinois' Fiscal Sustainability at the Civic Federation, "State of Illinois Enacted Budget FY2012: A Review of the Operating and Capital Budgets Enacted for the Current Fiscal Year," September 26, 2011, http://www.auditor.illinois.gov/Other-Public-Documents/TaxpayerAcctRpts/Taxpayer-Acct-Rpt-03-31-11.pdf.

What is the likely effect of Illinois's new spending limit? Empiricial investigation of tax and expenditure limits (TEL) in other states suggests that most TELs are associated with lower levels of spending in low-income states and higher levels of spending in high-income states.[64] In low-income states, TELs are associated with a 3 percent decrease in state spending as a share of residents' income.[65] However, in high-income states TELs are actually associated with higher levels of spending. It is common for the TEL formulas to tie budgets to either the level of residents' income or to growth in residents' income. So in high-income states these formulas permit officials to spend more than in low-income states, "It may be that in high-income states, TELs increase spending by acting as an excuse for elected officials to spend up to the limit."[66]

In the case of Illinois, the new TEL formula does not reference state income. Instead, it simply limits spending growth to 2 percent per year. Unfortunately, this variety of TEL does no better, as states with TELs which limit budget growth with reference to particular state income numbers typically spend more than other states.

4.4 Designing an Effective Spending Rule

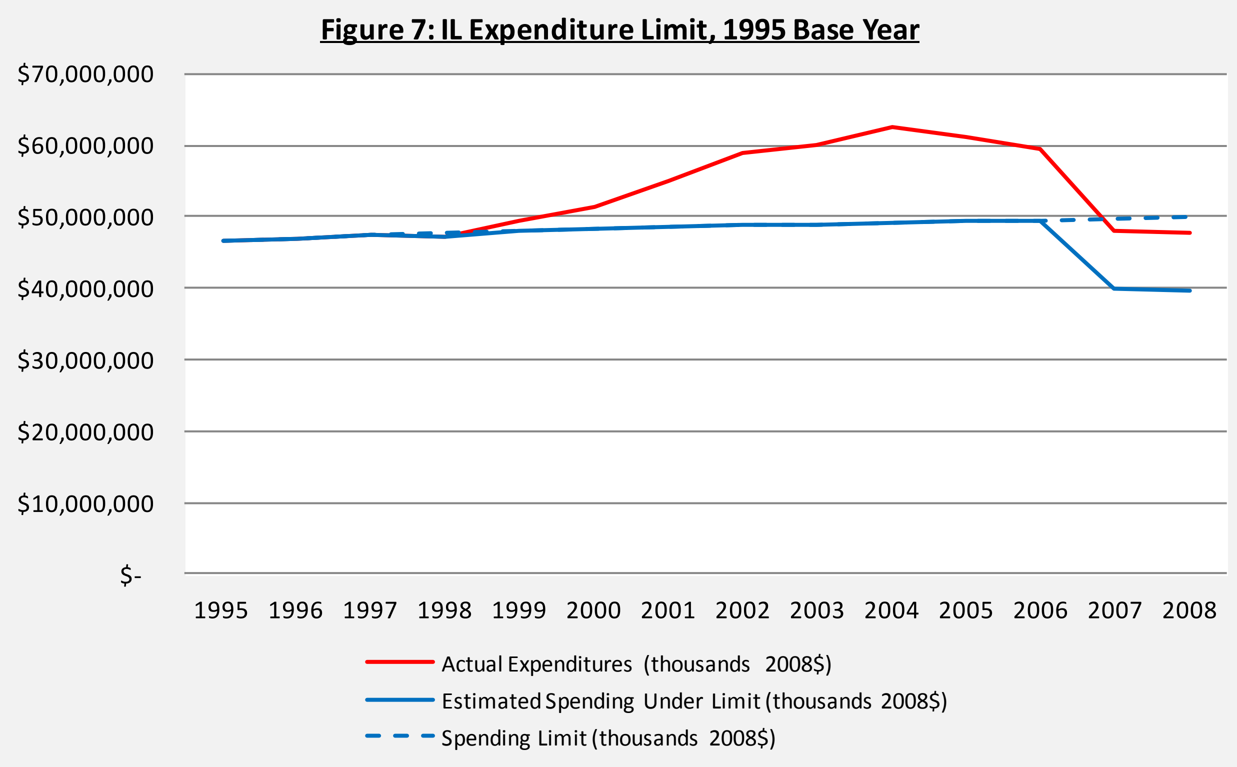
TELs that limit budget growth to the sum of inflation plus population growth do much better at controlling spending than income-based TELs. Moreover, unlike the common income-based TELs, this variety of TEL seems to limit spending in both high and low-income states. This rule is associated with a state spending share that is three percent lower than in states that adopt an income-based TEL.

There are also additional factors that can make TELs more effective. Research suggests that the most effective TELs are codified in a state's constitution, are based on spending not revenues, require a supermajority or public vote for an override, and contain a provision that automatically refunds surpluses in excess of the limit. Overall, this type of rule has a greater

[64] Matthew Mitchell, "TEL It Like It Is: Do State Tax and Expenditure Limits Actually Limit Spending?" (working paper, Mercatus Center at George Mason University, Arlington, VA, 2010), 1, http://mercatus.org/publication/tel-it-it.
[65] Ibid., 11.
[66] Ibid., 3.

effect on spending. The most important characteristic of these design features is the supermajority or public vote requirement to override the rule.[67]

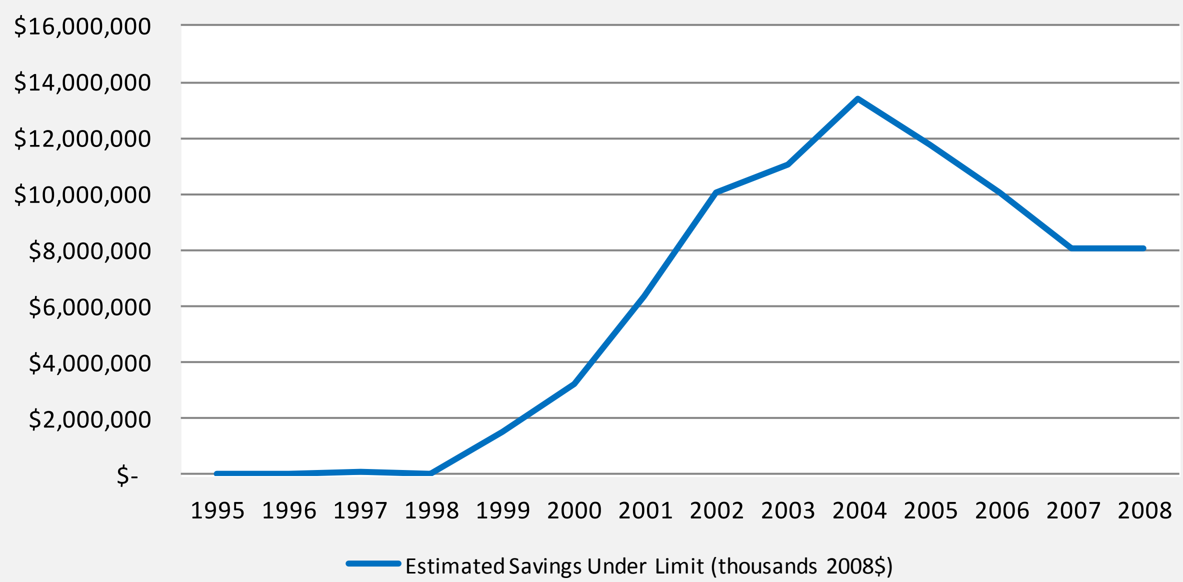
If Illinois had instituted a spending rule that limits annual increases in spending to the sum of inflation plus population growth, starting with a base year of 1995, expenditures in 2009 would have totaled $40 billion. Assuming revenue had followed the course it actually did, this would have enabled the state to avoid a budget gap in FY 2009.[68]



Source: National Association of State Budget Officers, State Expenditure Reports 1987 though 2009; Census Bureau Population Report; Bureau of Labor Statistics Consumer Price Index 2010; Produced by Mercatus Center at George Mason University

[67] Ibid., 22-23.
[68] Matthew Mitchell, "State Spending Restraint: An Analysis of the Path Not Taken," (working paper, Mercatus Center at George Mason University, Arlington, VA, 2010), 21, http://mercatus.org/sites/default/files/publication/State%20Spending%20Restraint%20An%20Analysis%20of%20the%20Path%20Not%20Taken%20corrected.%2010.1.10_0.pdf.

Figure 8: IL Estimated Savings Under Expenditure Limit, 1995 Base



Source: National Assocation of State Budget Officers, State Expenditure Reports 1987 through 2009; Census Bureau Population Report; Bureau of Labor Statistics Consumer Price Index 2010; Produced by Mercatus Center at George Mason University

Spending limits are but one rule to help constrain spending. Other measures include strict balanced budget requirements, item-reduction vetoes,well-designed Budget Stabilization Funds, and a supermajority requirement for tax increases. Several of these rules are present in Illinois but are not designed effectively and indicate an area where Illinois should focus its reform efforts.

In addition to the rules that guide Illinios's budget, the state's revenue structure affects its fiscal and economic performance. The recently passed Taxpayer Accountability and Budget Stability Act makes some changes to the state's tax structure and should be seen not only in the context of the current fiscal crisis but also the decade-long discussion over how to fund spending in Illinois.

5. Illinois's Taxation and Revenue

Table 8 provides a breakdown of Illinois's revenue sources by revenue type and as a percent of total appropriated funds for FY 2002 and FY 2010. There are a few notable changes that have occurred in the general makeup of Illinois's revenue funds since 2002. In 2010, state taxes made up a much smaller component of total revenue compared to 2002, decreasing from 53.8 percent to 40.4 percent. Many of the revenue sources under "other receipts" only experienced minor changes with the exception of the "other taxes, fees, earnings, and net transfers" section which increased from 3.8 percent to 13 percent during the same period. Although this was the largest increase in revenues, Illinois's operating budget does not explicitly state where this money came from or where the increases occurred.

Table 8: All IL Appropriated Fund Revenues by Source (2010 dollars)

Source ($ millions)	FY 2002		FY 2010	
	Total	Percent of Total	Total	Percent of Total
State Taxes				
Income Taxes	9,720	22.8%	9,870	17.7%
Individual	8,777	20.6%	8,510	15.3%
Corporate	943	2.2%	1,360	2.4%
Sales Taxes	7,808	18.3%	7,244	13.0%
Motor Fuel Taxes (Gross)	1,614	3.8%	1,339	2.4%
Public Utility Taxes	1,439	3.4%	1,851	3.3%
Cigarette Taxes and Tobacco Products Taxes	551	1.3%	582	1.0%
Liquor Gallonage Taxes	143	0.3%	230	0.4%
Insurance Tax and Fees	387	0.9%	243	0.4%
Corporate Tax and Fees	369	0.9%	421	0.8%
Corporate Franchise Taxes and Fees	187	0.4%	221	0.4%
Riverboat Gaming Taxes and Fees	681	1.6%	479	0.9%
Total State Taxes	22,899	53.8%	22,480	40.4%
Other Receipts				
Motor Vehicle and Operations License Fees	1,551	3.6%	1,370	2.5%
Interest Income	223	0.5%	144	0.3%
Revolving Fund Receipts	341	0.8%	658	1.2%
Lottery	972	2.3%	1,071	1.9%
Assessment Funds Receipts	74	0.2%	1,575	2.8%
Intergovernmental Receipts	1,095	2.6%	1,484	2.7%
Group Insurance Receipts	1,433	3.4%	1,305	2.3%
Tobacco Settlement Receipts	369	0.9%	284	0.5%
Other Taxes, Fees, Earnings, and Net Transfers	1,614	3.8%	7,213	13.0%
Total Other Receipts	7,671	18.0%	15,104	27.1%
Federal Receipts	12,011	28.2%	18,108	32.5%
Total Receipts All Sources	42,581	100.0%	55,692	100.0%

Illinois's primary sources of revenue come from a combination of the state's income tax, corporate tax, and sales tax. Illinois's tax on income is a flat-rate tax, stipulated in the Illinois state constitution. Until 2011, the income tax rate was 3 percent but was then increased to 5 percent. The flat and relatively low tax rate has been criticized as promoting slow-growing revenues and thus helping to fuel high property taxes, “Illinois has the nation’s eighth-highest property taxes, largely as a result of the high reliance on property taxes for funding schools… Concerns regarding high property taxes and disparities in property wealth and funding levels among local school districts have led to calls for state education funding reforms and property tax relief.” [69]

The call to move Illinois to a progressive income tax in order to provide more funding for schools is a recurring policy recommendation among some interest groups. In 1990, the EdEquity Coalition sued the governor, the state board of education and the state superintendent of schools to increase state education funding and in 1992 proposed an amendment to the constitution to raise the income tax. In 1994, Progress Illinois advanced a proposal to change the state’s constitution to move Illinois’s income tax from a flat rate to a progressive income tax.[70] These measures were rejected.

As a comparision, New Jersey implemented policies similar to the ones promoted by Illinois’s reformers and has experienced negative economic and fiscal effects. In 1976, New Jersey instituted an income tax to comply with a court-ordered remedy to fund low-income school districts in the state. The revenues were constitutionally dedicated to a Property Tax Relief Fund in order to be used as state aid, mainly to supplement school budgets, with smaller amounts dedicated to municipal aid and individual property tax rebates. The initial income tax to fund the aid program was nearly flat: 2 percent on those earning less than $20,000 and 2.5 percent on those earning $20,100 and higher.

New Jersey’s passage of an income tax to assist in funding low-income school districts was meant to enable the repeal of some business taxes while lessening reliance on property taxes. After the first year, the Property Tax Relief Fund failed to meet this objective. In FY 1977, property taxes fell by more than 17 percent, but state spending increased by 26 percent. By FY 1978, property taxes began increasing again by 2.4 percent. In FY 1979, revenues lagged behind appropriations by $100 million. By FY 1981, aid for schools began to outpace income tax

[69] Bunch, 107
[70] Finch, Bast, and Foys, 5-6.

collections. Property taxes began growing at 10 percent annually—equivalent to their average between 1962 and 1977.[71] Today, New Jersey has a highly progressive income tax with six income-tax brackets and one of the highest property tax burdens in the country.

Moving Illinois to a progressive income tax in order to earmark funds for education will not accomplish the aim of lowering property taxes and indeed may stimulate an increase in property taxes. By supplementing locally raised revenues with state aid, the potential for fiscal illusion exists. Since revenues are not raised directly there is greater incentive to grow spending beyond what is sustainable at the local level.

A tax system should be designed with the principle of generality in mind. It should constrain the use of taxing authority to benefit some groups at the expense of others and produce the least amount of distortion to economic activity. High tax rates and narrow bases create distortions as people change their behaviors. When all activities face the same low tax burden, individuals and businesses may pursue a broad range of activities and plan ahead without regard to taxation and without having to dedicate resources toward finding loopholes or undertaking activities that promise tax breaks. Rather, they are able to invest and produce in order to create economic value. The least distortionary and discriminatory tax system is one that is broad-based and low-rate. This type of system raises higher amounts of revenue with a lower cost to economic activity than one with high marginal rates and narrow bases.[72]

Illinois's income tax has the benefit of being a flat-rate tax and thus generally applied to all income groups. However, the sales tax contains several major exemptions for groceries, drugs and medical appliances, as well as many services. The state should remove these exemptions and expand the base of taxation which would also enable it to lower the rate of taxation on goods and services. It is estimated that the removal of these exemptions could add another $3.6 billion annually to Illinois's revenue collection.[73]

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[71] Norcross and Sautet.
[72] Ibid.
[73] Justin Higgenbottom, "Illinois should respond to recession by broadening tax bases and spending frugally, not by raising the person income tax rate," Tax Foundation, Fiscal Fact 216, March 11, 2010, http://www.taxfoundation.org/research/show/25979.html.

Illinois also offers numerous tax breaks and incentives to stimulate business activity. However, these tax programs have not delivered on economic development. Former governor James R. Thompson (1979-1990) created the Department of Commerce and Community Affairs (DCCA) which was given the role of dispensing state funds in order to attract new corporate projects to Illinois.[74] The DCCA attempted to incentivize business activity by creating a series of tax-based subsidies that successfully paid for the largest auto plant deal (Diamond Starr) in U.S. history as of 1985, as well as the retention of the Sears headquarters.[75] Additionally, Build Illinois was a Thompson-era public initiative that was meant to improve the state's image in terms of tourism and business investment.[76] Former governor Jim Edgar (1991-1998) expressed dissatisfaction with the explosive levels of DCCA spending in the Thompson era, during which the General Revenue Funds that went towards DCCA increased from $150 million to $600 million.[77] As a result, one of Edgar's first moves as governor was to cut DCCA's budget by 68 percent and its staff by 37 percent.[78] Edgar's effort to reduce DCCA's overspending was short-lived. At the beginning of George Ryan's governorship (1999-2002) his director announced that "We're going back to a Thompsonesque [style of] economic development."[79] In other words, the state went back to focusing on large, one-time subsidies.

5.1 Effects on the Illinois Economy

Like many state and local governments, Illinois has modified its tax code in order to attract businesses to the state. Various studies and organizations recognize these attempts and produce indices of business climate to show which states are *good* places to do business. There is an empirical debate over how well many of these indices explain a state's business climate. However, it is generally agreed that the indices do include useful economic information.[80] As

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[74] Jeff McCourt, Greg LeRoy and Philip Mattera, "A Better Deal of Illinois: Improving Economic Development Policy," The Heartland Institute, *Good Jobs First* , 2003, 4.
[75] Ibid., 4, 28, and 36. Note that the size of these subsidies were $249.3 million for the Diamond Star deal and $178 million of the retention of the Sears headquarters.
[76] Ibid., 5.
[77] Ibid.
[78] Ibid., 8.
[79] Ibid. See also McCourt, LeRoy, and Mattera for additional rule changing programs enacted during these three gubernatorial administrations such as Tax Increment Financing (TIF), the Economic Development for a Growing Economy (EDGE), and the Single Sales Factor (SSF).
[80] Benjamin VanMetre and Joshua Hall, "How Friendly to Entrepreneurs Are "Business Friendly" Policies? Some Preliminary Results," *Journal of Business and Economics Perspectives*, forthcoming.

Table 9 indicates, Illinois ranks in the middle to low range for state competitiveness. Moving away from the principle of generality and offering tax breaks to large industries has not had the effect intended.

Table 9: Business Climate Indices

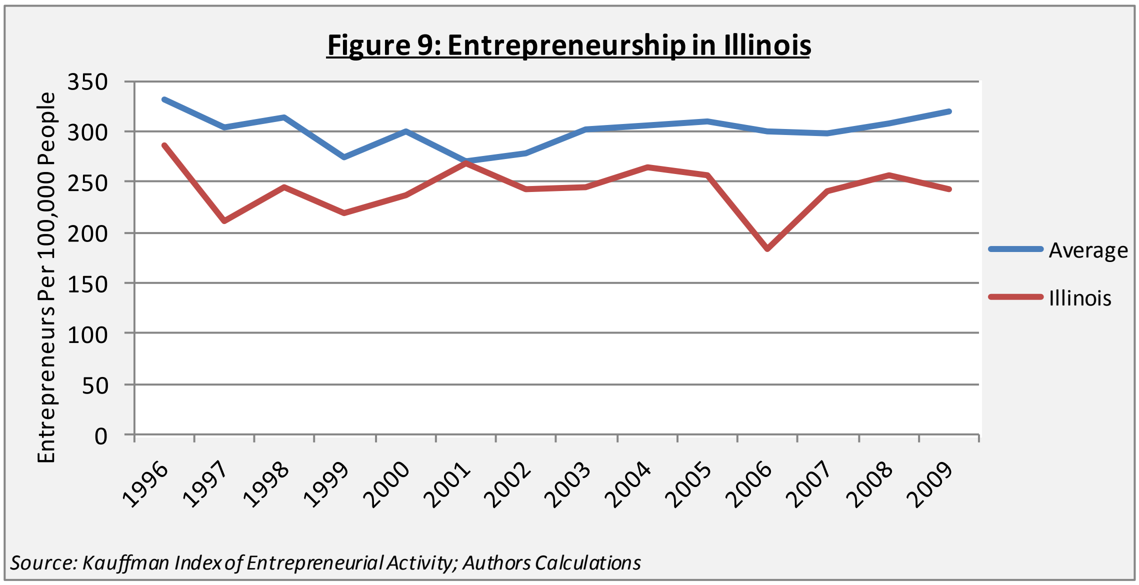
Index Name	Produced By:	Year	IL Rank
State Business Tax Climate Index	The Tax Foundation	2011	23
State Economic Performance	American Legislative Exchange Council	2011	48
State Economic Outlook	American Legislative Exchange Council	2011	44
State Competitiveness Report	Beacon Hill Institute	2010	34
Small Business Survival Index	Small Business and Entrepreneurship Council	2010	28
Best and Worst State Ranks	Chief Executives Magazine	2010	46
Best States for Business and Careers	Forbes	2009	37
Development Report Card for the States	Corporation for Enterprise Development	2007	37

The indices provide a telling story of the quality of the institutional structure for business activity in Illinois relative to the rest of the United States. However, a more robust measure of Illinois's business climate is the number of entrepreneurs that chose to do business in the state. The Kauffman Index of Entrepreneurial Activity (KIEA) provides the raw number of entrepreneurs per 100,000 people per state. More specifically, the KIEA uses the Current Population Survey (CPS) to measure the monthly rate of business creation at the individual owner level and reports the percent of non-business owning adults who start a business with more than 15 hours worked per week.[81]

From 1996 to 2009 Illinois has remained below average in its number of entrepreneurs (Figure 9). The state's worst year was in 2006, with 120 entrepreneurs per 100,000 people less than the national average. It is not clear exactly why 2006 stands out in the data. The low levels

[81] Ewing Marion Kauffman Foundation, "Kauffman Index of Entrepreneurial Activity," 2011, http://www.kauffman.org/research-and-policy/kauffman-index-of-entrepreneurial-activity.aspx. For a discussion on the advantages of using the KIEA over other measures of entrepreneurship, see Joshua C. Hall and Russell S. Sobel, "Institutions, entrepreneurship, and regional differences in economic growth" *Southern Journal of Entrepreneurship*, no. 1 (2008): 69-96.

of entrepreneurial activity could have been a result of the 2005 debate over House Bill 0750.[82] This bill would have made significant increases in the state's corporate and individual tax rates. Although this bill was not signed into law, the possibility of tax hikes, especially during a time of increasing capital and labor mobility, may have been enough to scare off potential entrepreneurial ventures. If this was the case, the future for entrepreneurial activity in Illinois is seemingly grim. As previously mentioned, Public Act 96-1496 recently increased the personal and corporate tax rates which may ultimately hinder Illinois's future rates of entrepreneurial activity.



The state's weak to mediocre business climate is coupled by another alarming trend: the outmigration of residents. In his 1956 paper, Charles M. Tiebout introduced the idea that when the tax-service mix does not reflect individual demands, people vote with their feet.[83] Tiebout's argument is that consumers move to the community that best represents their optimal demand for public goods and services.[84] There are many reasons that people choose to leave a community, city, or state, but when total net migration is examined it is clear that public policy has a

[82] Chris Atkins and Curtis Dubay, "Illinois "Index Analysis": The Potential Impact of HB 750," Tax Foundation, *Fiscal Fact* no. 20, February 7, 2005, http://www.taxfoundation.org/research/show/145.html.
[83] Charles M. Tiebout, "A Pure Theory of Local Expenditures," *The Journal of Political Economy* no. 64: 416-424.
[84] There is robust empirical support in the literature supporting Tiebout's argument. Moreover, the idea that people vote with their feet has been central to the study of various policy issues, including school quality, pollution, housing, and taxation. See H. Spencer Hanzhaf and Randall P Walsh, "Do People Vote with Their Feet? An Empirical Test of Tiebout's Mechanism," *American Economic Review* no. 98 (2008): 843-863.

significant impact on where people choose to live.[85] As a result, the net number of people entering or leaving a city or state can be used as a proxy for how accepting the general population is of the various institutional arrangements in place.

In the case of Illinois, net migration may indicate that people are unsatisfied with the state's institutions relative to their options in other states. According to a recent report by the Illinois Policy Institute, Illinois lost at net of 1,227,347 residents between 1991 and 2009. Moreover, between 1995 and 2007 Illinois lost $163 billion in net income and $16.9 billion in state and local taxes as a result of the out-migration.[86] Perhaps the most telling case of Illinoisans voting with their feet can be seen in Chicago. Figure 10 shows that the city of Chicago had fewer residents in 2010 than it did in 1920, with its peak population of 3.6 million in 1950.[87]

One possible reason for this out-migration is Chicago's high-ranking tax rates. Until recently, Chicago had the highest combined sales tax rate among all major metropolitan areas in the United States.[88] This changed in 2010 when Cook County lowered its rate by 0.5 percent, to 9.75 percent. To put Chicago's rate into perspective, other metropolitan areas that have high-ranking combined sales tax rates include Montgomery Alabama (10 percent), St. Louis Missouri (9.49 percent), and New York City (8.875 percent).

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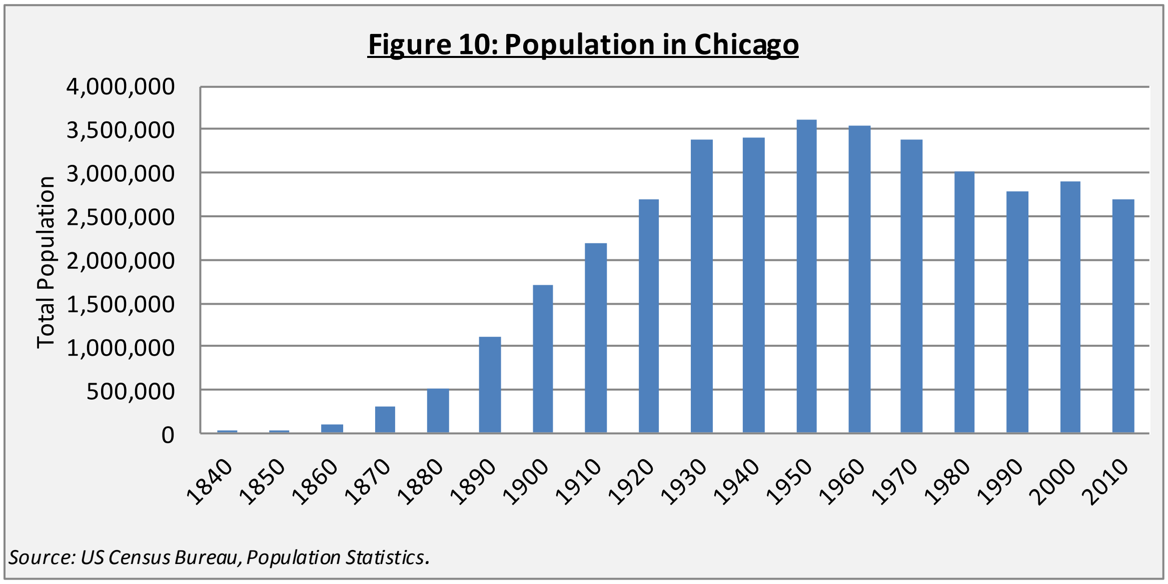
[85] J. Scott Moody, "Leaving Illinois: An Exodus of People and Money," The Illinois Policy Institute, *Tax & Budget Brief*, January 12, 2011, 1-17.
[86] Ibid.
[87] Kevin Helliker, "Chicago Population Sinks to 1920 Level," *The Wall Street Journal*, February 16, 2011, http://online.wsj.com/article/SB10001424052748703312904576146741729857936.html.
[88] Lawrence Summers, "Major Metropolitan Area Sales Tax Rates," *Tax Foundation*, Fiscal Fact no. 239(2010). The combined sales tax rate consists of the state rate plus the county rate plus the city rate.



Given the large and mounting obligation for pensions and benefits for public sector workers, the specter of tax-base erosion is a serious policy concern that must be addressed if Illinois is to get on the path to fiscal stability.

6. Recommendations

Our policy recommendations are in order of what is likely to be most effective for Illinois's fiscal and economic recovery. First, policymakers should consider institutional reforms that tackle ineffective or poorly designed bugetary and fiscal rules. Secondly, programmatic reforms to spending drivers must be undertaken to rein in rapidly expanding costs. Lastly, the state should reform taxation with a view towards ensuring the state's tax structure is based on the principle of generality by minimizing distortion to economic activity, thus encouraging the in-migration of both businesses and residents and ensuring stable revenues.

6.1 Reforming the Institutional Rules

Reccomendation 1: Reform the Balanced Budget Requirement

As it is currently written, Illinois's balanced budget requirement is not a transparent rule. The rule only applies to one portion of spending. Section 25 of the State Finance Act exempts Medicaid spending, thus allowing the state to push Medicaid spending into the next fiscal year. In addition, the rule permits the state to use bonds in order to balance the budget, a technique

Illinois has increasingly relied on to pay for its pension obligations and increase spending. In January 2010, the legislature passed a measure to phase-out Section 25. Until then, the state is likely to continue employing this loophole to present a balanced budget.

Reccomendation 2: Create an Effective Spending Limit

Illinois's recent passage of a spending limit indicates that policymakers understand the importance of rules to constrain spending growth. However, the rule as designed contains some flaws. Capping the annual increase in General Expenditures to 2 percent per year only applies to the General Fund and other funds are exempt from the cap. Research suggests states with TELs that limit budget growth with reference to particular numbers typically spend more than other states. Effective spending rules are dependent on their design. An effective rule should be transparent and easy to evaulate. Analysis indicates that spending rules that constrain annual spending growth to the sum of population plus inflation are effective at constraining spending growth. There are additional factors that can make TELs more effective and these should also be considered. Research suggests that the most effective TELs are codified in a state's constitution, are based on spending not revenues, require a supermajority or public vote for an override, and contain a provision that automatically refunds surpluses in excess of the limit.

Reccomendation 3: Strengthen the BSF

The design of Illinois's BSF has weak requirements for deposit and withdrawal. The Illinois legislature deposits funds when there is a surplus and may withdraw them by legislative appropriation. Illinois should consider tightening these requirements. The strongest deposit or withdrawal rule would require the state to deposit/or pemit the withdrawal of funds according to a mathematical formula based on the growth rate in the state's income. Alternatively, a stronger withdrawal rule would require a supermajority vote of the state legislature to withdraw money and a stronger deposit rule would require a despoit when revenue growth is positive. Such improvements may help to improve the state's credit rating.

Reccomendation 4: Constitutional Reform of the State's Pension System

Another major rule change for the state to consider is modifying the state's 1970 constitution by removing the strict protections that surround pension benefits for current employees. While the governor claims this rule is an insurmountable obstacle to funding the state's pension system, he is also advocating that the federal government guarantee Illinois's pension debt. In fact, it is in the fiscal interest of both the state of Illinois and the United States, that the governor and the legislature instead amend the state constitution to enable legislature to reduce the rate of accrual of benefits for active employees. While a politically difficult approach, this should not be avoided on the expectation of a federal bailout with the intent of shifting the risk of Illinois's pension system onto federal taxpayers.

6.2 Spending Reforms

Reccomendation 5: Structural Pension Reform

Given the size of Illinois's pension obligations, much more serious action needs to be taken by the legislature to ensure the payment of benefits. Reforming pension benefits for new employees does nothing to address the current liability. Instead, the state must move to reduce the rate of accrual for current employees, increase employee contributions, and plan for the increase in revenues that will be required to fund payments to retirees. By 2018, Illinois will require a tripling of the state's annual contributions, from $6 billion to $17.5 billion. Pension reform should also include closing the current defined benefit plans as well as moving employees to a defined contribution system. To date, legislators and the governor have cited the ironclad requirements of Illinois's constitution as an obstacle and instead are turning to the possibility of a federal guarantee of the debt. This indicates that the main obstalce to reforming Illinois's pension is more propertly understood as a political objection rather than a practical impossibility.

Reccomendation 6: Medicaid Spending Reform

Illinois, like all states, is facing a growing burden from the Medicaid program. Reform of this program must take place in conjuction with the federal government. The 2011 health care act, PPACA, prohibits the states from restricting eligibility for the program, and in the case of Illinois, from implementing anti-fraud measures that would require recipients to prove their eligibility. The costs of operating this program are an increasing share of the state's budget. In order to control costs and allow states more flexibility to tailor the program to suit the needs of state residents, the federal government should change the Medicaid program from a matching program to a block-grant program by giving states a set annual amount of funds to spend and eliminating current requirements that restrict states in how they spend those funds. The CBO estimtes that converting the long-term care portion of a block grant would save $187 billion and grant states the flexibility to find cost savings in the program.

6.3 Taxation Reform

Reccomendation 7: The Principle of Generality in Taxation

Illinois's tax system has some well-designed features. Illinois has a flat-rate tax on income instead of a progressive tax. This should be retained. A flat-rate tax is a principle of a broad-based tax system and makes Illinois competitive relative to other states.

The principality of generality in taxation should also be extended to the sales tax and current exemptions to the sales tax should be eliminated. The Tax Foundation estimates that Illinois has forgone $1.4 billion in revenue by exempting groceries, drugs, and medical appliances from the state's sales tax.[89] Eliminating these exemptions would allow the state to potentially lower the rate on its sales tax.

Tax breaks for business activity are shown to have little effect in stimulating economic activity. Illinois should eliminate current programs targeting individual industries or activities. By broadening Illinois's tax base, rates could be lowered on corporate income.

7. Conclusion

Over a period of decades, Illinois officials have made policy choices that have weakened the state's fiscal and economic position. Illinois's structural deficits have increased, its pension system is deeply underfunded and the state has continually relied on bonding to fulfil its spending obligations, and tax incentives to attract economic development. These approaches are fundamentally flawed. We find instead that Illinois can only reverse its current fiscal crisis by reforming the "rules of the game." This includes tightening balanced budget rule requirements, creating an effective spending limit, strengthening the state's Budget Stabilization Fund, and

[89] Justin Higginbottom, "Illinois Should Respond to Recession by Broadening Tax Bases and Spending Frugally, Not by Raising the Personal Income Tax Rate," *Tax Foundation*, Fiscal Facts no. 216, March 11, 2010, http://www.taxfoundation.org/research/show/25979.html.

reforming the state's pension system through modification of the 1970 constitution. In addition, other policy changes are in order, including moving the state to a defined contribution retirement system, joint federal-state Medicaid reform, and applying the principle of generality in taxation by broadening the sales tax base and lowering the rate. These reforms would have the combined effect of addressing the structural drivers of spending in the state while creating a more stable and predictable institutional environment in both the fiscal and the economic realm.