New Illinois Governor Facing Torrent of Red Ink

Previous Illinois administrations and politicians have been kicking the can down the road for decades. Now, the state has run out of road. Bruce Rauner (shown), Illinois' new Republican governor, was inaugurated on Monday and is facing a daunting task: a $4 billion backlog of unpaid bills and a budget showing deficits approaching $21 billion in three years unless something is done.

During his campaign that successfully ousted what *Huffington Post* noted as the "nation's least popular governor," Pat Quinn, Rauner made the usual political promises of streamlining government and improving education and the state's business climate, all without increasing taxes. In fact, he promised not only to freeze property taxes but opposed any attempt to extend the state's "temporary" income tax increase enacted under Quinn in 2011.

Prior to 2011, Illinois' personal income tax rate was a flat three percent, while the corporate income tax rate was 7.3 percent. But the state's history of profligate spending began to show up as large and increasing deficits, and so then-governor Quinn, a Democrat, joined with the Democrat-controlled legislature to raise "temporarily" the personal rate to five percent through 2014 with the promise it would fall back slightly to 3.75 percent on January 1, 2015. Likewise, the corporate rate jumped "temporarily" to 9.5 percent with a similar promise that it would drop at the end of 2014 to 7.75 percent.

The Tax Foundation's recently released study of the business tax climate in every state — its "2015 State Business Tax Climate Index" — revealed Illinois to be near the bottom (meaning least-favorable) in its ranking of corporate taxes, sales taxes, unemployment insurance taxes, and property taxes. Simply put, there is precious little blood remaining to be squeezed out of the Illinois turnip.

A closer look at Quinn's final budget reveals the primary cause of the red ink: pension and healthcare plan promises and obligations. Under current assumptions, the state's education pension plan expenses will grow from $4.8 billion to $5.5 billion in just three years, an increase of 13 percent. The state's employee pension obligations and healthcare expenses, which currently run $7.5 billion, will jump to $9.3 billion by 2018, an increase of 22 percent. Put another way, those pension and healthcare promises currently eat up a third of the state's entire budget, but will increase to a staggering 43 percent of the budget in three years.

Because of this, attempts to borrow to cover the shortfalls are getting increasingly expensive. With its existing bonds already putting Illinois at the lowest rating of any state by the three credit rating services, borrowing his way out of the mess is not an option for the new governor.

It gets worse. Those pension obligations are based on investment assumptions that are far too optimistic, according to economist Eugene Fama, a professor at the University of Chicago and the winner of the Nobel Prize in Economics in 2013. When asked about buying Illinois bonds, Fama responded:

> In the long term, I wouldn't touch them. The [state's] pension liability is much worse that [the reported $100 billion that] people think….
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> I think Illinois uses a discount [rate] of 7.5 percent … arguing that [that's] the expected annual return on their portfolio. But the expected return on a portfolio is totally irrelevant….
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> You've made a promise to your employees that you'll pay them a certain fraction of their income that is usually indexed [for inflation].
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> What's the risk-free real rate? Is it anywhere near 7.5 percent? It isn't. Historically, it's like 2 percent.
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> A 2-percent discount rate would approximately triple Illinois' pension liabilities.

Translation: Those pension and healthcare obligations, growing as fast as they appear in Quinn's outgoing budget, are far less than they need to be to keep those plans solvent and viable. They're already 60-percent underfunded as it is. This puts Quinn's budget into the realm of Peter Pan's Never Never Land, making Rauner's challenges even greater.

At the moment, Rauner is struggling to grasp reality. He has proposed cutting the state's spending by $1 billion — that's less than three percent — while cutting Medicare eligibility requirements a little. He has said he wants to eliminate the use of state shuttles for himself and his lawmakers and sell off the state's fleet of airplanes. And he wants to expand the state sales tax to cover some presently exempted services, estimating this would generate $600 million annually.

This is called nibbling around the edges. The time for that is past. Illinois' new governor needs to get a grip on reality, man up and face the fact that those pension and healthcare benefits will never be paid as promised. He needs to cut the state's corporate income tax rate to zero and bring back the three-percent flat income tax rate. Of course, this will cause massive pain and suffering from those still living in the dreamland of too-optimistic assumptions and promises that will never be kept. But it is the only real way out of the current problem.

Welcome to the end of the road, Governor Rauner.

Photo of Illinios Governor Bruce Rauner: AP Images

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