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Illinois Faces Big Revenue Hit in 2015.

Expiration of Tax Increase Comes as State Grapples With Budget Crunch, Unpaid Bills and Pension Woes

As fiscal prospects rebound for most states, Illinois has continued to struggle—and things are about to get worse.

Thanks to the expiration of a four-year tax increase put in place because of fallout from the 2007-09 recession, the state with the nation's most dire fiscal outlook will see income-tax rates fall by 25% in coming days even as it faces a budget shortfall, a deeply underfunded retirement system and billions of dollars in unpaid bills.

Blurring the picture is how Illinois will respond following November's elections. Before losing his re-election bid, Gov. Pat Quinn failed to get fellow Democrats in the legislature to make the higher taxes permanent, saying the money was needed to address the financial challenges that have left Illinois with the lowest credit rating among U.S. states.

Now, Republican Gov.-elect Bruce Rauner must work with Democrats, who kept control of the state House and Senate, to address the state's fiscal problems. "I'm the dog who caught the car," said Mr. Rauner in a recent speech.

State forecasters have projected that tax revenues will decline because of the falling rates by $2.1 billion in the current fiscal year and an additional $2.7 billion in the new fiscal year starting July 1. The state spends around $36 billion annually on services such as schools and health care, pension costs, and other operating expenses.

Illinois's budget challenges come as other states see their fiscal positions continue to stabilize and reserves build after weathering the deep recession at the end of last decade that fueled sizable drops in tax revenue. Illinois will need a projected $760 million to make through the fiscal year ending June 30 and, along with states like New Jersey and Connecticut, has one of the most deeply underfunded employee pension systems in the nation.

"Illinois is an outlier obviously in many respects," said Nick Samuels, a vice president at Moody's Investors Service, which has a negative outlook assigned to the state. The negative outlook corresponds with the significant fiscal challenge Illinois faces, and Moody's analysts said they will be watching closely to see what steps Mr. Rauner takes in the coming months.

In the bond market, Illinois has been helped by a strong demand for state government debt. Still, Matt Fabian, managing director at Municipal Market Advisors in Concord, Mass., expects investors will watch closely as Illinois's tax rate drops and state officials respond.

"There are a lot of institutional investors who expect Illinois will be downgraded immediately if the tax cuts expire and the budget deficit isn't accounted for," he said.

The governor-elect, who takes office Jan. 12, has talked broadly about stimulating economic growth by holding down taxes and curbing government spending but has provided few details. During his campaign, Mr. Rauner talked about having the income tax at 3% for individuals by the end of his first term, but he hasn't spelled out what rates he favors over the next four years to get there.

The individual income tax rate in Illinois is currently 5% and will fall to 3.75% on Jan. 1. It was at 3% before Mr. Quinn and lawmakers approved the temporary increase. Illinois doesn't have tax brackets; residents pay the same rate on all of their income.

Mr. Rauner also has discussed broadening the state's sales tax. Illinois's sales tax is largely applied to just goods and not services. A spokesman for Mr. Rauner said he will provide more details on his budget plans after being sworn into office.

Illinois Senate President John Cullerton said if Mr. Quinn had been reelected, the state likely would have stuck with the higher rate. At 5%, he sees Illinois as competitive with its Midwest neighbors, noting nearby states such Iowa and Wisconsin have top rates that are higher. But Mr. Cullerton added voters made a choice in November and now it's up to Mr. Rauner to propose a new plan.

"The guy said 'I'm going to lower your taxes and spend more money on education.' So he got elected and gets to tell us his budget," Mr. Cullerton said.

THE WALL STREET JOURNAL

By MARK PETERS

Dec. 30, 2014 2:28 p.m. ET

— Aaron Kuriloff contributed to this article.