



Issue Brief

Budget & Tax Policy Initiative



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Illinois Cannot Grow Its Way Out Of Fiscal Problems

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Revenue growth in Illinois is projected to slow down, making it clear that revenues will not be sufficient to meet state budget challenges. Instead of quick fixes, what's needed is new, reliable, recurring sources of revenue and a modernization of the state tax system to reflect current economic realities.

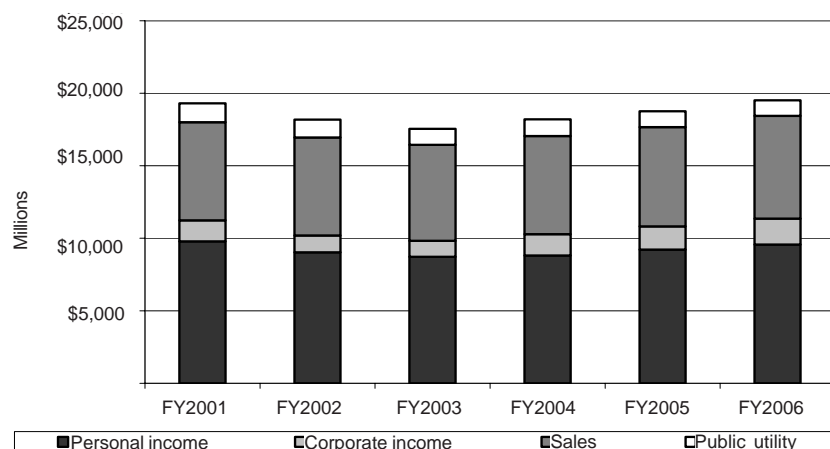
It has been widely reported that state governments around the country have largely recovered from the fiscal crisis of the last few years, even that “revenue is starting to burn holes in states’ pockets.”¹ For states other than Illinois, combined General Fund revenues have grown at a rate much higher than inflation: 7.7 percent for fiscal year 2006.² Illinois is not doing quite as well. For FY2006, General Funds receipts increased by 4.6 percent, showing growth of nearly \$1.2 billion over FY2005, from \$26.2 billion to \$27.4 billion.³ To keep this in perspective, just to keep up with inflation, General Funds revenues needed to grow by 3.8 percent, or \$996 million, making inflation-adjusted growth only \$203 million.⁴

Illinois has a deep budget hole. The state’s General Funds reported a deficit of more than \$3 billion at the end of FY2005.⁵ General Funds receipts actually decreased between FY2001 to FY2002 and again from FY2002 to FY2003. Even though Illinois’ revenues most closely tied to the economy – from income and sales taxes – performed well in FY2006 as compared with recent years, total revenues have merely climbed back to where they were in FY2001, before the last recession.

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General funds account for the largest portion of the state operating budget and

Figure 1. Stagnant General Funds Revenue Growth



Illinois General Funds revenues from the 4 major sources of General Funds revenues - personal and corporate income tax, sales tax and public utility taxes. Source: Illinois Commission on Government Forecasting and Accountability (formerly Illinois Economic and Fiscal Commission) monthly briefings. Inflated to FY2006 dollars using Consumer Price Index averages for July-June for fiscal years 2001-2005 as compared with average July 2005-June 2006 dollars.

encompass most of the funding for education, health care, human services and debt service. After adjusting for inflation, FY2006 General Funds revenues from the personal and corporate income taxes, sales tax and public utility taxes – the four major sources of General Funds revenues – are less than 1.1 percent higher than their FY2001 levels (see Figure 1). Meanwhile, the population has grown by 2.8 percent, increasing the demand for state services.⁶

Revenue growth in Illinois is projected to slow down in FY2007 with a General Funds base revenue increase of \$961 million over FY2006, just 3.5 percent.⁷ With General Funds FY2007 appropriations increases totaling nearly \$1.3 billion, it is clear that revenues will not be sufficient to meet our state budget challenges.⁸

The Size of Spending Pressures

State government provides vital services, including education, health care, human services, law enforcement and prisons, and roads and transportation infrastructure. Illinois is facing enormous spending pressures in many of these priorities simultaneously.

Education

Illinois ranks near the bottom in state share of education funding,

Table 1. General State Aid Foundation Level compared with EFAB Recommended Level

School Year	Foundation Level	Change from Previous Year	EFAB Level
2000-2001	\$4,425	\$100	N/A
2001-2002	\$4,560	\$135	\$4,560
2002-2003	\$4,560	\$0	\$4,680
2003-2004	\$4,810	\$250	\$5,665
2004-2005	\$4,964	\$154	\$5,665
2005-2006	\$5,164	\$200	\$5,665
2006-2007	\$5,334	\$170	\$6,405

Source: Illinois State Board of Education; Education Funding Advisory Board (EFAB)

Reaching the EFAB-recommended foundation level of \$6,405 per student would require the state to spend another \$1.7 billion this year.

making local property taxes the major funding source for schools. As a result, high-poverty districts spend 31 percent less per pupil than low-poverty districts, the highest such gap in the nation.⁹

The state's Education Funding Advisory Board (EFAB) was reconvened in 2005 to make a recommendation to the General Assembly regarding the K-12 foundation level – the minimum per-pupil basic education expenditure (including local funding). EFAB relied on research which looked at how much high-performing low-spending Illinois school districts spend for basic education expenses, and adjusted this figure for inflation. The board determined that the foundation level should be set at \$6,405 for FY2006 (see Table 1).

In the current year's budget, the state provides only enough funding for

a foundation level of \$5,334, still more than \$1,000 per pupil short of the goal.¹⁰ To reach this goal would require the state to spend an additional \$1.7 billion this year.¹¹ Hundreds of millions more would also be necessary to fully fund widely supported programs such as special education and "Pre-school for All."¹²

State Pensions

The current unfunded pension liability is more than \$38 billion,¹³ the highest unfunded amount in the nation, a result of decades of underfunding and investment losses.

This situation was exacerbated when, facing a FY2006 budget deficit, the Governor and the General Assembly chose to reduce the level of the state's contributions to the five state employee pension systems. Payments were decreased by a total of \$2.3 billion (\$1.2 billion for FY2006 and \$1.1 billion for FY2007), paying only about half of the scheduled amount due.

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Table 2. Estimated State Pension Payments FY2006-FY2010 after spring 2005 changes^a
(in millions, not inflation-adjusted)

Fiscal Year	Pre- P.A. 94-004	Post- P.A. 94-004 ^b	Increase/(Decrease) Over Previous Year
2006	\$2,142	\$936	\$(847)
2007	\$2,473	\$1,373	\$437
2008	\$2,767	\$2,221	\$848
2009	\$3,127	\$2,735	\$514
2010	\$3,524	\$3,300	\$565

a. The projections for each of the 5 retirement systems, presented at the August 23, 2005 meeting of the Commission on Government Forecasting and Accountability have been combined.

Even with decreased payments and savings from concurrent pension reforms, the FY2007 estimated payment still will be \$437 million more than the FY2006 payment, putting pressure on this year's budget. And the FY2008 estimated payment will be another \$848 million on top of that.¹⁴

To bring the state's pension fund assets up to the recommended level (90 percent of future obligations), the state's pension funds will continue to require more and more General Funds revenues in upcoming years (see Table 2).¹⁵

This pension debt poses a real threat to the state's fiscal health.

Future pension debt obligations will continue to consume a larger share of the budget, potentially crowding out other state priorities.

negative rating outlook, primarily a result of the state's large unfunded pension liability.¹⁷

Without accelerating growth in revenues, the state will be unable to keep up with current pension contributions and also make up for past skipped

payments. Future pension debt obligations will continue to consume a larger share of the budget, potentially crowding out other state priorities.

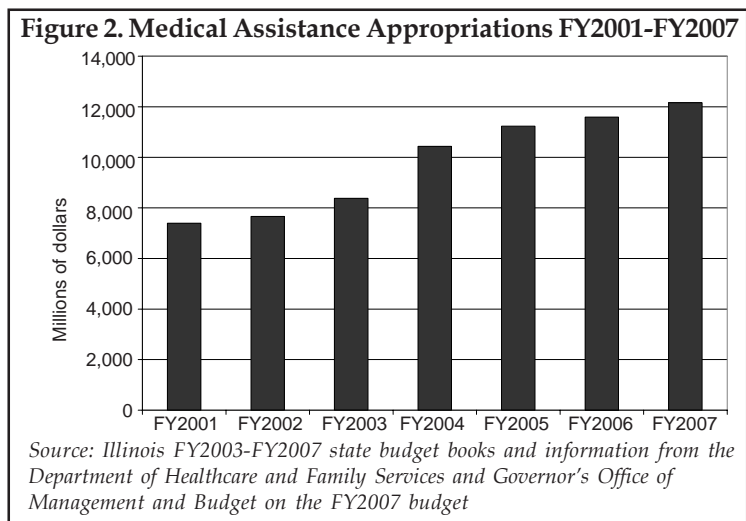
Health Care

In Illinois, policymakers expanded access to health care for low-income children and families through FamilyCare and All Kids (previously

Moody's Investors Service and Fitch Ratings both downgraded Illinois' bond ratings in 2003, after Illinois issued \$10 billion in pension obligation bonds to increase the pension fund balances and meet part of the payment schedule.¹⁶ Recently, Fitch Ratings named Illinois as one of only three states to receive a

KidCare). With FY2007 estimated enrollments of 176,000 and 135,000 for All Kids and FamilyCare, respectively, these programs will have provided access to health insurance for nearly 205,000 more Illinoisans since FY2003.¹⁸ Access to preventive health care can help to decrease the need for more intensive and costly services in the future.

The new All Kids initiative, which is designed to provide access to affordable health insurance for all uninsured Illinois children, is estimated to cost approximately \$45 million for FY2007. The program is



expected to generate savings through use of a primary care case management model, and pull in approximately \$37 million in federal Medicaid and State Children's Health Insurance Program matching funds.

With rapidly increasing costs for health care and expanded eligibility, state appropriations for medical assistance have grown by more than

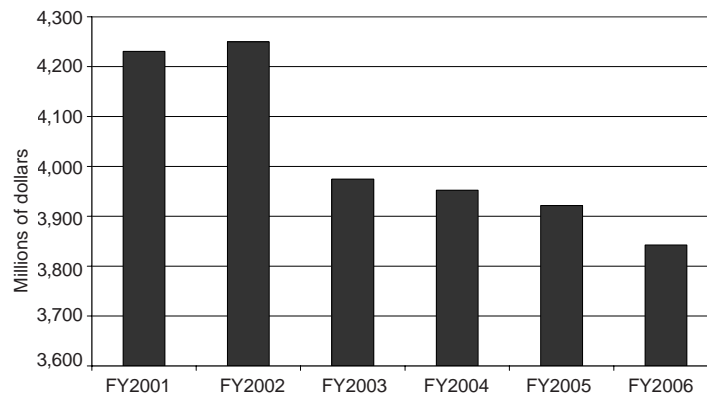
64 percent from FY2001-FY2007 in Illinois (see Figure 2).¹⁹ Still, as a share of Gross State Product, total state health care expenditures in Illinois ranked 44th in the nation at 2.6 percent for FY2003.²⁰ The state is struggling to keep up with Medicaid payments as evidenced by a payment backlog estimated to be \$1.3 billion and a payment cycle averaging 59 days.²¹

Human Services

Human services have been disproportionately affected by Illinois' funding crisis. Years of flat funding despite rising costs and program cuts have resulted in a loss of services for vulnerable populations - the developmentally disabled, mentally ill, substance dependent, and families struggling to make ends meet while working low-wage jobs.

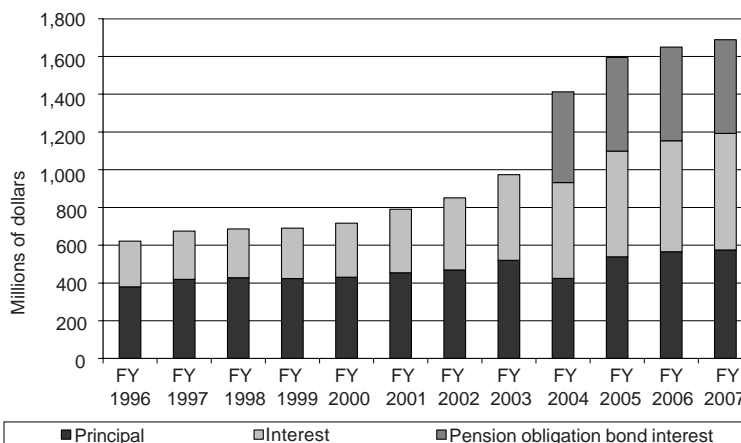
Between FY2001 and FY2006, human services General Funds appropriations have decreased by more than \$388 million, or 9.2 percent, after adjusting for inflation (see Figure 3).²² Demand for these services, however, has been growing with increased population.²³ An increased poverty rate from 2000 to 2005 shows that there is still work to

Figure 3. Human Services General Funds Appropriations FY2001-FY2006, in FY2006 dollars



Source: Illinois FY2003-FY2007 state budget books and information from the Department of Healthcare and Family Services and Governor's Office of Management and Budget on the FY2007 budget

Figure 4. General Obligation Debt Service Principal and Interest



Source: Illinois Commission on Government Forecasting and Accountability, "FY 2007 Legislative Capital Plan Analysis," April 2006. The FY2006 and FY2007 GO debt service amounts are estimated.

be done.²⁴

Debt Service

The amount of the state budget going to pay off debt is at an all-time high. Illinois ranks fifth among the states in debt burden per citizen at \$1,835.²⁵

The majority of Illinois' outstanding debt consists of General Obligation (GO) bonds which are backed by the state's "full faith and credit", ensuring that the bonds will be paid before other state commitments. The principal and interest payments on these GO bonds - debt service - are paid primarily from the General Revenue Fund, the Road Fund and the School Infrastructure Fund. In FY2007, the General Revenue Fund will be the source of nearly 59 percent of debt service payments for capital projects and more than 86 percent of debt service payments on the Pension Obligation bonds.²⁶

Because the General Funds account for most of the funding for education, human services, health care and public safety programs, higher debt service

payments can mean less money for other important programs. General Obligation bond debt service will total nearly \$1.7 billion for FY2007 (see Figure 4).

Capital Needs

Between FY1997 and FY2004, about \$3.1 billion in state-funded

grants helped build new schools and renovate buildings throughout the state. But the state has not appropriated funds for new capital projects since 2003.

According to the 2004 Capital Needs Assessment Survey conducted by the Illinois State Board of Education and the Capital Development Board, the cost of needed repairs and new construction for schools totaled \$6.7 billion. Other capital needs not addressed in the FY2007 budget include improving mass transit and building roads. Federal transportation funds may be at risk if matching funds are not appropriated for FY2008.

Short-Term Revenues

In the past three years, several strategies have been used in an

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attempt to fill the gap between revenues and expenditures. The legislature enacted some recurring additions to base revenues and

reduced spending by more than \$1 billion through program cuts that disproportionately affected human services for the most vulnerable populations. Increasingly, however, the state budget has largely been balanced with one-time measures that do not add to base revenues and threaten future stability.

The problem with these one-time revenues is that as the state's expenses grow with inflation and population growth, these funding sources do not grow, but instead disappear and must be made up from other sources.

These non-recurring, one-time cash infusions have included more than \$2 billion of the proceeds from the 2003 sale of \$10 billion in pension obligation bonds and more than \$1 billion from sweeping surpluses from state special purpose funds into the state's General Funds over the past three years. Over \$2.3 billion in state contributions due to employee pension funds have been skipped, shifting payments for today's costs to future taxpayers.

The use of short-term revenue sources for continuing programs such as education, health care and human services can weaken program stability and effectiveness.

Federal Funding

Help for the state's budget distress is unlikely to come from Washington. Instead, the strain on the state's future budgets will be exacerbated as grants from the federal government to the states decline. Excluding Medicaid, the President's 2007 budget proposal

includes cuts in funding to state and local governments totaling \$6.7 billion as compared with 2006 and nearly \$14 billion as compared with 2005, after adjusting for inflation.²⁷ In Illinois, if

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the President's budget is adopted, 2007 inflation-adjusted cuts would total more than \$286 million.²⁸

Cuts are proposed in programs that support services the state provides, including education, child care, environmental protection, housing, medical research and other programs to assist low-income children, families, and elderly and disabled people. The federal budget proposal includes accelerating cuts into the future which would result in large state revenue losses – more than \$2 billion for Illinois from FY2007-FY2016.²⁹ Federal funds make up nearly 13 percent of the state's FY2007 operating budget.

Tax Reform

Instead of quick fixes, Illinois should focus on creating new, reliable, recurring sources of revenue to address funding inadequacies. The design of

the Illinois state tax system itself is an obstacle to revenue growth.

Illinois state taxes are out of line with those of other states. Illinois ranks near the bottom at 41st nationally in state tax revenue as a percentage of personal income.³⁰

At a flat rate of 3 percent, the Illinois personal income tax is the lowest in the nation on the state's highest income earners, among the 41

states with an income tax.

Furthermore, the state sales tax incorporates fewer services – the largest growing sector of the economy – than all but 5 other states.³¹

Illinois needs to modernize the state tax system to reflect current economic realities. For example, an increase in the state income tax and expansion of the state sales tax to include personal services would help

to support state priorities in an ongoing reliable way and would align Illinois with other states' tax systems.

Policymakers must take a long-term, comprehensive approach to solving the state's revenue problems. However politically difficult it may be, reform of the tax system is necessary for the continued development of healthy, safe and well-educated children and families and strong communities throughout Illinois.

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Endnotes

¹ Jenny, Nicholas W. "State Tax Revenue Off to a Flying Start for Fiscal Year 2006," Nelson A. Rockefeller Institute of Government, State Revenue Report No. 62, December 2005. http://rfs.rockinst.org/exhibit/9032/Full%20Text/RR_62.pdf

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² "State Budget and Tax Actions 2006: Preliminary Report," National Conference of State Legislatures, August 2006. Illinois data were not included in the preliminary report.

³ Illinois Commission on Government Forecasting and Accountability, Monthly Revenue Briefing, June 2006. Base revenue numbers exclude revenues from short-term borrowing, and hospital provider fund and budget stabilization fund transfers.

⁴ Author's calculations based on Bureau of Labor Statistics Consumer Price Index figures for July 2005-June 2006 as compared with July 2004-June 2005.

⁵ General Funds balance, as measured in accordance with Generally Accepted Accounting Principles (GAAP). Illinois Comptroller, Comprehensive Annual Financial Report FY2005, June 2006.

⁶ U.S. Census Bureau. Illinois population, percent change, April 1, 2000 to July 1, 2005.

⁷ Illinois Commission on Government Forecasting and Accountability, Monthly Revenue Briefing, July 2006.

⁸ Governor's Office of Management and Budget.

⁹ Author's calculations based on data from "The Funding Gap 2005: Low-Income and Minority Students Shortchanged in Most States," The Education Trust. <http://www2.edtrust.org/NR/rdonlyres/31D276EF-72E1-458A-8C71-E3D262A4C91E/0/FundingGap2005.pdf>.

¹⁰ Senate Bill 1520, House Amendment 1. <http://www.ilga.gov/legislation/94/SB/PDF/09400SB1520ham001.pdf>.

¹¹ Author's calculations based on data provided by the Illinois State Board of Education.

Endnotes (cont.)

¹² The Preschool for All initiative is estimated to cost an additional \$180 million for FY2008-FY2011 – Governor’s Office of Management and Budget. Funding mandated categoricals at their current level (such as special education) would cost another \$104.1 million – Illinois State Board of Education. Doubling the amount of reimbursement for special education teachers and aides (to more closely reflect true costs) would have required an additional \$317.6 million in FY2006.

¹³ Illinois Commission on Government Forecasting and Accountability, “Report of the 90% Funding Target of Public Act 88-0593,” January 2006. http://www.ilga.gov/commission/cgfa/Funding_PA_88-0593.pdf.

¹⁴ Hankiewicz, Dan. “Projected Contributions for the State-Funded Retirement Systems,” Illinois Commission on Government Forecasting and Accountability, December 2005 Monthly Revenue Briefing, <http://www.ilga.gov/commission/cgfa/1205revenue.pdf>.

¹⁵ Voices for Illinois Children Budget & Tax Policy Initiative, “Illinois’ Pension Funding Crisis,” October 2005. <http://www.voices4kids.org/pensions.pdf>.

¹⁶ Moody’s Investors Service and Fitch Ratings both downgraded Illinois’ GO bond ratings in May 2003, from Aa2 to Aa3 (Moody’s) and from AA+ to AA (Fitch). The payment schedule adopted by the Illinois legislature in the spring of 1995 called for gradually increasing payments into the system for the first 15 years (through FY2010) and then having payments remain a level percentage of payroll for the remaining 35 years. This payment schedule revised for FY2006 created a steeper ramp for FY2006-FY2010.

¹⁷ Fitch Ratings, “State General Obligation Rating Outlooks,” April 13, 2006.

¹⁸ Illinois FY2007 state budget book.

¹⁹ Author’s calculations based on figures from Illinois FY2003-FY2007 state budget books and information from the Department of Healthcare and Family Services and Governor’s Office of Management and Budget on the FY2007 budget. Medical assistance does not include state appropriations for employee health care.

²⁰ “Total State Health Care Expenditures as a Percent of Gross State Product, FY2003,” Kaiser Family Foundation. <http://www.statehealthfacts.kff.org/>.

²¹ Illinois Department of Healthcare and Family Services.

²² Department of Human Services General Funds appropriations from Illinois FY2003-FY2007 state budget books. Inflated using Consumer Price Index averages for July-June for fiscal years 2001-2005 as compared with average July 2005-June 2006 dollars.

²³ U.S. Census Bureau. Illinois population, percent change, April 1, 2000 to July 1, 2005.

²⁴ Illinois 2000-2001 poverty rate – 10.4 percent; Illinois 2004-2005 poverty rate – 11.9 percent.

²⁵ Illinois FY2007 state budget book. Per capita debt is reduced to \$1,047 if you exclude the pension obligation bond debt.

²⁶ Illinois Commission on Government Forecasting and Accountability, “FY 2007 Legislative Capital Plan Analysis,” April 2006.

²⁷ Lav, Iris J., “Federal Grants to States and Localities Cut Deeply in Fiscal Year 2007 Federal Budget,” Center on Budget and Policy Priorities, February 2006.

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About Voices for Illinois Children

Voices for Illinois Children is a statewide, non-profit, non-partisan public awareness and advocacy organization that works with families, communities and lawmakers to build support for practical public policies that improve the lives of children. A recognized leader in child advocacy, Voices informs and inspires thousands of people to speak up and take action in order to ensure that children's basic needs - family, education, economic security, health, safety and the arts, recreation and culture - are public and private priorities. James J. Mitchell, III, is the chairman of the Voices for Illinois Children Board of Directors. Jerome Stermer is president. Contact Voices for Illinois Children at:

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About the Budget & Tax Policy Initiative

Investing in our children's health, education, safety and welfare is the long-term, common-sense approach to preserving and enhancing the well-being of children, their families and all citizens. Smart investment decisions require good information, sound analysis and timely action. Voices for Illinois Children's Budget & Tax Policy Initiative analyzes the state's revenue and spending policies to help policymakers and advocates set priorities and make wise fiscal decisions for the short- and long-term. Ann Courter is the Initiative's director. The Initiative is supported by grants from the Ford Foundation, Annie E. Casey Foundation and Chicago Community Trust. The findings and conclusions presented are those of Voices for Illinois Children and do not necessarily reflect the opinions of these foundations.